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, 21 May 2002.

I take pleasure in appearing before you today to continue our regular exchanges of views and to report to you on the ECB's assessment of economic and monetary developments and on the decisions taken by the Governing Council. Moreover, I should like to take the opportunity to address in my introductory remarks two issues related to the growth potential of the euro area economy and to wage developments, which were raised, among other matters, in a letter that you, Madam Chairman, sent me recently as a follow-up to the presentation of the ECB Annual Report to this Committee by the Vice-President of the ECB.

Economic and monetary developments

The evidence which has become available since my last testimony to your Committee on 23 January 2002 has indeed made us confident that a recovery is under way in the euro area. At the same time, recent developments in consumer price inflation in the euro area have been less favourable than we expected, mainly due to specific and partly temporary factors. Related to this, the outlook for price stability appears to be somewhat less favourable now than it was at the turn of the year. However, there are still uncertainties on the strength of the economic recovery and they, in turn, imply the existence of uncertainties regarding the inflation outlook - and these uncertainties have not diminished since the Governing Council meeting on 2 May. Let me now elaborate on this assessment of the economic outlook for the euro area.

Starting with the analysis under the first pillar of the ECB's monetary policy strategy, the annual growth rate of M3 remained high in the first quarter of 2002. The high annual growth rate still reflects the portfolio shifts to liquid positions which occurred last autumn, when the economic and financial environment was characterised by high uncertainty, and euro area investors showed a particularly marked preference for liquid holdings. At the same time, we saw some moderation in the short-term dynamics of M3 in early 2002. However, M3 growth has only recently started to decline and, for the time being, the reversal of the earlier liquidity build-up is proceeding only slowly. The persistence of excess liquidity could become a risk to price stability, particularly at a time of economic recovery in the euro area. In addition, it should also be considered that while the annual rate of growth of loans to the private sector continued to decline until March, there are also early indications that this decline may be coming to an end.

Overall, the information from the first pillar therefore continues to deserve particular attention.
As regards the second pillar, we are now certain that the trough in economic activity in the euro area was reached at the end of last year. The rise in business confidence in recent months is the most visible indication of the improvement in economic conditions. While the recovery is

expected to initially proceed at a gradual pace, euro area real GDP growth rates should again be in line with potential growth later this year. These expectations for a rebound in real GDP growth in the euro area are shared by recently published forecasts of international organisations, which all paint a similar picture. A reversal of the past reduction in inventories, a process which is now under way, and higher export growth, driven by a more positive international environment, should contribute to the gradual economic upswing. Overall, domestic and external factors should foster the recovery. Sound fundamentals and the absence of major imbalances in the euro area which would require a long correction process support this positive outlook for the euro area economy.

Yet, despite all these positive elements pointing towards an economic recovery, uncertainties remain about the strength of the current upswing. These are partly related to the development of oil prices and to the speed of the recovery of consumption. In addition, some risks to the economic recovery in the euro area are related to imbalances elsewhere in the world economy.

Turning to prices, recent developments in consumer price inflation have been less satisfactory than was expected at the end of last year, when annual inflation rates were expected to decline to levels safely below 2% in 2002 and stabilise thereafter. At present, partly as a result of higher oil prices, inflation rates during 2002 as a whole could turn out to be somewhat higher than we expected at the end of last year. For price stability to be maintained, it is essential that past upward shocks to inflation rates remain of a one-off nature and do not become entrenched in the expectations of economic agents. Recently published inflation forecasts, developments in indicators of inflation expectations, and recent trends in wages neither confirm nor contradict such an entrenchment. While we have to acknowledge that monetary policy cannot affect inflation developments over the short term, we are determined not to put our achievements at risk.

It is therefore particularly important at this juncture to remain vigilant with regard to the further evolution of the key factors determining the outlook for prices.
The rather protracted upward trend in services prices is, in this respect, one factor to be closely monitored. In addition, prospects for price stability depend largely on wage moderation. It is a mistake to believe that high wage rises per se will increase aggregate demand in real terms. On the contrary, excessive wage claims will increase costs and create inflationary pressures. By doing so, they risk reducing competitiveness, employment growth, and thus consumption. Wage moderation is a key factor not only to maintain price stability, but also to support job creation and economic growth on a sustained basis.

In this regard, it is important to bear in mind that the key challenge to the euro area remains the improvement in conditions for an increase in productivity. This would further expand trend potential growth and thereby create, supported by wage moderation, the conditions for reducing the high level of structural unemployment in the euro area. In this respect, the speeding-up of structural policy measures which aim to increase productivity is of the utmost importance. For this purpose, the 2002 Broad Economic Policy Guidelines should set the conditions for stepping up the pace of economic reform. This requires an acceleration and deepening of structural reforms in the labour, product and financial markets in order to provide economic agents with the proper incentives.

As regards fiscal policy, it is vital that that all Member States maintain a medium-term perspective in compliance with the framework of the Stability and Growth Pact. In particular, it is of the utmost importance that those that have not already done so manage the transition to

budgetary positions close to balance or in surplus in order to ensure the smooth and effective functioning of the Stability and Growth Pact in the future. Let me strongly emphasise that all the Member States concerned must honour the commitments made to achieving balanced budgets by 2003-04. Moreover, governments should pursue ambitious reforms with regard to the size and structure of public expenditure and revenue, also in order to create room for further tax cuts and to absorb the fiscal costs of population ageing.

Monetary policy will best contribute to the long-term growth prospects for the euro area if it remains firmly focused on the maintenance of price stability. This will create a stable monetary environment for economic agents to operate in. At the same time, greater flexibility in labour, product and financial markets together with sound fiscal positions and wage moderation will support the objective of maintaining price stability and will create stable conditions to foster employment creation. Such an interaction of policies, in which policy actors, in accordance with the Treaty, consistently pursue their own assignments and responsibilities, is the best possible way to enhance the long-term welfare of the citizens of the euro area.

I will be pleased to answer your questions now.