European Central Bank: Press conference – introductory statement

Introductory statement by Mr Jean-Claude Trichet, President of the European Central Bank, Frankfurt am Main, 7 December 2006.

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Ladies and gentlemen, the Vice-President and I are very pleased to welcome you to today's press conference. Let me report on the outcome of our meeting, which was also attended by the President of the Eurogroup, Prime Minister Juncker, and Commissioner Almunia.

At today's meeting, we decided to increase the **key ECB interest rates** by 25 basis points. This decision reflects the upside risks to price stability over the medium term that we have identified through both our economic and monetary analyses. Today's decision will contribute to ensuring that medium to longer-term inflation expectations in the euro area remain solidly anchored at levels consistent with price stability. Such anchoring is a prerequisite for monetary policy to make an ongoing contribution towards supporting sustainable economic growth and job creation in the euro area. After today's increase, our monetary policy continues to be accommodative, with the key ECB interest rates remaining at low levels, money and credit growth strong, and liquidity in the euro area ample by all plausible measures. Therefore, looking ahead, acting in a firm and timely manner to ensure price stability in the medium term is warranted. The Governing Council will monitor very closely all developments so that risks to price stability over the medium term do not materialise.

Turning first to the **economic analysis**, according to Eurostat's first estimate, the quarter-on-quarter growth rate of real GDP in the euro area for the third quarter of 2006 was 0.5%. The data thus confirm our assessment that economic activity continued to expand robustly, while moderating from the very strong rates seen in the first half of the year. Domestic demand remained the main driver of economic growth in the third quarter, confirming the anticipated broadening of the recovery and pointing to the increasingly self-sustaining nature of economic expansion in the euro area. The information on economic activity from various confidence surveys and indicator-based estimates supports the assessment that robust economic growth has continued in the fourth quarter of this year.

Looking ahead, the conditions remain in place for the euro area economy to grow at solid rates around potential. While some volatility in the quarterly growth rates is likely to emerge around the turn of the year, associated with the impact of changes in indirect taxes in a large euro area country, the medium-term outlook for economic activity remains favourable. As regards the external environment, economic growth has become more balanced across regions. Helped in part by lower oil prices, global growth is robust, thereby providing support for euro area exports. Domestic demand in the euro area is expected to maintain its relatively strong momentum. Investment should 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 should also strengthen further over time, in line with developments in real disposable income, as employment conditions continue to improve.

This outlook is also reflected in the new Eurosystem staff macroeconomic projections. The projections foresee average annual real GDP growth in a range between 2.5% and 2.9% in 2006, between 1.7% and 2.7% in 2007 and between 1.8% and 2.8% in 2008. Most recent forecasts by international organisations give a broadly similar picture. In comparison with the September ECB staff projections, the ranges projected for real GDP growth in 2006 and 2007 have been revised upwards, largely reflecting the assumption of lower energy prices and their impact on real disposable income.

In the Governing Council's view, the risks surrounding this broadly favourable outlook for economic growth over the projection horizon lie on the downside. The main risks relate 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 concerns about possible disorderly developments owing to global imbalances.

As regards price developments, according to Eurostat's flash estimate, annual HICP inflation rose to 1.8% in November 2006, from 1.6% in October and 1.7% in September. While no detailed breakdown of the November HICP data is available as of yet, the lower annual HICP inflation rates recorded in the two previous months reflected mainly the significant declines in crude oil prices from August onwards, as well as base effects. While the outlook for energy prices remains uncertain, on the basis of the oil prices currently implied by the futures market overall inflation rates are likely to increase again in early 2007 and then hover around 2% in the course of that year, also reflecting the impact of higher indirect taxes.

The December Eurosystem staff projections see annual HICP inflation at between 2.1% and 2.3% in 2006, between 1.5% and 2.5% in 2007 and between 1.3% and 2.5% in 2008. Most recent forecasts by international organisations give a broadly similar picture. Compared with the September 2006 ECB staff projections, the ranges for 2006 and 2007 are somewhat lower, largely reflecting the assumption of lower energy prices. In this context, let me remind you of the conditional nature of these projections, which are based on a series of technical assumptions, including market expectations for short and long-term interest rates as well as for oil and non-energy commodity prices.

In the Governing Council's view, the outlook for price developments remains subject to upside risks, stemming in particular from a pass-through of previous oil price increases which is stronger than assumed in the baseline scenario, the possibility of renewed oil price increases and additional increases in administered prices and indirect taxes beyond those announced and decided thus far. More fundamentally, given the favourable momentum of real GDP growth observed over the past few quarters and the positive signs from labour markets, wage developments could be stronger than currently expected. Therefore, it is crucial that the social partners continue to meet their responsibilities. Wage agreements should take into account productivity developments in connection with the still high level of unemployment and positions in price competitiveness. It is also important that wage settlements move away from automatic, backward-looking indexation mechanisms.

Turning to the **monetary analysis**, annual M3 growth was unchanged at 8.5% in October, remaining close to the highest rates observed since the introduction of the euro, which points to inflationary risks at medium to longer horizons. Increasing interest rates have exerted some influence over monetary developments in recent months, although as yet mainly by triggering shifts among the components of M3 rather than constraining the expansion of M3 itself. In particular, the annual growth rate of M1 has moderated somewhat, reflecting shifts from overnight deposits into other components of M3 which offer more market-related returns.

More generally, the rate of monetary and credit expansion remains rapid, reflecting the low level of interest rates and the strengthening of economic activity in the euro area. 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. In the context of rising interest rates, the growth of household borrowing has shown signs of stabilisation in recent months, albeit at very high growth rates. By contrast, 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 a medium to longer-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 continued strong property market developments in many parts of the euro area.

To sum up, annual inflation rates are projected to hover around 2% in the coming two years, with risks to this outlook remaining on the upside. In addition, given the ongoing marked dynamism of monetary and credit 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 long term. It is essential that inflation expectations remain firmly anchored at levels consistent with price stability. Indeed, acting in a firm and timely manner to ensure price stability in the medium term is warranted. The Governing Council will therefore monitor very closely all developments so that risks to price stability over the medium term do not materialise.

As regards **fiscal policy**, the European Commission's autumn forecasts suggest that deficits will fall below 3% of GDP in most euro area countries by 2007. This is welcome. However, the projected improvements in fiscal balances can only partly be attributed to substantial progress in structural consolidation, as higher economic growth and revenue windfalls are playing an important role. Moreover, in a number of countries with fiscal imbalances, adjustment efforts still fall short of what is needed to meet their respective medium-term objectives in a timely manner and thus fulfil the requirements of the revised Stability and Growth Pact. This is of major concern. It is therefore crucial that forthcoming updates of the stability programmes not only envisage significant progress towards the correction of excessive deficits in a sustainable manner but also make sufficient headway towards safe budgetary positions in the countries concerned. For all countries it is paramount that pro-cyclical policies be avoided in the current economic upswing. More progress is also needed with fiscal structural reform as part of a comprehensive medium-term strategy to improve economic incentives and the soundness of social security systems. This would be a crucial contribution of fiscal policies to economic growth and fiscal sustainability as well as to confidence in the revised Stability and Growth Pact.

As regards **structural reforms**, the Governing Council welcomed the 2006 progress reports submitted by EU Member States on their 2005-08 national reform programmes, in line with the renewed Lisbon Strategy. Although it is encouraging that many concrete reform steps are being taken or are planned, there is still a considerable way to go to make the euro area a more dynamic economy, which is crucial to meeting the challenges of globalisation, population ageing and rapid technological change. Reform measures should foster more integrated, flexible and competitive economies in the euro area, thus allowing more efficient adjustment processes and a stronger resilience to shocks. These are essential conditions for the substantial benefits of the single currency to be better exploited and for the economic performance to improve in both the euro area as a whole and in each member state.

We are now at your disposal for questions.