Willem F Duisenberg: Testimony before the Committee on Economic and Monetary Affairs of the European Parliament

Introductory statement by Dr Willem F Duisenberg, President of the European Central Bank, Brussels, 8 October 2002.

* * *

It is my pleasure to appear before your Committee today in order to explain the European Central Bank's assessment of economic and monetary developments and to report on the decisions taken by the Governing Council.

At the time of our last meeting, in May, we were expecting economic growth in the euro area to be in line with trend potential again by the end of this year, and we noted that some upward risks to price stability existed in the euro area. At the same time, we also noted that there were still uncertainties with regard to the strength of the economic recovery, which implied the existence of uncertainties with regard to the inflation outlook. Since then, some of the downward risks to our main growth scenario have in fact materialised. The recovery, both in the euro area and the world economy, has progressed more slowly than expected, and it has been necessary to scale down our expectations for economic growth in 2002. At the same time, the exchange rate of the euro has strengthened and we have seen some rather turbulent periods in financial markets. All these factors have contributed to balancing the risks to price stability over recent months.

Looking at recent information in more detail, and starting with the most recent data available for the first pillar of the ECB's monetary policy strategy, the figures up to August 2002 continue to suggest that monetary growth is strong in the euro area and that liquidity is ample. However, we need to be cautious in our assessment of recent monetary developments. On the one hand, in an environment marked by considerable uncertainty, especially in the financial markets, the current high rate of monetary growth reflects a preference for holding relatively safe assets included in M3. On the other hand, the strong monetary growth may also reflect stimulus from the low level of short-term interest rates. This can be seen from the fact that the most liquid components of M3, i.e. those included in the narrow aggregate M1, have continued to rise at a rapid pace recently.

The growth of loans to the private sector appears to be stabilising at levels above 5%. While the decline in loan growth which has occurred over the past 18 months is significant, the current rate of growth is not low by historical standards. This indicates that bank financing conditions are overall favourable.

The assessment of monetary developments remains complex at this stage. The existing excess liquidity, if sustained, might signal risks to price stability in the medium term. However, it is unlikely that excess liquidity will translate into inflationary pressures in the near future, given the environment of subdued economic growth.

Turning to the second pillar of the ECB's monetary policy strategy, at this juncture the most likely scenario is modest real GDP growth in the second half of 2002 and an acceleration towards growth rates more in line with potential in the course of 2003. The recent scaling down of expectations for economic growth stems partly from a weaker outlook for the global economy, which in turn is closely related to the significant fall in stock prices which has occurred over recent months in all major economies.

As regards domestic demand, higher growth of private consumption should be a key factor in supporting economic activity in the euro area. There are indications that such a recovery took place in the second quarter, but at a moderate pace. In the period ahead, if oil prices do not rise further, consumption should be supported by an increase in real disposable income resulting from the decline in inflation from the higher levels recorded at the start of this year. The impact of the introduction of the euro banknotes and coins on consumer prices has been very limited and we are convinced that divergences between factual and perceived inflation are a temporary phenomenon. Furthermore, the low levels of interest rates across all maturities should help to support investment and economic growth in the period ahead.

In spite of these positive factors, however, the uncertainty surrounding the economic outlook remains high in the short term. In principle, the increase in direct and indirect holdings of equities by euro area households over recent years has raised the potential for recent financial market developments to have an adverse influence through wealth effects. Moreover, recent financial market developments may make it more expensive to raise equity capital to finance corporate investment in the euro area. While all available evidence suggests that these effects will continue to be relatively limited and indeed much smaller than in other major economies, the sharp decline in equity prices is an element which has increased the uncertainty surrounding the recovery. In addition, imbalances in the global economy and their potential spillover to the euro area economy remain a significant source of risk for growth. Finally, uncertainty is also high because it is difficult to foresee developments in the oil markets against the background of current political developments.

Moving to the outlook for prices in the euro area, we have seen HICP inflation rates hovering around 2% over the past couple of months. These developments are broadly in line with previous expectations of inflation rates for the remainder of the year, but recent upward tendencies indicate that the short-term trend has been affected by oil price developments. However, subdued economic activity and the stronger euro should help to dampen inflationary pressures over time.

At the same time, however, we need to assess other factors which may involve upward risks to price stability. Among those, wage developments play a particular role. Wage growth remained on an upward trend until early this year. Although we have indications that this trend may have come to a halt in the second quarter of 2002, close monitoring is necessary.

To sum up, inflationary pressures have declined. Looking forward, recent trends in economic activity and the exchange rate of the euro imply downward pressure on inflation rates, but other factors, in particular monetary developments, wage trends and oil prices, need to be monitored for their possible upward impact on inflation. Overall, therefore, we are of the opinion that the risks to price stability over the medium term are at present balanced. We thus consider the current level of the key ECB interest rates to be appropriate.

At this juncture it is of utmost importance that all macroeconomic policies remain oriented to the medium term, with all players fulfilling their responsibilities. Monetary policy will continue to provide a reliable anchor for the economy, especially in an environment characterised by high uncertainty and fragile confidence. This implies focusing on the maintenance of price stability over the medium term.

Let me make a remark in this context, linked to comments which arise with a certain regularity in public debate and which argue that monetary policy should follow a different orientation, an orientation in which price stability is not the overriding objective.

I should like to recall in this connection the fundamental and yet simple principle that monetary policy should not be overburdened with objectives that it cannot fulfil. It is well established that monetary policy can only control price developments over the medium term and cannot have an impact on output beyond the short term. Monetary policy can certainly not heal structural problems in the economy, such as those underlying the high level of unemployment.

In line with these principles, the Treaty establishing the European Community has assigned the ECB the primary objective of maintaining price stability. In the end, strictly following this mandate, with the appropriate medium-term orientation, is the best contribution the ECB can make to supporting sustainable non-inflationary growth and a high level of employment in the euro area.

Taking a broader perspective, I should like to take this opportunity to further emphasise the overall soundness of the institutional framework for monetary and economic policy laid down by the Treaty. In fact, the Treaty provides, in all fields, a clear and consistent allocation of policy objectives and responsibilities among the various policy-makers.

In this respect, it is the task of fiscal policy to make its contribution to enhancing the growth potential of the euro area by maintaining sound fiscal positions and helping to reinforce the proper framework for the functioning of a market economy. It is also important that fiscal policy maintains a medium-term orientation throughout the economic cycle.

The results of fiscal policy in several countries have been very disappointing in the last few years. The pace of reform has significantly fallen and there have even been setbacks in the efforts to consolidate in some cases. In fact, the main reason why several countries at present are in budgetary difficulties is because they have not used the past phase of higher growth to substantially improve their fiscal position, i.e. they have shown precisely a lack of medium-term orientation.

It is crucial that fiscal policy fully respects the basic principles of the Treaty and of the Stability and Growth Pact, namely to avoid excessive deficits and to attain budgetary positions close to balance or in surplus in the medium term. If the Pact is to work efficiently, all countries with remaining imbalances must commit themselves to implementing a clear consolidation strategy. Such a strategy should specify a credible adjustment path with significant improvements in the cyclically-adjusted budget balance every year. This path should be followed strictly and completed within the shortest possible time frame. It must be based on realistic assumptions for the economic environment and include clearly specified measures. Furthermore, accounting rules must be rigorously applied and strict procedures established to monitor the implementation of the consolidation strategies. In the end, the full adherence of all governments to the Stability and Growth Pact can only be beneficial for the euro area.

Finally, it is important to stress, especially in a phase of uncertainty regarding economic activity, that decisive structural reforms will contribute to increasing the euro area's resilience to economic shocks, enhance price and wage flexibility, and thereby reduce the costs associated with an economic downturn and increase the euro area's growth potential. Structural reforms in product, labour and financial markets are essential in order to foster non-inflationary growth in the euro area and create a climate of economic stability and dynamism. Countries should therefore speed up their efforts to implement such structural reforms, without which the benefits of the introduction of the euro can hardly be reaped.

I will be pleased to answer your questions now.