Lucas Papademos: European Central Bank's Annual Report 2005

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, 25 April 2006.

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Madam Chairwoman, members of the Committee on Economic and Monetary Affairs, it is an honour for me to present to you the ECB's Annual Report for 2005. The presentation of the Annual Report is a core element of the ECB's accountability vis-à-vis the European Parliament. As we have always stressed, the ECB places the greatest value on 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 in 2005 and in early 2006, focusing on the monetary policy decisions of the ECB. I will then address a number of the policy issues examined in detail in the Annual Report which I consider to be of particular relevance.

Economic and monetary developments

In 2005 real GDP in the euro area expanded by 1.4%, somewhat below the 1.8% growth recorded in 2004, but the pace of economic activity tended to strengthen during the second half of the year. Annual HICP inflation averaged 2.2% in 2005, marginally higher than the rate of 2.1% observed in each of the two preceding years, mainly as a result of substantial increases in energy and commodity prices. When reviewing economic and monetary developments and the ECB's monetary policy decisions in 2005 and early 2006, it is useful to divide this time period into two parts.

In the first half of 2005, real GDP growth in the euro area remained moderate and there were heightened uncertainties with regard to the short-term evolution of domestic demand. Annual HICP inflation eased to 2.0% on average in the first half of 2005, mainly reflecting base effects. Although higher oil prices exerted significant upward pressure on inflation, there was no evidence of underlying domestic inflationary pressures building up, as wage developments remained moderate. At the same time, economic analysis identified a number of upside risks to price stability which were perceived to prevail over other, potentially dampening factors on prices. Moreover, monetary dynamics continued to strengthen in an environment of already ample liquidity, driven by the most liquid components of M3 and, on the counterparts side, by faster credit expansion to the private sector. These developments reflected to a large extent the stimulative effect of the very low level of interest rates.

Against the background of subdued domestic inflationary pressures, and with inflation expectations for the euro area as a whole solidly anchored at levels in line with price stability, the Governing Council concluded during the first half of 2005 that it remained appropriate to keep interest rates at their historically low levels. At the same time, it emphasised that the cross-checking of the economic analysis with the monetary analysis supported the case for continued vigilance with regard to the materialisation of risks to price stability over the medium to longer term.

In the second half of 2005, economic activity gradually strengthened and HICP inflation rates rose to levels significantly above 2%, peaking at 2.6% in September, mainly as a result of rising energy prices. In addition, it became increasingly apparent that the upward shift in oil prices would be protracted. Accordingly, in the course of the second half of 2005, the likelihood that average annual HICP inflation would remain above 2% over the medium term increased. Moreover, this scenario of elevated inflation rates remained subject to previously identified upside risks posed by possible further increases in oil prices, a stronger pass-through of past oil price increases, additional rises in administered prices and indirect taxes, and potential second-round effects in wage and price-setting. Furthermore, the monetary analysis continued to point towards increasing upside risks to price stability over the medium to longer term. Monetary growth gained momentum in the third quarter of 2005 and credit expansion to the private sector remained very robust.

Consequently, in the second half of 2005 the Governing Council expressed increasing concern about upside risks to price stability and emphasised the need for strong vigilance with regard to these risks and developments in longer-term inflation expectations. Indeed, by December a first adjustment of the very accommodative stance of monetary policy was clearly warranted. In view of the risks to price stability that had been identified in the economic analysis and confirmed by cross-checking with the monetary analysis, the Governing Council decided on 1 December to increase the key ECB interest rates by 25 basis points, after having kept them unchanged for two and a half years at the historically low level of 2%.

Turning next to more recent developments and assessments, in early March 2006 the outlook for growth and inflation over the medium term that had emerged at the time of the December 2005 decision was confirmed by the incoming data. HICP inflation rates were expected to remain above 2% over the horizon of the Eurosystem staff projections. Upside risks to the inflation scenario prevailed, as implied by the economic analysis and confirmed by the strong monetary and credit growth in an environment of already ample liquidity. The Governing Council thus decided on 2 March 2006 to increase the key ECB interest rates by a further 25 basis points.

The information which has become available since the Governing Council's decision on 2 March 2006 confirms our assessment that a further adjustment of our accommodative monetary policy stance in March was warranted. It is essential that inflation expectations continue to be solidly anchored at levels in line with price stability. Interest rates across the whole maturity spectrum are still at very low levels in both nominal and real terms. Monetary and credit growth remain strong and liquidity abundant. Our monetary policy thus remains accommodative. Both economic analysis and monetary analysis indicate that upside risks to price stability prevail. Accordingly, the Governing Council will continue to monitor very closely all developments, so as to ensure that risks to price stability do not materialise. By maintaining price stability over the medium term, we preserve the purchasing power of households, and by ensuring that inflation expectations are solidly anchored at levels in line with price stability, we help to maintain favourable financing conditions for investors. In this way, we make an ongoing important contribution to sustainable economic growth and job creation.

Fiscal policies and the revised Stability and Growth Pact

The preservation of price stability and the attainment of higher sustainable growth require the support of sound fiscal policies and the implementation of appropriate structural reforms. I would now like to address a number of pertinent economic policy issues, starting with fiscal policy. The spring fiscal notifications point to a euro area general government deficit of around 2.4% of GDP in 2005. Thanks to comparatively strong revenue developments, this outcome is slightly better than the deficit of 2.5% expected a few months ago. However, this improvement has generally not been translated into lower planned deficits: in 2006, according to the updated stability programmes, the euro area general government deficit is expected to decrease only marginally to around 2.3% of GDP, and the debt ratio is set to remain above 70% of GDP. These figures are still of a preliminary nature. In some countries, deficit-debt adjustments (that is, the differences between the change in debt and the deficit) continue to be sizeable. This may be a cause for concern, considering that in some cases in the past such discrepancies were followed by significant upward revisions of the budget deficit.

With regard to the implementation of the revised Stability and Growth Pact, there is no uniform picture emerging across Member States. Overall, progress towards sound public finances remains slow. In general, Member States have defined reasonable medium-term budgetary objectives, and the planned consolidation progress is in most cases in line with the revised framework. However, in some cases the planned pace of consolidation is very slow indeed, and many countries do not have sufficiently concrete or credible plans to comprehensively address the fiscal imbalances.

The implementation of the excessive deficit procedure is broadly consistent with the revised Pact. At the same time, a number of countries continue to report severe imbalances, and some of them have presented plans that barely attain the minimum adjustment called for by the revised Pact, despite the improving growth outlook.

The prospective budgetary costs of population ageing also cast a shadow over the long-term fiscal outlook for most euro area countries. To adequately address the long-term fiscal challenges and support higher sustained economic growth, sound budgetary positions should be pursued in a more determined manner, avoiding reliance on one-off and temporary actions and employing effective policy measures, embedded in a comprehensive reform strategy. Such comprehensive and systematic consolidation and reform efforts will enhance the credibility of the revised Pact, help to establish confidence in a sound and growth-friendly fiscal environment and boost consumer confidence, thus fostering economic activity and employment growth.

The Lisbon strategy

The recent call by the European Council to maintain the momentum of the relaunched Lisbon strategy for growth and employment is very important, and has been explicitly welcomed by the ECB. It is vital for potential output growth and job creation that this initiative is successful and that European citizens can see that it delivers results and eventually increases their welfare. There is a real danger that, with a further delay of reform delivery, Europe may not reap the expected benefits of reforms, including greater market flexibility and efficiency, higher productivity and potential growth, reduced unemployment and price pressures and increased resilience to economic shocks.

We clearly need more reform in almost all policy fields: more reforms of public expenditure as well as of tax and benefit systems, so as to enhance the quality and sustainability of public finances; more measures raising wage and price flexibility; more competition in goods and especially in services markets; more action to achieve a fully operational EU internal market; more steps towards an entrepreneur-friendly business environment; more research & development; more innovation; and better education, training and lifelong learning. It is, therefore, crucial that, at a minimum, the measures announced in the national reform programmes are implemented in a timely and comprehensive manner.

European Monetary Union may have increased the economic incentives for implementing such reforms as differences in cost and price levels between euro area countries have become more visible. However, in recent years a gap has developed between the need for and the actual implementation of reforms. Reducing this gap now requires both a greater public understanding and acceptance of reforms as well as more effective peer support and pressure, through the benchmarking of progress, than is currently in place. In this regard, we support the European Parliament's call to promote best practice across countries by measures such as "an annual league table showing the best and worst performing countries". As emphasised by the European Council, the Lisbon strategy is on the right track. There is a consensus on the objectives and agreement on the necessary institutional setting. What is now needed is a determined focus on the effective and comprehensive implementation of structural reforms.

Euro area enlargement

Let me conclude with a few remarks on a very topical issue – the enlargement of the euro area. As you are aware, both Slovenia and Lithuania have asked the European Commission and the ECB for an examination of whether they have achieved a high degree of sustainable convergence, in line with the Treaty requirements. The ECB is currently in the process of preparing the respective Convergence Report, which will be published on 16 May. I ask for your understanding that I cannot, of course, discuss today the substance of our assessment. What I can confirm, however, is that the ECB will make use of the same framework of analysis employed in the past and that our assessment will build on the same definitions and principles as set out in previous Convergence Reports, so as to guarantee continuity and equal treatment.

Our report will examine both countries' preparedness to adopt the euro by assessing whether a high degree of economic convergence has been attained, and whether such convergence has been achieved in a sustainable manner. The report will also ascertain whether the relevant national legislation is compatible with the Treaty and the Statute of the European System of Central Banks. I am aware that the Commission will be available to explain its Convergence Report to the plenary session of the European Parliament; the ECB would certainly stand ready to do the same with its own report, should such a meeting be desired, and – in this way – to continue the constructive dialogue between our institutions.

I am now at your disposal for questions.