Guy Quaden: The outlook for the European economy, the turmoil in financial markets and monetary policy

Remarks by Mr Guy Quaden, Governor of the National Bank of Belgium, at a business dinner, Dubai, 31 October 2007.

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I thank you very much for your invitation to this business dinner. I am very pleased to have the opportunity to spend a few days in the United Arab Emirates, one of the most quickly developing regions in the world and in my eyes one of the most fascinating places to be.

I will present some remarks about the outlook for the European (eurozone) economy, the consequences of the turmoil in financial markets (but not about the causes of the turbulence and the first lessons to be drawn: it will be the subject of another speech) and the stance of the monetary policy.

The latest news from Europe is not bad. 2006 was an excellent year and prospects for this year and next year remain positive. However the uncertainty surrounding these prospects has increased.

The world has been experiencing a fairly long period of economic good times. For a few years the strong activity has been driven only by the United States and the emerging markets whereas Europe seemed to stand back. However the pace of global economic activity has become more balanced across the main economic regions.

After having gone through a protracted period of subdued growth and short-lived recoveries, Europe was in the upswing of a cycle since early 2005, backed in particular by the long-awaited recovery in the largest economy of the zone, Germany.

In 2006, real GDP expanded by 2.9 % in the eurozone, twice the rate recorded in the previous year. Investment increased by 5.2 % and private consumption also picked-up. Gross exports rose by an impressive 8.2 %. However the contribution of net exports to GDP growth was relatively moderate (0.3 %) because imports also rose significantly.

Therefore last year GDP growth in the eurozone was mainly driven by the faster increase in domestic demand, sustained in particular by a steady improvement in the labour market. The number of employed people rose by around 2 million (1.4 %) and the unemployment rate dropped in 2007 to the lowest level since 1993. Moderate wage developments have also contributed to stronger employment growth.

That said, the level of unemployment in the eurozone (close to 7 %) is still high in comparison with other regions and there remain inefficiencies and rigidities in labour markets to be tackled through further structural reforms.

Until this summer, the diagnosis of the economic situation in the eurozone was bright. The outlook was seen as favourable, supported by both the external and internal pillars of demand. According to the June 2007 Eurosystem staff projections, GDP growth in the euro area was projected to be close to 2.6 % in 2007 and 2.3 % in 2008.

Obviously the turbulence in financial markets has clouded the prospects to some extent. The potential impact of this turmoil on the real economy is still difficult to assess. So far the effects have been limited. While euro area consumer and business confidence indicators declined in September, and most of the early indicators available fell slightly in October too, they were still above their historical averages and continued to point to ongoing sustained growth during the second half of 2007. Very recently, the IMF staff forecasted real GDP growth in the euro area at 2.5 % in 2007 and 2.1 % in 2008 and most private sector forecasts are close to these numbers.

As regards the short – and medium – term outlook, I would make a distinction between the main scenario, which is the most likely outcome, and the risk assessment. The most likely scenario remains favourable with growth still close to our potential but it is now surrounded by much more uncertainty than usual. And that applies to other regions of the world.

World economic growth is expected to remain robust over the medium term, despite the slowdown of the US economy, because the emerging market economies should continue to expand at a rapid pace. As the recent IMF World Economic Outlook points out, China, India and Russia have together accounted for half of global growth over the past year, and further strong expansion is also expected in other emerging markets and developing countries. This trend should improve living conditions and income for a large part of the world's population. It is also a source of continued support for euro area exports and investment.

However the slowdown in the US economy could be more pronounced and the US dollar exchange rate could come under renewed downward pressure. In these conditions, it remains to be seen whether the recent signs of emerging economies de-coupling from US developments will usher in a sustainable process. Another crucial question is whether the euro will continue to bear more than its share in the resorption of global imbalances. Here I refer to the continuous strengthening of the exchange rate of the euro not only vis-à-vis the US dollar but also vis-à-vis the currencies of countries recording year after year large current account surpluses.

Domestic demand for its part is expected to be supported by strong corporate sector earnings, healthy balance sheets, still moderate interest rates (lower than in the US) and better labour market conditions. The central scenario assumes financial markets gradually returning to normal, which does not mean that we should expect risks to be underpriced again, but simply that the current liquidity crunch will not turn into a fully-fledged credit crunch. This view is supported *inter alia* by the resilience of major financial institutions and more generally of the global financial system. True, profits have recently been deteriorating. Nevertheless this downturn in profitability starts out from a very high position. So far, potential credit losses appear to be manageable and banks' capital bases being largely in excess of regulatory requirements seem to be sufficiently solid to face additional stress. Nonetheless, the uncertainty about the exact magnitude and distribution of these losses remains and is a major cause of the persistent liquidity squeeze.

Therefore less benign scenarios cannot be ruled out altogether and the financial turmoil might affect bank lending conditions for households and non-financial corporations, through higher costs of financing or more restrictive credit standards, as well as corporate bond spreads. To a certain extent this seems to be happening already, although the levels reached so far do not seem really worrying. All in all, credit standards and bond spreads are still well below the situation seen in 2001-2003. Furthermore, the tightening of credit conditions is expected to affect mainly M & A activities, more than fixed investments.

Finally, greater uncertainty could curb both entrepreneurs' and consumers' confidence. It is up to policy-makers to ensure sound economic conditions and thus contribute to the preservation of economic agents' confidence. For its part, the Eurosystem – the European Central Bank and the national central banks associated in the single European monetary policy – has faced up to its responsibilities in this respect.

As the other central banks, the Eurosystem has to conduct the European monetary policy with a clear medium-term orientation. It therefore sets interest rates with the aim of preserving price stability. This action hinges on a macroeconomic assessment of the risks to price stability. On the other hand, the Eurosystem conducts money market operations that provide liquidity to ensure the orderly functioning of the money market. Monetary policy decisions are about the level of official interest rates. Once the level of interest rates is decided, the Eurosystem has the responsibility of ensuring the smooth functioning of the segment of the money market that it is able to influence. It should be very clear that these two responsibilities should not be confused. However in fulfilling these two responsibilities, they reinforce each other, to the benefit of both macroeconomic and financial stability.

In order to restore orderly conditions on the money markets, the Eurosystem injected liquidity over and above what is needed by the banking system under normal circumstances, through regular MRO allotments, ad hoc fine-tuning operations and supplementary longer-term refinancing operations (LTROs). These injections allowed banks to front-load the fulfilment of their reserve requirements and eased the tensions on the overnight interbank market. The Eurosystem also absorbed excess reserves when needed to avoid downward pressure on overnight rates.

While the Eurosystem's liquidity-providing and absorbing operations had a stabilising effect on euro money markets at the shortest end, market liquidity remains thin and activity limited in the unsecured interbank market. Recently, the ECB clearly communicated to the markets that it will reinforce its policy of allocating sufficient liquidity to accommodate the demand of counterparties to meet reserve requirements early within the maintenance period. This policy will be followed as long as necessary. However, the restoration of normal conditions over the whole maturity spectrum depends mainly on the return of confidence and trust by market participants, both in the other participants and in their own ability to access funding in sufficient amounts.

It must be emphasised that the Eurosystem conducted these operations through standard market-compliant procedures and without changing the overall stance of monetary policy. Let me now turn to an assessment of the monetary policy stance at the current juncture.

The primary mandate of the Eurosystem is to deliver price stability in the medium term. On the basis of a thorough economic and monetary analysis and by acting in a firm and timely manner, the Governing Council of the ECB has to ensure that medium- and long-term inflation expectations remain firmly anchored in line with price stability, thereby favouring an environment conducive to sustained economic growth and well-functioning markets.

The rise of many commodities prices – in particular oil –, the dynamism of monetary developments and the emergence of capacity constraints, implied upside risks to price stability over the medium term. This led us to issue in the summer a new message of "strong vigilance".

However, since then, the ECB Governing Council, which is never pre-commited, has not changed policy rates. What happened ? The incoming macroeconomic data remained in line with our baseline scenario and confirmed that risks to price stability are mainly on the upside over the medium term, as identified by both our economic and monetary analysis. However, the continued financial market volatility and ongoing reappraisal of risk has undoubtedly led to an increase in uncertainty surrounding the economic outlook, due to the possible effects of these financial developments on the real economy. Therefore, it was appropriate to gather additional information before drawing further conclusions for monetary policy.

This (very attentive) "wait and see" attitude did not jeopardise the maintenance of price stability over the medium term. Indeed, a market-driven tightening of monetary conditions could be observed, as money market rates have risen, lending standards have somewhat tightened and the euro exchange rate has again appreciated. By the way, let me remind you that the Eurosystem has no target for the euro exchange rate, as the primary objective concerns internal stability. However, the exchange rate is an important indicator in the economic analysis, in particular to the extent that it influences the overall outlook for price stability.

At its last meeting on 4 October, the ECB Governing Council still considered this outlook for price stability over the medium term to be subject to upside risks. It gave itself a period of time to analyse incoming information in order to refine and update its risk assessment. In particular, should financial market tensions persist or intensify, they would affect financing conditions more significantly and eventually economic activity too. These downside risks are, I think, relevant both for the growth and the inflation outlook, as they have the potential to alleviate some of the expected upward pressure on prices of a cyclical nature embedded in the baseline scenario. Conversely, should the financial turbulence fade away and the main scenario be confirmed, our monetary policy should be and would be ready to counter possible upside risks to price stability.

Uncertainty having increased, times have once again become more challenging for central bankers. More than ever they require from us to make appropriate, overall and forward-looking judgments.