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

Introductory statement by Dr Willem F Duisenberg, President of the European Central Bank, Brussels, 12 September 2001.

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Ladies and gentlemen,

In the light of the unprecedented and tragic events that occurred in the United States yesterday, I should like to be as brief as possible today in my introductory statement. Firstly, I should like to express my deep sympathy with the citizens of the United States and, in particular the relatives and friends of the victims of this brutal attack. Moreover, I should like to emphasise that the European Central Bank and the national central banks are standing ready to support the normal functioning of markets and relevant operational systems, if the need arises. Indeed, the ECB has been in close contact with the other major central banks in the world since the events have unfolded.

Let me now report to you on the recent monetary policy decision taken by the Governing Council of the ECB.

1. Economic and monetary developments

Over the last few months, the evidence available to the Governing Council has gradually pointed towards an improvement in the outlook for price developments. This has been particularly apparent from the information stemming from what we call the second pillar of our monetary policy strategy, while the information coming from the first pillar of our strategy has remained consistent with a favourable outlook for price stability in the medium term. At this stage, I do not want to speculate about the possible consequences of yesterday's developments in financial markets on economic and monetary developments. We will have a first discussion on this issue tomorrow, at the meeting of the Governing Council.

As regards the first pillar, the three-month average of the annual growth rates of M3 was 5.9% in the period from May to July 2001. This figure, however, has to be carefully analysed. First, the figure needs to be corrected for holdings of money market paper and short-term debt securities by non-residents of the euro area. As already announced, the ECB intends to publish an M3 series which is adjusted for these non-resident holdings of negotiable instruments towards the end of the year. At present, some preliminary estimates of the impact of these holdings on monetary aggregates are available. When these are taken into account, the three-month average of the annual growth of M3 would turn out to be slightly above 5%, thus not very far from the reference value of 4½%.

In addition, the increase in the annual growth of M3 in the recent past has to be interpreted with caution, as several factors indicate that it might not necessarily imply risks to price stability. In fact, the relatively flat yield curve and the weakness in the stock markets appear to have made the holding of short-term deposits and marketable paper included in M3 more attractive, thereby temporarily affecting M3 growth. Furthermore, the recent increase in the money stock seems also to reflect the adjustment in transaction balances in reaction to the past rise in energy and food prices. This, by itself, should be seen as a one-off level adjustment and should not indicate future upward pressures on inflation, provided that the rise in energy and food prices does not trigger second-round effects on inflation via wages. A further factor which suggests that the rise in M3 growth should be interpreted with caution is that the annual rate of growth of loans to the private sector has continued to decline over recent months.

Turning to the analysis from the second pillar of our monetary policy strategy, several developments clearly pointed to lower inflationary pressures coming from the demand side. Recent data on economic activity indicate that real GDP growth in the euro area will most likely be lower than was expected a few months ago. This reflects the slowdown in economic activity in the United States and the persistent economic weakness in Japan, which have both been more pronounced than was expected a few months ago, and have also affected other areas of the world. On the domestic side, the past strong increases in oil and food prices have counteracted the beneficial effects on households' real disposable income of the recent tax reductions in some Member States. All these factors have also had adverse effects on investment.

Looking ahead, a gradual strengthening in growth of domestic demand can be expected as the past increases in inflation continue to unwind. Domestic demand should be further supported by the positive impact on consumption of the recent tax reductions, and by the favourable financing conditions in the euro area.

In the current environment, it is likely that the process of wage moderation which we have seen thus far will continue in the period ahead. First, the slowdown in economic activity should contribute to containing inflationary pressure stemming from the labour market. In addition, the latest figures on producer and consumer prices provide encouraging signs that the past increase in consumer price inflation has been temporary and that, in the absence of further unfavourable shocks, HICP inflation will return to levels of below 2% in the not too distant future. The expected falling trend in consumer price inflation should contribute to containing the inflation expectations of economic agents and thereby have a positive influence on price and wage-setting behaviour. This view is confirmed by bond yields, which indicate that financial markets expect inflation developments to be in line with the definition of price stability in the medium term.

Overall, in view of recent monetary, financial and economic developments, the Governing Council saw scope for a downward adjustment in key ECB interest rates by 25 basis points on 30 August 2001. The Governing Council considers the new level of key ECB interest rates to be appropriate for the maintenance of price stability over the medium term.

Turning to fiscal policies, let me express my concern about the possible impact of the slowdown in economic activity on the willingness of the governments of some euro area countries to stick to the Stability and Growth Pact and to their stability programmes. Any loosening of fiscal commitments, or initiatives to "re-interpret" the Stability and Growth Pact itself, can only be counterproductive in the current circumstances, since this could undermine the confidence in the determination of the euro area to stick to a stability-oriented fiscal policy. To avoid this, only countries whose budget positions are close to balance or in surplus have scope to let the automatic stabilisers work fully in this phase of lower economic growth. By contrast, it would be advisable for those countries with remaining fiscal imbalances to limit the deviation from the nominal targets set out in their latest stability programmes.

Looking ahead, it will be important that budgetary targets for 2002 be set in such a way that budgetary positions close to balance or in surplus are either maintained or can be reached within the time frame set by the existing stability programmes. Indeed, a medium to long-term orientation is essential for the conduct of fiscal policies in all euro area countries. Short-term discretionary measures aimed at strengthening domestic demand not only risk having an unwelcome impact on the economy, partly as a result of time lags, but may also affect the solidity of public finances and the consolidation process in a more lasting manner.

Efforts to set the conditions for the further expansion of the production potential of the euro area must remain a priority. While progress is being made in a number of areas, more ambitious market-oriented structural reforms remain a challenge. Labour market reforms aimed at providing the right incentives to economic agents and the liberalisation of sectors still sheltered from competitive forces are areas in which progress is still needed. Fiscal reforms to diminish the adverse incentives provided by tax, benefit and pension systems need to be accompanied by ambitious expenditure restraint. It should always be kept in mind that such reforms will be beneficial to employment growth in the euro area and will help to improve the resilience of the euro area economy to potentially adverse shocks in the future.

2. Preparations for the introduction of euro banknotes and coins

Madam Chairman, honourable Committee Members, as you are aware, in less than four months we will enter the final stage of monetary integration, marked by the introduction of the euro banknotes and coins. This will make the single currency a tangible reality for the people of Europe, and even more – the euro in its final visual appearance, as displayed in the star before you, is indeed a new symbol of European integration. Madam Chairman, honourable Committee Members, it is my pleasure to offer this star to the European Parliament as a symbol of the achievements of European integration towards which we have all been working together and in the spirit of excellent co-operation that has always characterised the relations between our institutions.