# Jean-Claude Trichet: Testimony before the Committee on Economic and Monetary Affairs of the European Parliament

Introductory statement by Mr Jean-Claude Trichet, President of the European Central Bank, Brussels, 22 September 2004.

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Je vous remercie, Madame la Présidente, de votre accueil. Ceci étant ma première audition devant votre commission dans sa nouvelle composition, permettez-moi de souligner que je partage entièrement votre désir de continuer les relations étroites et fructueuses que nos institutions ont développées au cours des dernières années. Je me réjouis à la perspective de poursuivre notre dialogue dans cet esprit franc et coopératif, sachant combien cela est essentiel pour le bon fonctionnement de l'Union Economique et Monétaire.

Ich möchte diese Gelegenheit auch nutzen, um der langjährigen Vorsitzenden dieses Ausschusses und seines Vorgängergremiums, des Unterausschusses für Währungsfragen, Frau Randzio-Plath, nochmals herzlich für die ausgezeichnete Zusammenarbeit während der vergangenen Jahre zu danken.

Madam Chairman, honourable Committee Members, in my testimony today I will provide you with the ECB's assessment of current economic and monetary developments. I will then address a number of other issues of topical importance, namely fiscal policy, the implementation of structural reforms and, finally, issues related to euro banknotes.

## Economic and monetary developments

At the time of my last appearance before this Committee in April, I foresaw that annual inflation rates would edge up temporarily to above 2%, mainly on account of oil price developments and increases in indirect taxes. At the same time, I stated that we expected the economic recovery which had started in the second half of 2003 to continue, albeit at a gradual pace. In this light, I assessed that the outlook for price developments over the medium term remained consistent with price stability. Against this background, the Governing Council had left the key ECB interest rates unchanged at their historically low level of 2.0% since June 2003.

The data that have become available over the past few months in fact confirm the outlook I gave in April. They indicate that the economic recovery in the euro area has maintained its momentum. In the second quarter of 2004, real GDP grew at a rate of 0.5% relative to the previous quarter, after 0.6% in the first quarter. The conditions for a continuation of the economic recovery remain in place. On the external side, global demand remains robust, notwithstanding temporary fluctuations, contributing to euro area export growth. On the domestic side, higher corporate profitability and favourable financing conditions should support business investment. In particular, the level of interest rates is very low by historical standards, in both nominal and real terms. Private consumption should also be sustained by growth in real disposable income and, with some time lag, by an improvement in the labour market. Against this background, we expect the present gradual recovery to continue in the coming quarters and to become more broadly based, leading to a somewhat stronger upswing in the course of 2005. This picture is consistent with the most recent ECB/Eurosystem staff economic projections which, as you may be aware, are now published on a quarterly basis. The last projections, published on 2 September, envisage that euro area real GDP growth will recover from 0.5% in 2003 to between 1.6% and 2.2% on average in 2004, and will be slightly higher, between 1.8% and 2.8%, in 2005. I should add that forecasts from international organisations and other sources convey a broadly similar picture.

While this outlook for economic activity is surrounded by some uncertainty, overall the risks appear to be broadly balanced. On the upside, the momentum of the recovery, which was stronger in the first half of 2004 than was anticipated earlier in the year, may imply a positive stimulus in the coming quarters. On the downside, there are still concerns about continuing economic imbalances in other parts of the world which could affect the sustainability of the economic recovery, at both the global and euro area levels. In addition, if oil prices were to reach higher levels than currently expected by markets, this could dampen somewhat both foreign and domestic demand, even if the recent rise in oil prices cannot, by any mean, be compared with the historical first and second oil shocks of the 70s and the beginning of the 80s.

Regarding the outlook for inflation, recent oil price developments, together with increases in indirect taxes, have pushed inflation rates in the euro area to levels somewhat higher than 2% over recent months. Nonetheless, there is little evidence as yet of stronger underlying inflationary pressures building up domestically. In particular, wage developments should remain moderate. Against this background, the ECB staff projections put average annual HICP inflation at between 2.1% and 2.3% for 2004 and between 1.3% and 2.3% for 2005. These projections are broadly consistent with other recently released forecasts. However, several upward risks to the outlook for inflation exist. Concerns relate in particular to oil price developments, which pose a potential risk of second-round effects emerging in wage and price-setting. Further risks relate to the future evolution of indirect taxes and administered prices.

Cross-checking the economic analysis with the monetary analysis also supports the case for strong vigilance with regard to the materialisation of risks to price stability. The prevailing low level of interest rates is fuelling monetary and credit growth. While M3 growth has been moderating since the summer of 2003 as a result of a normalisation of portfolio allocation behaviour (following the easing of the exceptional economic and financial uncertainty which had prevailed previously), it remains resilient and is increasingly driven by developments in its most liquid components. Given the strength of M3 growth over the past few years, there remains substantially more liquidity in the euro area than is needed to finance non-inflationary growth. As a consequence, inflationary risks could rise. In addition, high excess liquidity and strong credit growth could become a source of strong asset price increases.

Overall, while the prospects for price developments remain in line with price stability over the medium term, upside risks to price stability have emerged. The Governing Council will remain vigilant with regard to all developments which could imply risks to price stability over the medium term. The markets and the general public should rest assured that price stability will be maintained over the medium term.

As regards fiscal policy, the latest budgetary notifications provide a mixed picture of public finance developments. The euro area deficit is expected to increase slightly. While some countries maintain sound budgetary positions, a significant proportion of the euro area countries are expected to have deficits near or above 3% of GDP. A majority of these countries are likely to miss the original budgetary targets set in their stability programmes. Euro area public debt is projected to increase further. With a few exceptions, public debt will remain largely unchanged or increase in countries with larger fiscal imbalances.

Although the period of significant further increases in public deficits seems to be coming to an end, important challenges for the consolidation of public finances are to be faced. Member States should use the improvement in the macroeconomic environment for renewed consolidation so as to comply with their commitments under the Stability and Growth Pact. Clearly, this would add credibility to the European fiscal framework and create confidence in the sustainability of public finances, thereby reinforcing confidence in the overall economic outlook. As recently stated by the ECOFIN Council, budgetary policies need to set the right priorities towards structural reform, innovation and competitiveness in support of the Lisbon agenda to promote economic growth and employment creation. Fiscal consolidations should be designed to form an integral part of such a comprehensive reform strategy.

As regards the European fiscal framework, the Governing Council is convinced that, whilst substantial improvements in the implementation of the Stability and Growth Pact are welcome, there is no need for changes to the text of the Treaty and of the Pact itself, namely the regulations concerned. The Pact is a very important and pertinent framework for dealing with countries' fiscal developments on a level playing-field, particularly within the single currency area. At the same time, we consider that improvements could be introduced in its implementation. There seems to be some common ground on elements to improve the implementation of the preventive arm, and the need for a stronger focus on public debt and sustainability. As regards the corrective arm of the Pact, the ECB's main message is that the nominal anchor of the framework, namely the 3% deficit-to-GDP reference value should not be undermined. Therefore, proposals that would allow for a loosening of the excessive deficit procedure, such as suggestions put forward with regard to the definition of exceptional circumstances and the time frame for the correction of excessive deficits, and proposals to introduce country-specific elements are not contributing to the solidity and soundness of EMU in our view.

A sound monetary policy and a stable macroeconomic framework are necessary for sustainable economic growth in the euro area. But this alone is not sufficient. The implementation of well-designed structural reforms in labour, product and capital markets is of the utmost importance for the euro area at the current juncture. The economic recovery would be stronger and more sustained if ambitious, well-designed structural reforms were to be implemented that improve the microeconomic fundamentals of the euro area and its resilience to adverse domestic and global economic developments. In this respect, a convincing commitment to the implementation of structural reforms and a successful communication of their economic benefits to the general public is crucial for raising consumer confidence and, ultimately, growth and employment. We are aware of the fact that structural reforms normally take time to show up in improved economic outcomes, which often makes it politically difficult to implement such reforms. Against this background we very much welcome the positive steps undertaken over recent months by several governments and Parliaments in the euro area and we strongly encourage them to continue and intensify these efforts.

**Issues related to euro banknotes**

Let me now highlight a few issues related to the experience with euro banknotes during the first couple of years. Since the introduction of the euro banknotes and coins on 1 January 2002, circulation has steadily increased. Indeed, by end-August 2004 some 9 billion banknotes with a value of EUR 460 billion were in circulation, an increase of 10% in terms of volume and 18% in terms of value compared with circulation one year earlier.

As regards the quality of banknotes, the Eurosystem closely monitors the banknotes in circulation and takes the appropriate measures to refresh the cash cycle, when needed. At the same time, the ECB is currently examining ways to enhance the durability of banknotes.

Moreover, to avoid shortages of certain denominations within the euro area which may occur in the event of strong cross-border flows of banknotes, the Eurosystem has set up a cross-euro area stock management scheme. This system greatly enhances efficiency in the use of banknote stocks, since shortages in one country can be compensated for by excess stocks in another country.

Turning to the issue of combating counterfeiting, the rate of counterfeiting has been relatively stable during the past 12 months, with around 50,000 to 55,000 counterfeit banknotes per month withdrawn from circulation. Assessing this number against the number of genuine banknotes in circulation (approximately 9 billion), the population of the euro area countries (more than 300 million) and the number of cash transactions involving banknotes (estimated to be approximately 120 billion per year), the initial years of experience with euro banknotes have proven that European citizens can remain confident in the security of their money. That being said, to improve even more the efficiency of the fight against counterfeiting, the Eurosystem has recently issued updated communication material on the security features, which should help cash users to spot counterfeits. However, there is no room for any complacency.

Cooperation in this domain is constantly being improved. In this context, a steering group comprising representatives from the ECB, the Commission and Europol was established to ensure the exchange of information and the coordination of activities in the field of combating counterfeiting at the EU level. At the same time, the international dimension of combating counterfeiting has gained increased importance. To take account of this development, the ECB concluded a bilateral agreement with Interpol - as was already done with Europol - which focuses in particular on the exchange of information and assistance in training and education exercises. Moreover, the ECB cooperates at the technical level with central banks or law enforcement authorities in key countries outside the euro area where euro banknotes are circulating. In addition, bilateral cooperation agreements on combating euro counterfeiting have recently been concluded with the Bulgarian National Bank and the National Bank of Ukraine.

I am now ready to answer your questions.