

Christian Noyer: Presentation of the European Central Bank Annual Report

Introductory statement by Mr Christian Noyer, Vice-President of the European Central Bank, to the Committee on Economic and Monetary Affairs of the European Parliament, Brussels, 17 April 2000.

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It is my pleasure to present today the second Annual Report of the European Central Bank (ECB). Even though it is the second Annual Report to be drawn up under the ECB's responsibility, it is also a "first" in that it gives an account of the Eurosystem's activities during the first year since responsibility for monetary policy in the euro area was conferred upon the Eurosystem on 1 January 1999. Accordingly, it will come as no surprise to you that the substance of this second report is fundamentally different. The focus is no longer on blueprints for an efficient operational and institutional set-up of the Eurosystem and the European System of Central Banks (ESCB). Rather, it comments on the effective implementation of instruments and procedures as well as on the actual pursuit of the various tasks of the Eurosystem, notably the conduct of a single monetary policy for the euro area.

Indeed, for the first time, this Annual Report gives a comprehensive account of the effective conduct of policies under the responsibility of the Eurosystem. It complements, as a specific instrument of accountability, the regular quarterly hearings before your Committee. However, at variance with this regular dialogue, its main focus is not on topical issues, but rather on past developments. Indeed, the Annual Report provides a comprehensive account to the European Parliament, as the only directly elected European institution, and to the other addressees, including the EU Council, the European Commission and, more generally, the wider public. It covers the full range of activities that the Eurosystem carried out in 1999 with regard to the fulfilment of the tasks assigned to it by the Treaty establishing the European Community (the Treaty), with the maintenance of price stability within the euro area at its core. Accordingly, the report comments in detail on the achievement of this primary objective and the monetary policy pursued to this end under the prevailing overall economic conditions. Moreover, it reports quite extensively on the other tasks and responsibilities of the Eurosystem, for instance in the fields of payment and security settlement systems, financial stability and prudential supervision, the preparation of the introduction of euro banknotes and the Eurosystem's role in European and international cooperation. We therefore hope that the Annual Report will be a useful source of information for its readers on these and various other issues.

1. Review of developments in 1999 and the outlook for 2000

I believe that we can justifiably look back on the first 15 months of the euro with satisfaction. The euro was launched successfully in January last year. The careful conceptual and technical preparatory work conducted by the EMI and later the ECB, the national central banks and the financial institutions of the euro area ensured a very smooth transition to the new environment of the single monetary policy. The 11 money markets of the countries which have adopted the euro from the outset were integrated into a single market right from the start. This swift adaptation to the reality of the single currency was helped by the successful launch and operation of the TARGET payment system, which has facilitated cross-border transactions between financial institutions across the euro area. The design of the operational framework for the Eurosystem's monetary policy also aided this rapid adjustment process. The successful launch of the euro has also been evidenced by a significant acceleration in initiatives aimed at integrating the euro area capital markets and by a substantial deepening of these markets during 1999 and in early 2000. Moreover, the euro has become increasingly important as an international currency. I should like to come back to these issues in the course of this presentation.

We are particularly satisfied with the achievements of the Eurosystem's single monetary policy thus far. 1999 saw one of the lowest inflation rates, 1.1%, recorded in the countries of the euro area during the past 50 years. While this was, given the lags in the transmission of monetary policy impulses, to a

large extent a reflection of the monetary policies conducted in the run-up to Stage Three, the evolution of all available forward-looking indicators up to now suggests that the Eurosystem has been successful in continuing the previous policies and in maintaining a positive outlook for price stability in the euro area. In this respect, the quantitative definition of price stability which the Governing Council already published in late 1998 has certainly helped to anchor medium-term inflation expectations to below 2% per year.

With regard to the Eurosystem's primary objective, the maintenance of price stability, the main challenge for monetary policy is to assess the risks to price stability in the future. In this respect, the use of a broad set of indicators, as reflected in the two pillars of the monetary policy strategy of the Eurosystem, has successfully contributed to framing and giving an orientation to the discussions on monetary policy in the euro area. The Eurosystem considers the experience with this two-pillar strategy to have been very positive, looking back on the first year of its operation.

The prominent role attributed to money, the first pillar, underpinned by the definition of a reference value for the annual rate of growth of M3, has been an important signpost for the considerations and decisions of the Governing Council, given the favourable empirical evidence that money is a leading indicator of future price developments. Accordingly, the Governing Council confirmed in December 1999 that it would continue to analyse monetary developments against the reference value for M3 growth of 4½%.

Similarly, the use of information from other, non-monetary indicators under the second pillar of the monetary policy strategy has enabled the Governing Council to cross-check appropriately and to complement the information content of monetary aggregates and to take into account relevant information from various other sources in assessing the outlook for price stability. Given the uncertainty in which monetary policy operates - and this uncertainty is particularly relevant at the start of Stage Three - the two-pillar approach is, in our view, the most appropriate way in which to exploit the available information from both monetary and real indicators and thereby to provide a sound basis for monetary policy decisions. Beyond that, this is probably also the most transparent means of explaining these monetary policy decisions to the markets and to the public at large.

At the current juncture, the outlook for the euro area economy is very favourable. We should, however, remember that the situation was quite different at the start of Stage Three. The financial crises which occurred in several emerging market economies had significantly worsened the outlook for economic growth in the euro area in late 1998. As the weakening outlook for economic activity implied downside risks to price stability at a time when inflation rates were below 1%, the Governing Council decided in April 1999 to reduce the ECB interest rates in a precautionary manner. At that time, developments in M3 were only slightly above the reference value and, also taking account of the uncertainties related to the analysis of monetary developments at the start of Stage Three of EMU, these developments were therefore not considered as pointing to upward risks to price stability.

In the following months, however, the subdued climate was replaced by a gradually improving economic environment. At the same time, upward pressures on consumer prices arose, mainly as a result of the increase in import prices, driven by rising oil prices and the depreciation of the exchange rate of the euro. In addition, the three-month average of annual M3 growth followed a gradually rising path, approaching 6.0% as from the summer of 1999. In conjunction with strong growth of credit to the private sector, at annual rates of around 10%, this indicated that liquidity was ample in the euro area. Against this background, there was a greater risk that the rise in import prices could trigger lasting effects on inflation and have an adverse impact on the outlook for price stability in the medium term.

The Governing Council has responded to these upward risks to price stability over recent months, with three successive increases in the ECB interest rates, which were effected in November 1999, and in February and March 2000. As a result of these increases, the main refinancing rate now stands at 3.50%, while the rates on the marginal lending facility and on the deposit facility have reached 2.50% and 4.50% respectively. These decisions were taken in order to contain the risks to price stability in a timely and pre-emptive manner. In this way, they have also contributed to the achievement of sustainable, non-inflationary economic growth in the euro area.

At present, the outlook for growth in the euro area is better than it has been for years. This positive outlook can be largely attributed to the convergence process in the run-up to Stage Three of EMU, as reflected in stable prices, a clear improvement in the public finance situation and a low level of interest rates in the euro area.

However, the exchange rate of the euro does not reflect the ongoing improvement in the domestic fundamentals of the euro area economy. The depreciation of the euro in nominal effective terms over the last months will, until reversed, put upward pressure on import prices and continue to affect the risks to price stability.

Developments in the exchange rate of the euro thus remain a concern with regard to future price stability. In addition, recent monetary and credit developments confirm that liquidity in the euro area remains ample. In the light of the favourable prospects for economic growth, the impact of these developments on inflationary pressures is being monitored closely.

The Eurosystem will remain vigilant in assessing upside risks to price stability. It is in the interest of the whole Community that, as and when required, the Eurosystem acts in a timely manner to maintain a positive outlook for price stability and, in this way, to support lasting non-inflationary growth in the euro area. There can be no doubt that a forward-looking monetary policy, which responds to risks to price stability before they materialise, avoids the need for costly and painful inflation reduction at a later stage, which would endanger the outlook for economic growth.

While the maintenance of price stability is the best contribution that monetary policy can make to sustaining strong economic growth, other actors also need to play their part if we are to turn the currently favourable prospects into a lasting period of economic growth and employment creation. In this respect, the continuation of moderate wage developments will be a crucial factor in both employment generation and the confinement of inflationary pressures.

At the same time, more decisive structural reforms in the euro area would certainly enhance the prospects for continued economic expansion. Only recently, the importance of structural reforms was emphasised by the Lisbon European Council, the conclusions of which should be implemented in a timely manner.

We are also encouraging governments to use the current favourable economic conditions to proceed more swiftly towards achieving the objectives of the Stability and Growth Pact. This will further enhance the growth prospects of the euro area and free up resources which could be used by the private sector to finance new initiatives to create employment.

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Turning from the macroeconomic assessment to more technical aspects of the implementation of the Eurosystem's monetary policy, I should like to draw your attention to the smooth functioning of the operational framework for monetary policy. The framework, which includes two standing facilities, a minimum reserves system with an averaging provision, and regular auctions for the allotment of liquidity in the euro area, has proved to be highly efficient. It has allowed the Governing Council to signal clearly its interest rate intentions through the rates set for the main refinancing operations. The effectiveness of the framework has also been reflected in the low volatility of short-term interest rates and the virtual absence of any fine-tuning operations on the part of the Eurosystem.

The smooth implementation of the single monetary policy has been closely linked to the rapid transformation of national money markets into a single euro area money market. This process has been significantly supported by TARGET, the Trans-European Automated Real-time Gross settlement Express Transfer system. TARGET, which is operated by the Eurosystem, commenced operations on 4 January last year and is currently the largest payment system within the EU, both in terms of the value of transactions and of the volumes processed.

Any review of the first year of the Eurosystem's operational existence would be incomplete without a reference to the international role of the euro. During this time, the euro has assumed an increasingly important role as an international currency, as evidenced by the strong issuance of euro-denominated

debt securities by non-residents of the euro area. The euro has, from the very outset, been the second most widely used currency at the international level, reflecting both the economic importance of the euro area and the legacy of the former national currencies which it replaced.

In this context, I should like to emphasise that the development of the euro as an international currency has been entirely determined by markets. The use of the euro by private agents both as an investment and financing currency and as a payment and vehicle currency has been largely supported by ever more integrated, liquid and diversified euro financial markets. Moreover, the euro has benefited from cross-border trade, investment flows and the overall economic stability of the euro area. The internationalisation of the euro is not an objective of ECB. However, it is evident that its monetary policy geared towards price stability plays an important role in inspiring investor confidence.

2. Comments on other activities of the Eurosystem

Let me now move on to other tasks performed by the Eurosystem during 1999. In view of the broad scope of these activities, I am only able to touch upon a few of them.

Starting with the Eurosystem's activities in the field of prudential supervision and financial stability, the ECB established, in 1999, appropriate channels and fora for ensuring cooperation with national supervisory authorities. The main forum of cooperation in this regard is the Banking Supervision Committee of the ESCB, which comprises high-ranking representatives of central banks and banking supervisory authorities of the 15 EU Member States. The various issues dealt with included, inter alia, an in-depth analysis of the overall soundness of and structural changes to the EU banking and financial sector. Moreover, considerable attention was devoted to ways of further improving the effectiveness of supervisory risk assessment systems.

As regards the promotion of the smooth functioning of payment systems, which is a task explicitly entrusted to the Eurosystem by the Treaty, I should like to recall in particular the initiative taken by the ECB in September last year, when it published a report on ways to improve cross-border retail payment systems in the euro area. The background to this initiative was the Eurosystem's concern that the service level, both in terms of speed of execution and of fees levied on customers, is still lagging behind the expectations of many European citizens and businesses. This situation is clearly unsatisfactory, since the efficient functioning of payment systems is crucial in order to reap the full benefits of the Single Market. Therefore, the ECB decided to publish a number of objectives which the banking and payment service industry is expected to fulfil by the time of the introduction of the euro banknotes and coins. While the direct involvement of the Eurosystem in retail payment systems does not seem to be justified at present, it will certainly act as a catalyst for change.

At this point, let me briefly refer to the issue of electronic money. As you are aware, the Eurosystem has expressed several concerns from a monetary policy, payment system and prudential supervision perspective with regard to the draft Directive on the establishment of electronic money institutions. The support that this Committee has lent to the Eurosystem's suggestions has indeed been appreciated. However, given that the Directive, in its final version, will not take into account our principal concerns, the Eurosystem will remain extremely vigilant and closely monitor further developments in this area.

The preparation of the changeover to euro banknotes and coins, which will take place on 1 January 2002, was another major task of the Eurosystem during 1999. In the course of the year, the printing of a pilot series of euro banknotes was successfully completed, and it was therefore possible to start production. The banknotes will be printed in 11 printing works, of which nine had already begun production by the end of last year. Particular importance is attached to the quality management for the euro banknotes.

In preparation for the changeover to euro cash, various measures were taken in the course of 1999 in order to protect the euro banknotes and coins against counterfeiting. Among these measures, let me highlight the ECB's decision to set up a database to collect and store all technical and statistical data on counterfeit euro banknotes and coins and to develop a counterfeit monitoring system. In addition, the ECB is liaising with the European Commission, Europol and Interpol in order to ensure an

effective exchange of information in this regard. Finally, I should take the opportunity to inform you that the ECB recently finalised the design and content of the EURO 2002 information campaign. You may be aware that the ECB will be presenting this campaign to your Committee at one of the forthcoming meetings.

Another main area of our activities related to international cooperation. As one might expect, the ECB closely monitors all international developments that may have a bearing on the achievement of its tasks. Moreover, given the economic importance of the euro area and the euro's role as the world's second international currency, the ECB is a major actor in the international monetary and financial system and certainly has a role to play in crucial fields such as the maintenance of financial stability and the soundness of the global economic and monetary environment.

As a consequence, the ECB regularly participates in the meetings of various international institutions and fora, such as the G7 Finance Ministers and Central Bank Governors, the G10, the G20 and the newly created Financial Stability Forum. Moreover, the ECB has obtained permanent observer status at the International Monetary Fund. It participates in all meetings of the IMF Executive Board at which issues related to euro area monetary and exchange rate policy are discussed and has established a permanent representation in Washington D.C.

I should also point out that the ECB has started to closely follow the process of accession of new EU Member States. In this context, the ECB intends to maintain close contacts with the European Commission, which will also help to ensure that the Eurosystem's views, within its fields of competence, are duly taken into account during accession negotiations. In order to facilitate the adoption of EMU-related legal, operational and policy requirements, the ECB has initiated a dialogue with the central banks of the accession countries, which was most notably reflected in the organisation of a high-level seminar in Helsinki in November last year.

Naturally, the broad range of activities of the Eurosystem, of which I have tried to give you a concise, albeit incomplete overview, has placed severe strains on personnel resources. In order to be able to cope with the increase in operational and policy competencies, the ECB had to recruit further staff. Having started from a level of 534 staff members at the beginning of 1999, the ECB currently employs around 760 people. This number is set to increase to slightly above 1,000 employees by the end of the current year. The rising staffing level has also necessitated extension of infrastructure and premises.

This brings me to the annual accounts of the ECB for 1999. I should like to report that the ECB made an operating profit of EUR 666 million. However, the ECB was required to pay EUR 913 million to the Eurosystem's national central banks as remuneration for the foreign reserve assets, including gold, which were transferred to the ECB at the beginning of 1999. Taking into account this remuneration, the financial result of the ECB for 1999 was a loss of EUR 247 million. Detailed explanations on the more complex factors behind this result are given in the Annual Report.

As you may be aware, the Statute of the ESCB contains precise provisions on the allocation of profits and losses. In line with these provisions, the greater part of last year's loss has been funded by the national central banks of the Eurosystem.