Jean Claude Trichet: Hearing before the Economic and Monetary Affairs Committee of the European Parliament

Speech by Mr Jean Claude Trichet, President of the European Central Bank, at a hearing before the Economic and Monetary Affairs Committee of the European Parliament, Brussels, 9 October 2007.

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Madame la Présidente, Mesdames et Messieurs les membres de la Commission Economique et Monétaire, je me réjouis d'apparaître devant votre commission aujourd'hui et de poursuivre notre dialogue fructueux. La situation sur les marchés financiers suscite toujours beaucoup d'intérêt. Aujourd'hui, je reviendrai d'abord brièvement sur la situation économique et monétaire, en expliquant les raisons sous-jacentes à nos récentes décisions de taux. Ensuite, je vous fournirai de plus amples informations sur les opérations de politique monétaire de la BCE en réaction aux tensions enregistrées sur le marché monétaire ainsi que sur les initiatives en cours visant à améliorer le cadre relatif à la réglementation, à la surveillance et à la stabilité financières. Schließlich möchte ich ein paar Anmerkungen machen zu den Produktivitätsentwicklungen in Europa, die wir in letzter Zeit beobachtet haben, sowie zu den Kriterien, die erfüllt sein müssen, um dem Euro-Währungsgebiet beizutreten.

Economic and monetary developments

Since my previous appearance before the European Parliament a month ago, the new economic data which have become available have confirmed our view that risks to price stability remain on the upside over the medium term, as identified by both our economic and monetary analyses. As already indicated on several occasions, unfavourable effects from energy prices will have an important impact on headline inflation over the coming quarters. Owing mainly to such effects, deriving from the marked decline in energy prices a year ago and the recent substantial increase in oil prices, the inflation rate is expected to remain significantly above 2% in the near future, including the first months of 2008, before moderating again. In 2008, largely as a consequence of capacity constraints and relatively tight labour markets, inflation is expected to remain around 2% on average.

As regards economic activity, it appears that the sustained real economic growth experienced in the euro area in the first half of 2007 has continued over the summer. The economic fundamentals support a favourable medium-term outlook for economic activity. While euro area consumer and business confidence indicators declined in September, mainly reflecting the financial market correction, they remain above their historical averages and continue to point to ongoing sustained growth during the second half of the year. Available forecasts for 2008 confirm the Governing Council's main scenario of real GDP growing at around trend potential. This scenario is based on the expectation that global economic activity will remain robust, with the moderation of economic growth in the United States largely offset by the continued strength of emerging market economies. Given the financial market volatility and the reappraisal of risks in recent weeks, this assessment remains surrounded by heightened uncertainty. On balance, risks to this outlook for growth are judged to lie on the downside.

The monetary analysis confirms the prevailing upside risks to price stability at medium to longer-term horizons. On the basis of latest available data, covering the period to the end of August, the underlying money and credit expansion remains strong. However, strong money and credit growth may have been influenced by temporary factors, such as the flattening of the yield curve and recent financial market volatility. The headline figures may therefore overstate the underlying money and credit growth.

In August, the flow of loans to households and non-financial corporations remained strong. However, financing conditions have tightened somewhat in the context of financial turbulence, although financing costs are not exceptionally high by historical standards. As regards developments in the bank lending behaviour, there are some signs showing an impact of recent financial market volatility. The results reported in our October 2007 bank lending survey point to some net tightening of the credit standards in the third quarter of 2007 both on loans to large enterprises and loans to households for house purchases, following a prolonged period where credit standards were eased or remained unchanged. Looking ahead, banks expect to further tighten credit standards in the fourth quarter of 2007.

The ECB's monetary policy stands ready to counter upside risks to price stability, in line with its Treaty mandate to maintain price stability as the primary objective of monetary policy. Under current circumstances, particular caution is required in assessing any potential impact of recent financial market developments on the real economy. Before drawing further monetary policy conclusions, the Governing Council deems it necessary to gather additional information and carefully examine all new data.

Against this background, on 4 October 2007 the Governing Council of the ECB decided to leave the key ECB interest rates unchanged. The Governing Council will monitor very closely all developments. By acting in a firm and timely manner, and based on its assessment, the Governing Council will ensure that risks to price stability over the medium term do not materialise and that inflation expectations are firmly anchored in line with price stability, thereby favouring an environment conducive to sustained economic growth, well-functioning markets and job creation. This is even more important at times of financial market volatility and increased uncertainty. In this respect, the Governing Council will continue to pay great attention to future financial market developments.

Monetary policy operations

Ladies and gentlemen, once the Governing Council has defined the monetary policy stance necessary for maintaining price stability in the medium term, the ECB has the responsibility to ensure the smooth functioning of the segment of the money market that we influence. As I explained last month, these two responsibilities are clearly distinct and should not be mixed.

The ECB continued to intervene in the money market in order to ensure its smooth functioning. Some tensions indeed remained in the money markets, in particular for maturities beyond one week. These tensions were fostered by the increase in liquidity needs related to banks' usual behaviour at the end of the quarter, when they need to adjust their balance sheets. Money market interest rates have remained more volatile than usual and our recent operations have attracted strong demand. On 11 September, we conducted a second supplementary long-term refinancing operation with the usual maturity of three months at a variable rate with no pre-announced allotment amount, while the regular long-term refinancing operation was conducted on 26 September as scheduled. In addition, we continued to allot in the regular main refinancing operations significantly larger amounts of liquidity than we would have done under normal circumstances, while aiming at balanced liquidity conditions at the end of the maintenance period.

Some tentative signs of improvement can now be seen in the money markets, in particular in the commercial paper market. Tensions still remain, in particular in the so-called Asset Backed Commercial Paper market segment, which has been at the root of the tensions. However, unlike during the peak of the difficulties in August, there is now some differentiation between commercial papers with different underlying assets or different credit of sponsoring banks. Lately, paper of higher quality could be placed more easily, and at better prices, than some weeks ago. Thus, a more discriminating market would seem to be emerging in the ABCP market.

Financial stability

Let me now provide you with an update of the recent developments regarding euro area financial stability. Last month, I drew some very tentative lessons from the events as we saw them evolving at the time. By now we have learned more, but the lessons to be drawn still remain tentative and provisional.

As I told you last month, the re-assessment of risk – which is still ongoing – reflects the materialisation of some of the vulnerabilities that had previously been identified by the ECB as well as by the global central banking community.

Since our last meeting, we have witnessed tentative signs of normalisation in some parts of the credit and financial markets. Nonetheless, as regards the prospects going forward I would certainly tend to agree with those who caution against complacency. The situation in certain parts of the euro area money markets remains complex, and banks are still reluctant to lend to each other in the unsecured interbank term money markets. In a number of cases the present episode of market correction will impact banks' profits. Fortunately, several years of rather favourable economic and financial developments, as well as better risk management, have significantly improved the resilience of the euro area banking system, placing the core financial institutions in a rather comfortable position to absorb the recent disturbances.

Our baseline scenario is that the process of adjustment in the money and credit markets will take place in an orderly manner. Nevertheless, it cannot be excluded that this positive baseline scenario could yet be challenged by some low-probability but potentially high impact negative events. Therefore, there is no room for complacency at the present juncture.

The first priority remains the need to restore confidence among the various participants of the global credit market. Today, we still have the paradox that there are large amounts of high quality assets which investors are currently treating as if they have poor credit quality. Last month, I tentatively identified three potential and non-exclusive remedies to this situation ; I will again stress them today and I will even add a fourth one. First, there is a need to increase transparency and further improve risk management – including liquidity risk management – relating to complex structured products. Second, an assessment of the role played by rating agencies needs to be undertaken. Third, a review of certain areas of the regulatory framework, such as the treatment of liquidity risk should be carried out. Fourth, the case of non regulated entities should continue to be examined very carefully, not only the "highly leveraged" non regulated institutions but also the other entities like "conduits" and "special vehicles": the case of the "highly leveraged" has already been examined by the Financial Stability Forum and orientations have been suggested.

I am pleased to see that international and EU level initiatives are already underway to address these issues. Whilst it is still too early to draw definitive conclusions, there is a common understanding on the need for finding solutions that can be applied consistently at the global level.

Concerning the international level, I welcome the initiative of the Financial Stability Forum, following a proposal by the G-7, to set up a high-level working group to analyse the causes of the current turmoil and to propose appropriate recommendations.

Concerning the European level, initiatives are under way involving the European Commission and the Member States, with the close association of central banks. A roadmap identifying both the key issues to be analysed as well as the bodies in charge will be submitted today to the ECOFIN for approval. The ECB is strongly supportive of these initiatives taken at both levels and will actively contribute to the work.

Productivity trends in Europe

Ladies and gentlemen, let me now share with you some thoughts on recent productivity trends in Europe. Notwithstanding robust employment growth in the euro area over the recent economic upswing, labour productivity data for the euro area remained very positive overall in 2006. Notably, data confirmed a clear acceleration in labour productivity growth (per person) in 2006 to 1.4%, up from 0.7% in 2005. Against this background, some observers had made an upbeat assessment of recent labour productivity developments, arguing that the euro area was ready to embark on a period of prosperous economic growth founded on the successful implementation of structural reforms. These improvements, however, were mainly due to cyclical rather than structural improvements. On a year-on-year basis, labour productivity growth reached 1.7% in the fourth quarter of 2006 but declined to 1.4% in the first quarter of 2007 and fell further to 0.8% in the second quarter of 2007. Overall, its current level is in line with its average rate of 0.9% over the past ten years.

From a longer-term perspective, labour productivity developments in the euro area are characterised by a sustained slowdown since the early 1960s, which mainly reflects both lower growth in innovation and other efficiency gains and lower growth in capital used per unit of labour. These disappointing developments in the euro area are in sharp contrast with the positive developments in the United States. The strong productivity performance of the US economy has been ultimately attributed to the development of new information and communication technologies (ICT) in combination with the overall flexibility of the US economy.

The bulk of the cross-Atlantic gap in labour productivity growth can be explained in terms of differences in more traditional, ICT-using sectors, where European firms do not seem to have exploited the benefits of the availability of new technologies to their full extent. Over the period 1995 to 2004, compared with the preceding 15 years, labour productivity growth fell especially in market services, including distribution, financial and business services. This evidence is broadly in line with the notion that ICT have the largest impact on productivity growth indirectly, namely by sparkling product and process innovations and by facilitating complementary innovations. The contribution from traditional services sectors (namely distribution, financial and personal services) to euro labour productivity growth declined from 0.4 percentage points over the period 1980-1995 to 0.2 percentage points over the period 1995-2004. In contrast the contribution went up from 0.6 to 1.4 percentage points in the United States over the same periods.

Today, there is a broad agreement that the structural rigidities that characterise the euro area economy in comparison with the United States are responsible for this development in Europe. In particular less flexible labour markets, a lower degree of competition in product markets and higher barriers to entry for new firms as well as a less developed capital market – are seen as the main factors explaining the relatively poor productivity performance in the euro area. Therefore, the Governing Council fully supports all the structural reforms that will permit to achieve the single market, enhance competition and promote flexibility in all markets of goods and services as well as in the labour markets, so as to enable firms to better profit from technological progress and innovation.

Criteria for joining the euro area

Ladies and gentlemen, I would like to end with some remarks on the criteria for joining the euro area. The convergence criteria are stipulated in the Treaty and have therefore been agreed upon by all parties involved. It should be clear that there is one set of criteria for all EU countries. The ECB applies the criteria in the same way as in the past and we have always stressed that convergence should be sustainable. A consistent set of rules and a consistent application over time will reinforce the credibility of the process of euro area enlargement. This will, in turn, facilitate the sustainability of convergence. The framework is flexible enough to accommodate the country-specific features of all countries that want to adopt the euro. I would also like to emphasise that meeting the convergence criteria in a sustainable manner before joining the euro area is in the interest of all parties concerned and above all for the candidate countries themselves.

I am now at your disposal for questions.