European Central Bank: Press conference – introductory statement

Introductory statement by Mr Jean-Claude Trichet, President of the European Central Bank, Paris, 5 October 2006.

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Ladies and gentlemen, the Vice-President and I are very pleased to welcome you to the press conference here in Paris. I would particularly like to thank Governor Noyer for his kind hospitality and express our special gratitude to the staff of the Banque de France for the excellent organisation of the meeting of the Governing Council.

Let me now 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. Also after today's increase, the key ECB interest rates remain at low levels, money and credit growth are strong, and liquidity in the euro area is ample by all plausible measures. Our monetary policy therefore continues to be accommodative. If our assumptions and baseline scenario are confirmed, it will remain warranted to further withdraw monetary accommodation. The Governing Council will therefore continue to monitor very closely all developments so as to ensure price stability over the medium and longer term.

Turning first to the **economic analysis**, the quarter-on-quarter growth rate of real GDP in the euro area for the second quarter of 2006 was confirmed at 0.9%. Moreover, since our previous meeting on 31 August, Eurostat has revised upwards the growth data for the two preceding quarters, thereby confirming that a significant acceleration in economic expansion has taken place over the past few quarters. On the basis of the revised data, economic activity has been growing at a quarterly rate of 0.7% on average over the last four quarters, the unemployment rate has been on a falling trend, employment growth has recovered and employment expectations overall have remained favourable. All in all, the economic recovery now appears somewhat stronger than on the basis of earlier data. It has become more broadly based and is mainly supported by domestic demand. The available information on activity in the third quarter – coming from various confidence surveys and indicator-based estimates – continues to support the assessment that economic activity will grow robustly while possibly moderating somewhat.

Looking ahead to the remainder of 2006 and 2007, the conditions remain in place for the euro area economy to grow at solid rates around potential, with some volatility in the quarterly growth rates likely to emerge around the turn of the year. Global economic activity has become more balanced across regions and is still robust, thereby providing ongoing support for euro area exports. Investment is expected to remain strong, 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, although the recent fall in oil prices – if it were to prove lasting – has the potential to lead to somewhat stronger demand and output growth than embodied in our baseline scenario for activity in the coming quarters. Over the longer term, risks to growth lie on balance on the downside, and relate 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 fell to 1.8% in September 2006, from 2.3% in August. Although no detailed breakdown is available as yet, this relatively sharp decline seems to be 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 is uncertain, on the basis of current energy prices and the higher quotations on futures markets, overall inflation rates are likely to increase again towards the end of the year and in early 2007. As a consequence, we expect a considerable degree of short-term volatility in the annual HICP inflation rate, while the overall inflation rate will remain elevated at levels above 2% on average in 2006 and is likely to remain so in 2007.

In addition, risks to the outlook for price developments 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 positive signs from 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, in particular 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 8.2% in August and, more generally, the rate of monetary and credit expansion remains rapid, reflecting the still low level of interest rates in the euro area. In particular, loans to the private sector continue to grow at double-digit rates on an annual basis, remaining broadly based across the household and corporate sectors. Taking the appropriate medium-term perspective, these developments remain consistent with the persistent upward trend in the underlying rate of monetary expansion, identified by the ECB's monetary analysis since mid-2004. Moreover, 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 still ample liquidity, as a result of the persistently high rate of monetary expansion over the past few years, point to upside risks to price stability over the medium to longer term. Monetary developments therefore require 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 dynamism of monetary and credit growth in an environment of already 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 term. It is essential that inflation expectations remain firmly anchored at levels consistent with price stability. If our assumptions and baseline scenario are confirmed, it will remain warranted to further withdraw monetary accommodation. The Governing Council will therefore continue to monitor very closely all developments so as to ensure price stability over the medium and longer term.

As regards **fiscal policy**, euro area countries are now in the process of finalising their 2007 budgets and preparing their next stability programme updates. In the current favourable economic environment, it is essential that adequate headway be made towards sound public finances, implying that budget targets for 2007 should generally be more ambitious than in previous programmes. Countries in excessive deficit need to remain fully committed to bringing their deficits to below 3% within the agreed deadline via adequate and credible structural consolidation. Other countries need to make clear progress towards their medium-term objectives in line with the requirements of the Stability and Growth Pact. In all cases, any revenue windfalls from faster than expected growth should be used to speed up deficit reduction or to increase surpluses. Pro-cyclical policies should be avoided and expenditure restraint is of particular importance, also given the high spending ratios and taxes as compared with many other industrialised countries. Experience has shown that expenditure reform is key to successful consolidation, and consolidation is essential for reducing overall public debt and for making public finances less vulnerable to the impact of ageing populations.

Fiscal consolidation is likely to be most successful when coupled with comprehensive **structural reforms**. These are urgently needed to help to cushion the unfavourable economic effects of the projected demographic change in the euro area. The decline in the working age population will place further pressure on pension and health care systems, and may have wide-ranging economic consequences. In order to support the potential economic growth of the euro area, to foster macroeconomic flexibility and dynamism, and to safeguard the future standard of living of our citizens, labour and product market reforms are urgently needed. This will increase labour market participation and employment and strengthen innovation and the other forces driving productivity and economic growth. The ECB will play its part by continuing to maintain price stability over the medium term. We are now at your disposal for questions.