

# 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, 10 September 2003.

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It is my pleasure to appear before your Committee here today. As usual, I shall start my testimony with the ECB's assessment of recent economic and monetary developments. I should then like to turn to issues relating to euro banknotes and conclude my opening remarks with a few personal observations.

## 1. Economic and monetary developments

Starting with our assessment of the economic environment, the data that has become available over recent months has confirmed that real economic activity in the euro area was very weak in the first half of 2003, with a slight quarterly decline in real GDP growth in the second quarter according to Eurostat's first estimate. At the same time, indications of an upturn in economic activity starting in the second half of the year have strengthened. In fact, survey data and financial market developments reflect an improvement in confidence. The expectation of a gradual economic recovery starting this year and strengthening in 2004 is in line with all the forecasts and projections which have recently become available.

Both external and domestic factors continue to support the expected pick-up in economic activity. As regards the external factors, the economic recovery which is already under way in several parts of the world should lead to an increase in euro area export demand. This development should counteract the effects of the loss of price competitiveness brought about by the past appreciation of the euro. Furthermore, real disposable income should be positively affected by terms of trade effects stemming from the past appreciation of the euro. Moreover, ongoing adjustment efforts by companies to enhance competitiveness and profitability should improve the conditions for an economic upswing. In this respect, the low level of interest rates strengthens incentives to invest.

As a consequence of recent developments, downside risks to the main scenario of a gradual economic recovery have declined, although they have not disappeared. Macroeconomic imbalances in some regions of the world still persist. Although these may not affect the short-term economic dynamics, they constitute a risk over the longer term. In addition, oil price developments may also pose a risk to economic activity.

As regards prices, Eurostat's flash estimate for annual HICP inflation in August was 2.1%. Annual HICP inflation is likely to hover around, or be slightly above, 2% for the remainder of 2003, not least as oil price developments imply some upward pressure in the short term. Beyond the short term, we continue to expect annual inflation rates to fall below 2% in 2004, stabilising at levels consistent with price stability. This expectation is based on the assumption of moderate wage developments in the context of a gradual economic recovery. Moreover, the significant past strengthening of the external value of the euro should continue to have lagged effects which will limit upward pressure on prices, despite some recent declines in the level of the euro exchange rate. Over longer time horizons, inflation expectations in the euro area seem to be well anchored at levels below but close to 2%.

As regards our monetary analysis, monetary growth has remained strong in recent months. As a consequence, there is significantly more liquidity available in the euro area than is needed to finance non-inflationary growth. This high excess liquidity is partly due to portfolio shifts and an increase in precautionary savings. However, the low levels of interest rates have contributed to the high demand for liquid assets. The current level of interest rates is also counterbalancing the negative impact of subdued economic growth on credit demand. In fact, the growth of loans to the private sector has stabilised at relatively robust levels since the beginning of the year.

At the current juncture, the ample liquidity is not expected to translate into inflationary pressure. However, monetary growth needs to be closely monitored, as the significant amount of excess liquidity could become a source of concern if it were to persist when economic activity strengthens significantly.

To sum up, and cross-checking the information from the two pillars, our economic analysis confirms the expectation that price pressures will remain subdued in the context of a gradual economic recovery and moderate import price and wage developments. The strong monetary expansion should not, in view of the economic situation, be seen as adversely affecting this outlook for the time being. Overall, therefore, the medium-term outlook for price stability remains favourable. Against this background, the key ECB interest rates are considered appropriate at present. Clearly, the Governing Council will continue to carefully monitor all factors that might affect this assessment.

Taking a longer-term view, the current level of short-term nominal interest rates in the euro area is the lowest recorded over the past 50 years. More importantly, the low level of interest rates is at present associated with inflation expectations that are compatible with price stability. This has not often been the case in the past.

In this respect, history tells us that loose monetary and fiscal policies lead to entrenched inflation processes, which in the end had adverse consequences for economic growth and employment. If we were to learn a lesson from the 1970s and the 1980s, it would be that there are high economic costs to be paid in fighting inflation once it has become entrenched. I should recall that it was this realisation which led to the worldwide conviction that monetary and economic policies should be stability-oriented.

If I look back at the early years of Stage Three of Economic and Monetary Union (EMU), I can say that I am satisfied with what has been achieved by the monetary policy of the ECB. Inflation expectations over this very challenging period indicate that there is public confidence in the fact that price stability in the euro area will be maintained. This confidence constitutes a major achievement which - through a variety of channels - contributes to raising the growth potential of the euro area.

However, I must also confess that other macroeconomic policies have not lived up to expectations.

In the area of fiscal policy, we have seen a process where commitments made have repeatedly been broken. From the start of Stage Three, some countries have not shown sufficient determination to meet one of the key objectives of the Stability and Growth Pact, namely to achieve budgets in balance or surplus over the medium term. As the times of strong economic growth have not been properly used to bring the fiscal position of these countries onto a sustainable basis, it is not surprising that these countries have had problems during the last few years in keeping fiscal deficits below the threshold of 3% of GDP laid down in the Treaty.

In this light, I view recent fiscal developments and the discussions surrounding the Stability and Growth Pact with great concern. There is growing evidence that most countries will miss their budgetary targets for 2003 by a significant margin. While the deterioration of budgetary balances mainly reflects the lower than anticipated economic growth, it is worrying that not all countries with severe imbalances have so far introduced sufficient consolidation measures.

The lack of fiscal discipline - and notably the lack of any clear medium-term-oriented consolidation strategies - is a factor weighing adversely on the euro area's long-term growth prospects. In order to strengthen confidence in the euro area, it is fundamental to maintain the credibility of the institutional and economic underpinnings of EMU and to abide in all respects by the agreed rules of the game. It is essential that, in the budgetary plans currently being prepared for 2004, there be a correction of excessive deficits within the agreed time-frame in the countries concerned. In the other countries with fiscal imbalances, a structural consolidation effort of at least 0.5% of GDP per year is required. All fiscal plans need to be part of a comprehensive and credible medium-term strategy, with an emphasis on expenditure restraint and a growth-oriented restructuring of expenditure.

Another area in which we have seen insufficient progress over recent years is that of structural reforms. While some initiatives are under way, more needs to be done to address structural rigidities in the labour and product markets. I should like to emphasise that the benefits of these reforms for the economic growth potential of the euro area would be substantial. Such reforms are essential to address what is perceived as the euro area's main economic problem, namely the high level of structural unemployment. While these benefits will be fully reaped over the medium term, I am also convinced that reforms would also support economic growth in the short term, as they would strengthen confidence and make the euro area more attractive to investors.

## **2. Issues relating to euro banknotes**

Let me now turn to issues relating to euro banknotes. Continuing a practice that was established last year, the ECB published, in July, its biannual information on the counterfeiting of the euro. The data

confirmed what was expected from the outset, namely that the counterfeiting figures would increase in the early years of the new currency. In addition, because of its status as an international currency, the euro may be considered a more attractive target than any of the legacy currencies were. However, despite these factors, and although it may be too early to identify any reliable trends, euro counterfeiting has currently settled at a level far lower than the aggregate level of counterfeiting of the legacy currencies in 2001. This factor should be clearly emphasised, since much of the public reporting in this regard has been exaggerated or distorted.

The euro banknotes are designed to be among the best in the world when it comes to counterfeit resistance. Moreover, in line with the normal practice of central banks, preparatory work has begun on developing even better protected banknotes. These may be issued towards the end of this decade. However, even the most sophisticated security devices will be useless if the banknote user makes no effort to check them. Therefore, our message to the public in our press releases on counterfeiting has consistently been that there is no undue cause for alarm about counterfeiting, but that the public should remain vigilant in checking banknotes using the FEEL-LOOK-TILT test, thereby denying criminals any chance of succeeding in their attempts at counterfeiting. This remains my message.

In addition, we are also trying to identify any need for the provision of additional information and training to the general public and, in particular, to professional cash handlers, i.e. cashiers of shops and banks, which are normally frontline targets for counterfeiters. At the same time, the ECB has been stepping up the institutional framework for combating counterfeits. In this context, I should like to refer to the close co-operation on anti-counterfeiting issues that has been established between the ECB, Europol and the European Commission. Moreover, co-operation agreements are about to be concluded between the ECB and Interpol, and between the ECB and national central banks of acceding countries.

Before concluding, let me make a final remark. As you know, this is my last testimony before your Committee. I have had the privilege to preside over the ECB for the past five years, guiding it from its very inception through a number of crucial - and successful - stages, such as the introduction of the euro in 1999 and, three years later, the euro cash changeover. Both events were, in my view, major steps towards a Europe "united ever more closely", and I am honoured to have served the European public and the cause of European integration during these times.

Madam Chairman, Honourable Committee Members, let me convey to all of you my sincere thanks for our very fruitful co-operation over the past few years. While we may not always have agreed on all issues, I believe that our relationship was marked by mutual confidence and a truly co-operative spirit. I have enjoyed working with you and wish you, as well as my successor, much success with the challenges that lie ahead.