European Central Bank: Press conference - introductory statement

Introductory statement by Mr Jean-Claude Trichet, President of the European Central Bank, Frankfurt am Main, 2 March 2006.

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Ladies and gentlemen, let me welcome you to our press conference and report on the outcome of today's meeting of the ECB's Governing Council. The meeting was also attended by the President of the Eurogroup, Prime Minister Juncker, and Commissioner Almunia.

At today's meeting, we decided to increase the **key ECB interest rates** by 25 basis points. This decision reflects the upside risks to price stability that we have identified on the basis of both our economic and monetary analyses. The adjustment of interest rates will contribute to ensuring that medium to long-term inflation expectations in the euro area remain solidly anchored at levels consistent with price stability, which is a prerequisite for monetary policy to make an ongoing contribution towards supporting economic growth and job creation in the euro area. Interest rates across the entire maturity spectrum still remain at very low levels in both nominal and real terms, and our monetary policy remains accommodative. While this policy stance reflects our current assessment, we will continue to monitor closely all developments with respect to risks to price stability.

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

According to Eurostat's flash estimate, quarter-on-quarter real GDP growth in the euro area was 0.3% in the fourth quarter of 2005. This was considerably lower than the strong 0.6% recorded in the previous quarter. However, looking through the short-term volatility and assessing recent economic indicators and survey information, the evidence suggests that economic activity is improving. Accordingly, we should see stronger growth rates over the short term, as also reflected in various indicator-based estimates.

Looking further ahead, the conditions remain in place for ongoing economic expansion in the euro area. The external environment remains favourable, providing support for euro area exports. Investment is expected to remain strong, benefiting from an extended period of very favourable financing conditions, corporate balance sheet restructuring and gains in earnings and business efficiency. Consumption growth should also strengthen gradually over time, in line with developments in real disposable income, as the labour market situation gradually improves.

The March ECB staff macroeconomic projections have provided an additional input into our analysis of the prospects for economic activity. These projections foresee average annual real GDP growth in a range between 1.7% and 2.5% in 2006, and between 1.5% and 2.5% in 2007. The results constitute a slight upward revision to the Eurosystem staff projections of December 2005, mainly reflecting a somewhat stronger outlook for private investment over the projection horizon. Most recent forecasts by international organisations and private sector institutions give a broadly similar picture. In the view of the Governing Council, downside risks to this outlook for growth relate mainly to oil price developments and global imbalances.

Turning to price developments, according to Eurostat's flash estimate, annual HICP inflation was 2.3% in February 2006, compared with 2.4% in January. In the short run, inflation rates are likely to remain at above 2%, with the precise levels depending strongly on future energy price developments, which have recently been relatively volatile. Beyond the short term, changes in administered prices and indirect taxes are expected to significantly affect inflation in 2006 and 2007, and an upward impact can also be expected from the indirect effects of past oil price increases. At the same time, wage dynamics in the euro area have remained moderate over the recent past; our working assumption is that this will continue to be the case, due not least to strong global competitive pressures, particularly in the manufacturing sector. Moderate wage trends have helped to contain domestic inflationary pressure despite strong oil price increases. Therefore, looking ahead, it is crucial that the social partners continue to meet their responsibilities in this regard, also in the context of a more favourable economic environment.

Further input into our assessment of the outlook for price developments is again provided by the March ECB staff projections. Annual HICP inflation is projected to lie between 1.9% and 2.5% in 2006, and between 1.6% and 2.8% in 2007. Compared with the December 2005 Eurosystem staff projections, these ranges imply a slight upward revision to the profile for HICP inflation over the coming years, reflecting mainly an increase in the assumption for future oil prices, in line with market expectations.

Risks to the outlook for price developments remain on the upside and include further increases in oil prices, a stronger pass-through of oil price rises into consumer prices than currently anticipated, additional increases in administered prices and indirect taxes, and – more fundamentally – stronger wage and price developments than expected due to second-round effects of past oil price increases.

Turning to the **monetary analysis**, the Governing Council has again discussed the assessment of monetary developments in depth. The annual growth rate of M3 remains robust, notwithstanding signs of a resumption of the unwinding of past portfolio shifts into monetary assets, which exerts a dampening effect on headline M3 growth. Looking through the short-term effects generated by such portfolio behaviour, the trend rate of monetary expansion remains strong, reflecting the stimulative impact of the low level of interest rates. Moreover, the annual growth rate of credit to the private sector has strengthened further over recent months, with borrowing by households – especially loans for house purchase – and non-financial corporations rising at a marked pace. Overall, strong monetary and credit growth in an environment of ample liquidity in the euro area points to risks to price stability over the medium to longer term.

To sum up, annual inflation rates are projected to remain elevated in 2006 and 2007, and the economic analysis indicates that risks to price stability over the medium term remain on the upside. Given the strength of monetary growth and the ample liquidity situation, **cross-checking** the outcome of the economic analysis with that of the monetary analysis confirms that upside risks to price stability prevail. An adjustment of interest rates was therefore warranted. By acting in a timely fashion, the Governing Council is helping to keep medium and long-term inflation expectations in line with price stability and thereby making an ongoing contribution to sustainable economic growth and job creation. The Governing Council will continue to monitor closely all developments to ensure that risks to price stability do not materialise.

As regards **fiscal policies**, while some countries plan to maintain or attain budgetary positions close to balance or in surplus over the horizon of their stability programmes, progress towards sound public finances in the euro area as a whole remains slow. A number of countries continue to report severe imbalances, and in some of them consolidation efforts barely attain the minimum required by the revised Stability and Growth Pact, despite the improving growth outlook. At the same time, the fiscal costs of population ageing cast a shadow over the long-term fiscal outlook for most euro area countries. It is therefore essential that countries pursue a more determined consolidation, introducing concrete and effective measures where needed. These consolidation efforts will more easily succeed if they are embedded in a comprehensive reform programme that adequately prepares for the long-term fiscal challenges. This will enhance the credibility of the revised Pact and create confidence in a sound and growth-friendly fiscal environment.

The broader implications of population ageing also require attention in other fields of economic policy. Comprehensive **structural reforms** in labour and product markets and the creation of a favourable and competitive environment for firms are vital to support potential growth and raise employment rates as the demographic effects materialise. Completing the EU internal market – including the market for services – should be a key priority. On the labour supply side, tax and benefit system reforms are essential to provide stronger incentives for people to stay in or enter the labour market. On the labour demand side, there is a need to promote wage flexibility and address labour market rigidities. Moreover, better education and training are important for the development of human capital. The forthcoming meeting of the European Council on 23-24 March 2006 will review progress made with the Lisbon strategy, which was relaunched last year. We strongly support the initiatives taken by the European Commission and the European Council to revive this reform process. A full and effective realisation of the necessary reforms is the key to the long-term economic success of the European Union.

We are now at your disposal for questions.