

Willem F Duisenberg: Testimony before the Committee on Economic and Monetary Affairs of the European Parliament

Introductory statement by Dr Willem F Duisenberg, President of the European Central Bank, Brussels, 3 December 2002.

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It is my pleasure to continue today our regular dialogue. I will start my opening remarks with an explanation of the European Central Bank's assessment of economic and monetary developments. Subsequently, I will address some issues related to the EU arrangements for financial regulation, supervision and stability.

Economic and monetary developments

Already at the time of our last meeting in October, the expectation had faded that economic activity in the euro area would reach growth rates in line with trend potential by the end of 2002. In the course of the summer, the downside risks to economic growth had become evident, reducing the likelihood that upward risks to price stability would materialise. This development was mainly related to the episodes of turbulence in financial markets and to the persistence of geopolitical tensions, which created uncertainty and affected the outlook for economic activity in the euro area and at the global level.

Starting with the first pillar of our monetary policy strategy, since our last meeting monetary growth has remained rather strong in the euro area. However, recent monetary data need to be interpreted with caution, as the dynamics in M3 over recent months have been considerably boosted by high uncertainty in financial markets, which has favoured portfolio shifts to the more liquid instruments included in M3. At the same time, the persisting strong monetary growth and the resulting ample liquidity have also been driven by the low level of short-term interest rates, which stimulates demand for the most liquid assets which are included in the narrow aggregate M1. Loans to the private sector have stabilised at growth rates between 5 and 5 ½% in the most recent past. These are levels which, in real terms, are not low given the cyclical situation.

Overall, more liquidity is available than would be needed to finance sustainable, non-inflationary growth. At the same time, in the current economic environment, we do not see the risks of this excess liquidity translating into inflationary pressures in the near future.

Turning to the second pillar of the ECB's monetary policy strategy, and starting with economic activity, the available evidence indicates that economic activity has most likely continued to grow only moderately in the third quarter of this year. As already noted, the hesitant pace of economic activity, as compared with our expectations in early 2002, together with lacklustre confidence, reflects the significant degree of uncertainty that has been building up over recent months. Early indications for the fourth quarter of 2002 suggest that the pace of economic growth has remained broadly unchanged.

For the time being, the main scenario for the euro area remains that economic growth should return to rates close to potential in the course of 2003. This expectation is consistent with forecasts published by international organisations and private institutions. In addition, financial markets have shown signs of stabilisation in recent weeks, although volatility in the stock markets has remained high by historical standards. The expectation of an improvement in economic activity in the euro area is contingent on the unwinding of the current high level of uncertainty and on a recovery of growth in private consumption, which has shown signs of resilience in the recent past. In addition, this expectation is also based on a gradual recovery of world demand which, together with the low levels of interest rates, should help to strengthen investment.

However, there are several downside risks to this scenario. They relate to the persistence of macroeconomic imbalances in the global economy, geopolitical tensions and the uncertainty about the size of the adverse effects of the past sharp declines in stock prices on aggregate demand in the euro area and in the other major regions of the world. Moreover, risks also stem from the fact that structural rigidities in the euro area economy do not facilitate the process of price and wage adjustments to external shocks. Thus, overall, it remains difficult to predict at this juncture the timing and strength of the acceleration of economic activity.

Regarding price developments, annual HICP inflation rates have been slightly above 2% in recent months. These annual HICP inflation rates are likely to increase in the remainder of 2002 and stay above 2% in the early months of next year, mainly on account of base effects and increases in indirect taxes and administered prices in a number of countries. Subsequently, however, HICP inflation rates should fall again, and provided that oil prices do not increase significantly and wage moderation prevails, reach levels in line with our definition of price stability in the course of 2003. Looking further ahead, both the strengthening of the euro exchange rate this year and the subdued economic activity continue to contribute towards reducing inflationary pressures. Furthermore, for price pressures to be contained, it is crucial that the upward trend in labour cost indicators observed in recent years does not continue. The notable inertia in wages despite the subdued economic expansion has been of some concern, although recent developments may suggest that wage costs have not accelerated further in the course of this year.

At our last monetary policy meeting on 7 November we discussed extensively whether or not to reduce the key ECB interest rates, in view of the high uncertainty surrounding future economic growth and its implications for medium-term inflationary pressures. Summing up, there were elements in favour and against both alternatives. On the one hand, the subdued trends in economic activity and the stronger exchange rate of the euro supported the view that inflationary pressures should decline. On the other hand, the stubbornly persistent rate of inflation excluding the volatile components of energy and food prices as well as monetary and wage trends, argued for caution. Overall, on that occasion the view to keep the key ECB interest rates unchanged prevailed. However, we also indicated that we needed to monitor the downside risks to economic growth for their impact on medium term inflationary pressures.

Since our last meeting, the evidence has strengthened that inflationary pressures are easing somewhat and downside risks to economic growth have not vanished.

Regarding fiscal policy in the euro area, I would like to reiterate that budgetary discipline is indispensable for the success of EMU. Fiscal discipline strengthens the conditions for strong sustainable growth conducive to employment. Sound fiscal positions also provide scope for dealing with the expected fiscal challenges caused by population ageing. Clearly, therefore, sound public finances, as enshrined in the Treaty and further developed in the Stability and Growth Pact, are in the interest of all Member States.

I want to stress that the current fiscal framework strikes the right balance between discipline and flexibility. By prescribing a medium-term objective of budgetary positions close to balance or in surplus, the Stability and Growth Pact guarantees that fiscal policies will preserve the sustainability of public finances while providing sufficient flexibility for automatic fiscal stabilisers to operate.

While it is clear that, for many – partly formal – reasons, annual budgetary targets always need to be set in nominal terms, the assessment of fiscal policies naturally must take into account cyclical developments. Though the discussion surrounding this issue may, at times, appear confusing, it does not reflect a flaw in the Pact as some critics claim.

In this context, it is worth recalling that most Member States have reached budget positions which are "close to balance or in surplus". Current fiscal problems in other countries have arisen not because the rules are inflexible, but because countries have not honoured their commitments to make progress in fiscal consolidation, particularly during good times. It is now high time for the countries with deficits approaching or even exceeding 3% of GDP to honour their commitment to respect the rules. We very much support the Eurogroup agreement that all countries with remaining imbalances should undertake to fulfil their commitments by implementing a clear consolidation strategy. And we very much believe that a growth-oriented consolidation policy – which aims at strengthening the productive forces of the economy – will be an important means to strengthen the economic prospects for the euro area at this juncture.

Additional efforts regarding transparency and timeliness in the implementation of the procedures of the Pact are also necessary. They will help convince the public that the current framework is fully successful in preserving discipline and providing flexibility. In this context, the Commission recently issued a communication which aims to clarify certain aspects of the fiscal framework while strengthening its main principles and objectives. The ECB considers this a good starting-point for rebuilding confidence in the budgetary policy framework.

Finally, neither the discussion on monetary or fiscal policy, nor the current economic outlook should divert attention from the need to implement decisively the structural reform agenda. We note with some concern that progress is slow in many countries of the euro area. I should like to emphasise that

the benefits of these reforms for the economic growth potential of the euro area are likely to be substantial. While these benefits will only be fully reaped over the medium term, I believe that reforms would be particularly important at the current juncture. Indeed, determined structural reforms in labour, product and financial markets should make a significant contribution to strengthening confidence, making the euro area more attractive for investors. In the end, this will also support economic growth in the short term.

Issues related to the EU arrangements for financial regulation, supervision and stability

Today, the ECOFIN Council is considering adapting the EU structures for financial regulation, supervision and stability. The ECB keenly supports the basic thrust of such proposals, namely to reduce barriers to further financial integration and to maintain systemic stability in financial markets, which have become increasingly interconnected in a single currency area. Against this background, the respect of the subsidiarity principle in supervisory matters necessitates enhanced co-operation between national authorities.

The ECB has repeatedly stressed that in the banking sector close and effective co-operation between central banks and supervisory authorities is crucial for the promotion of financial stability, a point that I am glad to see strongly backed also in recent resolutions of the European Parliament. The ECB has also emphasised that technical authorities need to be represented in regulatory committees and that any new arrangements for financial stability should draw on the technical expertise at central banks and supervisory agencies. All these points are reflected in the proposals endorsed by the ECOFIN Council in October.

Now the crucial phase is beginning when the ability of the new arrangements to meet the high expectations they are raising will be tested in practice. The measure of success will be whether the overall rulebook, with which financial institutions operating throughout the EU have to comply, becomes more homogeneous across countries. This will require a fine re-balancing of primary and secondary Community legislation and national rulebooks, which should be conducted in a transparent manner by the committees to be set up under the new supervisory regime, paying careful attention to the costs of compliance. The review of the new arrangements that was requested by the European Parliament will offer an appropriate tool for checking the progress made. Let me conclude by highlighting that supervisory authorities and central banks should step up information sharing and develop joint assessments. This will also allow the effectiveness of the new arrangements in supporting financial stability in the Single Market to be tested.