Lucas Papademos: Economic outlook in the euro area

Statement by Mr Lucas Papademos, Vice-President of the European Central Bank, at the 2008 Asia-Europe (ASEM) Finance Ministers' Meeting, Jeju, Korea, 16 June 2008.

* * *

Introduction

It is a great pleasure for me to participate in the ASEM Finance Ministers' Meeting. In my statement, I will focus on the economic outlook in the euro area, with special emphasis on inflation prospects and risk, the monetary policy stance of the European Central Bank (ECB), recent financial market developments and our assessment of the outlook for financial stability.

Economic outlook

The pace of economic activity in the euro area is expected to decelerate in 2008 and 2009 from the robust 2.7% GDP growth rate recorded last year. The Eurosystem staff projections, published on 5 June 2008, foresee annual real GDP growth in the range between 1.5% and 2.1% in 2008, and between 1.0% and 2.0% in 2009. Recent growth forecasts for the euro area by the European Commission, international institutions and organisations and the private sector are broadly in line with the Eurosystem staff projections.

All in all, our latest assessment, based on the macroeconomic projections produced by the staff of the Eurosystem, and our analysis of the most recent information, from data and survey indicators, confirms the expectation of moderate but ongoing economic growth.

Both domestic and foreign demand are expected to support GDP growth in 2008. The resilience of global economic growth, which benefits from the robust economic activity in emerging market economies, should support euro area exports. Domestic factors, however, are expected to contribute the largest part of euro area growth in both 2008 and 2009. In particular, non-residential private investment is expected to provide support to economic activity, as capacity utilisation remains high and profitability has been sustained in the non-financial corporate sector.

This outlook for economic growth is surrounded by continuing high uncertainty and downside risks prevail. The financial market turmoil could have a more adverse impact on the real economy than currently anticipated. In addition, further unanticipated increases in energy and food prices could have dampening effects on consumption and investment. There are also risks stemming from the possible emergence of protectionist pressures and from the still large, though declining, global imbalances.

Turning to price developments, the outlook for price stability in the euro area has deteriorated and the risks to this outlook remain on the upside and they have increased. Annual inflation has remained above 3% over the past seven months and it is estimated to have increased to 3.6% in May 2008, reaching again the ten-year peak recorded in March. These developments confirm the persistence of strong upward pressures on euro area inflation, which are largely the result of the sharp increases in energy and food prices at the global level in the previous months.

Domestic inflationary pressures have also intensified. They partly reflect the accumulation of price pressures, also driven by higher energy and commodity prices in the initial stages of the production chain that have not yet reached the consumer level. Producer price inflation rose to a new peak at 6.1% in April. Moreover, after a period of contained labour cost increases, an acceleration of wage growth was visible in the first quarter of 2008. The pick-up of wage growth could continue in 2008 in an economic environment characterised by tight

labour markets, high capacity utilisation and persistently high inflation involving the risk of second-round effects.

According to the June Eurosystem staff projections, average annual inflation is expected to be between 3.2% and 3.6% in 2008 and between 1.8% and 3.0% in 2009. These projections are based on the assumptions that external price pressures will diminish over the projection horizon, in line with futures prices for oil and agricultural commodities, and that there will be no broad-based second-round effects on wages. Given these assumptions, it is likely that the annual inflation rate will remain above 3% for a protracted period of time before it moderates only gradually in 2009.

The medium-term outlook for prices continues to be subject to a number of upside risks. These risks include, on the external side, possible further increases in energy and food prices beyond those foreseen thus far, and, on the domestic side, the risk of broad-based second-round effects in wage and price setting. This latter risk is greater in market segments with low competition, such as parts of the services sector, where the pricing power of firms may prove stronger than currently expected. Moreover, higher-than-expected wage growth may emerge, taking into account high capacity utilisation, tight labour market conditions and the elevated inflation perceptions and expectations of consumers. In addition, the continuing very vigorous money and credit growth confirms the assessment that upside risks to price stability prevail over the medium and longer term.

Monetary policy

Against this background – the prospect of stronger and more protracted inflationary pressures than previously envisaged and the assessment of the increased upside risks to price stability over the medium term – the Governing Council indicated that it is in a state of heightened alertness and ready to act in a firm and timely manner to prevent second-round effects and ensure that risks to price stability over the medium term do not materialise. The Governing Council also emphasised its commitment to maintain price stability in the medium term and its strong determination to secure a firm anchoring of medium and long-term inflation expectations in line with price stability.

Financial markets

Let me now turn to financial market developments and the financial stability outlook in the euro area. The financial system of the euro area is still undergoing further adjustment as the processes of risk repricing and de-leveraging continue. The stresses on the financial system have persisted longer and they have become broader and deeper than anticipated six months ago.

Although there have been some signs of easing tensions in certain markets since mid-March, elevated pressures remain in others, notably in the term money markets of major currencies. Moreover, high uncertainty surrounds the future dynamics of property prices, the magnitude of possible further asset valuation write-downs by financial institutions and the effects of the market turmoil on the broader economy.

Over the past two months, money, credit and other financial markets appear to be sending mixed signals. The term money market spreads between euro deposit and EONIA swap rates have remained high and close to record levels, for maturities from three to twelve months. Tensions in the term money market continue to be a global phenomenon. Currently, the spreads between three-month deposit and overnight-indexed swap rates are virtually the same in the euro, US dollar and pound sterling money markets.

In the credit markets, greater risk awareness by banks and increased bank funding costs have been reflected in the significant and general further tightening of lending standards in the euro area, the UK and the US. At the same time, credit default swap (CDS) indices in

Europe and the US have declined since mid-March (though recently they have increased somewhat), the availability of bank credit to households and non-financial corporations in the euro area has not been significantly affected by the financial market turbulence, and corporate bond spreads have narrowed Moreover, the functioning of the leveraged loan market is showing some tentative signs of improvement.

With regard to the impact of the market correction on bank profits, the write-downs disclosed by many euro area financial institutions went far beyond the expectations of late last year. Although major euro area banking groups did report large write-downs, these were significantly smaller than the income losses disclosed by their European peers from outside the euro area and by large US banking groups. More write-downs are expected to be revealed in 2008 and these expectations have been broadly confirmed by the financial results reported for the first quarter of 2008.

The disclosure of the full-year 2007 financial results of euro area major banking groups revealed that the subprime-related turmoil has had a material impact on their profitability, but their capital buffers remained largely intact in 2007. Looking ahead, it can be expected that the profitability of these institutions will be adversely affected this year as the process of de-leveraging continues and as spillovers to asset markets and the real economy materialise. The expected slowdown in profit growth is a consequence of possible further valuation losses, increased funding costs, as well as declining non-interest income from securitisation and capital market activities.

Financial stability outlook

With regard to the outlook for financial stability, according to our assessment (recently published in the June 2008 edition of the ECB Financial Stability Review) the risks to euro area financial system stability, on balance, have increased in 2008. And, indeed, since the beginning of the year, some of the risks previously identified have materialised. Conditions in the US housing market have further deteriorated, valuations losses endured by large banks were larger than anticipated at the end of 2007, and banks have tightened their lending standards significantly.

Looking ahead, the risk of de-leveraging by euro area large banks of sufficient severity to induce a significant shortage of credit in the economy appears rather low. However, the financial stability outlook remains highly uncertain and depends, among other things, on the following three factors: First, how conditions in the US housing market develop; second, how banks respond to a much more challenging operating environment; and third, the extent to which initiatives and measures aimed at restoring confidence and strengthening financial system resilience are eventually implemented.

It is probable that the adjustment process within the financial system will be protracted as banks continue to strengthen their liquidity and capital positions. This means that balance sheet expansion is likely to be somewhat curtailed in the period ahead. So far, however, the availability of bank credit to households and non-financial corporations has not been significantly affected by the financial market turbulence.

Given the heightened uncertainty and an environment in which balance sheet conditions could change unexpectedly, vigilance by financial institutions and market participants is of the essence and those with relevant exposures will need to step up their efforts to effectively manage the risks that may lie ahead. I would like to conclude on a positive note by recalling that the losses disclosed so far by the financial institutions affected by the turmoil are mostly mark-to-market losses on hard-to-value assets. If the outturns for implied credit losses ultimately prove less severe than currently expected, then it cannot be ruled out that those financial firms still holding these assets will see some offsetting valuation gains in their portfolios.