

## **Jean-Claude Trichet: Presentation of the ECB's Annual Report 2005 to the European Parliament**

Introductory statement by Mr Jean-Claude Trichet, President of the European Central Bank, to the European Parliament, Strasbourg, 26 October 2006.

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Monsieur le Président, Mesdames et messieurs les députés,

C'est pour moi un grand honneur et un grand plaisir de m'exprimer aujourd'hui devant vous. Je suis ici pour présenter au Parlement européen, comme le prévoit le Traité, le Rapport annuel 2005 de la BCE. Mais comme vous le savez, les relations entre le Parlement et la BCE vont au-delà des obligations spécifiques qui sont imposées par le Traité. De fait, nous avons établi, au fil des années, un dialogue très étroit qui – je tiens à le souligner – s'est intensifié au cours de cette année. Ce mois-ci, c'est la troisième fois que j'interviens devant vous. De même, mes collègues au sein du Directoire de la BCE ont été en contact étroit avec le Parlement européen concernant diverses questions, telles que la réforme du FMI, les systèmes de paiement et les systèmes de compensation et de règlement. Pour notre part, nous attachons la plus grande importance aux contacts portant sur ces questions.

Ich werde Ihnen zunächst einen kurzen Überblick über die wirtschaftlichen und geldpolitischen Entwicklungen im Jahr 2005 geben und die geldpolitischen Maßnahmen der EZB erläutern. Danach möchte ich einige Anmerkungen zu Punkten und Vorschlägen machen, die Sie in Ihrem Entwurf einer Entschließung zum Jahresbericht 2005 der EZB vorgebracht haben.

### **Economic and monetary issues**

Let me first of all welcome the assessment of the Economic and Monetary Affairs Committee as regards the ECB's monetary policy in 2005 and beyond. As recognised in the draft report, the ECB's monetary policy – which is designed to fulfil our primary objective of maintaining price stability – has continued to be successful in anchoring inflation expectations at levels consistent with price stability, despite a number of challenges, in particular relating to the continued strong surge in oil prices until the most recent period of time. As already emphasised on several occasions, such anchoring is a prerequisite for monetary policy to make an ongoing contribution towards supporting sustainable economic growth and job creation in the euro area, fully in line with Article 105 (1) of the EC Treaty.

In this respect, let me emphasise that the ECB's open and transparent communication is a key element in guiding market expectations. In particular, my Introductory Statement at the press conference after the first Governing Council meeting each month provides a clear view, on the part of the Governing Council, on the current monetary policy stance in real time. Hence, we make the outcome of our deliberations public. As such, the Introductory Statement is comparable with what other central banks call "summary minutes".

In 2005, the ECB's monetary policy operated in an environment of increasingly improving economic conditions. While real GDP growth remained moderate in the first half of the year, in an environment of heightened uncertainties surrounding domestic demand, the pace of economic activity gradually strengthened during the second half of the year, from around 1.2% year-on-year on average in the first half of 2005 to around 1.7% year-on-year on average in the second half. Overall, real GDP in the euro area grew by 1.4%.

As regards price developments, annual HICP inflation averaged 2.2% in 2005, compared to 2.1% in each of the two preceding years. While annual HICP inflation eased to 2.0% in the first half of 2005, mainly reflecting base effects, HICP inflation rates accelerated to levels significantly above 2% during the second half, reaching a peak of 2.6% in September, mainly on the back of substantial increases in energy prices.

Thus, reviewing the ECB's monetary policy decisions in 2005 and early 2006, it is useful to split this time period in two parts. In the first half of 2005, against the background of subdued inflation developments and with inflation expectations for the euro area solidly anchored at levels in line with price stability, the Governing Council concluded that it remained appropriate to keep interest rates at their historically low levels. At the same time, the Governing Council was constantly alert with regard

to the materialisation of upside risks to price stability, as signalled by both the ECB's economic and monetary analyses.

In the second half of 2005 and early 2006, the likelihood that average annual HICP inflation could remain above 2% over the medium term increased and a spill-over to inflation expectations had to be avoided. This scenario of elevated inflation rates remained subject to previously identified upside risks, notably further increases in oil prices and indirect taxes and, particularly, potential second-round effects in wage and price-setting. It was also confirmed by the monetary analysis, given strong monetary growth, robust credit expansion and ample liquidity.

As a consequence, by the end of 2005, the regular cross-checking of the ECB's economic and monetary analyses indicated that an adjustment of the very accommodative stance of the ECB's monetary policy was clearly warranted in order to contain upside risks to price stability and preserve the firm anchoring of long-term inflation expectations in the euro area. Therefore, in December, the Governing Council of the ECB decided to raise the key ECB interest rates by 25 basis points, after two and a half years of maintaining these rates at historically low levels. Since then the Governing Council has continued to withdraw monetary accommodation, thereby establishing the minimum bid rate of the main refinancing operations of the Eurosystem at 3.25% by now.

Turning to recent developments, all the main indicators of economic activity in the euro area that have become available in the course of 2006 confirm the Governing Council's assessment that economic growth has gained momentum and, in addition, become more broadly-based and sustained, mainly supported by domestic demand.

With regard to consumer prices, annual HICP inflation rates, notwithstanding their decline in most recent months, will remain elevated, at levels above 2% on average in 2006. As regards 2007, inflation risks remain on the upside. These risks include, in particular, a stronger than expected rise in wages on the back of improving labour markets and a stronger than expected pass-through of past oil price rises. The assessment of upside risks prevailing is confirmed when cross-checked with the monetary analysis, given the ongoing dynamism of monetary and credit growth, ample liquidity and, from a medium-term perspective, a persistent upward trend in the underlying rate of monetary expansion. Monetary developments therefore require enhanced monitoring, in particular against the background of improved economic conditions and strong property market developments in many parts of the euro area.

As I said publicly on behalf of the Governing Council after our last decision, if our assumptions and baseline scenario are confirmed, it will remain warranted to further withdraw monetary accommodation. The Governing Council will therefore continue to monitor very closely all developments so as to ensure price stability over the medium to longer term.

As regards fiscal policy, budgetary developments in 2005 and 2006 and plans for 2007 point to further, albeit slow improvements in budget balances. However, this should not give rise to complacency. It remains of the essence that budgetary consolidation is strengthened in the current upswing and that pro-cyclical policies are avoided, which would boost the confidence of both the markets and the public.

As regards structural reforms, I welcome the view of the European Parliament that comprehensive structural reforms are needed to raise the potential growth rate of the euro area and underpin the momentum of the ongoing economic recovery. In this respect, the reform measures initiated in the context of the renewed Lisbon Strategy were a welcome additional step in the right direction. The successful implementation of national reforms aimed at removing rigidities and inefficiencies in euro area countries would improve the smooth functioning of EMU and facilitate the conduct of the ECB's single monetary policy.

## **Other issues raised in the European Parliament's draft resolution on the ECB's Annual Report 2005**

Mister President, honourable members of the European Parliament, in your draft resolution you raise a large number of issues of relevance to the ECB and I would like to assure you that we will consider them with great care. On two issues I already should like to share our assessment, in view of their topical nature and the exchanges of views I and my fellow Members of the Executive Board had with you on these issues.

In the draft resolution, the ECB is called upon to carry out further analysis in the area of hedge funds. Amid the increasing attention being paid to the activities of hedge funds, I think that it would be unfair

not to mention their role as regards enhancing market liquidity, providing significant diversification opportunities for investors, and fostering financial innovation. That being said, it is clear that there are potential risks for financial stability from their very rapidly growing presence in the financial system and it has yet to be tested whether they would amplify market volatility or pose greater counterparty risks in a less benign financial market environment. Against that background, the ECB will definitely follow-up on your request for further analysis. I do not exclude that we will conclude that there is a real case for enhancing the present framework which relies essentially on the vigilance of the financial institutions that are themselves under supervision as regards their counterparty risks on the hedge funds. But I also note that any such enhancement should be agreed upon at the level of the International Community and, in particular, on the basis of an appropriate transatlantic discussion.

As regards payment and settlement issues, let me first thank the European Parliament for the support expressed for the implementation by November 2007 of the TARGET2 system. Being an integrated large-value payment system, TARGET2 will provide for efficiency gains and improved liquidity management by banks. In this regard, I should like to refer to an increased pressure to also have an integrated platform for the settlement of securities transactions in euro. The Eurosystem is therefore currently examining, in co-ordination with the European Commission and in close co-operation with the market, the feasibility of setting up a Eurosystem infrastructure for the provision of securities settlement services in central bank money. A decision on whether to offer such a service, referred to as "TARGET2-Securities", is expected in early 2007. In the field of retail payments, we strongly support the efforts to establish a Single Euro Payment Area (SEPA). We welcome the EU Commission's initiative for a Directive on Payment Services and I warmly welcome European Parliament's contribution to a swift adoption of this directive to assist the banking industry in their implementation of SEPA payment instruments as from 1 January 2008.

I thank you very much for your attention. I am now available to answer your questions.