

## **Lucas Papademos: Presentation of the European Central Bank's Annual Report for 2004**

Introductory statement by Mr Lucas Papademos, Vice-President of the European Central Bank, to the Committee on Economic and Monetary Affairs of the European Parliament, Brussels, 26 April 2005.

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Madam Chairman, members of the Committee on Economic and Monetary Affairs, it is an honour for me to present to you today the ECB's Annual Report 2004. The presentation of the Annual Report is an essential part of the ECB's accountability vis-à-vis the European Parliament. As you know, the ECB accords the utmost importance to the fulfilment of its accountability obligations, and I am looking forward to a fruitful dialogue with you.

In my introductory statement, I will first briefly review economic and monetary developments over the past year and give our assessment of the economic outlook and the monetary policy stance. I will then focus on a number of policy issues examined in the Annual Report which I consider to be of particular importance.

### **Economic and monetary developments**

Looking back to 2004, the ECB's monetary policy operated in an environment of gradual economic recovery and subdued domestic inflationary pressures in the euro area. The recovery in economic activity, which had started in the second half of 2003, continued in 2004 at what was, overall, a moderate but uneven pace. The euro area economy grew strongly in the first half of the year, in particular as a result of robust global economic expansion. However, partly on account of rising oil prices, growth moderated in the second half of 2004. Nevertheless, on a working day-adjusted basis, euro area real GDP grew by 1.8% in 2004, a markedly higher average annual rate than the 0.5% recorded in 2003.

Against this background of relatively modest economic growth, underlying domestic inflationary pressures remained contained throughout 2004 and early 2005. Continued wage moderation played a key role in this respect. However, increases in administered prices and indirect taxes and renewed rises in oil prices, particularly in the second half of the year, had a sizeable impact on inflation. Overall, annual HICP inflation was 2.1% in 2004, unchanged from the previous year.

All in all, the Governing Council continued to take the view throughout 2004 and early 2005 that the outlook for price developments was consistent with the maintenance of price stability over the medium term. Key ECB interest rates were therefore kept unchanged at historically low levels. Across the entire maturity spectrum, the levels of both nominal and real interest rates remained exceptionally low, lending substantial support to economic activity.

At the same time, a number of upside risks to price stability emerged in the course of 2004. These risks related mainly to developments in oil prices, potential second-round effects on wage and price-setting behaviour and uncertainty about further increases in indirect taxes and administered prices. Moreover, strong monetary and credit growth and the accumulated stock of excess liquidity in the euro area increasingly gave cause for concern.

Turning to the current economic situation and the outlook for the future, recent data and survey indicators suggest continued moderate economic growth in the first half of 2005, with no clear signs of a strengthening in underlying economic dynamics. Looking further ahead, the conditions remain in place for real GDP growth to increase towards trend rates. On the external side, euro area exports should continue to be supported by foreign demand. On the domestic side, investment is expected to benefit further from the prevailing very favourable financing conditions and the robust corporate earnings currently being observed. Consumption growth should evolve broadly in line with expected developments in disposable income. Accordingly, the Governing Council anticipates continued economic growth in 2005 and 2006. This is consistent with the ECB staff projections of March 2005 and with forecasts made by international and private sector organisations. This outlook is subject to a number of uncertainties. Notably, the persistently high level of oil prices and the possibility of further rises pose downside risks to economic growth.

With regard to consumer prices, the outlook for price developments over the medium term has remained broadly in line with the ECB's definition of price stability. At the same time, annual HICP inflation has exhibited a relatively high degree of short-term volatility, mainly caused by changes in oil prices and developments in indirect taxes and administered prices. There is so far no significant evidence of underlying domestic inflationary pressures building up in the euro area. Wage increases have remained contained over recent quarters and, in the context of moderate economic growth and weak labour markets, this trend should continue. This assessment is also supported by the ECB staff projections of March 2005.

However, risks to price stability remain on the upside, calling for continued vigilance on the part of the Governing Council of the ECB. These risks relate again to oil price developments, particularly if second-round effects on wage and price-setting behaviour were to materialise. Upside risks to price stability are also signalled by the ECB's monetary analysis. Concerns relate to continued strong monetary and credit growth, which reflects the sustained stimulative effect of the historically very low level of interest rates in the euro area. Since monetary dynamics are driven mainly by developments in the most liquid components of M3, the stock of excess liquidity which has built up over the past few years may increasingly entail upside risks to price stability in the medium to longer term as economic activity gains momentum. Finally, the strong monetary and credit growth and, in particular, the marked growth in loans for house purchase require careful monitoring in view of the strength of house price dynamics in some regions of the euro area.

### **The Stability and Growth Pact**

I should like now to address a number of economic policy issues, starting with the EU fiscal framework. In 2004 the debate concerning a reform of the Stability and Growth Pact intensified, subsequent to the judgement of the European Court of Justice annulling the conclusions of the ECOFIN Council of November 2003 and following the Commission's proposals to strengthen economic governance and clarify the implementation of the excessive deficit procedure. Throughout that debate, the ECB clearly and consistently stated its position, namely that improvements in the implementation of the Pact, particularly the strengthening of its "preventive arm", were possible and, indeed, welcome. At the same time, the ECB warned against any weakening of the Pact's "corrective arm" and of the provisions governing the excessive deficit procedure, as these could be detrimental to the credibility of the fiscal framework. In March 2005 the European Council unanimously approved a number of changes to the Pact. There are some aspects of the reform which can potentially help to strengthen the "preventive arm" of the Pact, provided they are implemented effectively. The agreed amendments, however, also allow – against the advice of the ECB – for greater flexibility as regards the "corrective arm" of the Pact. Specifically, the reform of the excessive deficit procedure implies a shift towards a more judgemental approach to the enforcement of fiscal discipline, for example by allowing the Commission and the Council to take into account "other relevant factors" or by making the time frame for correcting excessive deficits more conditional. I should recall that the ECB has stressed the vital importance of implementing the new framework in a manner conducive to prudent fiscal policies.

It is essential that decisions and actions to be taken in the context of the reformed Pact do not undermine confidence in the European fiscal framework and in the sustainability of public finances in the euro area. It is imperative that Member States, the Commission and the Council, in fulfilling their respective responsibilities, implement the revised framework in a rigorous and consistent manner. Sound fiscal policies, together with a stability-oriented monetary policy, are fundamental to the success of Economic and Monetary Union. For its part, the ECB will not waver in its commitment to delivering price stability.

### **The Lisbon strategy**

Let me now turn to the recently concluded mid-term review of the Lisbon strategy. Five years after the launch of the strategy, there is broad agreement that progress in structural reforms has been mixed. On the positive side, some EU Member States have made good progress towards implementing reforms in recent years. However, much still needs to be done if Europe as a whole is to face successfully the challenges of technological change, globalisation and ageing populations.

In this context, the ECB welcomes the Presidency Conclusions of the Brussels European Council of 22 and 23 March 2005, which state that "it is essential to relaunch the Lisbon strategy without delay

and refocus priorities on growth and employment". Member States urgently need to promote innovation and human capital formation, establish a regulatory environment which is friendlier for businesses, accelerate market liberalisation and increase labour utilisation and labour market flexibility.

Against this background, attention must now shift towards implementing the newly refocused Lisbon agenda. Closing the implementation gap in all Member States is essential in order to reap the full benefits of structural reforms in terms of a higher growth potential and a higher employment rate in the medium term, as well as improved consumer and business confidence in the short term. The new governance framework introduced by the European Council should support this process by fostering effective decision-making and priority-setting, and by increasing national ownership. Peer support and, where necessary, peer pressure need to be employed to push the Lisbon strategy forward. In this context, benchmarking on the basis of sensibly defined quantitative indicators, taking account of national circumstances, would be a useful tool and a welcome driver for public discussion. Moreover, this would raise public awareness of the fact that successful implementation of structural reforms is indeed possible in EU Member States and would show that structural reforms lead to important benefits.

As for the ECB, we will continue to support the Lisbon process by maintaining price stability, which fosters sustainable output growth, employment and social cohesion. At the same time, comprehensive structural reforms aimed at increasing flexibility and competition in labour, product and capital markets would significantly improve the prospects for non-inflationary economic growth in the euro area, thereby facilitating the conduct of monetary policy and enhancing its effectiveness.

## **EU enlargement**

I should like to conclude by commenting briefly on the event that marked 2004 as a milestone in the history of European integration, namely the accession of ten new Member States to the European Union. With this step, Europe has passed another landmark along the road to ever closer union.

Since 1 May 2004, these ten countries have been full members of the European Union and have assumed the rights and responsibilities associated with that membership. The national central banks of these countries have become members of the European System of Central Banks (ESCB), and their governors participate in the meetings of the General Council of the ECB. The integration of the ten new national central banks into the ESCB proceeded very smoothly, thanks to the comprehensive preparation and the active assistance provided by the ECB in various fields.

The economic integration of the new Member States has been progressing at an impressive pace. It is notable that the new Member States' share in euro area exports and imports has doubled since 1995 and that direct investment from the euro area in these countries has increased significantly. The potential economic benefits of enlargement are substantial, both for the fifteen old and for the ten new Member States, just as previous rounds of enlargement have also benefited the entire European Union.

As described in detail in the convergence reports issued respectively by the ECB and the Commission in October 2004, the new Member States have also made substantial progress in terms of nominal convergence. However, these convergence reports concluded that none of these countries have yet fulfilled all the conditions required for adopting the single currency.

One of these conditions is participation in the Exchange Rate Mechanism II (ERM II). Three new Member States – Estonia, Lithuania and Slovenia – joined ERM II in June 2004. In this respect, I should like to reiterate the importance of undertaking major policy adjustments – in particular with regard to price liberalisation and fiscal policy – prior to participation in the mechanism, as this is key to ensuring smooth membership of ERM II.

The 2004 accession process does not, however, mark the end of the EU's enlargement. Indeed, yesterday we witnessed the signing of the Accession Treaty with Bulgaria and Romania. I am convinced that, as past experience has demonstrated, the prospect of EU membership will continue to serve as a catalyst for macroeconomic stabilisation and structural reforms in these countries.

I am now at your disposal for questions.