Lucas Papademos: European Central Bank's Annual Report 2006

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, Strasbourg, 23 April 2007.

* * *

Madam Chair,
Honourable members of the Committee on Economic and Monetary Affairs,

It is a great privilege and pleasure for me to present to you today the ECB's Annual Report 2006. As you know, this is a key aspect of the ECB's accountability obligations towards the European Parliament and we welcome this opportunity to explain our policy decisions and report on our activities to you. In my introductory remarks, I will first briefly review the economic and monetary developments in 2006 and early 2007 and explain the reasons behind the monetary policy decisions that we have taken. I would then like to address a number of policy issues examined in the Annual Report, including issues pertaining to the stability and integration of Europe's financial system.

Before doing so, however, I would like to recall that on 1 January 2007 the euro area welcomed its 13th member, Slovenia. Accession to the euro area is rightly considered a tremendous success for that country. Thanks to the diligent preparations of all parties concerned, the currency changeover from the Slovenian tolar to the euro went very smoothly, to the great satisfaction of everybody involved, especially the people of Slovenia.

Economic and monetary issues

Turning to economic and monetary issues, the euro area economy expanded at a robust pace in 2006: real GDP grew by 2.8% (on a working-day adjusted basis), compared to 1.5% in 2005. The economic upswing was broad-based, with domestic demand being the main driver of economic growth. Sizeable gains in corporate profits and an extended period of favourable financing conditions supported investment growth. In addition, euro area exports continued to benefit from a solid and broad-based global economic expansion. Labour market conditions in the euro area improved significantly last year. Employment rose by more than 2 million, and the unemployment rate decreased further to 7.5% in the fourth quarter of the year. The improvements in the labour market reflected both the rebound in aggregate demand and the impact of labour market reforms in a number of euro area countries.

As regards price developments, average annual HICP inflation was 2.2% in 2006, unchanged from 2005, and above the ECB's definition of price stability, i.e. below but close to 2%. Annual inflation rates exhibited considerable volatility over the year, mainly as a result of developments in energy prices. Overall, labour costs increased moderately and contributed to containing domestic inflationary pressures in the euro area, although the situation varied greatly from country to country. Despite significant inflationary shocks in 2006, and the fact that headline inflation was above 2% throughout most of the year, longer-term inflation expectations remained anchored to price stability.

Nevertheless, risks to price stability remained clearly on the upside throughout 2006, on the basis of the ECB's economic and monetary analyses. In addition to the possibility of further oil price increases, several other risks were identified. These included: the risk of stronger-than-anticipated pass-through of past rises in oil prices; additional increases in administered prices and indirect taxes beyond those already announced; and, more fundamentally, the prospect of stronger-than-expected wage developments and potential second-round effects in wage and price-setting behaviour.

The monetary analysis confirmed, by cross-checking, the assessment of upside risks to price stability. Money and credit growth remained very robust during 2006, mainly reflecting the stimulative effects of the low level of interest rates and the strength of economic activity. The persistent underlying rate of monetary expansion since mid-2004 has resulted in the accumulation of a stock of liquidity which is ample by all plausible measures. A broad-based and comprehensive analysis of these developments pointed to upside risks to price stability over the medium to longer term.

To address the upside risks to price stability, the ECB's Governing Council adjusted the monetary policy stance in 2006 by raising the key ECB interest rates gradually by a total of 125 basis points, reaching the level of 3.50% by December 2006. On 8 March 2007 the Governing Council decided to raise rates by another 25 basis points because it assessed that upside risks to price stability continued to prevail.

The information which has become available since the last meeting of the Governing Council has lent further support to the reasoning behind the decision to raise rates in March. It has also confirmed that risks to the medium-term outlook for price stability remain on the upside. In addition to potential further oil price increases, these risks relate primarily to stronger than currently expected wage developments in an environment of robust growth in employment and activity. In order to sustain robust economic growth and foster job creation, wage agreements should take into account productivity developments as well as the price competitiveness positions and the prevailing high level of unemployment in many economies.

Cross-checking the outcome of our economic analysis with that of our monetary analysis supports the assessment that upside risks to price stability prevail over the medium to longer term. Accordingly, the Governing Council will continue to monitor very closely all developments and ensure that risks to price stability over the medium term do not materialise. Given the favourable economic environment, the Governing Council is of the view that the ECB's monetary policy continues to be on the accommodative side, with the key ECB interest rates moderate, money and credit growth vigorous and liquidity abundant. Consequently, firm and timely action is warranted to ensure price stability over the medium term.

It is precisely because the ECB has always acted in a firm and timely manner in the past years that our monetary policy, with its medium-term orientation, has succeeded in solidly anchoring longer-term inflation expectations at levels broadly consistent with price stability. As explained on various occasions before, it is through the continued anchoring of inflation expectations that monetary policy can make an ongoing contribution towards supporting sustainable economic growth and job creation in the euro area.

Fiscal developments and structural reforms

Fiscal developments in euro area countries in 2006 turned out to be significantly better than anticipated. However, this budgetary improvement was largely the result of buoyant tax revenues in an environment of stronger-than-expected economic growth, offsetting in some cases higher-than-planned public expenditure. Against the background of the current economic "good times", it remains essential to step up the pace of fiscal consolidation in 2007 and beyond, allowing unexpected tax revenue to be fully allocated to deficit and debt reduction. After all, common sense dictates that "the best time to repair the roof is when the sun is shining". It is important that all euro area countries achieve their medium-term objective of a sound fiscal position as soon as possible, and by 2010 at the latest. Furthermore, pro-cyclical fiscal policies should be avoided in all countries. It is vital to ensure fiscal sustainability in view of ageing populations in order to support long-term growth and facilitate the conduct of a stability-oriented monetary policy.

With regard to structural reforms, euro area countries have become increasingly aware in recent years of the need to adjust to the challenges of increased global competition, ageing populations and accelerating technological change. Countries should make the best use of the current "good times" to make further progress on the path of economic reform, especially in view of the positive response of the supply side of the economy to the reforms implemented over the past few years. Employment has risen significantly, by more than 12 million people since the launch of the euro, and the unemployment rate has steadily declined to the lowest level since 1993, although it is still unacceptably high. Moreover, we have recently witnessed an increase in productivity growth. Although this seems to be mainly associated with cyclical factors, there is some evidence that, in certain sectors of the European economy, and in a number of euro area countries, efficiency gains of a structural or permanent nature are being achieved. For the euro area as a whole, however, it is too early to reach definite conclusions. In order to foster higher and sustained economic growth and job creation and enhance the capacity of euro area countries to adjust to shocks, further reforms are needed that can contribute to improving the efficiency, flexibility and adaptability of product, labour and financial markets.

Financial stability outlook

I would now like to address a number of issues concerning financial stability and integration in the euro area. As you know, the ECB monitors and analyses risks to financial stability in order to assess the financial system's shock-absorbing capacity. At the end of 2006, our assessment suggested that the main scenario for euro area financial stability remained broadly favourable. Various considerations underpinned this judgement, including: first, global economic activity was expected to remain robust and become more evenly balanced; second, the credit quality of banks' key counterparties – households and firms – generally remained high; and third, euro area banks' profitability was anticipated to strengthen further, their solvency ratios comfortably exceeded regulatory requirements and risk management methods had greatly improved. Against the background of the positive macroeconomic outlook and benign financing conditions, and in the light of the latest information on the euro area banks' performance, that assessment has been confirmed.

At the same time, several pre-existing sources of risk and vulnerability remain and some of them might even have grown in importance. Among the vulnerabilities in financial markets, I would like to highlight the following three: first, the low levels of long-term yields and credit spreads in some markets make them vulnerable to a reappraisal of risks; second, unabated growth in the volume and complexity of new financial instruments, combined with the increasing presence of lightly regulated and highly leveraged financial institutions in the same markets could have made them vulnerable to disruptive adjustments with possibly unforeseen consequences as it is not always clear where the risk exposures ultimately lie; and third, rapid re-leveraging in some parts of the euro area corporate sector, partly induced by a surge in leverage buy-out activity, makes a turn in the credit cycle increasingly probable.

The global financial market turbulence of late-February and early-March of this year vividly highlighted the existence of some of these market vulnerabilities. It seems to have reflected an abrupt reappraisal and re-pricing of risks in response to a combination of triggering events, especially a rising concern about rapidly deteriorating credit quality in the US sub-prime mortgage market and, more generally, increased uncertainty about the macroeconomic outlook in the United States. This temporary increase in financial market volatility served to illustrate how an abrupt decline in risk appetite, when asset prices may have departed from intrinsic values, can result in very sharp changes in asset valuations, even when changes in the economic fundamentals are relatively small.

Looking ahead, in this context of what we have called "pricing for perfection" – in the sense that some asset valuations appear to be based on highly optimistic expectations about future economic outcomes and very low risk premia – some markets could continue to prove vulnerable to adverse disturbances and changing market sentiment. Added to this, there is uncertainty about how markets for innovative and complex financial instruments (in particular, structured credit derivatives) will perform and how lightly regulated and highly leveraged financial institutions will behave in a more challenging macrofinancial environment.

That said, financial innovation and the growth of alternative investment vehicles, such as hedge funds, have had, in our assessment, an overall positive effect on financial markets in Europe, contributing significantly to enhanced market liquidity and greater pricing efficiency, portfolio diversification and a better distribution of risks within the financial system. However, hedge funds' activities are also associated with potential operational and systemic risks. Moreover, the monitoring and management of these risks by their counterparties and investors have become more complex. An appropriate level of transparency is therefore important for effective market discipline and for the assessment and management of risk by the counterparties of such institutions and by investors.

A final point I would like to stress with regard to the activities of the Eurosystem in the field of financial stability concerns its ability to cope with a possible financial crisis affecting the euro area. To this end, the Eurosystem carried out a comprehensive financial crisis simulation exercise in May 2006 which confirmed its preparedness to deal with potentially systemic events that could affect the euro area's financial system. This exercise also contributed to the enhancement of the existing arrangements for managing financial crises.

European financial integration

Before closing, I would like to say a few words on European financial integration. A well-integrated financial system in Europe is beneficial for the European economy for a number of important reasons: it promotes economic growth by raising the economy's growth potential and adaptability; it enhances the smooth and effective transmission of monetary policy impulses across the euro area; and it is expected to positively affect financial and macroeconomic stability. Although intensified cross-border financial links may imply potentially an increased risk of financial contagion, the improved risk-sharing made possible by deeper and more integrated markets should contribute to a more balanced systemic response of the economy to asymmetric shocks – which is, of course, of particular relevance for the smooth functioning of Economic and Monetary Union. This is not a theoretical argument. The evidence available for the United States shows that banking integration across the federal states has led to a better alignment of business cycles and a reduction in the volatility of economic activity, employment and personal income growth across the United States.

Given the importance of financial integration for the reasons I have mentioned, the ECB actively seeks to promote this process through a variety of measures, for example the provision of central banking services that foster integration and the regular monitoring and reporting on the progress of financial integration with a view to enhancing knowledge and raising awareness of this process. In line with the latter objective, the ECB launched in March a new annual publication entitled "Financial integration in Europe", which provides, among other things, an overview of the main Eurosystem activities pursued in 2006 that contributed to advancing European financial integration.

Thank you very much for your attention. I am now at your disposal for questions.