Willem F Duisenberg: Presentation of the ECB's Annual Report 2001 to the European Parliament

Introductory statement by Dr Willem F Duisenberg, President of the European Central Bank, to the European Parliament, Strasbourg, 2 July 2002

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Six months ago we witnessed a milestone in European history: the launch of "the euro, our money", in its visible form. European citizens are now able to perceive - and benefit from - the tangible reality of the euro, and the rapid substitution of legacy currencies at the beginning of this year bears witness to the successful launch of the euro banknotes and coins.

The year 2001 provided a particularly challenging environment for the monetary policy of the ECB. The worsening economic outlook was accompanied by short-term upward pressures on prices from various sources, which complicated the conduct of monetary policy. This task was made more difficult by the extreme uncertainty which followed the terrorist attacks in the United States on 11 September.

As usual, the monetary policy response of the ECB to such a situation had to look beyond short-term developments, focusing on the risks to price stability over the medium term. From this perspective, we could see that medium-term inflationary pressures were in fact receding. The ECB took account of this by reducing interest rates four times in 2001, by a total of 150 basis points. As a consequence, the minimum bid rate on the main refinancing operations of the ECB - the most important among our key interest rates - reached 3.25% in November 2001. The key ECB interest rates have remained unchanged since November and short and long-term real interest rates have been, in a historical perspective, very low.

The average annual inflation rate in 2001, as measured by the HICP, was 2.5%. Inflation in 2001 was affected by the lagged effects of the increases in import prices in 2000, and by the new impact of livestock diseases on unprocessed food prices. We are not satisfied with such an outcome, which is not in line with price stability. However, it has to be recognised that the factors which contributed to shaping this outcome could not be controlled by the ECB. In fact, monetary policy only affects inflation with a lag and cannot control it in the short term.

We are satisfied that our policy in 2001 was very well understood by our observers and by the markets. In fact, the level of bond yields, as well as various other indicators of inflation expectations of economic agents, pointed to continued confidence throughout 2001 in the ECB maintaining price stability in the medium term.

There were some concerns about the possible impact of the cash changeover on euro area inflation, which have also been echoed in the draft resolution on the ECB Annual Report prepared by your Committee on Economic and Monetary Affairs. Indeed, the increase in annual consumer price inflation in the euro area from 2.0% in December 2001 to 2.7% in January 2002 has unfortunately been associated, in many people's minds, with the cash changeover. In reality, other factors contributed to this increase, such as the rise in vegetable prices related to adverse weather conditions and higher tobacco taxes in several euro area countries. But it has to be recognised that, in particular in some sectors with a low level of competition, some upward price adjustments might have occurred in connection with the cash changeover. However, there were also price reductions in the euro area associated with the cash changeover and statistical evidence has so far confirmed that the effect on the overall price level has been contained.

Turning now to the current economic situation, over the past few months the economic conditions have gradually changed. The impact of the terrorist attacks on economic confidence has gradually faded away and economic activity has stabilised. While the strength of the ongoing recovery is still subject to uncertainty, the most likely scenario is for economic activity to gradually accelerate and reach levels in line with trend potential growth later this year.

Regarding monetary developments, we saw a high demand for liquid and safe assets in the autumn of last year, particularly associated with financial market uncertainty following the terrorist attacks. We saw some moderation in early 2002 but recent data indicate a new increase in the demand for liquid assets. In addition, the decline in the growth of loans to the private sector has come to a halt and credit demand has recently strengthened. These developments need to be closely monitored, as they may start to point to upward risks to price stability, in particular during a period of economic recovery.

Overall, the outlook for price stability is now less benign than it was in November 2001, when we last adjusted the key ECB interest rates. Inflation has so far declined less steeply and less rapidly than we expected at the turn of the year. This has been partly due to the temporary factors I mentioned before, and to the renewed increase in oil prices in the first quarter of 2002. At the current juncture, even though the appreciation of the exchange rate of the euro will contribute to easing inflationary pressures, we will continue to closely monitor all relevant developments, against the background of the risk that the deviations from price stability, which followed the exceptional clustering of upward shocks on inflation over the past couple of years, may be transmitted into longer-term inflation expectations, thereby potentially affecting wage and price-setting behaviour.

In order to maintain price stability, it is crucial that wage moderation prevails in the future. In this respect, we are concerned about recent trends in wages. The importance of wage developments in line with our definition of price stability cannot be overemphasised. Wage moderation is a key factor in favouring the expansion of employment and in helping to create the conditions for a sustainable increase in the potential growth rate of the euro area economy.

Current estimates for trend potential growth in the euro area are in the order of 2-2½%. There is much scope for raising potential growth in the euro area. The ECB will make its contribution by focusing on maintaining price stability in the medium term. But other policy actors also have to take up their responsibilities. The Broad Economic Policy Guidelines for 2002, which have just been approved in Seville, place the emphasis quite rightly on the need for further structural reforms in the euro area. I understand that this view is also shared in the draft resolution.

The future welfare of euro area citizens will also depend to a large extent on the prudent conduct of fiscal policies. The solidarity pact of our monetary union requires all participants to maintain a medium-term perspective in compliance with the framework of the Stability and Growth Pact. This implies that budgetary positions in all countries should be close to balance or in surplus over the business cycle as a whole in order to allow sufficient room for a smooth functioning of automatic stabilisers. We have seen some worrying developments in fiscal policy in some countries over the last few months. We therefore recall the importance for those countries that still have not achieved a balanced budget position to honour their commitments to catch up with the other countries of the euro area by 2003/04.

Let me now turn to some other issues raised in the draft resolution on the ECB's Annual Report. We welcome the draft resolution's clear support for the ECB's monetary policy strategy. The draft resolution concludes that short-term movements in monetary aggregates should not be overemphasised and that there should not be any mechanical reaction to deviations of M3 growth from the reference value. This is fully in line with the ECB's monetary policy strategy and practice. The first pillar of our strategy, which gives a prominent role to the analysis of monetary developments, is based on the empirical evidence of a close and stable relationship between money and prices in the euro area over the medium term. There is no evidence yet to suggest that this link has weakened over time. The ECB is fully aware that monetary developments may be subject to portfolio shifts in the short term, which are not directly related to future spending decisions. Indeed, what matters is to identify and understand the underlying reasons for monetary developments in order to assess the implications for the risks to price stability over the medium term. In this respect, the analysis of monetary developments has provided useful guidance to the ECB's monetary policy also over the past year.

This leads me to another point mentioned in the draft resolution, namely the importance for a central bank to take account of asset prices when assessing risks to price stability, while not introducing moral hazard in financial markets through inappropriate reactions to excessive asset price developments. The ECB fully shares this view. It closely monitors asset price developments as indicators for monetary policy but it does not target them or react to them mechanically.

As regards the proposed endorsement of macroeconomic projections by the Governing Council of the ECB, allow me to clarify once again the role of those projections in the process of monetary policy-making at the ECB. These projections play an important role for us, but they have by no means an all-encompassing role. They are an important technical input by ECB and national central bank staff in summarising and assessing the implications of a large body of information for future inflation in a consistent way. However, we are also fully aware of the difficulties of making projections. In particular, we recognise that it is impossible to summarise all the relevant information for assessing the maintenance of price stability in one single projection. Given the difficulties of forecasting over the longer term and the uncertainty regarding the appropriate economic model, we do not advocate the use of a single projection to analyse the risks to price stability. We therefore explicitly look at many other indicators and analyses in the context of our two-pillar strategy, and we do not try to hide the complexity of monetary policy-making behind the production of a single Governing Council forecast.

The projections reflect the expert judgement of Eurosystem staff and we prefer to keep this distinct from the judgement of the Governing Council regarding the overall assessment of the risks to price stability. Therefore, our decision to clearly separate the production of the projections from the analysis of the Governing Council is fully transparent as it honestly reflects the decision-making process within the ECB.

As regards communication, we have always taken an approach that ensures a high level of transparency and clarity of our message. Our monthly press conferences are key in this respect. The timeliness and detail of our communication is without comparison. At the same time, we have not changed our view regarding the publication of minutes. We fear that, given the multi-country context in which the Governing Council works, published minutes - or a procedure in which dissenting views of Council members are published (even without mentioning names) - could lead to undue pressure on national central bank governors to deviate from a euro area perspective. This cannot be in the interest of the euro area, no more than if the Governing Council were to end its approach of speaking with one voice.

The draft resolution also suggests that the balance of votes within the Governing Council should be published anonymously. As I stated in my last testimony, I have some doubts whether this would give more clarity to the markets or more transparency than is the case now. In any event, I believe it is crucial that we continue to place the emphasis of our communication on the economic rationale behind monetary policy decisions, rather than on a pattern of differing views in the Governing Council.

To conclude my statement, I should like to briefly refer again to the euro cash changeover. With a single currency, our citizens now have a common symbol of European identity which they use in their daily lives. Indeed, the euro has created the foundations that may stimulate further integration - in both the political and the economic and financial fields. In this sense, “the euro, our money” can provide a new and more solid basis on which to build an “ever closer union”.