Willem F Duisenberg: The euro area - recent developments and the economic outlook

Opening remarks by Dr Willem F Duisenberg, President of the European Central Bank, of the panel on "Recent developments in the world economy"at the 2nd international conference organised by the Banco de Mexico, Mexico City , 12 November 2002.

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Ladies and gentlemen,

It gives me great pleasure to chair this panel today and to speak before such a distinguished audience. In my opening remarks, I will briefly touch on recent economic developments in the euro area and on our assessment of current developments in the economic outlook.

Although, earlier this year, we were expecting a relatively pronounced *economic recovery* in the euro area, since the summer it has become increasingly clear that this scenario of rapid acceleration will not materialise. Over recent months, a high degree of uncertainty - stemming mainly from developments in stock markets and geopolitical tensions - has taken its toll on confidence worldwide. These developments have weakened the pace of growth in the euro area. Recent data and information suggest that activity in the euro area has continued to grow only moderately in the third quarter of 2002 and available evidence also points to only moderate rates of growth of real GDP at the turn of the year.

Still, for the time being, the main scenario for the euro area remains that economic growth is expected to return to rates close to potential in the course of 2003. This expectation is consistent with all available forecasts by international organisations and by leading private forecasters. Moreover, financial markets have shown signs of stabilisation in recent weeks following a period of considerable turbulence.

The expectation of an improvement in economic activity in the euro area is contingent on a recovery of growth in private consumption, which should be supported by growth in real disposable income and a correction of high perceived inflation rates towards those of actual rates, which are lower. This expectation is also conditional on a projected gradual recovery in foreign demand in line with expected stronger growth in the world economy which, together with low interest rates, should lead to a resumption of stock building and stronger investment. However, this main scenario is still surrounded by considerable uncertainty, and it is difficult to determine precisely both the strength and the timing of the economic upswing in the euro area and globally.

Turning to price developments, *euro area inflation* is currently slightly above 2%, the upper limit of our definition of price stability. Annual headline inflation rates in the euro area are likely to remain above 2% for the remainder of 2002 and even increase slightly around the turn of the year. Despite the recent decline in oil prices, changes in administered prices and some adverse base effects on the most volatile components could have some upward impact and delay the return to inflation rates below 2%. However, these developments should be temporary.

Looking further ahead to the prospects for inflation, let me start by reviewing the liquidity situation, as evidenced in monetary developments, which is an important part of our analysis of risks to price stability over the medium term. At present, there is more liquidity in the euro area than would be needed to finance sustainable, non-inflationary growth. This is due in part to the low level of interest rates in the euro area, which is fuelling the demand for liquid assets. However, the continued strength of monetary growth is also due, to a large extent, to portfolio shifts into M3. These shifts occur for precautionary reasons in an environment of high financial market uncertainty. In view of this, and given the current environment of subdued economic activity, we do not see a high risk of this translating into inflationary pressure in the near future.

The continuing strengthening of the euro since early this year together with the weak pace of economic growth in the euro area are in fact dampening inflationary pressure. However, for annual inflation rates to fall below 2% in the course of 2003 and for them to remain in line with our definition of price stability thereafter, it is crucial that oil prices do not significantly increase again and that the upward movement in labour cost indicators in the euro area, which has been taking place over recent years, does not continue. These indicators have shown a notable inertia despite the subdued economic expansion.

At the last meeting of the Governing Council of the ECB on 7 November, in view of the high uncertainty on future economic growth and its implications for medium-term inflationary developments, we discussed extensively the arguments for and against a cut in the key ECB interest rates. The overall view was to keep interest rates unchanged. In the same statement, however, we also said that we will monitor closely the downside risks to economic growth in the euro area, in view of their potential dampening effect on inflationary pressures.

Let me now briefly turn to fiscal policies, an issue that is currently receiving particular attention in Europe. Let me remind you that that the principle of budgetary discipline enshrined in the Treaty and the Stability and Growth Pact establishes that Member States should maintain over the medium term fiscal positions close to balance or in surplus and ensure that they do not breach at any time the ceiling on the fiscal deficit of 3% of GDP. It is the Governing Council's view that these rules are indispensable for Economic and Monetary Union and are also in the interest of the Member States. The Stability and Growth Pact has been successful in promoting sound public finances in the euro area. As a result, 8 of the 12 euro area countries have reached budget positions which are "close to balance or in surplus", a development which has helped to support the maintenance of price stability and growth in employment and real GDP. These 8 countries are now in a position to let the automatic stabilisers work in full, as envisaged by the Pact.

The other 4 countries still have to make progress to achieve the medium-term requirements of the Pact. These countries now need a credible consolidation policy that will be supportive to the outlook for economic growth, as direct short-term effects on demand should be counteracted by a higher credibility for the conduct of fiscal policy, boosting confidence and thus private spending. In this regard, the full implementation of the Stability and Growth Pact is particularly important at the current juncture.

In this same vein, the euro area should implement the reforms needed to reduce the structural rigidities in its labour and goods markets. This would not only increase trend potential growth over the medium term, but also make the euro area economy more resilient to economic shocks. Under the current circumstances, rapid and decisive action would be a very important contribution to support confidence in the euro area.

Thank you.