# 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, 17 February 2003.

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It is my pleasure to appear before your Committee today. As usual, I will begin my introductory remarks by reporting to you on the ECB's assessment of economic and monetary developments, before turning to the ECB recommendation on the adjustment of voting modalities in the Governing Council, which the ECB adopted following the entry into force of the Treaty of Nice and on which the European Parliament and the European Commission have been invited to give their opinion.

## 1. Economic and monetary developments

In its first meeting of December 2002, the Governing Council of the ECB decided to lower the key ECB rates by 50 basis points. The basis for this decision was the assessment that the prospect for inflation to fall below 2% in the course of 2003, against the background of subdued economic growth, and for it to remain in line with price stability thereafter, had strengthened. With this move, the key ECB interest rates reached a very low level by historical standards.

Before turning to our assessment of the current economic outlook for the euro area, I would like to report that on 5 December 2002 we also reviewed the reference value for monetary growth, which plays an important role under the first pillar of the ECB's monetary policy strategy. The Governing Council decided to leave the current value unchanged at an annual growth rate of 4½% for the broad aggregate M3, as the evidence continues to support the assumptions which have formed the basis of the derivation of the reference value since 1999, namely a trend potential output growth of 2-2½% per annum and a trend decline in M3 income velocity of ½-1% per annum in the euro area.

When comparing current developments with the reference value, it is important to bear in mind that the assessment of monetary developments is essential for long-term trends in inflation and that the reference value is therefore to be seen as a medium-term concept. Short-term movements of M3 do not necessarily have implications for future price developments. Moreover, deviations of M3 from the reference value must be analysed in conjunction with other real and financial indicators in order to understand their implications for price stability.

Turning to our current assessment on the outlook for price stability in the euro area, and starting with the first pillar, M3 growth remained high in the last quarter of 2002. The continued strength in monetary growth reflects an ongoing pronounced preference for liquidity in an environment of high financial, economic and geopolitical uncertainty. In addition, the low level of interest rates in the euro area makes the holding of liquid assets relatively attractive. Overall, although liquidity remains ample, it is unlikely at this stage that it will give rise to inflationary pressures, given the current economic environment and the expectation that some of the portfolio shifts will be reversed once the financial market uncertainty diminishes. This assessment is supported by the continuing moderate growth of loans to the private sector, particularly to non-financial corporations.

As regards the information under the second pillar, recently published data and survey information indicate that economic growth in the euro area remained subdued around the turn of the year and that the overall sentiment in the economy remained lacklustre. While these indications suggest that growth dynamics will remain weak for the early part of this year, the most likely scenario remains that of a gradual increase of real GDP growth rates, starting in the second half of 2003. The current low levels of interest rates should contribute to this scenario materialising. In addition, while the appreciation of the euro over recent months is likely to contribute to a dampening of export growth to some extent, this should be counterbalanced by the assumed recovery in the world economy. In this respect, it should also be taken into account that the price competitiveness of euro area companies remains favourable in a medium-term perspective.

At the same time, uncertainty regarding the economic outlook remains high, in particular due to the ongoing geopolitical tensions. Further turbulence in the oil markets could have a negative impact on economic activity throughout the world and, therefore, on euro area employment as well. These concerns could weigh adversely on confidence. In addition, the accumulated macroeconomic imbalances outside the euro area have led to uncertainty surrounding the strength of the recovery in other major economies. By way of conclusion, there are still downside risks to the outlook for euro area economic activity.

Turning to prices, HICP inflation has remained slightly above 2% in recent months. On the one hand, there was upward pressure from oil prices and from various increases in indirect taxes and administered prices. On the other hand, the strengthening of the euro, together with base effects, helped to limit year-on-year consumer price increases. Looking ahead, given the outlook for moderate economic growth, the gradual pass-through of the appreciation of the euro should contribute to a dampening of inflationary pressures. Overall, the most likely outcome remains that inflation will fall and eventually stabilise at a level below 2% in the course of 2003. However, the volatility in oil prices makes it very difficult to forecast prospects for inflation movements accurately, especially in the short term.

Moderate wage developments are a major prerequisite in order for price stability to prevail in the medium term. This will also help to improve the prospects for economic growth and further employment creation. When looking back we see that wage growth followed an upward trend until recently, despite the economic slowdown. This indicates that significant structural rigidities have prevented an appropriate adjustment of wages.

Taking all of the above into account, at its last meeting on 6 February 2003, the Governing Council concluded that following the decision to lower the ECB key rates by 50 basis points in December, the monetary policy stance remained appropriate to preserve a favourable outlook for price stability in the medium term. Consequently, the ECB kept its key interest rates unchanged. Their already low level should help to counterbalance the negative effects on economic activity that currently stem from the high degree of worldwide uncertainty and should, therefore, contribute to a sustainable economic recovery in the course of 2003.

For the time being, we still assume that the high degree of uncertainty will decline in the course of this year. However, at this juncture it is not possible to assess how the ongoing geopolitical developments will affect the world economy and, in particular, the euro area economy. The Governing Council will continue to monitor closely all factors that may affect the prospects for inflation in the euro area.

The euro area outlook will also very much depend on progress in other policy areas. As regards fiscal policy, full adherence to the fiscal policy framework laid down in the Treaty and the Stability and Growth Pact provides a sound basis for limiting the risk of fiscal imbalances occurring and thus contributes significantly to favourable financing conditions for the private sector. At the same time, it preserves an appropriate medium-term orientation for fiscal policy. The Governing Council supports the steps taken by the Commission to maintain the functioning of the framework, including the implementation of excessive deficit procedures and the issuing of early warnings, where required.

Furthermore, I should also like to stress that it is the implementation of structural reforms at the micro level that ultimately raises the production potential in the euro area. By improving flexibility in the economy and making the euro area more resilient to external shocks, structural reforms will also reduce the high level of unemployment. The slow progress in structural reform is one of the key factors currently hampering a recovery in confidence.

Against this background, the Governing Council welcomes the recent communication by the Commission on the implementation of the Broad Economic Policy Guidelines. Renewed momentum in the process of structural reform will not only be crucial to foster confidence among consumers and investors in long-term growth and employment opportunities in the euro area, but it should also have a positive effect on spending and investment decisions in the short and medium term.

Finally, I should like to mention that after four years of practice with our monetary policy strategy, the Governing Council has considered that it is the appropriate point in time to take stock of our experience so far and to reflect on the various elements of the strategy. All this does not necessarily imply that we see a need for any changes. We are very satisfied with our strategy and with the fact that it has given appropriate and effective guidance to monetary policy decisions. Let me also assure you that there will be no change in our firm commitment to our overriding objective of maintaining price stability over the medium term, i.e. avoiding both inflation and deflation. Indeed, this could not be otherwise, since the achievement of the price stability objective is at the core of our mandate in the Treaty.

## 2. The ECB Recommendation on the adjustment of voting modalities in the Governing Council

On 3 February 2003, the Governing Council adopted a recommendation on the adjustment of its voting modalities, which will prepare the Governing Council for a future expansion of the euro area. With the timely submission of this recommendation, and a hopefully rapid completion of the overall procedure, we hope to preclude any uncertainty about the continued effectiveness of the ECB's governance structures in view of a future expansion of the euro area. In this context, I should like to emphasise how much I appreciate your Committee's efforts to respect an ambitious timetable in order to present in good time the Opinion of the European Parliament as foreseen by the Treaty.

As you are aware, the task of coming up with a new voting system presented the Governing Council with a formidable challenge. I know that the final outcome of our discussion, the rotation of voting rights based on three groups, has met with certain criticisms not only from the media, but also from the members of this Committee. Therefore, allow me to highlight a few crucial features of the new voting system, which might help to clear up any misunderstandings about the functioning of the system and the motivation behind it.

First of all, I should like to stress that the "enabling clause" contained in the Treaty of Nice had set us clear legal limits, in that any reform should be restricted to a change in the voting modalities only. More fundamental reform options were, therefore, outside the scope of our discussions. For example, suggestions by academics or media commentators to restrict the membership of the Governing Council, to delegate decision-making on monetary policy to the Executive Board or some form of Monetary Policy Committee would call for more fundamental changes to the Treaty than foreseen by the "enabling clause".

The Governing Council sought to devise a system which maintains its capacity for timely, efficient and euro-area focused decision-making in a substantially enlarged euro area. Therefore, we recommend to cap the number of NCB governors with a voting right at 15, which is the number of governors under the "Maastricht" framework if all current Member States were to have adopted the euro, with the six members of the Executive Board retaining a permanent voting right. At the same time, we introduced as a new element the principle of "representativeness", linked to the desire that at any moment in time the NCB governors exercising the voting right represent a reasonable share of the euro area as a whole. This desire to ensure "representativeness", by way of the differentiation among governors on the basis of the country ranking, should not be misunderstood as an attempt to re-introduce national elements into decision-making. On the contrary, the allocation of governors to groups is a purely auxiliary device, which is used *exclusively* to determine who votes when. For substantive decision-making – and that is what was crucial to us – the tried-and-tested principles of the Eurosystem constitution have been kept fully intact: the principle of *ad personam* participation of governors remains valid and the "one member, one vote" principle applies to all members exercising a voting right. All of this will ensure that, also in a future enlarged Governing Council, it is the force of arguments that counts in our deliberations and not which country an NCB governor comes from and whether this is a large or a small country.

Finally, given that the sequencing of future euro area expansions is highly uncertain, the new voting system had to be sufficiently robust and able to accommodate up to 27 euro area Member States, so as to avoid having to change the rules every time a new Member State joins the euro area.

In view of all these complications I believe we have succeeded in devising a suitable new voting system which should muster the unanimous support of the Council and eventually be ratified by the Member States. I know that it is not as simple as we would have liked. It is, however, as simple or complex as any other rotation system and fairly similar to the system operating at the Federal Reserve, where the presidents of Federal Reserve Banks are also allocated to groups and exercise their voting right in the Federal Open Market Committee (FOMC) with different frequencies.

I hope that our exchange of views later on will help to clarify any other outstanding issues.