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,
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In continuation of our regular dialogue, it is my pleasure to report to your Committee today on our assessment of the economic and monetary environment and the monetary policy decisions taken by the European Central Bank (ECB). Moreover, as this testimony is the last before the introduction of euro banknotes and coins on 1 January 2002, I will give you a brief overview of the final state of preparations for this important event. Finally, the ECB has taken decisions relating to the issue of euro banknotes and the allocation of monetary income within the Eurosystem, which I shall also briefly address in my opening remarks.

1. Economic and monetary developments

Since my last testimony on 12 September, the economic outlook for the world economy and the euro area has changed significantly. As I reported to you at that time, immediately after the terrorist attacks on the United

States, the ECB and the national central banks of the Eurosystem started to take measures to ensure the normal functioning of the financial markets. The Eurosystem conducted several open market operations which helped to stabilise money markets in the euro area and, benefiting from a swap agreement between the ECB and the Federal Reserve System of the United States, also contributed to alleviating shortages of liquidity in US dollars among euro area banks.

The monetary policy response of the ECB after the terrorist attacks was equally prompt. As the attacks increased uncertainty substantially, the events of 11 September had the potential to reinforce the downward trend in economic activity which was already working its way through the global economy, including the euro area. With the prospects for economic growth weakening, it was also likely that inflationary pressures in the euro area would moderate. On the basis of these considerations, the Governing Council reduced the key ECB interest rates by 50 basis points on 17 September, in concert with an equivalent decision by the Federal Reserve System of the United States.

In the subsequent weeks, it became increasingly clear that the economic slowdown in the euro area would last longer and be more pronounced than previously expected. At the same time, we could then see that the shocks to the price level stemming from the increases in oil prices and the depreciation of the euro in 1999 and 2000, as well as from the food price

increases seen in early 2001, would eventually have only temporary or one-off effects on consumer prices and were gradually falling out of the calculation of annual inflation rates. The expectation of a downturn in inflation rates in the context of a weakening of domestic demand in the euro area also increased the likelihood of wage moderation continuing. It was therefore likely that inflationary pressures in the euro area would remain contained.

This assessment was in line with the analysis stemming from monetary developments. The strong growth in M3 in this year largely reflected shifts in private investors' portfolios away from shares and other longer-term financial assets to more liquid, relatively safe short-term assets included in M3. These shifts should only have a temporary effect on M3 growth and should not be seen as an indication of future inflationary pressures. This assessment was also supported by the fact that credit growth to the private sector has been falling steadily since end 2000.

In light of these considerations, the Governing Council took the decision on 8 November to reduce the key ECB interest rates by 50 basis points.

At its meeting on 8 November 2001, the Governing Council also decided that it would henceforth – as a rule – assess the stance of the ECB's monetary policy only at its first meeting of the month. Accordingly, interest rate decisions will normally be taken during that meeting. At the second meeting of the month, the Governing Council will focus on

discussing issues related to the other tasks and responsibilities of the ECB and the Eurosystem.

Let me now elaborate a little further on the current economic situation.

As regards the first pillar, the three-month average of the annual growth rates of M3 amounted to 6.8% in the period from August to October 2001 and was thereby significantly above the reference value of 4½% for annual M3 growth. The Governing Council reviewed and confirmed this value of 4½% at its meeting on 6 December. This decision was taken on the grounds that the available evidence continues to support the medium-term assumptions underlying the derivation of the reference value, namely a trend potential output growth of 2-2½% per annum and a trend decline in M3 income velocity of ½-1% per annum in the euro area.

When comparing current monetary developments with the reference value for the rate of growth of M3, it should be borne in mind that the reference value is a medium-term concept. Temporary deviations of M3 growth from the reference value do not necessarily have implications for future price developments. The Governing Council has therefore always made it clear that monetary policy should not react mechanically to deviations of M3 growth from the reference value, but would rather have to carefully analyse the causes and implications of such deviations. In fact, temporary deviations from the reference value relating to pure portfolio shifts are not unusual and might even be expected in the context of extraordinary

economic developments, as has been the case in the most recent period. At the same time, we will need to continue analysing developments in M3 in detail. Should the current economic and financial market uncertainties subside, any persisting excess liquidity in the economy should be carefully reassessed with respect to whether it signals risks for price stability.

Turning to the analysis under the second pillar of our monetary policy strategy, the evidence that has become available after the Governing Council meeting of 8 November 2001 has confirmed the expectations of the Governing Council regarding lower inflationary pressures in the medium term. A first estimate by Eurostat shows that real GDP growth was close to zero in the third quarter of 2001, and recent indicators show that economic activity has remained very subdued in the fourth quarter of 2001. Looking further ahead, real GDP growth is likely to remain weak in early 2002. However, conditions are in place for economic growth to improve in the course of 2002. First and foremost, the economic fundamentals of the euro area are sound and there are no major imbalances that would require a lengthy process of adjustment. The uncertainty currently overshadowing the world economy should diminish over time. In addition, financing conditions are very favourable in the euro area. The recent fall in oil prices and the expected further decline in consumer price inflation will have a positive effect on real disposable income and should thus support domestic demand. In the same vein, developments in financial

markets over the past few weeks signal a more optimistic assessment both of the prospects for economic growth in the euro area and of the international environment by market participants.

The expectation of stronger growth in the euro area economy in the course of 2002 is reflected in all available forecasts of international institutions and also in the most recent projections produced by Eurosystem staff and published last week.

With regard to price developments, the euro area is now clearly approaching a return to inflation rates of below 2% following the temporary peak of 3.4% in April this year. This reflects, as I have mentioned already, the unwinding of the previous increases in energy prices and the fact that there were no further shocks to food prices. Looking ahead, all information, including all available forecasts and the Eurosystem staff projections, supports the view that annual HICP inflation should remain at levels safely below 2% in the foreseeable future.

All in all, we concluded at the meeting of the Governing Council on 6 December that the current level of ECB interest rates continues to be appropriate for the maintenance of price stability over the medium term. The information which had become available after the Governing Council meeting on 8 November had confirmed our expectations and thereby also the forward-looking monetary policy decisions we had taken over the past

few months. Recent information continues to confirm this assessment. Let me recall that, with these reductions, key ECB interest rates have been brought down by 125 basis points since 30 August 2001 and by a total of 150 basis points in 2001. In both nominal and real terms, short-term interest rates have thus reached levels which are very low in a historical context. The same applies to long-term interest rates.

The best contribution monetary policy can make to preserving favourable financing conditions is to safeguard its credibility in maintaining price stability. Monetary policy does not only have an effect on inflation expectations (and thereby on nominal interest rates), but also on risk premia, and thus also on real interest rates. From the point of view of the functioning of the economy, risk premia impose additional costs on the private sector in raising finance, thus hampering economic growth. In order to contribute efficiently to the long-term growth prospects of the euro area, the best monetary policy can do is to preserve a stance clearly focusing on the maintenance of price stability, thereby also safeguarding the low degree of policy-induced uncertainty that has been achieved so far.

As regards recent developments in fiscal policy, similar considerations apply. The maintenance of a medium-term perspective in the fiscal policies of euro area countries is crucial to supporting the overall credibility of the Stability and Growth Pact and, thereby, to strengthening

the confidence of consumers and investors, particularly in the current context of weaker economic growth. For countries which have not yet attained budgetary positions close to balance or in surplus or which have very high public debt-to-GDP ratios, the current slowdown should not change the scope for meeting the medium-term commitments made in the context of national stability programmes within the framework of the Stability and Growth Pact. On the other hand, countries with a fiscal position close to balance or in surplus could benefit from the full operation of the automatic stabilisers. However, there is no case for fiscal activism, as this has often proved to be ineffective in the past and carries the risk of creating imbalances in public finances.

A key remaining challenge for the euro area is to strengthen the productive forces in the economy by providing the proper incentives for economic agents. Indeed, we believe that the potential upward impact of structural reforms and technological innovation on trend output growth could be large. However, while some progress has been made in the field of structural reform, significant further steps – especially in the labour and goods markets – need to be taken in order to achieve a permanent and significant increase in potential output growth in the euro area. Furthermore, in the fiscal area, governments should pursue determined structural expenditure reforms in order to create room for further tax cuts, and for absorbing the fiscal costs associated with the ageing of

populations. Such reforms would enhance the effectiveness of the fiscal environment in supporting employment, investment and economic dynamism.

2. Preparations for the introduction of euro banknotes and coins

In less than two weeks' time, the process of monetary integration in Europe will be completed by the introduction of euro banknotes and coins. Overall preparations for this important event are now in their very final stages, with a total of 15 billion euro banknotes having been produced by end-November, i.e. far more than the just under 10 billion euro banknotes which are expected to be put into circulation during the cash changeover. This higher production figure also reflects the fact that several national central banks have, in the course of autumn, reassessed the number of banknotes to be produced, in order to accommodate the higher than expected orders for frontloaded euro cash, especially as regards low-denomination banknotes. Indeed, low-denomination banknotes, in particular the EUR 5 and EUR 10 banknotes, will be put into circulation on a large scale in the first few days of January 2002, so as to further contribute to a smooth cash changeover. Frontloading of euro banknotes has started in all participating Member States and is progressing on schedule, with about 59% of all ordered banknotes having

been delivered to the respective credit institutions by the end of last month.

The mass media campaign conducted by the Eurosystem started in September and will continue to run until early next year. In addition to TV and newspaper advertisements, more than 200 million information leaflets in the 11 official Community languages have been distributed to the general public in order to provide all the information needed for them to familiarise themselves with the new banknotes and coins.

Moreover, the ECB has set up a special Cash Changeover Committee, comprising representatives of the ECB, the national central banks and the Commission, to monitor the proceedings of the cash changeover closely and to facilitate swift reactions by the Eurosystem, if warranted. To ensure efficient communication with the media and the general public, the ECB will publish daily press releases during the first two weeks of January. The ECB is also participating in the euro changeover information network set up by the European Commission in order to share all relevant information with the members of the network.

In economic terms, the cash changeover should not have significant direct effects on price levels in the euro area. This is largely due to the strong competition in the retail sector and the vigilance of consumers, but also reflects the commitment of governments not to increase the average level of administered prices in the context of the cash changeover.

3. The issue of euro banknotes and the allocation of monetary income

As of 1 January 2002, euro banknotes will be legal tender in all euro area countries and may migrate freely throughout the euro area. It was thus necessary to take a decision on how to allocate the issue of euro banknotes within the Eurosystem.

In accordance with Article 16 of the Statute of the European System of Central Banks and of the European Central Bank (Statute of the ESCB), the Governing Council decided that the ECB and the 12 national central banks comprising the Eurosystem shall issue euro banknotes, whereby the ECB will assume a share of 8% of the total value of euro banknotes in circulation. This corresponds approximately to one-thirteenth of the total amount, a percentage that was considered appropriate, as there are thirteen central banks within the Eurosystem. The remaining volume of banknote issue will be assigned to the national central banks in accordance with their paid-up shares in the capital of the ECB.

Moreover, the Governing Council has established the regime to be applied to the allocation of the so-called monetary income among the national central banks of the Eurosystem as from 2002. Monetary income is the income generated by the performance of the monetary policy function and is also referred to as “seigniorage income”.

Article 32 of the Statute of the ESCB provides for the monetary income to be pooled and allocated to the national central banks of the Eurosystem in accordance with their paid-up shares in the ECB's capital. As from 2002, this provision will also apply to the seigniorage income from banknotes, which was hitherto not pooled and allocated. To mitigate the impact on current relative income positions of the national central banks, the Governing Council has decided to set up a transitional regime which provides for a progressive adjustment to the monetary income distributed among the national central banks. The adjustment will apply in full during 2002 in order to take account of the cash changeover and the dual circulation period. It will be phased out progressively until the end of 2007. Thereafter, as from 2008, all monetary income will be distributed fully in proportion to the national central banks' paid-up shares in the ECB's capital.

Let me conclude my statement by reconfirming my strong conviction that the preparations for the introduction of euro banknotes and coins have been, or are currently being, concluded successfully and that we all can look forward with confidence to our new money.

I now stand ready to answer any questions you may have.