

Willem F Duisenberg: Presentation of the ECB's Annual Report 2000 to the European Parliament

Introductory statement delivered by Dr Willem F Duisenberg, President of the European Central Bank, to the European Parliament, Strasbourg, 3 July 2001

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It is my great pleasure today to present the third Annual Report of the ECB, two and a half years after launch of the euro and less than half a year before the single currency will become fully visible for our citizens in the form of banknotes and coins.

Economic and monetary developments and the monetary policy strategy of the ECB

2000 was a remarkable year for the euro area, as economic growth reached its highest level for over a decade and was accompanied by continued strong job creation. The HICP in the euro area has also been above 2% since the middle of 2000, mainly owing to oil price increases and the depreciation of the exchange rate of the euro last year. While this increase in the HICP to above the ECB's definition of price stability is not welcome, the ECB cannot and should not avoid short-term price fluctuations caused by such temporary factors. Nonetheless, it is crucial to prevent any spillover of transitory short-term pressures into medium-term inflation expectations. During 2000 the ECB had to be particularly vigilant in this regard in a context of strong economic growth and given that monetary developments clearly indicated the existence of upward risks to price stability. It was for this reason that we raised interest rates six times in 2000. By doing so, the ECB contributed to ensuring the sustainability of non-inflationary economic growth in the euro area.

In this respect, the evolution of long-term interest rates in the euro area in 2000 indicated that financial markets generally expected medium-term price developments to remain in line with the definition of price stability. The forecasts which became available in 2000 painted a similar picture. This is a clear indication that the ECB affirmed its credibility in 2000.

Before sharing with you my analysis of the current situation, let me turn to some issues raised in the draft resolution prepared by your Committee on Economic and Monetary Affairs concerning the monetary policy strategy of the ECB. I should like to begin by saying that I share the view expressed in the draft resolution that the ECB's two-pillar strategy can be understood as a means of analysing all the pieces of information relevant for monetary policy. However, there are other points in the resolution with which I would not agree. These concern the doubts expressed with regard to the definition of price stability, the importance that the first pillar should be given in our strategy and the role of projections under the second pillar.

The Governing Council of the ECB has defined price stability in the euro area as "*year-on-year increases in the HICP for the euro area of below 2%*", and has stated that "*price stability has to be maintained over the medium term*". The definition provided by the Governing Council ensures accountability and gives clear guidance to expectations of future price developments. The phrase "*below 2%*" clearly defines the upper boundary of the rate of HICP increases which is consistent with price stability. This upper boundary is in line with the practice of the national central banks of participating Member States before the start of the Stage Three of EMU. In addition, the word "increase" clearly signals that prolonged declines in the level of the HICP index would not be deemed consistent with price stability. There should be no doubt that the commitment of the ECB to maintain price stability is compatible neither with inflation above 2% in the medium term nor with deflation. In this sense, the monetary policy of the ECB is fully symmetric, fighting both upward and downward pressures on prices which may result in outcomes not in line with our definition of price stability.

Within our monetary policy strategy, the first pillar assigns a prominent role to money. This reflects the fundamental monetary nature of inflation – as supported by empirical evidence, much of which is available from our Working Paper Series – which indicates a stable long-run demand for M3 and good leading indicator properties of M3 growth for inflation in the medium term. The need to follow monetary developments is therefore key to analysing risks to price stability in the euro area in the medium term. I should also emphasise at this point that the quality of monetary statistics is among the highest of all statistics available in the euro area. These monetary statistics are based on a fully harmonised reporting scheme across all Monetary Financial Institutions in the euro area. The quality of monetary

statistics has recently been improved by identifying, as a separate item, non-resident holdings of money market funds. Furthermore, we expect that it will be possible for the non-resident holdings of other negotiable paper to be appropriately measured and published towards the end of the year. For all these reasons, M3 will continue to play a prominent role in the monetary policy of the ECB.

With regard to the projections, and in particular to the suggestion that they should be explicitly endorsed by the Governing Council, let me remind you that the Governing Council is accountable only for maintaining price stability. It is up to the Governing Council to take the decisions necessary to ensure the performance of the tasks entrusted to the ESCB by the Treaty. In this respect, the Governing Council decided, for several reasons, to follow a two-pillar strategy. In particular, it was decided not to follow a strategy under which monetary policy decisions would be made solely on the basis of inflation forecasts. While the staff projections play an important role in the analysis the Governing Council conducts under the second pillar, it is important to understand that this analysis is not centred on these forecasts. Given the difficulties of forecasting over longer-term horizons and the uncertainty regarding the appropriate economic model, the Governing Council does not deem it advisable to use only a single projection to analyse risks to price stability. The uncertainty surrounding forecasts has also been appropriately reflected in the manner in which the ECB publishes them, namely in the form of ranges rather than point estimates.

Turning to an analysis of current economic and monetary developments, after the decision on 10 May to lower the key ECB interest rates by 25 basis points, at its meetings in June the Governing Council considered that, on the basis of the information available, the current level of key ECB interest rates was appropriate to ensure price stability in the euro area over the medium term. Since the last meeting of the Governing Council, there has not been any new information that would justify changing this assessment.

As regards the information contained in the first pillar, monetary developments point towards a favourable outlook for the medium-term maintenance of price stability. After having followed a gradual downward trend since spring 2000, the three-month average of annual M3 growth rates has tended to broadly stabilise over recent months. When account is taken of the upward distortion to monetary figures, M3 would have been growing at around the reference value in the most recent period. Moreover, the annual growth rate of loans to the private sector has continued to moderate, mainly driven by the slowdown in loans to households.

With regard to the second pillar, we continue to expect the currently high rates of inflation to remain a transitory phenomenon and, in the absence of further unfavourable price shocks, inflation rates should fall below 2% in 2002. These developments are expected to take place in an environment of weaker economic growth, which should, however, remain broadly in line with trend potential growth of the euro area.

In this context let me turn to an issue which has attracted considerable attention just recently: the potential impact of the cash changeover on price pressures. In general, price transparency and competition are likely to limit inflationary pressures from the cash changeover. In this respect it is also worth noting the commitment of finance ministers in the euro area, as reflected in a statement issued by the Eurogroup, that, overall, the conversion into euro of all prices, charges and fees administered by their governments will be price neutral or else "smoothed" in favour of the consumer. We call on governments at other levels but also on firms to follow this example set by central governments. In addition, the public's vigilance in monitoring prices and price changes will also be important during the conversion period.

The ECB will continue to pursue its mandate to maintain price stability over the medium term, irrespective of whether prices are quoted in euro or in the component currencies. We shall therefore continue to remain vigilant as regards future developments affecting the balance of risks to price stability, including – in particular – monetary developments, real GDP growth, price-setting behaviour and wage developments. At this juncture, when price developments are mainly being affected by transitory factors, it is crucial that the current upward movement of prices does not become a more lasting one, and it is therefore important that wage moderation continue.

The introduction of the euro banknotes and coins

With a view to the introduction of the euro banknotes and coins, I can report that the Eurosystem's preparations are well on track. At the end of June 2001 the total number of euro banknotes produced so far amounted to about 9 billion, which is about 90% of the initial launch stock. Moreover, as an

insurance against potential production risks, in March 2001 the ECB decided to establish a Eurosystem central reserve. This reserve will amount to about 10% of the launch and logistical stocks.

On 1 January 2001 the Eurosystem launched the "*Euro 2002 Information Campaign*", which is designed to complement other information campaigns being conducted at the national level. The main objective of the campaign is to familiarise the general public and specific target groups with the visual appearance of the euro banknotes and their security features and to raise the awareness of citizens about the overall changeover modalities. The information campaign is progressing on schedule. It will become fully visible for citizens once the mass media part of the campaign starts on 30 August 2001, after the unveiling of the final visual appearance of the euro banknotes and their security features.

The Eurosystem is fully aware of the importance the successful introduction of the euro banknotes and coins will have for overall confidence in the single currency, and the careful and comprehensive preparations being made by the Eurosystem are commensurate with this task. We should all bear in mind the fact that the cash changeover is an unprecedented challenge and a huge logistical exercise and that all the parties involved will have to assume their part of the overall responsibility for making the introduction of the euro banknotes and coins a success.

At this point, I should like to comment briefly on the issue of the sub-frontloading of euro banknotes to the general public, a matter on which I have reported to you in greater detail on previous occasions. Let me remind you that the ECB's decisions have been taken in full respect of the general interest, and after a thorough assessment of all the aspects involved. No new elements have emerged which would justify a renewed reflection on this issue.

Issues related to banking supervision

Turning to issues related to banking supervision also raised in the draft resolution on the ECB's Annual Report, I should like to recall, at the outset, that the framework for financial stability in the EU relies on two building blocks: national competence and co-operation. It is our firm belief that the impressive changes in financial markets prompted by the introduction of the euro call for a substantial enhancement of the mechanisms for co-operation between national authorities and with the Eurosystem. This is so because EMU is changing the nature and scope of systemic risk. It is no longer possible to assess threats to financial stability or the potential channels for the spread of contagious risks only at the domestic level. I was therefore particularly glad to see that the contribution of the ESCB to improving the institutional framework for financial stability and, in particular, the development of macro-prudential analysis have been acknowledged and supported in the draft resolution.

The draft resolution also refers to the need to avoid conflicts between supervisory responsibilities and the responsibilities of the monetary authorities. I should like to say, first, that the empirical evidence of potential conflicts between the objectives of financial stability and price stability is unclear and, second, there is no possibility for such a conflict to arise in the context of the institutional arrangements in the euro area. Indeed, the introduction of the euro has entailed an institutional separation between monetary policy decision-making, which is addressed to the euro area as a whole, and the exercise of supervisory tasks, which relates to domestic institutions and markets. The decision-making mechanisms for the two tasks no longer coincide, and the risk of conflict has been overcome by the institutional set-up. To conclude my statement, I should like to underscore that the introduction of the single currency has indeed reinforced the need for the strong involvement of central banks in prudential supervision and financial stability.