The eurozone, the US, and global markets

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I would like to thank the European Institute for giving me the opportunity to express my views at this occasion. Today, in my short intervention, I will sketch out a few ideas about recent macroeconomic developments at the global level, but in the US and in Europe in particular.

Let me start with the **global macroeconomic environment** and its outlook. The dynamism of the world economy since its rebound in mid-2003 is unmatched in a longer retrospective, both as regards the level of growth as well as its duration. In the previous expansion for example, world GDP growth peaked at 4.9% [in 2000].

Cyclical factors, underpinned by favourable financing conditions, have supported this expansion. But it is equally likely that trend world growth is on a rising path. The integration of, first, the Eastern European economies and, later on, China and India into the world's trading system, have probably boosted trade and world growth in a more structural way. And the catch-up potential of these economies is that large that it is unlikely that trend growth will revert soon.

This year, we are likely to witness a mild drop of growth, to slightly below 5% according to the IMF's recent WEO, very much in line with the scenario already envisaged in its previous assessment. Notwithstanding this moderation of growth, the favourable macroeconomic environment is expected to continue, the global Purchasing Managers' Index (PMI) is stable in positive territory. In particular, the pursuit of the rebalancing of growth around the world, away from the US to the euro area and Japan, reduces the risks of a more abrupt global slowdown. The US economy should probably see sub-par growth, the euro area will see some easing, from 2.8% in 2006 to 2.5% in 2007 [mid-point of range of March 2007 MPE], whereas the expansion in Japan is set to continue at a broadly similar pace as in 2006. The outlook for the emerging economies, in particular in Asia, is assumed to remain robust as the spillover effects from a soft landing in the US should be contained.

The latest episode in the ongoing correction of the US housing market, the bankruptcies of a forty subprime mortgage lenders, is at first blush a sign that some lenders had failed in their risk appraisals. House prices have merely stabilised, and yet borrowers have already significantly defaulted on adjustable-rate loans in the subprime segment. While a contained correction in the housing market is welcome as it prevents a further build-up of the prevalent disequilibrium, there are - to some extent – also benefits in the market failure of lenders. First, it halts the aggressive lending practices that have partially nurtured the initial run-up of house prices. And, second, it reminds us of the risks involved and that those risks should be assessed and priced accordingly. As long as there are no knock-on effects to the prime segment of the mortgage market - and there are none at the current juncture - and as long as the labour market remains in good shape - and it is according to the latest employment data -, one can be fairly assured that the US economy can weather these challenges, even if Q1 figures look not too good.

A more pessimistic view would judge that the adjustment remains incomplete - given that inventories remain over 6, 8 months - and if the risk of adjustment would materialise, the resulting wealth effect would cause a drop in demand. But one needs to consider that the balance sheet of US households is solid.

The prospects of Europe and other parts of the world have in the recent past hinged on the US economy. So while most economists concede that the US economy is sneezing, how does it come that the rest of the world is not expected to catch a cold? In particular, why are we so confident that the euro area can successfully **decouple from the US slowdown**?

Well, the slowdown does not really come as a surprise. The FED and international organisations had to some extent anticipated this moderation of growth, which is therefore already part of the projections, as is an adjustment scenario to global imbalances. The IMF in its latest WEO expects the US to grow by 2.2% in 2007 and 2.8% in 2008, admittedly at the lower end of the FED’s January projections. These growth forecasts are marginally lower than those of the September 2006 exercise. So are the ECB staff macroeconomic projections which expect real GDP growth in the US to be more moderate than in the previous years.

A divergence appears in the charts on business confidence compared to latest revisions to GDP growth and the recent changes in interest rate expectations. Also, the productivity gap by hour worked is closing.

Since the economic slowdown reflects mostly adverse developments in the housing market that affected GDP growth via the residential investment component, the primary issue is of a purely domestic nature. Thus, if the concerns do not spread further but remain contained to the housing market, they will unlikely entail more severe direct consequences for the euro area. Recent studies have tried to quantify the spillover effects from a potential hard landing scenario in the US and they have also concluded to a fairly muted impact on euro area growth. The ECB staff has estimated that a 1pp shock to GDP growth in the US would lower growth in the euro area by a mere 0.2pp. These results encompass the direct and indirect trade channels and are in line with recent estimates by the European Commission. The latter has estimated further that, if these trade effects were to be compounded by spillovers through the balance sheets, equity markets and confidence channels, the impact would increase to -0.5pp after 2 years. An additional 10% depreciation of the dollar vis-à-vis the euro could take the impact to -0.8pp.

[Of course, these scenarios assume that the adjustment on the housing market is not further exacerbated by a weaker labour market. If that were to be the case, a more thorough reassessment of the growth outlook would be necessary.]

All in all, since September 2006, 7 global risk factors have evolved in diverging directions. There is a reduced risk now on the one hand of a receding US housing market, of a disruption in oil supply, of a disorderly unwinding of global imbalances as well as of inflation. On the other hand, there is a higher upside risk of domestic demand in the European Union and emerging market growth. Lastly, there is today an increased downside risk for financial stability.

Global markets seem rather unimpressed by the current US slowdown as well. The **financial market jitters** observed at the end of February appear to have only been a short episode, and the prices of all kinds of assets remain at high levels. In a context of huge amounts of liquidity chasing assets that are by comparison rather scarce, we observe low pricing of risks and flat yield curves. In fact, long term interest rates are strikingly low.

While macroeconomic risks are moderating, credit risk has increased. Easy financing conditions have led to a rising risk appetite, reflected in LBO activity, mortgage lending and carry trades. A market correction potentially triggered by a volatility shock could be amplified by leveraged positions and uncertainties about risk concentration in some of the less liquid secondary markets of innovative products.

Pockets of vulnerability of household and corporate sectors have increased and need to be followed up, but on average financial positions remain sound and the financial sector resistant to shocks. The shift of power in terms of credit creation from banks to the market with Hedge Funds and Private Equity Pools with much higher multipliers than banks risks loosening the transmission channel of Central bank monetary policy and this new situation is largely untested in stress. As stated Jacques de Larosière recently, *“high asset valuations and low risk pricing are, as they have always been, a source of vulnerability, because they can well be reversed* “.

Let me now come back to the **euro area** in particular. You know that 2006 has been a very good year in terms of growth, during which the Governing Council of the ECB accompanied the upswing with a series of moderate key policy interest rate increases aimed at progressively normalising the level of interest rates and at anchoring inflation expectations. The first quarter of 2007 can be viewed as a continuation of these developments: There are signs that activity has remained strong, and the Governing Council of the ECB has decided on another moderate interest rate increase at the beginning of March.

So where are we standing today? Up to now, we can see that our decisions proved to be right. Our interest rate increases have been well received by the financial markets, inflation expectations remain in line with price stability, and at the same time real GDP growth is projected to remain robust throughout 2007 and beyond, Growth for Q1 and Q2 might well surpass the Eurosystem March projections. It is important to note that at this juncture, growth in the euro area depends less on external developments but is to a significant extent driven by domestic developments. There is however no room for complacency. Both our economic and monetary analyses confirm that the risks to inflation in the medium term remain on the upside. The upward evolution of input prices in manufacturing, combined to an increased pricing power of firms in the services sector as well as recent survey data and the evolution of producer prices all point to upward pressures. These risks include increases in oil prices, as well as in administered prices and indirect taxes. Also, liquidity is ample and money and credit growth are strong, as interest rates remain moderate. In an environment of strong GDP growth and increases in employment accompanied by falling unemployment, the Governing Council of the ECB keeps stressing the need for moderate wage developments. This can pave the way for limiting the inflationary pressure stemming from the wage side. Yesterday, we decided on leaving key interest rates unchanged. But all these considerations will be duly taken into account when we decide next about the future evolution of interest rates. We have to disentangle structural versus cyclical effects. As slack vanishes, we have to watch resource constraints, capacity building, results of structural change, productivity developments and potential growth developments, and thoroughly interpret money and credit developments.

I am confident that we will do the right thing, in a firm and timely manner, to preserve price stability and that, by doing so, we will continue to contribute to a sustainable growth environment in the euro area.

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Ladies and gentlemen, I thank you for your attention and I hope we can engage in a stimulating discussion.