Mr Duisenberg discusses prospects, challenges and opportunities for the euro area and gives a brief overview of developments in Latin America

Speech by Dr Willem F Duisenberg, President of the European Central Bank, at the conference "Resilience and Resurgence in Latin America", held in New York on 1 October 1999.

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Ladies and Gentlemen,

Europe's strong ties and close affinity with Latin America stem from its people's common origins, culture, and trade. I am particularly pleased, therefore, to be able to participate in this conference.

During the past few months, the prospects for the global economy have gradually improved and the world economy appears to be heading towards a more balanced growth path. While uncertainties still remain as to the strength of the recovery, especially in regions which were most affected by the global slowdown in 1998, the risks of a worldwide recession have receded and inflationary pressures generally remain subdued.

A more optimistic view of the global economy is warranted, as macroeconomic policies around the world have become more stability-oriented over the past decade. A general consensus has emerged on the need for monetary policy to focus on the achievement and maintenance of price stability. In many countries, a higher level of fiscal discipline has also favoured the pursuit of a stability-oriented monetary policy and has set the conditions for a more sustainable economic growth.

While these are certainly important policy achievements, still, as emphasised by the IMF in its latest World Economic Outlook, important challenges lie ahead and need to be addressed by policymakers around the world if a long-lasting and sustainable recovery is to be ensured.

The growing international integration of capital markets offers great opportunities for a more efficient allocation of global resources. As recent experience has shown, however, it also carries risks of destabilisation, especially in countries where domestic financial systems are fragile or macroeconomic imbalances are still present. In such a situation, economic policy faces new and more complex challenges.

It is important to stress, however, that the improved outlook for the global economy points to the possibility of addressing old problems and facing new challenges with a higher probability of success.

This is particularly true for the euro area economy where the outlook for growth has recently improved, contributing to more optimistic prospects at the global level. The euro area comprises the economies of the eleven countries which, at the beginning of this year, introduced the euro, the new single European currency. In the euro area, a slowdown in output growth was observed around the turn of the year 1998-99. Today, most of the available information, from both coincident and leading indicators for the euro area, supports a picture of ongoing cyclical improvement. Against this background, most forecasts point to a strengthening of economic activity in the remaining part of this year and in the course of next year.

The European Central Bank's (ECB's) stability-oriented monetary policy for the euro area is contributing to these developments by aiming, in fulfilment of its mandate, to maintain price stability, thereby fostering a favourable environment for business activity. The ECB has defined price stability as a year-on-year increase in the harmonised index of consumer prices of below 2% in the euro area, and has stated that price stability is to be maintained over the medium term.

In the euro area, consumer prices increases have indicated some upward pressure recently, rising from 0.9% in June to 1.2% in August. The recent increases in oil prices and the lagged effects of the developments of the exchange rate in the first half of 1999 are the main factors behind the upward movement of prices. Overall, however, the upward pressure has so far turned out to be moderate because the increase in import prices has been partially offset by a favourable development in domestic factors, such as the increased competition in the services sector and the success of deregulation in some markets. Yet, in the immediate future further upward pressures on consumer prices can be expected as a result of the above-mentioned external factors. In the short-term, price developments should remain below 2%. Looking further ahead, however, upward risks to price stability should not be overlooked. Monetary growth in terms of the three-month moving average of the annual growth rates of the broad aggregate M3 has been following a moderately rising trend since the start of this year, moving gradually away from the reference value of 4½% set by the Governing Council of the ECB. The Governing Council is the main decision-making body of the ECB. Its members are the six members of the ECB Executive Board and the eleven governors of the national central banks of the countries which have adopted the euro. Monetary policy decisions are taken on a one person-one vote basis and from a euro area-wide perspective. The rising trend in M3 mainly reflects a continued, strong demand for its most liquid components, which to a large extent is due to the low opportunity costs of holding these monetary assets, but probably also to improving economic conditions in the euro area. As you may know, monetary developments play a prominent role in our monetary policy strategy. The reference value announced by the Eurosystem (i.e. the ECB and the eleven national central banks in the euro area) has a medium-term orientation, as M3 has a stable relationship with the price level in the euro area over the medium term. The short-run relationship between money supply and prices is more complex to interpret. While monetary policy cannot therefore react mechanically to every deviation from the reference value, deviations of monetary growth from the reference value need to be carefully analysed.

Other upward risks to price stability in the euro area may be indicated by the fact that the annual rate of growth of credit granted to the private sector remains substantial, at around 10%. The demand for credit is broadly based, originating from both households and corporations. The main factors behind this development appear to be the low levels of bank lending interest rates in conjunction with the ongoing strengthening of economic activity in the euro area. More favourable access to financing, linked with increased competition in the banking industry since the start of Monetary Union, may also have played a role. Finally, in some countries an interplay of credit growth and rising house and land prices has been observed, as well as the need to finance intense merger and acquisition activity.

Overall, therefore, current monetary developments seem to indicate that the liquidity situation in the euro area is at present rather generous.

The outlook for price stability in the euro area will also very much depend on forthcoming wage rounds. In recent years, wage growth has been relatively moderate in Europe, thereby facilitating the attainment of price stability. In an environment in which the unemployment rate stands at around 10% for the euro area as a whole, wage moderation is, however, not only crucial for maintaining price stability but also for helping to improve the labour market situation. In this light, the forthcoming wage negotiations will very much influence the future course of the European economy.

It is my firm belief that the present situation in Europe provides a golden opportunity to set the stage for a virtuous scenario of continued higher growth and stable prices. However, the task of exploiting the potential for growth created by the environment of stable prices and of achieving the highest possible pace of economic development, while preserving price stability, calls for appropriate action on the part of all policymakers and economic actors.

In the euro area, a prolonged period of sustained growth and lower unemployment requires decisive measures for tackling existing market imperfections, in particular inflexible market structures, and the resolute continuation of the process of consolidating public finances, including the reform of social security systems. We do not get tired of repeating the message over and over again, as it is our firm conviction, that the future of Europe will to a large extent depend on structural and fiscal policies within the Member States, which must commit themselves to improving the conditions for further economic development and, in particular, employment developments.

The high rate of structural unemployment remains the main challenge for economic policy in Europe. Although a faster pace of expansion of economic activity should foster net job creation, without structural reforms this will not be sufficient to bring about a significant reduction of unemployment.

The structural nature of the problem in Europe is evident from a comparison of the euro area labour market with that of the United States, and also from a comparison of the respective performances of the different countries within Europe. Structural reforms with a view to increasing flexibility in labour, product and services markets are the key to solving Europe's single most pressing economic problem. If undertaken promptly, such reforms would be the best way for the euro area to make the most of its potential for growth and employment.

Another main challenge for Europe at the present juncture remains that of consolidating fiscal policy. Several Member States are not yet meeting the medium-term budgetary objectives of being in surplus or close to balance. This is the objective to which all governments in the European Union have committed themselves through a Stability and Growth Pact. The fiscal measures which are currently planned are often not ambitious enough, and only relatively modest reductions in structural deficits are envisaged. The improving economic environment will provide an opportunity to achieve sounder budgetary positions. This, in turn, will create the conditions for a more efficient conduct of fiscal policies and allow governments to face important challenges ahead, such as the ageing of populations. Undoubtedly, this will in turn help to support non-inflationary growth and enhance the prospects for maintaining a stable social environment.

The achievement of a scenario of higher growth and continued price stability is, in my opinion, the best contribution that the euro area can make to an orderly and balanced development of the world economy and of global financial markets. The ECB, as the single monetary authority in the euro area, hereby plays its part by focusing on its primary objective of maintaining price stability over the medium term.

Let me now give a brief overview of how we perceive developments in *Latin America*. The overall outlook continues to improve, although uncertainties as to the strength and resilience of the growth recovery remain. The region's output is bottoming out as South America's recession is being partially offset by a better situation in Mexico and Central America. The region's recovery has been helped by higher than expected growth in Brazil in the first two quarters of 1999, while inflation remained subdued. Most observers expect inflation to be some 10% in 1999, the lowest level in 50 years. Factors which may affect the region's growth over the next year are external financing conditions, the extent of the expected slowdown in the US economy, and uncertainties about the pace of Brazil's recovery. Moreover, a number of countries have fragile banking systems, which may affect economic growth in the medium term.

Recovery in Latin America may, however, benefit from stronger growth in Europe given the size of bilateral trade and financial relations. The EU in particular accounts for about 20% of Latin American exports (2% of the region's GDP), and about 25% of Mercosur exports. Moreover, Europe has been a traditional exporter of capital to Latin America. Europe accounts for some 40% of the net foreign direct investment in the region, some EUR20.8 billion or USD20 billion. Numerous European corporations and banks now have a significant share of investments in Latin America.

Over the last decade Latin America has made a great deal of progress toward sound economic policies, and the region's growth potential is vast in terms of human and natural resources. Latin America is still carrying out the challenging work of building up its economic institutions in order to foster financial stability and sustained non-inflationary economic growth.

The policy developments to date are encouraging. Several countries in the region have adopted sound budgetary policies, redirected public investment towards health and education, privatised a large number of public sector companies, changed their laws to give foreign investors the same treatment as national ones, opened up their economies, and adopted more disciplined monetary polices, thereby curbing inflation. Moreover, a number of countries have granted a more independent status to their central banks and have strengthened their banking systems. All these factors lead us to believe that we are witnessing an enduring and genuine structural change in the region. The containment of the Brazilian financial crisis early this year offers evidence that economic reforms have been beneficial to the region. It is also worth pointing out that the countries in the region have come a long way in enhancing relations with international institutions, which undoubtedly helped to contain the impact of the crisis.

If Europe's recent history is any guide, possible setbacks along the path of economic and financial development should not discourage the governments and peoples of the region from persevering in the pursuit of sound economic policies and economic reform. Latin America has made extraordinary progress in the last decade, which it should try to further pursue in order to build a firmer and more equitable base for non-inflationary economic growth.