European Central Bank: Press conference – introductory statement

Introductory statement by Mr Jean-Claude Trichet, President of the European Central Bank, Frankfurt am Main, 2 November 2006.

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Ladies and gentlemen, let me welcome you to our press conference and report on the outcome of today's meeting of the ECB's Governing Council. The meeting was also attended by Mr Heinäluoma, President of the Ecofin Council, and Commissioner Almunia.

On the basis of our regular economic and monetary analyses, we decided at today's meeting to leave the **key ECB interest rates** unchanged. The information that has become available since our last meeting has further underpinned the reasoning behind our decision to increase interest rates in October. It has also confirmed that strong vigilance remains of the essence so as to ensure that medium to longer-term inflation expectations in the euro area remain solidly anchored at levels consistent with price stability. With the key ECB interest rates at still low levels, money and credit growth dynamic, and liquidity ample by all plausible measures, our monetary policy continues to be accommodative. If our assumptions and baseline scenario continue to be confirmed, it will remain warranted to further withdraw monetary accommodation. Indeed, acting in a firm and timely manner remains essential to ensuring price stability over the medium term. As emphasised on previous occasions, this is a prerequisite for monetary policy to make an ongoing contribution towards supporting sustainable economic growth and job creation in the euro area.

Allow me to explain our assessment in greater detail, turning first to the **economic analysis**.

Eurostat's second estimate confirmed that real GDP growth in the euro area was 0.9% quarter on quarter in the second quarter of 2006, after 0.8% in the first quarter. Looking through the usual volatility of quarterly growth rates, economic activity has been growing at an average quarter-on-quarter rate of 0.7% over the four quarters to mid-2006, and thus faster than generally expected a year ago. On the basis of various monthly indicators of economic activity and confidence surveys, available up to October, the momentum of the economic expansion is expected to have continued in the second half of this year. In addition, the unemployment rate has been declining, employment growth has recovered and employment expectations remain favourable. All in all, the assessment of a more broadly based and more self-sustaining recovery continues to be confirmed by the incoming data, notwithstanding some possibility of a somewhat slower pace of quarter-on-quarter real GDP growth in the second half of this year than in the first.

Looking further ahead, the conditions remain in place for the euro area economy to grow at solid rates around potential, although some volatility in the quarterly growth rates is likely to emerge around the turn of the year, mainly reflecting the impact of an increase in indirect taxes in a large euro area country in January 2007. Global economic activity has become more balanced across regions and remains robust, thereby providing ongoing support for euro area exports. Investment is expected to remain dynamic, benefiting from an extended period of very favourable financing conditions, balance sheet restructuring, accumulated and ongoing strong earnings, and gains in business efficiency. Consumption growth in the euro area should also strengthen further over time, in line with developments in real disposable income, as employment conditions continue to improve.

Risks to the outlook for economic growth are broadly balanced over the shorter term, taking into account, in particular, the recent slowing down in the US economy on the one hand and the recent fall in oil prices on the other. The oil price decline – if it were to prove lasting – has the potential to lead to somewhat stronger demand and output growth than embodied in our current baseline scenario for activity in the coming quarters. Over the longer term, risks to growth continue to lie on the downside, relating mainly to the possibility of a renewed increase in oil prices, fears of a rise in protectionist pressures, especially after the suspension of the Doha round of trade talks, and possible disorderly developments owing to global imbalances.

As regards price developments, according to Eurostat's flash estimate annual HICP inflation was 1.6% in October, after having declined to 1.7% in September from 2.3% in August. The recent decline in inflation is the combined result of favourable base effects, given in particular the strong rise in oil prices a year ago, and the recent significant fall in oil prices. While the outlook for energy prices remains uncertain, on the basis of current energy prices and the higher quotations on futures markets, inflation rates are likely to increase again in the next few months and early 2007. As a consequence, we expect a high degree of short-term volatility in the annual HICP inflation rate. Looking through this volatility, however, HICP inflation will remain elevated at a level above 2% on average in 2006 and is likely to remain so in 2007.

Risks to the outlook for price stability remain clearly on the upside. They continue to include a stronger pass-through of past oil price rises into consumer prices than currently anticipated and additional increases in administered prices and indirect taxes beyond those announced thus far. Furthermore, renewed increases in oil prices cannot be excluded. More fundamentally, given the favourable momentum of real GDP growth observed over the past few quarters and the ongoing improvement in labour markets, stronger than currently expected wage developments pose substantial upward risks to price stability. Against this background, it is crucial that the social partners continue to meet their responsibilities, particularly in the context of a more favourable environment for economic activity and employment.

The **monetary analysis** continues to point to upside risks to price stability at medium to longer horizons. Annual M3 growth rose again to 8.5% in September, after having increased to 8.2% in August. Although the annual growth rate of M1 has moderated somewhat in recent months, reflecting shifts into instruments with more market-related returns in a context of rising interest rates, this has been more than compensated by the stronger expansion of the other components of M3.

More generally, the rate of monetary and credit expansion remains rapid, reflecting the still low level of interest rates in the euro area and the strengthening of economic activity. In particular, loans to the private sector continue to grow at double-digit rates on an annual basis, their dynamism remaining broadly based across the household and corporate sectors. While the growth of household borrowing shows some signs of stabilisation, albeit at very high rates, the growth of borrowing by non-financial corporations continues to trend upwards and has now reached rates of over 12% on an annual basis, the highest seen since the early 1990s. Thus, when the counterparts of M3 are considered, the main driver of strong monetary growth remains the expansion of credit to the private sector.

Taking the appropriate medium-term perspective, the latest developments are consistent with a continuation of the persistent upward trend in the underlying rate of monetary expansion, identified by the ECB's monetary analysis since mid-2004. Furthermore, following several years of robust monetary growth, the liquidity situation in the euro area is ample by all plausible measures. Continued strong monetary and credit growth in an environment of ample liquidity point to upside risks to price stability over the medium to longer term. Monetary developments therefore continue to require very careful monitoring, particularly against the background of improved economic conditions and strong property market developments in many parts of the euro area.

To sum up, annual inflation rates are projected to remain elevated in 2006 and 2007, with risks to this outlook remaining clearly on the upside. Given the ongoing marked dynamism of monetary growth in an environment of 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. It is essential that inflation expectations remain firmly anchored at levels consistent with price stability. If our assumptions and baseline scenario continue to be confirmed, it will remain warranted to further withdraw monetary accommodation. Indeed, acting in a firm and timely manner remains essential to ensuring price stability over the medium term. The Governing Council will therefore exercise strong vigilance.

As regards **fiscal policy**, euro area countries have recently notified their deficit and debt figures for 2005 to the European Commission, and most have reported on developments in 2006 and budget plans for 2007. While, on average, this information points to further, albeit slow improvements in budget balances, this should not give rise to complacency. It is important that commitments under the revised Stability and Growth Pact are met in all euro area countries. It is essential that budgetary consolidation is strengthened in the current economic upswing and that pro-cyclical policies are avoided. This would boost confidence among market participants and the public. To that effect any revenue windfalls from faster than expected growth should be pre-committed and used in full to speed up deficit reduction or to increase surpluses in good times. The prospects for attaining sound budgetary positions improve when consolidation plans are based on credible commitments to reduce expenditure ratios and better expenditure control mechanisms. Finally, let me reiterate previous calls for high quality statistical data and sound statistical reporting, which are key for the prevention and correction of budgetary imbalances.

As regards **structural reforms**, the Governing Council stressed the importance of creating a fully operational Single Market and flexible product and labour markets in order to enhance the adjustment capacity of the euro area economy and its resilience to external shocks. Liberalising product markets to allow more competition would raise incentives for firms to invest and innovate, thereby raising productivity growth. Removing labour market rigidities and distortions in wage and price formation are key conditions for promoting more homogeneous cost and price competitiveness trends among euro area countries and for generating sustained output growth and job creation. In particular, wage increases should be guided, in general, by the trend in labour productivity growth, while taking full account of the present level of unit labour costs, in order to preserve or restore price competitiveness. Moreover, it is desirable that wage settlements move away from automatic, backward-looking indexation mechanisms. The successful implementation of reforms aimed at removing rigidities and inefficiencies in euro area countries would raise potential growth and employment prospects.

We are now at your disposal for questions.