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, 5 February 2009.

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Ladies and gentlemen, the Vice-President and I are very pleased to welcome you to today's press conference. We will now report on the outcome of today's meeting of the Governing Council, which was also attended by Commissioner Almunia.

On the basis of its regular economic and monetary analyses, at today's meeting the Governing Council decided to leave the **key ECB interest rates** unchanged. As anticipated in our interest rate decision of 15 January 2009, the latest economic data and survey information confirm that the euro area and its major trading partners are undergoing an extended period of significant economic downturn, and that accordingly both external and domestic inflationary pressures are diminishing. We continue to expect inflation rates in the euro area to be in line with price stability over the policy-relevant medium-term horizon, thereby supporting the purchasing power of euro area households. This assessment is supported by available indicators of inflation expectations for the medium term. It is also confirmed by the further deceleration in monetary and credit growth in the euro area. Fully in line with its primary objective, the Governing Council will continue to keep inflation expectations firmly anchored in accordance with its definition of price stability, that is inflation rates of below, but close to, 2% over the medium term. This supports sustainable growth and employment and contributes to financial stability. Overall, the level of uncertainty remains exceptionally high. Accordingly, we will continue to monitor very closely all developments over the period ahead.

Allow me to explain our assessment in greater detail, starting with the **economic analysis**. Reflecting the impact of the intensified and broadened financial market turmoil, economic activity throughout the world, including in the euro area, has weakened substantially. Foreign demand for euro area exports has declined, and domestic factors, notably very low confidence and tight financing conditions, have adversely affected domestic demand. Taken together with other available economic data for the euro area, this points to very negative quarter-on-quarter real GDP growth in the last quarter of 2008.

This information is in line with our current analysis and forward-looking assessment. We continue to see persistent weakness in economic activity in the euro area over the coming quarters, as the financial market tensions have a further impact on the global and domestic economy. At the same time, the very substantial fall in commodity prices seen since the middle of 2008 should support real disposable income, and thus consumption, in the period ahead. Most recently, there have been tentative signs of stabilisation in some survey data, albeit at historically low levels. These indications, however, require confirmation on a broader basis.

In the view of the Governing Council, the outlook for the economy remains surrounded by an exceptionally high degree of uncertainty. Overall, risks to economic growth remain clearly on the downside. They relate mainly to the potential for a stronger impact on the real economy of the turmoil in financial markets, as well as to concerns about the emergence and intensification of protectionist pressures and to possible adverse developments in the world economy stemming from a disorderly correction of global imbalances.

Over time, the euro area should reap the benefit of the effects of significant policy measures that have been decided upon over recent months to deal with the financial turmoil. They should help to restore trust in the financial system and to ease constraints on credit supply to companies and households. In order to ensure that such measures effectively support a sustainable recovery, it is of the utmost importance that they remain focused and temporary in nature so as to maintain a stability-oriented and medium-term perspective in macroeconomic policy-making.

With regard to price developments, annual HICP inflation continued to decline in January 2009, falling to 1.1%, according to Eurostat's flash estimate, from 1.6% in December 2008. While no detailed breakdown for HICP developments in January is available as yet, the decline in headline inflation observed since the middle of 2008 primarily reflects the sharp falls in global commodity prices over this period, owing mainly to weak global demand.

Looking ahead, lower commodity prices and the prospect of weak demand confirm our assessment of mid-January that inflationary pressures in the euro area are diminishing. Owing mainly to base effects stemming from the past behaviour of energy prices, headline annual inflation rates are projected to decline further in the coming months, possibly reaching very low levels at mid-year. However, also owing to base effects stemming from past energy price developments, inflation rates are expected to increase again in the second half of the year. Accordingly, it is likely that HICP inflation rates will fluctuate sharply during 2009. Such short-term volatility is, however, not relevant from a monetary policy perspective. Looking over the policy-relevant medium-term horizon, annual HICP inflation is expected to be in line with price stability. This assessment is supported by available indicators of inflation expectations for the medium term.

Regarding risks to price stability over the medium term, unexpected further declines in commodity prices or a stronger than expected slowdown in the economy could put downward pressure on inflation, while upside risks to price stability could materialise, particularly if the recent fall in commodity prices were to reverse or if domestic price pressures turn out to be stronger than assumed. It is therefore crucial that price and wage-setters fully live up to their responsibilities.

Turning to the **monetary analysis**, the latest evidence confirms a continued deceleration in the underlying pace of monetary expansion in the euro area, supporting the view that inflationary pressures are diminishing.

In analysing monetary developments it should be recognised that the intensification and broadening of the financial turmoil since September 2008 has the potential to affect the evolution of monetary aggregates significantly. It has already had a substantial impact on the behaviour of market participants, as indicated by recent money and credit data. Both the broad aggregate M3 and, in particular, the components of M3 that are most closely related to the ongoing financial tensions – such as holdings of money market funds – have shown high month-to-month volatility of late. Overall, looking to the extent possible through this volatility, the underlying pace of broad money expansion continues to decelerate gradually from the peak seen in early 2007. However, the intensification of financial tensions since September 2008 is leading to significant substitution among the components of M3.

Turning to the evolution of bank credit, the flow of MFI loans to the private sector moderated in the course of 2008, largely on account of weakness in loans to households, especially for house purchase. In December, however, outstanding MFI loans to non-financial corporations contracted for the first time since the onset of the financial turmoil, confirming the significant weakening of corporate credit at the end of the year after a long period of dynamic growth. At the same time, the substantial reduction in key ECB interest rates since October 2008 appears to have been passed through to lower bank lending rates, thereby easing financing conditions for companies and households. Moreover, there are some indications that the pace of tightening of bank credit standards is stabilising, albeit at high levels by historical standards. Overall, the incoming information on financing conditions requires continuous close monitoring.

To sum up, as anticipated in our interest rate decision of 15 January 2009, the latest economic data and survey information confirm that the euro area and its major trading partners are undergoing a period of significant economic downturn, and that accordingly both external and domestic inflationary pressures are diminishing. We continue to expect inflation rates in the euro area to be in line with price stability over the policy-relevant medium-term horizon, thereby supporting the purchasing power of euro area households. This assessment is supported by available indicators of inflation expectations for the medium term. It is also confirmed by a **cross-check** of the outcome of the economic analysis with that of the monetary analysis, against the background of a further deceleration in monetary and credit growth in the euro area. Fully in line with its primary objective, the Governing Council will continue to keep inflation expectations firmly anchored in accordance with its definition of price stability, that is inflation rates of below, but close to, 2% over the medium term. This supports sustainable growth and employment and contributes to financial stability. Overall, the level of uncertainty remains exceptionally high. Accordingly, we will continue to monitor very closely all developments over the period ahead.

Turning to **fiscal policy**, the European Commission projects in its January 2009 interim forecast a substantial rise in the average euro area government budget deficit, to 4.0% of GDP this year, from 1.7% in 2008. This rapid deterioration of the fiscal position is broad-based among euro area countries and is due to the economic downturn, additional revenue shortfalls and the fiscal stimulus measures adopted by many governments. In 2009 seven euro area countries are currently expected by the Commission to exceed the 3% of GDP reference value for the budget deficit. In addition, many governments have assumed large contingent liabilities in connection with the guarantees provided to banks and will need to finance the capital injections in support of the financial sector. To support the public's confidence in the sustainability of public finances, it is therefore essential that governments return to a credible commitment to medium-term budgetary objectives as soon as possible.

As regards **structural policies**, it is important to continue on the long-term reform path foreseen by the Lisbon agenda. At the current juncture, it is essential to pursue economic policies in line with the principle of an open market economy with free competition, resisting any protectionist pressure. Moreover, product and services market reforms should foster competition and help to speed up effective restructuring. Labour market reforms should help to facilitate appropriate wage-setting, as well as labour mobility across sectors and regions. This will be particularly important for those areas and sectors hit strongly by the negative demand shock. In several countries, it is also crucial to take measures with a view to addressing competitiveness losses accumulated over recent years.

We are now at your disposal for questions.