

## European Central Bank: Press conference - introductory statement

Introductory statement by Mr Jean-Claude Trichet, President of the European Central Bank, and Mr Lucas Papademos, Vice President of the European Central Bank, Brussels, 7 October 2004.

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Ladies and gentlemen, the Vice-President and I are very pleased to welcome you to the press conference here in Brussels. Today's meeting is the tenth time that the Governing Council has met outside Frankfurt, and I would like to thank Governor Quaden for his invitation. Let me also express our gratitude to the staff of the Nationale Bank van België/Banque Nationale de Belgique for their kind hospitality and perfect organisation of today's meeting.

Let me now report on the outcome of today's meeting. As regards economic growth, while some uncertainty has recently arisen concerning the expected strengthening of activity, the economic recovery in the euro area is ongoing. Looking at price developments, high oil prices have had a visible direct impact on inflation rates this year. However, the risk of second-round effects still seems to be contained, and the overall outlook remains consistent with price stability over the medium term. Accordingly, we have left the key ECB interest rates unchanged. This means that the level of interest rates continues to be very low by historical standards, in both nominal and real terms. Strong vigilance is warranted with regard to all developments which could imply risks to price stability over the medium term.

I shall now explain our assessment in more detail, turning first to the economic analysis.

The information available to date indicates that the economic recovery in the euro area is continuing. In particular, survey indicators up to September point to ongoing growth in industrial production and the services sector. Moreover, the gradual recovery in consumer confidence is proceeding, and there are some tentative signs of an improvement in the prospects for employment, although available indicators for household spending do not yet point to an immediate strengthening of consumption growth.

All in all, the growth momentum seen in the euro area in the first half of 2004 should be broadly maintained in the coming quarters, in line with available forecasts from international organisations. On the external side, euro area exports should continue to benefit from favourable global demand conditions, not least from trade with the new EU Member States, where import demand has been strengthening. On the domestic side, investment should benefit from the positive global environment and the very favourable financing conditions in the euro area. As companies restructure, improvements in corporate efficiency and higher profits are also supporting business investment. Moreover, there is scope for a recovery in euro area private consumption, in line with growth in real disposable income.

Any central scenario for future developments is surrounded by a good deal of uncertainty, which at present is particularly related to oil prices. If oil prices were to remain high, or even increase further, it could dampen the strength of the recovery, both inside and outside the euro area, even though the oil intensity of production has fallen significantly since the 1970s and 1980s. All in all, while the burden resulting from higher oil prices cannot be avoided, its medium-term impact should be of a more limited magnitude than in the past. Obviously, for this outcome to materialise, all parties concerned must live up to their responsibilities.

Turning to consumer prices, the oil market developments have had a direct impact on the euro area HICP. Following an annual rate of inflation of 1.7% in the first quarter of 2004, inflation reached 2.3% in the second quarter and remained at that level in July and August. According to Eurostat's flash estimate, annual HICP inflation seems to have fallen slightly in September, to 2.2%. Higher energy prices may have been more than compensated by lower food prices, partly due to base effects resulting from last year's strong increases in this sub-category. Still, on the basis of current market expectations for oil prices, it appears unlikely that annual inflation rates will return to levels below 2% in the remainder of this year.

Nevertheless, looking further ahead, the available information does not indicate that stronger underlying inflationary pressures are building up domestically. Recent wage developments have remained moderate, and this trend should continue. On the basis of this assumption, and provided

that there are no further significant shocks to prices, annual inflation rates should drop below 2% in 2005.

Several upward risks to the outlook for price stability continue to exist. Concerns again relate to oil price developments, in particular to the extent that second-round effects stemming from wage and price-setting behaviour materialise. It is therefore of the utmost importance to avoid inappropriate reactions, as observed in past episodes of strong oil price increases. A further upward risk relates to the future development of indirect taxes and administered prices. These upside risks call for ongoing vigilance, which is a necessary condition for keeping medium to long-term inflation expectations in line with our definition of price stability.

As regards the monetary analysis, M3 growth remains resilient. The downward trend in annual M3 growth from mid-2003 appears to have halted over the summer months, and the shorter-term dynamics of M3 have strengthened. This reflects the fact that the historically low level of interest rates in the euro area continues to support monetary expansion, especially of the most liquid assets included in the narrow aggregate M1.

The low level of interest rates also fuels the growth of MFI credit. The annual growth rate of loans to the private sector remains robust, largely driven by the dynamism of mortgage loans. These are also supported by strong house price increases in several euro area countries.

There remains substantially more liquidity in the euro area than is needed to finance non-inflationary growth. At present, it is not clear how this excess liquidity, which is mainly the result of past portfolio shifts, will be used in the future. If significant parts of these liquid holdings were to be transformed into transaction balances, particularly at a time when confidence and economic activity were strengthening, inflationary risks would rise. In addition, high excess liquidity and strong credit growth could become a source of substantial asset price increases.

To sum up, annual inflation rates should fall below 2% in 2005, but a number of medium-term upside risks to price stability need to be carefully monitored. Cross-checking with the monetary analysis also supports the case for strong vigilance with regard to the materialisation of risks to price stability.

Let me also address the current evidence on fiscal developments, where the latest budgetary notifications are a source of concern. While some countries will maintain a sound budgetary position, a significant number of euro area countries are expected to record deficits near to or above 3%. The aggregate euro area fiscal deficit-to-GDP ratio is expected to increase somewhat, as is the debt-to-GDP ratio. In the coming years, important challenges for the consolidation of public finances will have to be faced. Member States need to renew their consolidation efforts and should not rely on one-off measures, so as to comply with their commitments under the Stability and Growth Pact and to foster confidence. They must also set the right priorities in public finances, towards structural reform, innovation and competitiveness. This would very much support the Lisbon agenda and thereby promote economic growth, foster job creation and reduce unemployment.

Concerning the European fiscal framework, the Governing Council is convinced that substantial improvements in the implementation of the Stability and Growth Pact are possible and would be beneficial, while we would warn against a change to the text of the Treaty or the Regulations which form the basis of the Pact. We consider the Pact as key to ensuring macroeconomic stability on a sustainable basis. It is a framework which is necessary to preserve sound fiscal policies in the euro area, for which strict surveillance and effective peer pressure on national budget policies are indispensable.

It is of vital importance to the credibility of the budgetary surveillance that the reliable compilation and timely reporting of government finance statistics is ensured. The European accounting rules must be fully respected when recording all types of expenditure and revenue. This should be done in a manner that is consistent and stable over time and homogeneous across countries. The procedures must not be vulnerable to political and electoral cycles, as stated by the ECOFIN Council. Countries should consider the quality and integrity of their statistics as a priority matter.

Finally, let me report on the detailed discussion we had today on employment and unemployment developments in the euro area. Two observations stand out when we look at the period of relatively slow real GDP expansion since early 2001. First, after an initial rise, the euro area unemployment rate has remained broadly unchanged since early 2003. And second, there seems to have been a relatively limited negative impact on employment growth over the past few years. The following factors might help to explain this pattern. While the period of slow growth has been relatively long from a historical perspective, the cyclical amplitudes have been smaller and have not therefore triggered

very sharp reactions of employment and unemployment. In addition, wage developments have been more favourable than in previous episodes, and firms may have - to a greater extent than previously - adjusted labour input downwards in term of hours, rather than in terms of employees. This in turn might indicate that firms have gained an element of flexibility to adjust costs.

Looking forward, from a cyclical point of view, employment should recover and unemployment could start falling in the course of next year if overall demand develops as expected. This should support economic growth through an increase in labour income and a positive impact on consumer confidence, and thus on consumption. However, structural problems remain large. This is highlighted, for example, by the fact that over 40% of all unemployed people in the euro area have been without a job for more than a year. In order to decisively overcome the obstacles towards more employment growth and to reduce the trend or structural level of unemployment, further comprehensive labour market reforms are of the essence.