Jean-Claude Trichet: Presentation of the European Central Bank's Annual Report for 2003

Introductory statement by Mr Jean-Claude Trichet, President of the European Central Bank, to the Committee on Economic and Monetary Affairs of the European Parliament, Brussels, 27 April 2004.

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In four days' time the EU will witness the most significant enlargement in its history when some 75 million people from ten central and eastern European and Mediterranean countries join the European Union. The importance of this enlargement goes beyond considerations of size. Its significance lies in its political message. By overcoming post-war rifts, Europe has passed another milestone along the way to establishing an "ever closer union" among its peoples.

I will come back to this issue at the end of my opening remarks. I should like to start by reporting on economic and monetary issues. Since I have the pleasure today of presenting to you the ECB's Annual Report 2003, I would first like to briefly review economic and monetary developments over the past year, and then turn to developments that have occurred since our last meeting in mid-February. I should then like to address another important issue raised in the Report, namely the Governing Council's evaluation of the ECB's monetary policy strategy.

Economic and monetary developments

In 2003, monetary policy in the euro area operated in a rather uncertain and challenging environment. In the first half of the year, euro area real GDP growth stagnated in the context of considerable economic and geopolitical uncertainty, due to the escalation of tensions in Iraq and the associated turbulence in oil prices and financial markets. It was only from the summer of 2003 that a global economic recovery began and euro area economic confidence gradually started to improve. After the moderate recovery in the second half of the year, real GDP growth in the euro area amounted to 0.4% for 2003 as a whole.

In this context, HICP inflation fell from an annual rate of 2.3% in both 2001 and 2002 to 2.1% in 2003. The persistence of inflation above 2% in 2003 was due mainly to unexpected increases in some volatile components of the HICP, such as oil prices and, in the second half of 2003, food prices. Increases in indirect taxes and administrative prices also played an important role. At the same time, there were good reasons in 2003 to expect that annual HICP inflation would decline to below 2% in 2004 and remain consistent with price stability over the medium term.

This picture of a favourable outlook for price stability that resulted from our economic analysis was not challenged when cross-checked with the monetary analysis. Much of the strength of monetary growth in early 2003 was due to the high level of economic and financial market uncertainty prevailing at that time, which prompted portfolio shifts into safer, short-term liquid assets included in M3. In the Governing Council's assessment, the accumulation of excess liquidity was less of a concern for price stability as long as the economic recovery in the euro area remained gradual.

In view of the moderation of inflationary pressures in the first half of 2003, the key ECB interest rates were reduced by 25 basis points in March 2003 and by 50 basis points in June to reach the historically low level of 2.0%. Since then rates have remained unchanged. The low level of interest rates across the maturity spectrum provides ongoing support to the economic recovery in the euro area.

Let me now turn to more **recent developments**. The evidence available continues to indicate that the moderate recovery of euro area real GDP growth that started in the second half of 2003 has continued in 2004. Although recently released economic indicators have been mixed, we remain confident in our expectation of a gradual recovery, a continued, though modest, real GDP growth in the euro area.

Conditions remain in place for the recovery to continue in 2004 and to gather strength over time. The strength of global demand provides a positive external environment in which euro area exports are expected to grow significantly both this year and next. On the domestic front, favourable financing conditions and an improvement in corporate earnings should continue to support investment in the euro area. Euro area firms also look set to return to issuing equity, although only in modest quantities, favoured by the decline in the cost of equity. Issuance of debt securities by non-financial corporations was robust throughout 2003, but slowed somewhat at the start of 2004. Growth in real disposable income should sustain private consumption at a time when there are no financial constraints on households that could pose an obstacle to higher spending. Over time, private consumption should also be fostered by an improvement in the labour market situation.

Looking at price developments, annual HICP inflation has been below 2% since December last year. Over the coming months, annual inflation rates will edge up, mainly on account of energy price developments and increases in indirect taxes. However, looking beyond these short-term fluctuations, the outlook for price stability continues to be favourable. In a context of gradual economic recovery, wage developments should remain moderate. The lagged effects of the past appreciation of the euro exchange rate will continue to alleviate import price pressures. They should thereby also dampen the inflationary impact of the rise in commodity prices, which is largely related to strong demand at the global level.

Turning to monetary developments, annual M3 growth has been moderating since the summer of 2003, albeit only slowly, while the growth of loans to the private sector has been edging up. Both monetary and credit growth are supported by the low level of interest rates prevailing in the euro area, and may also reflect the improvement in the economic environment since last summer. Given the strength of M3 growth over the past few years, there is currently more liquidity in the euro area than is needed to finance non-inflationary growth. The effects of this high liquidity on inflation will greatly depend on future developments in the economy and the financial markets. Should excess liquidity persist, it could lead to inflationary pressures over the medium term.

Overall, at this juncture, given the expected gradual nature of the economic recovery, the outlook for price developments remains consistent with price stability. This expectation is in line with available forecasts and projections. Obviously, the Governing Council will continue to monitor closely all developments that could affect the assessment of risks to price stability over the medium term.

In terms of fiscal policy, 2003 was a disappointing year. Public finances in several Member States were marked by significant deficits, a large part of which were of a structural nature. There is a risk of continued or renewed deficits above 3% of GDP in several countries over the coming years. As a consequence, after several years of uninterrupted, albeit moderate declines, the aggregate debt-to-GDP ratio in the euro area has started to rise again.

In the light of these budgetary imbalances, the Stability and Growth Pact must be implemented. As you will recall, in November 2003, the ECOFIN Council made a commitment to continuously monitor budgetary developments and to act accordingly if countries did not live up to their obligations. The European Commission has announced its intention to activate the procedures foreseen by the Pact to prevent and deter excessive deficits. We support the Commission’s initiatives. They are necessary to maintain the credibility of the fiscal framework, which, in turn, is essential for fostering macroeconomic stability and growth in the euro area in the long run.

On a more positive note, 2003 saw progress in several euro area countries towards structural reforms. These reforms are necessary to maintain and strengthen the euro area’s growth potential over the long term and to increase the flexibility of the euro area economy to adjust smoothly to external shocks.

While progress has been made, substantial further efforts are needed. I therefore warmly welcome the Presidency conclusions of the Brussels European Council held on 26 March 2004, which underline that the pace of reform needs to be stepped up significantly.

The evaluation of the ECB’s monetary policy strategy

Turning to specific issues raised in the ECB’s Annual Report 2003, let me briefly summarise the Governing Council’s comprehensive evaluation of the ECB’s monetary policy strategy, which was carried out in the first half of 2003.

Since 1999, the ECB’s monetary policy strategy, with its clear focus on the maintenance of price stability, has served to anchor long-term inflation expectations in the euro area at low levels. It has also provided both a solid basis for internal decision-making and a consistent framework for the presentation of policy decisions to the public. The strategy has been an indispensable tool in organising the analysis prepared for the Governing Council and in structuring the discussion within the Council. The strategy has also provided a sound framework for the ECB’s overall accountability.

Following the detailed evaluation, the Governing Council confirmed the main elements of the strategy originally announced in 1998, namely its quantitative definition of price stability and the two-pillar structure underlying the overall assessment of risks to price stability. We continue to define price stability as a year-on-year increase of below 2% in the Harmonised Index of Consumer Prices (HICP) for the euro area. At the same time, we clarified that in the pursuit of price stability the ECB aims to keep inflation rates below, but close to 2% over the medium term.

In addition, the Governing Council also confirmed that its monetary policy decisions would continue to be based on a comprehensive analysis of the risks to price stability, comprising an economic analysis and a monetary analysis. The economic analysis seeks to identify short to medium-term risks to price stability. The monetary analysis assesses medium to long-term trends in inflation, given the close relationship between money and prices over extended horizons. The Governing Council emphasised that the monetary analysis would serve mainly as a means of cross-checking, from a medium to longer-term perspective, the short to medium-term indications coming from the economic analysis. Given the medium to long-term nature of the monetary analysis, the Governing Council decided to no longer review the reference value for M3 on an annual basis. We trust that the monetary analysis serves us well in helping anchoring the long term expectations of inflation, which is very important for the success of our monetary policy as well as for preserving a financial environment favourable to growth and job creation.

The outcome of the evaluation ensured continuity with the past conduct of monetary policy. The changes to the presentation of the two-pillar framework were made in order to explain the conduct of monetary policy more clearly to the general public as well as to market participants and economic agents. We trust that the clarification has helped to improve the overall understanding of our strategy.

EU enlargement

To conclude my statement, let me make a few comments on EU enlargement.

Besides the historic dimension, EU enlargement will also imply substantial benefits in economic terms, both for the new and the current Member States. In the ten acceding countries, the prospect of accession has encouraged countries to pursue economic policies that have already led to substantial progress in macroeconomic stabilisation and structural reforms. This progress is set to continue, as the new Member States will be subject to the EU's overall economic policy coordination and surveillance framework. Looking further ahead, full integration into the Single Market will increase growth prospects and thus foster the catching-up process with the current Member States, mainly through trade and investment.

At the same time, the new Member States will be confronted with a number of challenges. One key challenge for the acceding countries will be to advance real convergence without putting current achievements in terms of macroeconomic and financial stability at risk. At the moment, the gap in per capita income between the current Member States and most of the new ones remains large. Also, in most cases, the process of catching-up in real incomes has been slower than initially expected. This stresses the need for prudent macroeconomic policies, such as those that lock in inflation at low levels, that preserve the soundness of the financial sector, that renew efforts towards fiscal consolidation and, in a few cases, that correct unsustainable external imbalances.

Another major challenge for the new Member States will be monetary integration. Upon accession, these countries will join the EU as "Member States with a derogation", and the central banks of the new Member States will gain the status of "full member" in the ESCB - just like the central banks from the three current EU Member States that are not part of the euro area. The new Member States will be required to treat their exchange rate policies as a matter of common interest and to pursue price stability as the primary objective of monetary policy. Under the Treaty, they will be expected to join ERM II at some point. To ensure smooth participation in ERM II, major policy adjustments - such as price liberalisation and credible fiscal consolidation plans - must be made prior to participation in the mechanism.

Sometime in the future, monetary integration of the new Member States will culminate in these countries adopting the euro. This will be an irrevocable decision and, therefore, it is of the utmost importance that countries fulfil the convergence criteria both in a nominal and a real - namely sustainable - manner before they join the euro area, in accordance with the Treaty.

Since the signing of the Treaty of Accession in April 2003, the dialogue among central bankers from the current and new Member States has been further strengthened to help the national central banks of the new Member States to prepare for accession to the ESCB. Indeed, cooperation among central banks has played an important role in this regard.

Over the last four-and-a-half years, staff members from the ECB and the euro area NCBs have devoted around 22,000 working days to such cooperation activities. Over the past year, the Eurosystem has continued to provide assistance to central banks of the acceding countries in their technical preparations for a smooth integration into the ESCB, in particular, high-level policy seminars, training courses at expert level and other activities. And most notably, since June 2003, the governors of the acceding country central banks have attended meetings of the ECB's General Council as observers.

So the ECB and the ESCB are well prepared both for EU enlargement itself and for the challenges that the future monetary integration of the new Member States will pose. We will continue to steer the process of monetary integration in keeping with the principles of the ECB's stability-oriented monetary policy, in line with the Treaty provisions.

Given that this is my last testimony to your Committee during this parliamentary term, let me take the opportunity to thank you all - Madam Chair, honourable Members - for your excellent cooperation. I look forward to continuing our regular dialogue with the new Committee in the next parliamentary term.