

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, Frankfurt am Main, 10 April 2008.

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Ladies and gentlemen, the Vice-President and I are very pleased to welcome you to our press conference. Let me report on the outcome of our meeting, which was also attended by Commissioner Almunia.

On the basis of our regular economic and monetary analyses, we decided at today's meeting to leave the **key ECB interest rates** unchanged. The latest information has confirmed the existence of strong short-term upward pressure on inflation. In fact, we are experiencing a rather protracted period of temporarily high annual rates of inflation, resulting mainly from increases in energy and food prices. The latest information also clearly confirms our assessment of prevailing upside risks to price stability over the medium term, in a context of continuing very vigorous money and credit growth. The economic fundamentals of the euro area are sound. Incoming macroeconomic data continue to point to moderate but ongoing real GDP growth. However, the level of uncertainty resulting from the turmoil in financial markets remains unusually high and tensions may last longer than initially expected. Against this background, we emphasise that maintaining price stability in the medium term is our primary objective in accordance with our mandate. The firm anchoring of medium to longer-term inflation expectations is of the highest priority to the Governing Council and there is certainly no room for complacency in this regard. We believe that the current monetary policy stance will contribute to achieving our objective. The Governing Council remains strongly committed to preventing second-round effects and the materialisation of upside risks to price stability over the medium term. We will continue to monitor very closely all developments over the coming weeks.

Allow me to explain our assessment in greater detail, starting with the **economic analysis**.

According to Eurostat's second estimate, quarter-on-quarter real GDP growth in the fourth quarter of 2007 was 0.4%, following 0.7% in the previous quarter. The latest information on economic activity also underpins previous expectations of moderate but ongoing growth in the first quarter of 2008. Overall, the euro area economy has sound fundamentals and does not suffer from major imbalances.

Looking ahead, both domestic and foreign demand are expected to support ongoing real GDP growth in the euro area in 2008, albeit to a lesser extent than during 2007. While moderating, growth in the world economy is expected to remain resilient, benefiting in particular from strong growth in emerging economies. This should continue to support euro area external demand. Meanwhile, investment growth in the euro area should provide ongoing support to economic activity, as capacity utilisation is high, profitability has been sustained and there are no significant signs of supply constraints on bank loans. At the same time, as a result of the improved economic conditions and wage moderation, employment and labour force participation have increased significantly and unemployment rates have fallen to levels not seen for 25 years. While being dampened by the impact of higher energy and food prices on purchasing power, consumption growth should continue to contribute to economic expansion, in line with real disposable income growth.

The uncertainty surrounding this outlook for economic growth remains high, and downside risks prevail. The risks relate mainly to the financial market turbulence, which could last longer than initially thought and could have a broader than currently expected impact on the

real economy. Moreover, downside risks also stem from the dampening impact on consumption and investment of further unanticipated increases in energy and food prices, as well as from protectionist pressures and the possibility of disorderly developments owing to global imbalances.

With regard to price developments, according to Eurostat's flash estimate, the annual HICP inflation rate was 3.5% in March 2008, after 3.3% in February. This outturn confirms the ongoing strong and lately further increasing short-term upward pressure on inflation, resulting largely from sharp increases in energy and food prices in recent months. Looking ahead, the annual HICP inflation rate is likely to remain significantly above 2% in the coming months, moderating only gradually over the course of 2008. Accordingly, we are currently experiencing a rather protracted period of temporarily high annual rates of inflation.

The risks to the outlook for inflation over the medium term remain clearly on the upside. These risks include the possibility of further rises in energy and food prices, as well as of increases in administered prices and indirect taxes beyond those foreseen thus far. Most importantly, there is a risk that price and wage-setting behaviour could add to inflationary pressures. In particular, the pricing power of firms, notably in market segments with low competition, may prove stronger than currently expected, and stronger than expected wage growth may emerge, taking into account high capacity utilisation and tight labour market conditions.

Against this background, it is imperative that all the parties concerned meet their responsibilities. Second-round effects stemming from the impact of higher energy and food prices on wage and price-setting behaviour must be avoided. In the view of the Governing Council, this is of key importance in order to preserve price stability in the medium term and thereby the purchasing power of all euro area citizens. The Governing Council is monitoring wage negotiations in the euro area with particular attention. In this context, the Governing Council is concerned about the existence of schemes in which nominal wages are indexed to consumer prices. Such schemes involve the risk of upward shocks in inflation leading to a wage-price spiral, which would be detrimental to employment and competitiveness in the countries concerned. The Governing Council therefore calls for such schemes to be avoided.

The **monetary analysis** confirms the prevailing upside risks to price stability at medium to longer-term horizons. Annual M3 growth remained very vigorous at 11.3% in February, supported by the continued strong growth of MFI loans to the private sector. While annual M1 growth has moderated further in recent months, as higher short-term interest rates have increased the opportunity cost of holding the most liquid components of M3, the growth of time deposits remains extremely strong. This reflects the relatively flat yield curve, which has made it more attractive to hold monetary assets remunerated at close to market rates than to hold riskier, longer-maturity instruments. Overall, the impact of the flat yield curve and a number of other temporary factors suggest that annual M3 growth currently overstates the pace of the underlying monetary expansion. However, even after taking such effects into account, a broad-based assessment of the latest data confirms that the underlying rate of money and credit growth remains strong.

The growth of household borrowing has moderated over recent months, reflecting the impact of higher key ECB interest rates since December 2005 and cooling housing markets in several parts of the euro area. However, the growth of loans to non-financial corporations has remained very robust. Bank borrowing by euro area non-financial corporations grew at an annual rate of 14.8% in the year to February 2008. Overall, bank loans to the domestic private sector have grown at around 11% on an annual basis for the past two years.

For the time being, there is little evidence that the financial market turbulence seen since early August 2007 has strongly influenced the overall dynamics of broad money and credit aggregates. Notwithstanding the tightening of credit standards reported in the bank lending

survey for the euro area, continued strong loan growth to non-financial corporations suggests that the supply of bank credit to firms in the euro area has not been significantly impaired by the financial turmoil thus far. Further data and analysis will be required in order to obtain a more complete picture of the impact of the financial market developments on banks' balance sheets, financing conditions and money and credit growth.

To sum up, a **cross-check** of the outcome of the economic analysis with that of the monetary analysis clearly confirms the assessment that upside risks to price stability prevail over the medium term, in a context of very vigorous money and credit growth and with no significant signs of supply constraints on bank loans to households and non-financial corporations. The economic fundamentals of the euro area are sound. Incoming macroeconomic data continue to point to moderate but ongoing real GDP growth. However, the level of uncertainty resulting from the turmoil in financial markets remains unusually high and tensions may last longer than initially expected. Against this background, we emphasise that the firm anchoring of medium to longer-term inflation expectations is of the highest priority to the Governing Council. We believe that the current monetary policy stance will contribute to achieving this objective. The Governing Council remains strongly committed to preventing second-round effects and the materialisation of upside risks to price stability over the medium term. We will continue to monitor very closely all developments over the coming weeks.

Regarding **fiscal policies**, the intentions reflected in the latest round of stability programmes imply a rise in the euro area general government deficit ratio in 2008. Further fiscal pressures are likely to arise as overly optimistic macroeconomic assumptions are already being revised downwards and political demands for fiscal loosening are increasing. In this situation, countries with fiscal imbalances are urged to make further progress with structural consolidation, in line with the requirements of the Stability and Growth Pact. At the current juncture, particularly prudent and stability-oriented fiscal policies would also contribute to containing inflationary pressures.

Turning to **structural reforms**, we welcome the launch of the 2008-10 cycle of the renewed Lisbon strategy for growth and jobs by the European Council. The favourable labour market trends in the euro area suggest that economic reforms are paying off. However, many challenges remain as overall employment is still below the Lisbon target of 70% and unemployment is still unacceptably high. Moreover, productivity growth remains weak, constraining general income growth. Therefore, we strongly encourage euro area countries to increase reform efforts, in particular to foster market integration and to reduce rigidities in product and labour markets that restrict competition, employment flexibility and wage differentiation, and we support them in these efforts. They would not only promote employment and support potential growth, but would also contribute to moderating price pressures.

We are now at your disposal for questions.