Otmar Issing: Testimony before the Committee on Economic and Monetary Affairs of the European Parliament

Introductory statement by Professor Otmar Issing, Member of the Executive Board of the European Central Bank, in Brussels, 20 March 2002.

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Today, I would like to review economic developments in the euro area in the context of the monetary policy strategy of the ECB. Before doing this, allow me to mention that we are extremely pleased to see that the euro cash changeover went so smoothly. There were no significant technical problems in this complex logistical process and the fact that national banknotes were largely withdrawn well before the final deadline of their ceasing to be legal tender confirms that the European public became familiar with the new banknotes and coins very quickly. The Governing Council would like to express its gratitude once more to all those who helped to make the euro cash changeover such a success.

Turning to monetary policy, let me start with some remarks on the first pillar of the ECB's monetary policy strategy. In 2001, the annual rate of M3 growth doubled from a low of almost 4% in March to 8% in November, before declining slightly in January 2002. From June 2001 onwards, M3 growth stood clearly above the reference value of 4½%. However, the Governing Council has so far assessed that these developments do not imply risks to price stability over the medium term. Let me explain in some more detail this assessment. As you are well aware, the Governing Council of the ECB does not react in a mechanistic way to deviations of M3 growth from its reference value. Rather, it conducts a thorough analysis of monetary analysis with a view to derive information about the outlook for price stability in the medium term. This analysis is based on clear evidence of high M3 growth leading to inflation over the medium term in the euro area. However, in addition, we need to take into account that monetary developments are at times affected by a number of temporary factors such as changes in tax regulations or, as has been the case, turmoil in financial markets. Hence, an appropriate assessment of monetary developments always needs to take a medium-term perspective and in addition requires a detailed knowledge of their underlying factors.

The year 2001 highlighted the importance of taking a broad-based approach to monetary analysis. M3 growth in 2001 was driven to a significant extent by a number of factors which we continue to judge as not indicating upward risks to price stability over the medium-term. Let me just point to one important factor, namely the fact that M3 growth was significantly influenced by portfolio decisions of economic agents. Initially, the relatively flat yield curve until August 2001 and the persistent decline in stock prices until September seemed to induce many investors to shift parts of their portfolios out of the capital markets and into shorter-term assets, such as those included in M3. Subsequently, in the aftermath of the events of 11 September, the exceptional rise in economic and financial uncertainty led to further shifts out of longer-term assets and into low-risk, liquid instruments included in M3.

In addition, let me point to the substantial decline in the growth of loans to the private sector in 2001. This contrasting development of money and loans is a feature which clearly distinguishes the monetary situation in 2001 from that in 1999, when the strengthening of M3 growth was accompanied by very strong loan dynamics. Hence, our overall assessment was that monetary developments in the euro area in 2001 have so far not indicated risks to price stability.

However, this assessment needs to be continuously checked, because what matters in monetary analysis are the medium-term trends. It will therefore be crucial to monitor how M3 develops this year. Should a moderation in monetary growth not materialise the implications of monetary developments for risks to price stability may need to be reassessed, in particular in conjunction with a stronger economic recovery in the euro area. On the basis of the available evidence on the fundamental long run stability of money demand in the euro area, which has not been affected by the events of 2001, the analysis of monetary developments over the medium term thus remains crucial for assessing future inflation. It is also worth pointing out that the strong increase in liquidity in 2001 was not specific to the euro area but was a global phenomenon which pointed to the existence of common (financial market) factors influencing monetary developments as well as reflecting the stance of monetary policy in the major economies in 2001.

Turning now to the second pillar, recent data releases have been providing further evidence on the improvement of economic conditions in the euro area. This has in turn increased the likelihood that the economic cycle reached a trough at the end of last year.

Starting with external developments, there are indications of a gradual firming of economic activity, which should in turn lead to a gradual strengthening of the external demand for euro area products and services. These developments certainly reinforce the expectation of an upturn in economic activity in the euro area in 2002. The recovery should be supported by continuous favourable financing conditions and the significant positive impact of past and expected future declines in inflation on real disposable income. In addition, the recovery should not encounter any fundamental impediments, given the lack of major economic imbalances in the euro area which require a longer adjustment process. Recent data point to a recovery starting moderately in early 2002 and accelerating in the course of the year, an assessment that seems to be shared by expectations formed in financial markets. Our expectation is that real GDP growth might be in line with potential towards the end of 2002. Overall, however, we still face significant uncertainty as regards the strength of the economic upswing this year.

Turning to price developments, the current outlook for a gradual economic recovery in the euro area should imply that inflationary pressures stemming from economic activity are likely to remain subdued for some time. In fact, the downward trend in annual HICP inflation observed since May 2001 is expected to continue in the coming months. However, annual inflation rates are, as expected, undergoing some volatility in the first few months of this year. The pick-up in HICP inflation in January 2002 has to be seen in this light. It was partly due to base effects stemming from falling energy prices in early 2001 and to higher indirect taxes in some euro area countries early this year. The increase also reflected a considerable rise in unprocessed food prices due to adverse weather conditions in some parts of Europe and a slight increase in energy prices at the start of 2002. In the next few months, the effects of past increases in energy and food prices should gradually subside, as the data for February 2002, when annual HICP inflation declined to 2.4% from 2.7%, have already indicated, and annual inflation rates should fall to below 2%.

It is now well known that there is no evidence that the euro cash changeover has had a significant upward effect on the average price level in the euro area. While we have observed some significant increases in some sub-components of service price inflation, we have also seen other prices rounded down in the context of the cash changeover. In our view, and also replying to one of the questions addressed to the ECB in the letter of the Chairperson of this Committee a few weeks ago, it is expected that the greater transparency resulting from the introduction of the euro and the move to exclusive euro pricing will strengthen competition in the retail sector and thereby support the maintenance of price stability in the euro area.

Besides uncertainty about the oil price, a key factor in the current assessment of risks to price stability is the development of wages. The Governing Council will closely monitor forthcoming wage negotiations and analyse their implications for future price developments. A favourable outlook for price stability in the euro area rests fundamentally on the assumption that wage moderation will continue. This is also a major condition for employment growth and decline in unemployment.

In this respect, and following up to the letter from the President of the ECB to the Chairperson of this Committee, let me briefly recall that the Governing Council is very satisfied with its definition of price stability, which – by the way – is fully consistent with the goals pursued by the most successful national central banks in the euro area prior to Stage Three of Economic and Monetary Union. It is worth pointing out that this quantitative definition, namely an annual increase of below 2% in the HICP for the euro area, is symmetric, i.e. it is also definitely not compatible with deflation. Furthermore, by also stating that price stability is to be maintained "over the medium term", the Governing Council acknowledges the existence of shocks to inflation which monetary policy cannot control and makes clear that the ECB intends to pursue its objective by responding differently to different economic shocks. This consideration may lead, in some cases, to a gradual response by monetary policy to risks to price stability. Our forward-looking strategy with its medium-term orientation towards maintaining price stability thus helps to avoid harmful trade-offs with growth and employment. Most importantly, our definition of price stability has contributed to anchoring inflation expectations in the euro area, thereby reducing risk premia and ultimately supporting an efficient allocation of resources and favourable long-term financing conditions for the economy. For all these reasons, the maintenance of price stability over the medium term is the best contribution of monetary policy to sustainable growth and employment creation.

Turning to the main challenges that the euro area faces at present, let me start by mentioning that stability-oriented macroeconomic policies require further steps towards fiscal consolidation. The recently reaffirmed commitment of the governments of the euro area countries with fiscal imbalances to avoid breaching the 3% deficit limit this year and to adhere to the objective of achieving balanced budgets by 2003-2004 is the appropriate policy to pursue. The Governing Council supports the actions taken by the European Commission in the context of the Stability and Growth Pact and the subsequent outcome of the ECOFIN Council meeting last month. In this same vein, vigilance is necessary to ensure strict adherence to the medium-term plans and implementation of the existing procedures. In particular, countries that still have sizeable fiscal imbalances should take advantage of the coming upswing to strengthen their budgetary positions and attain the targets presented in their stability programmes.

Finally, in order to put the expected recovery on a broad and sustainable basis, it is of the utmost importance that euro area countries now strengthen their efforts to implement comprehensive structural reforms. Over the past few years, considerable progress has been made in enhancing the flexibility of the euro area's product and capital markets, as well as in improving the way its labour markets operate. These reforms, together with moderate wage developments, have contributed to the strong employment growth and the considerable reduction in unemployment witnessed in many euro area countries in the last cyclical upswing. However, unemployment is still intolerably high and much more remains to be done.

In this context, it is important to make headway with the reform agenda put forward in the Lisbon strategy. We should just not accept that the recovery might again be constrained by the unsatisfactory potential growth level. The sound macroeconomic situation which can be expected presents a perfect opportunity to accelerate badly needed reforms. This requires the acceleration of financial market reforms as well as product markets reforms, such as those related to network industries. As regards labour market reforms, it is worth noting that despite the continued high level of unemployment in the euro area significant mismatches between labour supply and demand in a number of areas in euro area countries are still reported. As concluded in a recent report prepared by Eurosystem experts, published on 11 March, this provides evidence that despite some improvements, there is still much work to be done in the labour market reform process. With respect to reform on the financial markets, the ECB very much supports the implementation of the procedures suggested in the Lamfalussy report on securities regulation. The ECB believes that the procedures suggested in this report will allow for a swift implementation of the priorities set out in the Financial Services Action Plan relating to the integration of securities markets. The reform of financial market regulation, also including the other measures foreseen in the Action Plan, will complement and enhance the effects of reform in the labour and product market.