Mr Duisenberg's opening statement at the European Parliament on 18 January 1999

Introductory statement by the President of the European Central Bank, Dr Willem F. Duisenberg, before the European Parliament's Sub-Committee on Monetary Affairs in Brussels on 18/1/99.

On 1 January 1999 a new chapter in European economic history was opened. After years of intense and thorough preparation, the launch of the single currency in Europe was accomplished successfully. Today, just a little more than two weeks after this historic event, it is a great privilege for me to be here at the European Parliament for another exchange of views with your committee. I should like to begin my statement by reviewing the changeover to the euro, including money market developments during the first two weeks of the single currency. I shall then go on to summarise the assessment by the Governing Council of the European Central Bank (ECB) of the economic environment in which the new currency has been launched and which has shaped our initial decisions about monetary policy. Moreover, I shall comment on some of the challenges that lie ahead. Finally, I shall touch briefly upon some issues related to the communication policy of the European Central Bank, after which I shall, as usual, stand ready to answer any questions you might have.

A. Transition to the euro

The transition of the banking and finance community from the national currencies to the euro in only three and half days after the publication of the conversion rates was, indeed, a success. The smooth migration of all electronic systems and procedures was a sign of the quality of the preparatory work carried out over recent months and years. In our view, the workforce that was directly involved in the changeover in the global financial markets - including all major financial centres outside the euro area - was probably higher than the 50,000 reported by the media.

Within the Eurosystem, which comprises the ECB and the 11 participating national central banks (NCBs), preparations had been ongoing for some time. The first plan of action for the changeover weekend had already been approved by the EMI Council in March 1998. After the establishment of the ECB, the Governing Council examined reports on the changeover at four of its meetings. During the changeover weekend several thousand staff members were at work or on call at the ECB and the NCBs.

The major concern of the Governing Council was to avoid a breakdown in the transition to the euro - at the ECB, at any NCB or within any of the systems of the "core infrastructure" of financial markets in the euro area. For this reason, the ECB made recommendations to credit institutions and securities settlement systems and set up a procedure for monitoring developments within and outside the European System of Central Banks (ESCB) during the weekend. Moreover, the decision-making bodies of the ECB stood ready to convene extraordinary meetings via teleconference and to adopt, if needed, contingency measures. The latter was not necessary. The monitoring of conversion activities conducted by the ESCB during the changeover weekend revealed no incident that might have impaired the smooth start of Monetary Union.

As to the involvement of the Eurosystem in the changeover activities, I should like to mention that I had the honour of attending the meeting of the ECOFIN Council on 31 December 1998, during which the conversion rates were irrevocably fixed. I delivered personally to the ECOFIN Council the Opinion of the ECB on the proposed conversion rates. On the morning of 31 December, the Eurosystem had contributed to the computation of the conversion rates. Later on, the Governing Council had, with the participation of the national central bank governors of the countries not adopting the euro at the start of Stage Three, a meeting by means of a teleconference to approve its legal Opinion. The Eurosystem also contributed to the dissemination of the conversion rates in a prompt and secure manner to the banking and finance community, as requested by market operators in order to enable them to start their conversion activities as soon as possible in the early afternoon of 31 December.

In addition, on 31 December 1998 the euro central rates for the Danish krone and the Greek drachma in ERM II were agreed by written procedure between the relevant parties. The new central rates are in line with the previous ones, after allowing for minor deviations due to rounding. Moreover, the ECB, Danmarks Nationalbank and the Bank of Greece established by common accord and announced, on the same day, the compulsory intervention rates for the Danish krone and the Greek drachma. Fluctuations of the two currencies during the first two weeks of the year remained subdued.

B. Market developments in the first two weeks of January

With a view to ensuring a smooth transition to the euro, the Governing Council took two important decisions already on 22 December 1998, in order to give guidance to the markets on the monetary conditions at the outset of Monetary Union. First, it was decided to start the provision of liquidity via the first tender operation, which was carried out in the first week, at a fixed rate of 3%. The Governing Council also agreed that the interest rate for the marginal lending facility would be set at 4.50% and the interest rate for the deposit facility at 2%. Together, these two rates form the so-called “corridor” for movements in short-term rates.

However, the Governing Council considered the possibility that market participants may need some time to accustom themselves to the new environment for monetary policy. To this end, it was decided to use a relatively narrow corridor of interest rates for the standing facilities of the Eurosystem in the first three weeks of Stage Three as an automatic device to reduce the maximum range of fluctuations in the overnight interest rate. Accordingly, the Governing Council temporarily introduced an exceptionally narrow corridor of only 50 basis points, with the interest rate for the marginal lending facility at 3.25% and the interest rate for the deposit facility at 2.75%. This measure will be terminated on 21 January 1999.

Indeed, this guidance given to the markets proved to be justified, since market developments over the first days showed that the formation of the single European money market would not happen overnight.

- There were signs that short-term market rates in the different countries were not fully aligned and, in particular, that the spreads between the highest and lowest rates were larger than is normal in an integrated money market.
- The counterparties of the Eurosystem made very high use of the marginal lending facility at 3.25% (EUR 27.5 billion on Monday, 4 January), since this rate was only slightly higher than the prevailing market conditions for overnight borrowing in the euro area. The overnight EONIA rate for effective market transactions was 3.20% and credit institutions may have preferred to pay a slightly higher rate instead of entering into market transactions with other banks across the border.
- The counterparties also deposited large amounts overnight with the Eurosystem (EUR 9.2 billion), as they may not have been willing or able to lend them to other market counterparties.

In the meantime, this situation has been overcome. The spread between the highest and the lowest rates reported to the ECB by banks of the EONIA (Euro Overnight Index Average) panel has narrowed from 21 basis points on 4 January to below 10 basis points. Moreover, the use of the marginal lending facility and the deposit facility has been significantly reduced to a more normal level.

A further confirmation of the increasing integration of money markets in the euro area is the growing use of payment and securities settlement systems. On 5 January 1999 the value of cross-border transactions settled through TARGET had already exceeded EUR 310 billion. Including domestic real-time gross settlement (RTGS) transactions, which themselves accounted for at least another EUR 660 billion, the total value of transactions settled was therefore almost EUR 1,000 billion. This amount corresponds to about 17% of last year's GDP of the euro area. In the meantime, the total volume of transactions has increased further. Moreover, the extensive use of the so-called correspondent central banking model (CCBM) – a mechanism which permits banks to make cross-border use of eligible assets as collateral in monetary policy operations and payment systems– suggests that market integration is proceeding well.

The TARGET system, the cross-border payment system of the ESCB, has contributed substantially to the integration of the euro money market and has made possible the consolidation of the treasury management of institutions with different activity centres throughout Europe. TARGET has processed more cross-border payments than anticipated in these early days of Monetary Union and, in so doing, has amply demonstrated its processing capacities. Given the extensive use of the system, the ECB recently decided to extend the operating hours of the TARGET system by one hour to 7 p.m. for a limited period ending on 31 January 1999. This should alleviate some of the time pressure on commercial banks when familiarising themselves with the TARGET rules. Similarly, the Governing Council decided that, during this transition period, the deposit facility of the Eurosystem would be available until one hour after the closure of TARGET.

I should also like to mention the results of the two first main refinancing operations of the ECB. EUR 75 allocated at a fixed rate of 3% to the banking system under the first operation, while the amount for the second operation was, under the same conditions, EUR 48 billion. In addition, on 13 January 1999 the ECB allocated EUR 45 billion in three tranches with maturities of 42, 70 and 105 days through its first longer-term financing operation, at marginal single rates of, respectively, 3.13 %, 3.10 % and 3.08 %. We have provided sufficient liquidity to allow credit institutions, on aggregate, to neutralise their monetary reserve deficit relatively soon within the first reserve maintenance period.

C. Current economic developments and prospects

The Governing Council's decisions on the initial level of interest rates for the euro area, announced on 22 December 1998, have been made with a view to the objective of maintaining price stability. The decisions were taken on the basis of a thorough assessment of the monetary, financial and economic situation in the euro area and against the background of the stability-oriented monetary policy strategy. As you will be aware, the Governing Council has announced a quantitative definition of price stability, measured on the basis of a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%. The monetary policy strategy further consists of two key elements: first, a reference value of 4 1/2% for annual growth in the broad monetary aggregate M3; and, second, a broadly based assessment of the outlook for price developments and the risks to price stability. The views of the Governing Council on the monetary and financial situation, the economic conjuncture and prospects for price developments in the euro area which underpinned its decisions on the appropriate monetary policy stance to be adopted were set out at a press conference at the time of the announcement. In addition, a more detailed assessment of the economic situation underlying the Governing Council’s monetary policy decisions will be released in the ECB’s first Monthly Bulletin, to be published tomorrow. This will include a commentary on the economic situation in the euro area. Let me briefly summarise the main features of our assessment of the current economic situation and outlook.

As regards monetary developments, which are monitored on the basis of a three-month moving average of the 12-month growth rate of M3 (in order to minimise distortions from erratic monthly figures), the Governing Council set the first reference value at 4 1/2%. The latest three-month moving average of annual growth in M3 was around 4.7%, which is very close to the reference value and compatible with the maintenance of price stability.

A broader assessment of economic and financial developments supported the available monetary data in signalling the absence of significant upward or downward pressures on prices. Financial indicators suggested that market participants expect the current climate of price stability to continue in the medium to longer term. In this context, it may be observed that at the start of Stage Three nominal short-term and long-term interest rates in the euro area have reached levels which are very low by historical standards and that real interest rates are also significantly below their long-term averages. The real long-term interest rate is currently at a level of about 3%, which is approximately 1 percentage point below the level prevailing at the end of 1997.

Increases in consumer prices, as measured by 12-monthchanges in the HICP, have been around 1% since autumn 1998, falling to 0.9% in November. The rate of increase in service prices has remained unchanged at around 2%, but increases in goods prices are much lower, at 0.3%, reflecting downward influences on both food and industrial consumer goods prices. Energy prices have also continued to contribute to moderate price developments, falling by 4.3% in the 12 months to November. In addition, modest developments in unit labour costs are a further key factor underpinning the current low rate of consumer price increases.

The preliminary data released by EUROSTAT for the third quarter of 1998 showed euro area-wide real GDP growth at 2.4%, thus reflecting some deceleration compared with the first half of the year, when output growth averaged 3%. Growth has increasingly been driven by domestic demand rather than net exports in the course of 1998. Private consumption, in particular, has been robust, supported by growth in employment. However, unemployment in the euro area remains very high (at 13.8 million) and is declining only gradually. In the short term, output growth is expected to slow somewhat as a consequence of a weaker global environment. In addition to the lower real GDP growth figure in the third quarter, further evidence of an economic slowdown has been provided by survey data, most notably on order books and industrial confidence, which have weakened significantly since the spring of 1998. Industrial production growth also slowed during the course of last year. By contrast, consumer confidence was quite resilient, providing some support to domestic demand. There is considerable uncertainty about the impact of external developments on the euro area, not least because of recent events in Brasil, but the slowdown is currently expected to be temporary. The current low levels of short and long-term interest rates in the euro area should contribute to sustained confidence and domestic demand.

Overall, the Governing Council felt that the risks to price stability appear to be balanced. However, there is a potential downside risk to the global situation, which could lead to lower inflation via a more pronounced growth slowdown in the euro area and weaker import and producer prices. On the other hand, higher-than-expected wage increases and/or a relaxation of the fiscal stance could lead to higher price increases. The ECB will continue to monitor these developments closely.

D. Challenges ahead

Looking ahead, the introduction of the euro and a stability-oriented monetary policy will contribute significantly to the creation of the conditions necessary for improved growth and employment prospects. However, important challenges remain, two of which I should like to mention in particular:

- In order to achieve a sustained and substantial reduction in unemployment, it remains necessary to press ahead with structural reforms to labour and product markets. As I have already mentioned, the rate of unemployment in the euro area has remained very high, at 10.8%, despite real GDP growth of around 3% in the first half of 1998. Monetary policy will play its part by continuing to pursue its objective of maintaining price stability, thus helping to keep inflationary expectations and risk premia in long-term interest rates low. Some benefits from price stability have already been seen in the decline in long-term interest rates to below 4% by the end of last year. Moreover, as I have already mentioned, real long-term interest rates have also declined substantially. However, while this should foster investment and employment growth, it cannot by itself reduce structural unemployment.
- Fiscal imbalances, reflected in both current deficit and debt levels in relation to GDP, are also a major challenge. A sound and sustainable policy framework is characterised by fiscal policies which are consistent with the Stability and Growth Pact. Compared with the progress in fiscal consolidation achieved in previous years, only a small reduction in the euro area-wide budget deficit is estimated to have occurred in 1998: to 2.3% from 2.5% in 1997. Moreover, the decline was the result of favourable cyclical developments together with savings in interest payments. After adjusting for the cyclical effects of stronger growth, the “structural deficit” actually worsened somewhat in 1998. According to the European Commission, this is the first such deterioration since 1991. The ratio of euro area general government debt to GDP is estimated by the European Commission to have been 73.8% in 1998, which is well above the reference level of 60%. Deficit ratios are still too high to put debt levels on a rapidly declining path. Fiscal plans should thus be aimed at ensuring early compliance with the Stability and Growth Pact, which includes a commitment to achieving fiscal positions “close to balance or in surplus” in the medium term. This is also required in order to allow automatic stabilisers to work without exceeding the 3% deficit ceiling in less prosperous times.

E. Communication policy of the Eurosystem

Coming now to the last part of my statement, I should like to touch briefly upon some decisions related to the ECB’s communication policy that have been taken recently. As you might be aware, the ECB published, on 5 January 1999, a consolidated opening financial statement of the Eurosystem, and subsequently, on 12 January, the first weekly financial statement, containing the assets and liabilities held by the ECB and the national central banks of the euro area vis-à-vis third parties. With a view to providing regular information, in particular on monetary policy operations and changes in foreign reserves, the ECB will continue to publish a weekly financial statement every Tuesday, accompanied by an explanatory note, in all official EU languages.

As already indicated, the ECB will release the first edition of its Monthly Bulletin tomorrow. It will contain an assessment of the current economic situation underlying the ECB’s monetary policy decisions and also tables and charts covering a wide range of statistics relevant to monetary policy. In addition, the ECB will continue to release current monetary statistics on wire services.

I should like to conclude by emphasising that these publications, together with the regular press conferences following the meetings of the Governing Council of the ECB and the numerous speeches given by the members of the Executive Board, demonstrate the importance which we attach to explaining the ECB's monetary policy in a clear and transparent manner.

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