European Central Bank: Press conference – introductory statement

Introductory statement by Mr Jean-Claude Trichet, President of the European Central Bank, Frankfurt am Main, 8 March 2007.

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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 Mr Steinbrück, President of the ECOFIN Council, and Commissioner Almunia.

At today's meeting, we decided to raise the **key ECB interest rates** by 25 basis points. This decision was taken in view of 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 fostering sustainable economic growth and job creation in the euro area. After today's increase, given the favourable economic environment, our monetary policy continues to be on the accommodative side, with the key ECB interest rates moderate, money and credit growth vigorous, 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 fourth quarter of 2006 was 0.9%, which was above previous expectations. Our current assessment is that the quarterly profile of real GDP growth is likely to be somewhat smoother in response to the impact of indirect tax changes in one large euro area country than had originally been anticipated. The strength of real GDP growth in the fourth quarter is thus indicative of ongoing robust growth in the euro area. Both domestic demand and exports made significant contributions to real GDP growth, confirming the sustained and broad-based nature of the current expansion. The information on economic activity from various confidence surveys and indicator-based estimates supports the assessment that robust economic growth has continued into 2007.

Looking ahead, the medium-term outlook for economic activity remains favourable. The conditions are in place for the euro area economy to grow solidly. As regards the external environment, global economic growth has become more balanced across regions and, while moderating somewhat, remains robust, supported in part by lower oil prices. External conditions thus provide support for euro area exports. Domestic demand in the euro area is also 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 corporate 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 ECB staff macroeconomic projections. The projections foresee average annual real GDP growth in a range between 2.1% and 2.9% in 2007 and between 1.9% and 2.9% in 2008. In comparison with the December Eurosystem staff projections, the ranges projected for real GDP growth in 2007 and 2008 have been revised upwards, largely reflecting the strength of GDP growth in the second half of 2006 and the lower energy prices, which, if sustained, would have a positive impact on real disposable income.

In the Governing Council's view, the risks surrounding this favourable outlook for economic growth are broadly balanced over the shorter term. At longer horizons, risks lie mainly on the downside. The main risks relate to the possibility of a renewed increase in oil prices, fears of a rise in protectionist pressures and concerns about possible disorderly developments owing to global imbalances.

As regards price developments, according to Eurostat's flash estimate, annual HICP inflation was 1.8% in February 2007, unchanged from January 2007. The fall in headline inflation rates since the summer of 2006 has been predominantly due to lower energy prices. Looking ahead, last year's volatility in energy prices will lead to significant base effects, affecting the profile of annual inflation rates this year. On the basis of the current level of oil prices and oil price futures, annual inflation rates are likely to fall during the spring and summer before rising again towards the end of the year and then most likely hovering again at around 2%.

The new ECB staff macroeconomic projections foresee annual HICP inflation averaging between 1.5% and 2.1% in 2007 and between 1.4% and 2.6% in 2008. Compared with the December 2006 Eurosystem staff projections, the upper bound of the range projected for inflation in 2007 is somewhat lower, largely reflecting the fall in oil prices. By contrast, the projected range for inflation in 2008 is slightly higher, largely on account of the anticipated stronger economic growth, which could exert more intense pressure on factor utilisation and factor costs. 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 future short and long-term interest rates as well as for oil and non-energy commodity prices.

At the policy-relevant medium-term horizon, the outlook for price developments remains, in the Governing Council's view, subject to upside risks. These relate to 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, stronger than currently expected wage developments would pose significant upward risks to price stability, not least in view of the favourable momentum of real GDP growth observed over the past few quarters. It is therefore crucial that the social partners continue to meet their responsibilities. In this context, wage agreements should take into account price competitiveness positions, the still high level of unemployment in many economies, as well as productivity developments. The Governing Council will monitor the upcoming wage negotiations in the euro area countries very carefully.

The **monetary analysis** confirms the prevailing upside risks to price stability at medium to longer horizons. Annual M3 growth was unchanged at 9.8% in January, thus remaining at the highest rate observed since the introduction of the euro.

At 10.6%, the annual growth rate of loans to the private sector also remained strong in January. Strong growth in private sector credit reflects the continuation of the upward trend in the growth of borrowing by non-financial corporations seen since mid-2004. Meanwhile, in the context of rising mortgage rates throughout the euro area and a slowing increase in house prices in some regions, the growth of household borrowing has shown some further signs of moderation in recent months, albeit remaining at still high rates.

Taking the appropriate medium to longer-term perspective for assessing trends in money and credit growth, the latest developments confirm the continuation of a persistent upward trend in the underlying rate of monetary expansion. Following several years of robust monetary growth, the liquidity situation in the euro area is ample by all plausible measures.

The robust expansion of money and credit reflects the accommodative monetary policy stance over a prolonged period of time and the strengthening of economic activity in the euro area. In an environment of ample liquidity, it points 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 a solid expansion in economic activity and continued strong property market developments in many parts of the euro area.

To sum up, in assessing price trends it is important to look through any short-term volatility in inflation rates. The relevant horizon for monetary policy is the medium term. Risks to the medium-term outlook for price stability remain on the upside, relating in particular to stronger than currently expected wage developments in a context of robust ongoing growth in employment and economic activity. Given the vigorous 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 to longer term. The Governing Council will continue to monitor very closely all developments so that risks to price stability over the medium term do not materialise. This will support the solid anchoring of medium to longer-term inflation expectations in the euro area at levels consistent with price stability. Therefore, looking ahead, acting in a firm and timely manner to ensure price stability in the medium term remains warranted.

As regards **fiscal policy**, there is growing confirmation that the favourable cyclical developments led to better than expected budgetary outcomes in 2006 in a number of countries and in the euro area as a whole. However, updated stability programmes foresee only moderate progress with fiscal consolidation in the coming years. In this respect, some countries' consolidation targets appear not fully in line with the requirements of the revised Stability and Growth Pact. Risks stem in particular from a lack of well-specified and credible measures, notably on the expenditure side of budgets.

Given the favourable economic environment, the Governing Council considers it essential that pro-cyclical policies are avoided in all euro area countries and that sufficiently ambitious fiscal consolidation efforts are made in the countries with remaining budgetary imbalances and/or high public debt outstanding. The opportunity should be seized to attain sound public finances within the programme horizons and by 2010 at the latest in all euro area countries. Fiscal consolidation that is part of a medium-term-oriented, credible and expenditure-based reform strategy would support longer-term output and employment growth and help prepare for the fiscal impact of population ageing.

As regards **structural reforms**, the European Council will discuss the current state of, and future progress in, the implementation of the Lisbon strategy at its meeting which starts today. It is positive to see that reforms and moderate increases in labour costs have helped to bring about higher employment and lower unemployment in recent years, although progress has been uneven across EU Member States. We encourage action to create incentives and structures which support the integration of all groups into the labour market, including those for which employment rates have been relatively low in the past. Reforms of tax and benefit systems should enhance incentives to work and to create jobs. Reducing labour taxes (including social security contributions) and thereby labour costs would support employment, while setting minimum wages at a level not in line with productivity reduces the employment chances of less skilled workers. We fully support policies to improve education and the adoption of technological innovations in order to raise productivity growth. Coupled with initiatives to create a business-friendly environment, such policies would broaden the opportunities of all to participate in an enhanced growth process.

We are now at your disposal for questions.