Lucas Papademos: Presentation of the European Central Bank's Annual Report for 2002

Introductory statement by Mr Lucas Papademos, Vice-President of the European Central Bank, to the Committee on Economic and Monetary Affairs of the European Parliament, Brussels, 29 April 2003.

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It is my pleasure to appear before the Committee to present the ECB's Annual Report 2002. In my view, last year was marked by two milestones in the process of European integration. The first was the euro cash changeover. The successful and remarkably smooth introduction of euro banknotes and coins on 1 January 2002 has created a new symbol of European identity that has been fully embraced by the 300 million citizens of the euro area. On this occasion, I would like, on behalf of the ECB, to thank again the citizens of Europe and all the parties involved for their contribution to the success of this unique and complex undertaking.

The second historic event was the decision of the EU Heads of State or Government in December last year to invite ten countries to join the European Union in 2004, thereby marking the end to the post-war rifts within Europe. Even though major challenges remain to be tackled, as many of the acceding countries are still in the process of transition to fully-fledged market economies, I believe that the signing of the Accession Treaty at the Athens summit meeting on 16 April bore witness to our commitment to European integration. I would like to briefly elaborate on some of the consequences of EU enlargement for the ESCB and the ECB, before turning to the monetary and economic developments in 2002.

1. Preparations for EU enlargement

It goes without saying that an enlarged European Union will require a number of adaptations in the working procedures and the internal functioning of European institutions and bodies. Upon accession, the new Member States will join Economic and Monetary Union with the status of "countries with a derogation" and their central banks will become part of the ESCB. At a later stage, the acceding countries' central banks will become part of the Eurosystem, after these countries have fulfilled the convergence criteria for adopting the euro. A key priority of the ECB is to have in place the necessary technical and institutional infrastructure which will ensure an orderly enlargement of the ESCB and, later on, of the Eurosystem.

To this end, and in line with the provisions of the Nice Treaty, the Governing Council of the ECB issued a recommendation on the adjustment of its voting modalities, which was the basis for the decision adopted by the EU Council, in the composition of Heads of State or Government, in March 2003. Although the new voting system – like any rotation system – is characterised by a degree of complexity and was criticised for that reason by the European Parliament, in our judgement it will help to ensure that the Governing Council will maintain its capacity for timely and efficient decision-making in a substantially enlarged euro area. Another amendment to the Statute of the ESCB was introduced at the initiative of the ECB, when the ECOFIN Council recommended in October 2002 that the Accession Treaty provide for an increase, upon accession by new Member States, of the ECB's subscribed capital and of the ceiling on the transfers of foreign reserve assets by NCBs.

In addition to these statutory changes, the Eurosystem is involved in an intense and manifold dialogue, concerning both policy and technical issues, with the central banks of the accession countries to assist them in their preparations for a smooth integration into the ESCB and the Eurosystem. The numerous internal preparations within the ESCB are guided by an Accession Master Plan, which comprehensively reviews the ECB's functions and infrastructures so as to ensure that all relevant issues are dealt with in a timely and effective manner.

2. Economic and monetary developments

The review of economic and monetary developments in 2002 clearly reveals that the environment in which monetary policy was conducted in 2002 was one of considerable uncertainty. In particular, signals regarding medium-term inflation prospects and risks were at times mixed and subject to change.

Following the slowdown in economic activity throughout 2001, which was further aggravated by the negative shocks to confidence in connection with the terrorist attacks in the United States in September of that year, a moderate recovery of real GDP growth in the euro area was recorded at the beginning of 2002. Indeed, at that time, projections prepared by the Eurosystem's staff as well as forecasts by international organisations and private institutions agreed that euro area real GDP growth would again be in line with trend potential growth later in the year. However, as the year progressed, the recovery lost momentum, affected by the renewed turbulence in financial markets and geopolitical tensions, which had consequences for oil prices and confidence. Overall, annual real GDP growth in the euro area is estimated to have been a disappointing 0.8% in 2002, after amounting to 1.4% in 2001.

Despite the subdued pace of economic recovery, HICP inflation remained at 2.3% on average in 2002, unchanged from 2001. Inflation in 2002 was thus slightly above the upper limit of the ECB's definition of price stability and it turned out to be higher than expected at the end of 2001. In part, this was due to the fact that prices were pushed up in 2002 by a number of temporary or one-off factors, including higher oil prices, increases in indirect taxes and adverse weather conditions. On top of this, there have been some effects from the cash changeover, even though I should stress that the *perceived* impact of the euro cash changeover on inflation was much greater than the *actual* impact. Of greater concern than the effects of these short-term factors on the medium-term outlook for price stability was that real wage growth remained relatively strong despite the weakening of economic activity and a rise in unemployment. This development pointed to persistent structural rigidities in the labour markets of the euro area.

The assessment of the implications for price stability of monetary developments was less straightforward, particularly in the second half of 2002. The average annual growth rate of the broad monetary aggregate M3 increased to above 7% in 2002, from around 5½% in 2001, considerably exceeding the reference value of 4½%. This development was in part the result of high volatility in financial markets, and largely reflected investors' preferences for short-term liquid and less risky financial assets. It also reflected the relatively low interest rates in the euro area in 2002. The strong monetary growth in the euro area has resulted in the creation of more liquidity than may be needed to finance sustainable non-inflationary growth over the long term. Overall, however, in an environment of subdued economic activity and moderate credit growth, monetary developments in 2002 were not seen as pointing to risks to price stability.

I should also like to recall that our assessment of risks to price stability changed gradually over the year. In the first few months, when economic activity accelerated, we regarded monetary developments, wage trends and the high persistence of service price inflation as possibly indicating upward risks to price stability in the medium term. Later on, the appreciation of the euro, beginning in late spring started to dampen inflationary pressures. Furthermore, an important factor shaping the monetary policy assessment at that time was that the economic outlook was still subject to uncertainty. In this environment, the Governing Council was of the view, in the first half of 2002, that the available information provided inconclusive signals as regards the balance of risks to price stability over the medium term.

As from the autumn onwards, however, the significant worsening of the outlook for economic activity and the sizeable and protracted appreciation of the exchange rate of the euro were increasingly pointing towards lower inflationary pressures over the medium term. Against this background, the Governing Council decided to reduce the key ECB interest rates by 50 basis points in December 2002 and by a further 25 basis points in March 2003. The decisions to reduce the key ECB interest rates were consistent with the preservation of price stability over the medium term and were expected to provide some counterweight to the various factors having an adverse effect on economic activity. With these decisions, the minimum bid rate on the main refinancing operations reached 2.50% in March 2003, which is a very low level by historical standards, both in nominal and real terms.

In recent weeks, financial market developments and economic indicators have been affected significantly by the geopolitical tensions related to the conflict in Iraq. It has therefore been difficult to assess the incoming information, given the pronounced volatility of most indicators. At the current stage, we continue to expect a rather moderate pace of economic growth in the first half of 2003, followed by a gradual acceleration of economic activity, associated with diminishing uncertainty, later in the year. The low level of interest rates prevailing and the recent decline in oil prices support this expectation.

As regards the outlook for price stability, the fall in energy prices, the effects of the sustained appreciation of the euro over the past 12 months and the environment of subdued economic growth are factors which should contribute to lower inflationary pressures in the euro area. It is expected that inflation will gradually fall below 2% and remain in line with price stability. However, short-term inflation prospects significantly depend on future oil price developments. Moreover, the maintenance of price stability over the medium term is conditional on moderate wage developments, which would also contribute to improving the labour market situation in the euro area.

In view of this outlook, the Governing Council concluded at its meeting on 3 April of this year that the prevailing monetary policy stance is consistent with the preservation of price stability over the medium term and it maintains a monetary environment that is in itself favourable to economic growth. The Governing Council will continue to monitor developments carefully and evaluate them in the light of its mandate.

3. Policy orientation

The uncertainties surrounding the euro area economy in 2002 emphasised the importance of having a medium-term and stability-oriented framework in all policy areas. Within the stability-oriented framework of monetary policy, the ECB is committed to its primary objective of maintaining price stability over the medium term. In the area of fiscal policies, the Stability and Growth Pact aims at securing sound public finances and anchoring the expectations of economic agents to this objective. It provides a robust and flexible framework which promotes budgetary discipline while allowing automatic stabilisers to operate.

Fiscal developments in the euro area were generally not satisfactory in 2002. Most countries failed to comply with the fiscal targets set in their stability programmes. However, countries that did adhere to the rules of the Stability and Growth Pact as from the late 1990s have experienced fewer budgetary difficulties recently and have been able to benefit from the smooth operation of automatic stabilisers in this phase of economic weakness. By contrast, countries which did not achieve a fiscal position close to balance or in surplus in previous years when economic conditions were favourable are having to struggle hard to put their fiscal house in order.

Looking ahead, it remains essential that the Stability and Growth Pact is effectively implemented and adhered to. At the current juncture, those countries with a deficit close to or exceeding 3% of GDP should embark on growth-fostering fiscal consolidation measures. This will help to build confidence in the fiscal framework and anchor expectations about the future macroeconomic environment. A credible medium-term oriented fiscal consolidation strategy, by strengthening confidence, will support economic growth also in the short term.

One of the main messages of 2002 has been that the euro area economy needs to become more flexible and that, to this end, structural reforms need to be stepped up, notably in labour and product markets. While there appears to be a broad consensus among policy-makers and the public that such reforms are crucial to ultimately raising the euro area's production potential, the effective pace of reform has so far remained disappointingly slow in several countries. In our assessment, this lack of initiative has clearly contributed to the weakness in economic activity and confidence last year.

Only decisive action to implement structural reforms can make the euro area a more dynamic economy and raise the welfare of its citizens. Furthermore, better functioning markets should also foster capital and labour mobility as well as price adjustments in reaction to changing economic circumstances, thereby dampening economic fluctuations and reducing regional differences within the euro area. Progress towards structural reforms would increase confidence in the medium-term production capacity of the euro area and thus help to counteract the current high degree of uncertainty.