Lucas Papademos: The outlook for the European economy

Speech by Mr Lucas Papademos, Vice-President of the European Central Bank, at the Spring Membership Meeting of the Institute of International Finance, Athens, 1 June 2007.

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I. Introduction

Being in Athens, it seems appropriate to start with a reference to a great thinker who had established his Lyceum not far from this auditorium: Aristotle once said “We are what we repeatedly do. Excellence, then, is not an act, but a habit.” To me, the connection to the regular membership meetings of the Institute of International Finance is obvious: the regular semi-annual gatherings of this broad and distinguished group have established a forum that is well-known for its excellence of debate and high quality analysis. It is indeed a great pleasure and privilege to have been invited by the Institute to be part of this session on key issues facing the global economy, and specifically to share some thoughts with you on the outlook for the European economy and its financial system. I will first discuss the prospects for growth and price stability in the euro area and provide an assessment of the ongoing structural changes in its economy which may be establishing a new basis for higher sustainable growth. Then, I will briefly address some issues pertaining to the stability of the European financial system, focusing in particular on one of its features, the abundant liquidity which characterises both the European and global financial markets.

II. The outlook for the euro area economy

The world economy has been experiencing a fairly long period of economic good times and the medium-term outlook for the global economy remains positive. Annual world real GDP growth averaged 5% over the past three years (2004-2006), and it is expected to remain robust, moderating only slightly to just below 5% in both 2007 and 2008.[1]

Global financial market conditions have remained, for the most part, very favourable. Except for a few episodes of market turbulence, notably in May and June 2006 and in late February and early March this year, financial markets have been characterised by unusually low (implied) volatility, very low risk premia and credit spreads, and rising equity prices. Indeed, for much of the time over the past three years, financial market volatility and risk premia have been falling, reaching historically low levels, while asset prices have been following a rising trend. Robust economic growth, macroeconomic stability and favourable financial market conditions have been mutually reinforcing. In particular, the low levels of short and long-term interest rates and the cost of capital have supported economic activity, while expectations of strong economic growth and price stability have contributed to the decline in financial market volatility and risk premia.

The pace of global economic activity is becoming more balanced across the main economic regions. Despite a slowdown in the US economy this year, economic growth in Europe, Japan and, especially, in emerging market economies is forecast to remain robust.

In the euro area, economic growth has progressively strengthened significantly. In 2006, real GDP expanded by 2.7% in the euro area, almost twice the growth rate of 1.4% recorded in the previous year, reflecting a strong increase in investment (by 4.7%) but also a pick-up in private consumption growth. Gross exports of goods and services rose by an impressive 8.3% and stimulated aggregate demand and domestic investment. The contribution of net exports to GDP growth in 2006 was relatively moderate (0.3 percentage point) because imports also rose significantly, but it was nevertheless greater than in the previous year (by 0.5 percentage point). Thus, overall for the euro area as a whole, GDP growth last year was mainly driven by the faster increase in domestic demand.

Looking forward, incoming data as well as survey indicators confirm the view that the outlook for euro area growth remains positive. Eurostat’s recent flash estimate of real GDP growth of 0.6% in the first quarter was slightly higher than expected, underlining the continuing strength of the euro area economy.

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1 According to the Spring 2007 forecast of the European Commission, world real GDP growth is expected to be 4.8% in both 2007 and 2008; in the latest IMF World Economic Outlook, annual global growth is forecast at 4.9% in both 2007 and 2008.

Increases in industrial production and retail sales as well as a further upsurge in various business confidence indicators point to an expansion of euro area economic activity at solid rates in the coming quarters. Although indicators of private consumption have recently provided mixed signals, consumer confidence has remained unchanged but at the highest level since 2001. At the same time, the sustained strength of the global economy will continue to support euro area exports. All in all, however, the positive growth prospects for the euro area will continue to be primarily driven by the strength of domestic demand, and notably investment which has risen significantly in recent quarters, benefiting from still very favourable financing conditions, strong corporate earnings and gains in business efficiency. According to the Spring forecast of the European Commission (released on 7 May 2007), euro area real GDP growth is forecast at 2.6% in 2007 and 2.5% in 2008. The ECB survey of professional forecasters, recently published (in the May edition of the ECB Monthly Bulletin), points to similar, though slightly lower growth rates in 2007 and 2008.[2] These growth forecasts and expectations are within the ranges of the ECB staff macroeconomic projections released in March 2007.

The current upswing in economic activity has been accompanied by a steady improvement in the euro area labour markets. This has been a job-creating economic recovery. In 2006, employment rose by 1.4%, almost double the rate recorded in the previous year, and the number of employed persons increased by around 2 million in the euro area. The unemployment rate has steadily declined in recent quarters and dropped to 7.2% in March 2007, the lowest level observed since the introduction of the euro – and, indeed, since the official series began in 1993 – and it is expected to further decline in the coming quarters. Such positive labour market dynamics provide the basis for solid growth in personal disposable income and help improve consumer confidence; they thus underpin the outlook for private consumption and sustained economic growth in the euro area.

While recent conjunctural developments have been very encouraging and the medium-term growth prospects remain favourable, ultimately the prosperity of the euro area economy will depend on its capacity to sustain a higher long-term rate of economic growth. The forecast growth rates for 2007 and 2008 (by the European Commission, the International Monetary Fund and private sector institutions) are above the range of available estimates of the euro area's potential growth. Therefore, a key issue is whether structural changes underlying the ongoing expansion of the euro area economy imply a gradual improvement in its potential growth rate. Two fundamental determinants of potential growth, the rates of change in productivity and labour utilisation, have risen significantly over the past two years. Are these increases mainly cyclical, reflecting the upswing in activity, or partly a consequence of structural factors with a permanent positive impact?

Starting with labour utilisation, we have seen a significant improvement in the year 2006. This was not only the result of the decline in the unemployment rate that I mentioned earlier, but was also due to the continued increase in the labour force participation rate. In addition, though to a lesser extent, this improvement stems from a relatively stable number of hours worked per employed person, in contrast with the decline in hours worked observed in the past. What are the factors or forces that account for the recent increase in labour utilisation? It is partly related to the important labour market reforms implemented in many euro area countries, which, among other things, have increased the incentives to work. In addition, moderate wage developments have also contributed to stronger employment growth. In this context, I would like to recall that since the launch of the euro, employment in the euro area has risen by more than 12 million people. Looking ahead, we expect the labour market to continue to benefit from past reforms and others being implemented. That said, we cannot rest on laurels: certain inefficiencies and rigidities in labour markets remain and should be tackled through further structural reforms, not least in view of the still unacceptably high level of unemployment – especially among the young – in comparison with other advanced economies.

With regard to productivity, the second fundamental determinant of potential growth, developments in the euro area since the mid-1990s have been, on the whole, unsatisfactory, both compared to previous decades and relative to the productivity gains achieved in other major economies, notably the United States. More recently, however, the productivity performance of the euro area has improved. Annual labour productivity growth (output per person employed) increased from a 0.2% per annum in the first quarter of 2005 to 1.8% in the fourth quarter of 2006. The crucial question is again whether this recent improvement is of a temporary or permanent nature. In real time, it is very difficult to distinguish a potential change of the longer-term trend from cyclical and temporary fluctuations in the productivity

[2] The participants in the ECB survey expect real GDP growth of 2.5% in 2007 and 2.3% in 2008. The longer-tem growth expectations (i.e. for the year 2011) of the survey participants remained unchanged at 2.1%.

data. There is some evidence that, in certain sectors, and in a number of euro area countries, structural reforms and corporate restructuring have been raising productivity and are contributing to higher potential output growth. However, sectoral analysis – notably the fact that the recorded productivity gains were concentrated in the industrial sector and that there were limited improvements in the services sector – and survey evidence suggest caution and support the view that recent improvements in labour productivity have been mainly cyclical.

It is, thus, too early to reach a verdict on the extent to which the observed acceleration in productivity growth since early 2005 represents a structural improvement beyond that resulting from cyclical dynamics. More information and analysis are certainly needed to reach any definite conclusions. Two pertinent conclusions emerge from this assessment: First, further reforms are undoubtedly necessary in order to foster permanently higher productivity growth; second, there is an encouraging message for all to see: reforms do pay off.

Improvements in productivity and labour utilisation growth which help increase the euro area's potential growth have also implications for the conduct of monetary policy: for they can help raise the "speed limit" of the euro area economy, meaning that the economy can attain a faster rate of sustainable growth that is compatible with price stability. This leads me to a discussion of price developments.

In recent months, annual HICP inflation in the euro area has fluctuated at levels slightly below 2%, mainly reflecting developments in energy prices. In the short term, as a result of significant base effects deriving from last year's energy price volatility, and barring further increases in oil prices, annual inflation rates are likely to remain below 2% and may fall somewhat in the coming months, before rising again towards the end of the year to levels around 2%. What is relevant, however, for monetary policy is the outlook for price stability over the medium term. Over this policy-relevant horizon, the outlook for price developments remains subject to a number of upside risks. These relate notably to the increasing capacity utilisation in the euro area economy, the possibility of further oil price rises and additional increases in administered prices and indirect taxes beyond those announced and decided thus far. More fundamentally, stronger than currently expected wage developments could pose significant upward risks to price stability, not least in view of the favourable momentum in labour markets.

Moreover, monetary and credit developments and liquidity conditions also point to upside risks to price stability over the medium to longer-term. Recent monetary data confirm that the underlying rate of monetary expansion remains robust, in an environment of already ample monetary liquidity. The strength of monetary expansion is reflected in the continued rapid growth of M3, which reached an annual rate of 10.4% in April 2007. What is behind these developments? The ongoing strength of monetary and credit expansion is due partly to the moderate level of interest rates and solid economic growth. However, the evolution of monetary aggregates can be volatile in the short run, and it has been affected by a number of factors. First, the flattening of the euro area yield curve in recent months has encouraged substitution into shorter-term monetary assets from longer-term instruments outside M3. Second, the growth of the "other financial intermediaries" (OFI) sector may accentuate this development, since institutional investors such as OFIs, which have become increasingly important over recent years, may be more sensitive to such yield differentials than households. Third, the shift in international investor sentiment in favour of the euro area economy has led to capital inflows, which – as foreigners purchase euro-denominated securities from domestic residents – have also contributed to the acceleration of M3 growth. Such phenomena suggest some caution in interpreting the latest annual growth rates. Nevertheless, they should not lead to the conclusion that the strong recent dynamism of M3 can be discounted. The fact remains that the underlying rate of monetary expansion continues to be strong.

Higher policy rates and short-term interest rates are starting to influence monetary and credit dynamics, although, as yet, they have not significantly dampened their overall strength. The growth of credit to the private sector has moderated somewhat, though it seems to have stabilised at double-digit rates. Borrowing for financial transactions – notably in the context of securitisation activities, private equity transactions and leveraged buyouts (LBOs) – has supported strong rates of credit expansion. Credit extended for such purposes may not have the same immediate implications for aggregate demand as lending to finance investment or consumption spending. Nonetheless, such borrowing contributes to the accumulation of monetary liquidity in the euro area, as bank balance sheets expand.

Given the vigorous monetary and credit growth in an environment of already ample liquidity, a cross-check of the outcome of the economic analysis with that of the monetary analysis supports the assessment that upside risks to price stability prevail over the medium to longer term. Accordingly, as stressed by the Governing Council already last month, strong vigilance is of the essence in order to ensure that risks to price stability over the medium term do not materialise. This will support the solid anchoring of medium to longer-term inflation expectations in the euro area at levels consistent with price stability.

III. The euro area financial system

Let me now conclude with a brief assessment of the prospects for financial stability in the euro area. As I mentioned at the beginning of my presentation, the external macro-financial environment of the euro area financial system has been favourable. Credit quality in the euro area remains high, and it should be further underpinned by the positive economic outlook. Although there are some pockets of vulnerability in the euro area household and corporate sectors that have most likely increased, on average financial positions continue to be sound. Moreover, financial institutions, including banks and insurance companies, have shown improving financial results and market participants expect profitability to remain strong in the foreseeable future.

In late February and early March this year, the shock-absorbing capacity of the global and euro area financial system was tested by the third significant burst of market volatility in the past two years. This had been weathered comfortably. Improvements in the risk management practices of financial firms have contributed to ensuring that higher financial market volatility did not prevent the capital markets from facilitating the intermediation of capital.

Nevertheless, the fact that the global and euro area financial systems have so far proven resilient to a series of adverse disturbances, while comforting, does not provide any ground for complacency. The few episodes of sharply rising market volatility endured in the past two years were triggered by relatively small and transitory disturbances in an environment of strong macroeconomic fundamentals and abundant financial market liquidity. Therefore, it is unlikely that these episodes can provide sufficient guidance on how the financial system would perform in the event of larger shocks that could trigger a more material reappraisal of risks, or a change in risk appetite, at a less favourable stage of the credit cycle. Moreover, previously identified sources of risk and vulnerability to financial system stability remain. And some of these vulnerabilities could be quickly exposed if financial market liquidity were to abruptly and sharply decline, for example as a result of a sudden decrease in investors' risk appetite.

There are several interesting and policy-relevant issues pertaining to the existing abundance of financial market liquidity. They relate to its nature, causes, symptoms and consequences. It is essential to emphasise that financial market liquidity is a concept distinct from monetary liquidity, although there can be links between the two.

Financial market liquidity can be defined as the ability of market participants to undertake securities transactions without triggering large changes in asset prices. The measurement of financial market liquidity is not straightforward, but the symptoms of abundant market liquidity are visible and include high leverage, low bond yields, low volatility, narrow credit spreads, and high market turnover.

We have constructed a composite indicator of financial market liquidity for the euro area which is based on a methodology developed by the Bank of England. The indicator relates to equity, bond and foreign exchange markets and aims to gauge three different dimensions of market liquidity: tightness, depth, and resiliency. This particular indicator confirms that financial market liquidity in the euro area increased gradually since the late 1990s, rose significantly during 2003, and since then markets have remained very liquid. This indicator will be presented in the forthcoming edition of the ECB's Financial Stability review, which will be published by mid-June.

This increase in market liquidity in recent years seems to reflect partly, if not mostly, structural changes, for example, the liberalisation of international flows of funds, the securitisation of loans, the development of new financial instruments, and the rapidly growing presence of highly active financial market participants in markets, such as hedge funds. However, ample market liquidity could also reflect the "search for yield" and excessive risk appetite, indicating that liquidity risk could be underpriced. If this is soothe case, the current favourable market liquidity conditions could suddenly fade away if there were an abrupt and lasting increase in risk aversion. This could expose several underlying vulnerabilities and result in funding liquidity challenges for highly leveraged institutions, unwinding of carry trades and increasing credit spreads across the credit quality spectrum.

The triggers that could expose vulnerabilities in the financial system cannot be predicted with any degree of certainty. However, financial institutions can prepare to mitigate potential disturbances before they occur through appropriate risk management arrangements and by stress-testing. This is especially relevant today because the modern – developed and efficient – financial markets are – if I may employ a fitting image used before – like a highway; they get you where you want to go faster and more efficiently. But accidents, if they occur, may be worse than before. For this reason, there is no room for complacency and we must be alert so as to look forward to a safe journey for the global financial markets and, more generally, the world economy.

Thank you very much for your attention.