Willem F Duisenberg: Monetary and fiscal policy in the euro area

Introduction by Dr Willem F Duisenberg, President of the European Central Bank, at the International Monetary Conference, Berlin, 3 June 2003.

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I would like to begin today by situating my analysis of the current situation in the context of the institutional framework for macroeconomic policies in the euro area. In the euro area, fiscal policies remain under the exclusive responsibility of national governments. Contrary to monetary policy, fiscal policies are decentralised. In this set-up, in which there is a multiplicity of actors, certain rules are indispensable. Rules provide a clear allocation of responsibilities and thereby set appropriate incentives. If they are abided by, these rules create an efficient co-ordination device for budgetary policies within the euro area. In addition, the setting of numerical limits and goals provides clear yardsticks for other policy-makers and the general public to gauge the current and future course of fiscal policies, thus facilitating surveillance and peer pressure.

The Maastricht Treaty states that countries should avoid excessive deficits. Important reference values for this assessment are a government deficit level of 3% of GDP and a debt-to-GDP ratio of 60%. In addition, through the Stability and Growth Pact, countries have committed themselves to respect the objective of a budgetary position close to balance or in surplus over the medium term. At the current juncture, compliance with the fiscal rules is not satisfactory in several euro area countries, with some of them experiencing or expecting fiscal deficits above the 3%-of-GDP reference value. These countries now have to pay the price for not having sufficiently consolidated their public finances when economic growth was strong.

For these countries, there is a need to abide by the Pact and therefore prevent or correct excessive deficits, so that confidence in the macroeconomic framework of the euro area is boosted. However, some of the euro area countries still facing high, or even excessive, deficits are not sufficiently forcefully implementing the consolidation measures needed to reach sound budgetary positions. At this stage, these countries should focus on the implementation of growth-oriented consolidation policies that strengthen the productive forces of the economy. Such policies would support confidence of economic agents and therefore economic growth also in the short term.

By contrast, many other euro area countries have already reached medium-term budgetary positions close to balance or in surplus. They can let automatic stabilisers operate freely, resulting in the current economic environment in a deterioration of the headline budget balance but not in excessive deficits.

The importance of the functioning of automatic stabilisers in the euro area should not be underestimated. In the euro area, the contribution to economic stabilisation made by these stabilisers is generally higher, on average, than in other industrialised countries due to the high sensitivity of revenues and expenditures to economic fluctuations in Europe.

However, we have serious doubts about the efficiency of discretionary fiscal policies. Activist policies may have pro-cyclical effects, given the time-lags involved. In addition, they risk undermining the confidence of economic agents in the fiscal framework and in its stability.

As regards the monetary policy of the ECB, let me start by presenting the principle which forms the foundation of the macroeconomic institutional framework in the euro area. This principle is that of a sound monetary policy aimed at maintaining price stability.

The ECB's Governing Council takes its monetary policy decisions within the framework of a well-designed monetary policy strategy. Less than one month ago, we confirmed our definition of price stability as a "year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%". We also confirmed our medium-term orientation. At the same time, we clarified that in the pursuit of price stability we aim to maintain inflation rates below but "close to 2%" over the medium term. This clarification underlines the ECB's general commitment to provide a sufficient safety margin to guard against potential risks of deflation. It also addresses the issue of the possible presence of a measurement bias in the HICP and the implications of inflation differentials within the euro area.

Let me turn now to the factors which need to be taken into consideration by monetary policy at the current juncture. The first few months of this year were dominated by the uncertainty related to the escalation of geopolitical tensions in the Middle East. This environment, which was also characterised by rising oil prices, was clearly not beneficial for investment and, more generally, economic activity in the euro area and at the global level. As a result, economic growth was relatively weak in early 2003 and expectations for economic growth, at least for this year, have had to be scaled back.

The rapid conclusion of the military activities was accompanied by a normalisation in oil prices and a rebound in stock markets. Both developments indicate that market fears of a worst-case scenario of a prolonged phase of acute geopolitical tensions, with negative implications for economic growth, are fading away. Still, the signals coming from economic indicators – mainly the results of surveys on the confidence of consumers and producers – have remained mixed over recent months and have complicated the assessment of the economic situation.

In this regard, it remains difficult to disentangle factors which may have a transitory effect on economic activity from more entrenched trends. Overall, the information that we have gathered so far points to the continuation of weak economic growth throughout the first half of 2003. However, we expect some acceleration in economic activity in the second half of this year and thereafter. This outlook seems to be in line with financial market expectations. Let me review some of the factors which have shaped this outlook.

First, corporate investment continues to be hesitant. This may be related to the process of adjustment of the balance sheets of corporations, following the rapid accumulation of debt until 2000. The effects of this build-up of debt have been compounded by the significant fall in the value of financial assets from the peak reached in early 2000. There is uncertainty over the size of the adjustment still needed in the euro area corporate sector in order to enhance productivity and profitability.

At the same time, we should not forget that the low level of interest rates that has prevailed for quite a long time in the euro area has helped firms in this adjustment process and should foster a recovery in investment. In addition, the financial position of households in the euro area has remained healthy overall. The stability of the saving ratio in the past years indicates that in the euro area as a whole there is no need for significant adjustments which could constrain the recovery in consumption. The recent fall in oil prices should also support private consumption.

As regards the external balance, given the extent and the length of the period of the appreciation of the exchange rate of the euro, some restraining effects on exports of the euro area will be felt in the period ahead. However, we should keep in mind that after the correction which has occurred over the past 12-14 months, the competitive position of euro area producers, measured by indicators of real exchange rates, is now back in line with long-term averages. Furthermore, the effects of the appreciation of the exchange rate of the euro on aggregate demand may be mitigated by the significant improvements in the terms of trade, as the lower import prices will be conducive to a pick-up in consumption. In addition, the effects of the changes in the exchange rate on trade are likely to be more than compensated for in the coming years by the expected acceleration in economic activity world-wide.

On the latter aspects I should however not conceal that we also see some downside risks to the global recovery in economic activity. Notably, the possible correction of macroeconomic imbalances in other major economies remains a factor of risk. In addition, we cannot exclude that the SARS epidemic may have negative supply and demand effects, although it is difficult at this juncture to assess the possible implications.

What does all this mean for the outlook for price stability? Obviously, prospective developments in economic activity should contribute to restraining inflationary pressure in the euro area in the coming years. In this respect, after a period of rising wage growth, despite a context of subdued economic growth in 2001 and early 2002, we have seen signs of stabilisation of wage growth more recently. The effects of recent exchange rate developments will also make a significant contribution to reducing inflationary pressure, although some of the effects may be visible only with a certain time-lag.

Over the last couple of months, inflation has remained somewhat above 2%. We expect that, after hovering around 2% over the coming months, consumer price inflation should fall more significantly in 2004.

Partly due to the high volatility observed in financial markets in the past, but also due to the low level of interest rates, the euro area economy has continued to accumulate liquid assets significantly above the amount needed to sustain non-inflationary growth. The concerns about this situation are, however, limited, at least as long as economic activity remains subdued. The easing of geopolitical tensions and the recent stabilisation in financial markets should support an unwinding of these portfolio shifts over time. In addition, the moderate growth in loans to the private sector indicates that the growth in monetary aggregates does not reflect internal demand dynamics.

Thus, overall, not least due to the appreciation of the euro, inflationary pressures have declined significantly over recent months. This assessment will be reflected in our deliberations on monetary policy.

As the organiser has asked me to also say a few words on the "policy mix" in the euro area, let me briefly conclude with some remarks on this topic. I think that the macroeconomic policy framework in the euro area is appropriate to ensure sustained and non-inflationary economic growth. Fiscal policy should contribute to maintaining an environment of macroeconomic stability. At the same time, the monetary policy of the ECB takes into account the fiscal policy stance, as one of the factors which contribute to the outlook for price stability over the medium term. In this respect, an efficient assignment of objectives and instruments, together with a clear division of responsibilities, is in place in the euro area. The policy objectives and the policy execution framework are known to all policy actors. An open exchange of views and information between individual policy actors can assist the overall outcome if this enhances an understanding of the objectives and strategies to pursue them.

However, there cannot be any scope for an active co-ordination of fiscal and monetary policies. Such active co-ordination is bound to be ineffective, given the inability of both fiscal and monetary policy-makers to fine tune economic developments. Commitments to ex ante co-ordination between fiscal and monetary policies may blur the responsibilities of monetary and fiscal authorities and ultimately reduce their incentives to pursue their objectives. The economic outcome of such co-ordination is likely to be worse than the conduct of policies within the existing institutional set-up as only the latter ensures genuine accountability.