EUROPEAN CENTRAL BANK

Transmission embargo until
3.30 p.m. ECB time (C.E.T. on Monday, 28 May 2001

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,

European Central Bank

Press Division

Kaiserstrasse 29, D-60311 Frankfurt am Main

Tel.: 0049 69 1344 7455, Fax: 0049 69 1344 7404

Internet: http://www.ecb.int

Reproduction is permitted provided that the source is acknowledged.

Brussels, 28 May 2001

Check against delivery

It is a pleasure for me again to appear before your Committee to report to you on recent decisions by the Governing Council in the area of monetary policy as well as within its other fields of competence. I shall start with the ECB's assessment of current economic and monetary developments, as well as the prospects for the euro area, and explain our recent monetary policy decisions. I shall then turn to the preparations for the introduction of the euro banknotes and coins. Finally, I should like to address the role of central banks in the field of banking supervision. I should like to indicate already at this stage that my opening remarks may slightly exceed the usual time frame.

1. Economic and monetary developments

Since my last appearance before this Committee on 5 March 2001, the Governing Council of the ECB decided to reduce its key interest rates by 25 basis points on 10 May. I would like to explain the reasons for the decision.

Over the last few months, the Governing Council has gradually changed its view on the balance of risks to price stability in the euro area, moving from a situation where the risks basically remained on the upside towards a far more balanced situation.

Starting with the first pillar, we have been witnessing a downward trend in the dynamics of both money and credit growth in the second half of 2000 and early 2001, partly reflecting the increase of 225 basis points in key ECB interest rates, which occurred between November 1999 and October 2000. The three-month average of the annual growth rates of M3 was 4.8% in the period from January to March 2001. In addition, some slowdown in credit aggregates had also been visible over the past few months, and M1 continued to grow at a very low pace.

Moreover, there is now evidence that the monetary growth figures are distorted upwards by non-euro area residents' purchases of negotiable paper included in M3. The Vice-President of the ECB already informed this Committee on 2 May, in his presentation of the ECB's Annual Report, that the ECB was working on identifying these distortions precisely and on making the necessary corrections to the data. Some of these distortions have recently been confirmed by more specific evidence, and there are now indications that, over recent months, the

inclusion of non-euro area residents' holdings of negotiable instruments has increasingly led to an upward distortion of M3 growth. The magnitudes involved are significant and higher than previously expected.

As regards holdings of money market fund units/shares by non-euro area residents, on which reliable statistical data are now available, the distortion has become more sizeable over recent months and currently amounts to around half a percentage point of the annual rate of growth of M3. As for non-euro area residents' holdings of other marketable paper included in M3, precise statistical information is currently being developed. Preliminary evidence indicates that the size of this upward distortion to M3 growth might have been similar in early 2001 to that related to non-resident holdings of money market funds units/shares. Consequently, the upward distortion to M3 growth figures in early 2001 may be in the order of one percentage point.

A detailed analysis of these distortions to M3 growth was published in the Monthly Bulletin of May. The ECB intends to publish a revised M3 series towards the end of this year. In the meantime, the ECB will continue to inform the public about these developments and explain how these distortions are taken into account in the regular assessment of monetary developments.

Taking into account all these factors, it was clear that the slowdown in M3 over the past few months was more pronounced than expected, with estimates of corrected M3 growth at or even below the reference value of 4½% for some months now. Overall, the Governing Council therefore concluded on 10 May that current analysis under the first pillar no longer signalled risks to price stability over the medium term.

In the analysis from the second pillar of the monetary policy strategy, several developments pointed to moderating inflationary pressures in the medium term. The global outlook for growth in 2001 has deteriorated over the last few months, and has continued to be characterised by substantial uncertainty, especially with respect to the outlook for the US and Japanese economies. Owing to a less favourable external environment, a moderation in real GDP growth in the euro area from the high levels reached in 2000 is expected in 2001, and this should dampen upward pressure on consumer prices. Data on economic activity recently released in the euro area, like industrial production in March, and business confidence indicators confirm this picture of a moderation in growth. This notwithstanding, currently available forecasts, both by international organisations and private institutions, expect that economic growth in the euro area will, supported by domestic demand, be broadly in line

with trend potential growth in 2001. This outlook for a continuation of solid growth in the euro area is accompanied by expectations for inflation to remain in line with the ECB's definition of price stability in the medium term. Bond yields in the euro area further underpin this expectation.

The improvement in the medium-term outlook for price stability will, however, be overshadowed for some more months by short-term developments in inflation. As expected, the annual rate of increase in the Harmonised Index of Consumer Prices (HICP) rose to 2.9% in April 2001. Recent increases in HICP inflation have mainly resulted from developments in unprocessed food prices due to the BSE related health concerns and the measures taken to contain the outbreak of the foot-and-mouth disease. Furthermore, energy prices continue to have an impact, after the strong increases seen in 2000. In addition, other non-energy components of the HICP, namely prices of services and industrial goods, have been on an upward trend since summer 1999. However, this upward movement was partly due to temporary factors (such as rises in administrative prices or indirect taxes) and is also a consequence of indirect effects of past oil price increases and the feeding-through of the depreciation of the euro.

The effects of all these factors, which have caused HICP inflation to remain above 2% since mid-2000, should, however, gradually diminish, making it likely that annual HICP inflation will start to fall in the course of this year and be below 2% in 2002. The protracted period of time in which inflation has remained above 2% should not have medium-term consequences. This assessment is also supported by the continuation of wage moderation in the euro area, as we have seen so far.

Overall, the recent reduction in key ECB interest rates is to be seen as an adjustment of the levels of interest rates to somewhat lower inflationary pressures in the medium term. The Governing Council of the ECB has to focus on the maintenance of price stability in the medium term, as only this perspective takes account of the time lags for monetary policy to work its way through the economy. On the basis of the information available, the current stance of monetary policy is appropriate to ensure that the euro area will be able to maintain price stability over the medium term. Nonetheless, while recent wage developments have been encouraging, we will monitor very closely the upward risks to price stability related to the risk of possible second-round effects of past oil price increases on consumer prices via wages.

The maintenance of robust non-inflationary growth is a challenge to be met by many policy areas. Fiscal policy will have to continue the consolidation process, and governments should abide by the commitments of the Stability and Growth Pact and by those made in the context of their stability programmes, pursuing further improvements on the expenditure and revenue sides of the budget. Progress along the way to the medium-term objective of budgetary positions “close to balance or in surplus” cannot be delayed. In fact, economic growth lower than previously expected should not be a reason to miss budgetary targets in countries with remaining fiscal imbalances.

Finally, the objective of expanding the growth potential of the euro area economy must remain a priority in the agenda of the euro area. While progress is being made in a number of areas, more ambitious market-oriented structural reforms remain a challenge. The still high level of unemployment calls for ongoing policy efforts to remove structural rigidities from the product and labour markets, and to diminish adverse incentives provided by tax, benefit and pension systems. Moreover, it is crucial to increase investment incentives through structural policy measures such as deregulation, privatisation, and tax reforms.

2. Issues relating to the introduction of the euro banknotes and coins

I should now like to turn to the preparations for the introduction of the euro banknotes and coins. As far as the Eurosystem is concerned, preparations are well on track. At the end of April 2001, more than half of the euro banknotes to be put into circulation from 1 January 2002 onwards, or needed as logistical stocks, had already been produced. If measured only against the initial launch requirements, the produced banknotes amount to as much as 70% of those needs.

At the same time, the logistical arrangements within the Eurosystem related to the circulation of the euro banknotes and coins are being implemented in line with the plans that have been agreed over the last few years after careful consultation with all parties involved. This includes the storage of substantial amounts of banknotes and coins, for which adequate provisions have been established, even though it posed unprecedented logistical and organisational challenges, not least with regard to security and spatial requirements. The preparations for the transportation and frontloading of banknotes to banks also form part of these activities.

As concerns the latter, on which I have already reported on previous occasions, there are still discussions in some quarters, even at this late stage of the

preparations, on whether it might not be preferable to go back on our decision not to frontload euro banknotes to the general public. As I have seen, your Committee, too, is preparing a Resolution calling for a review of this decision.

In this context, I should like to stress that the Governing Council of the ECB does not intend to change its decisions with regard to the front-loading of euro banknotes to the general public. The reasons for this decision, which I have already spelled out in detail on other occasions and which I am willing, if necessary, to elaborate further, are still valid and there are, according to our assessment, no new elements which would justify a renewed reflection on this issue at this late stage of preparations. We are certainly aware that retailers, albeit not all of them, are very vocal in their demands for a frontloading of euro banknotes to the general public. It is also indisputable that there might be specific situations in support of this request. However, the ECB has to take a global perspective covering all aspects and, especially, the general interest.

Having said this, I should like to stress that, in any case, the smooth conduct of the cash changeover will require particular efforts by all parties concerned, be they banks, businesses or citizens. However, quite a number of measures have been prepared or are under consideration which should help to smooth the introduction of the euro banknotes and coins, in particular during the very first

days of the cash changeover. In this respect, I should like to mention the conversion of ATMs already in the early hours of 1 January as well as their provision with lower-denomination banknotes. Moreover, the opening of banks on 1 January 2002, as has so far been foreseen in some countries and might be considered by others, should help smooth the specific challenges during the early stages of the changeover. Finally, I should like to stress that the various extensive and well-prepared information campaigns should familiarise the general public with the organisation of the cash changeover.

All in all, the challenges with regard to the cash changeover should, of course, not be underestimated. At the same time, however, I am not aware of any indications that could place the effectiveness of the careful and comprehensive preparations for a smooth and successful cash changeover in doubt.

3. Issues related to banking supervision

To conclude my opening remarks, I should like briefly to address some issues related to banking supervision. As you are aware, the financial systems are undergoing an impressive transformation, which – in the euro area – is further reinforced by the changes triggered by the introduction of the euro. In many euro area countries, this has led to a debate on the institutional structure for

prudential supervision. The ECB is strongly convinced that there are good arguments for maintaining, or even reinforcing, one of the basic features of the institutional arrangements in the euro area, that is the strong involvement of central banks in the conduct of supervisory tasks.

Within the institutional framework brought about by the introduction of the euro, many of the arguments frequently raised for attributing supervisory and monetary policy responsibilities to separate authorities do not apply, since the two functions are now performed with distinct decision-making processes and with reference to different geographic jurisdictions. At the same time, Economic and Monetary Union (EMU) is changing the nature and scope of systemic risk. This calls for extensive monitoring within the euro area, attentive to the cross-border dimension and to the channels for contagion through increasingly integrated payment, clearing and settlement infrastructures and capital markets. Central banks, due to their traditional focus on systemic issues and to their twofold nature of national institutions and members of the Eurosystem, are well placed to carry out this monitoring activity. In this way, they also provide a substantial contribution to the operation of prudential supervision.

The Governing Council of the ECB has discussed these issues extensively and has decided to convey its position to the Ministers of Finance, anticipating the

main elements of the opinions it intended to deliver on national legislative projects for reform, according to Article 105 (4) of the Treaty. In the analysis of concrete draft laws reforming national arrangements for prudential supervision, the ECB will reiterate its views. In cases where supervisory responsibilities are not allocated to national central banks, in particular, we will argue in favour of a strong operational involvement of the central bank in prudential supervision, calling also for an open exchange of information and effective mechanisms for close co-operation between all authorities with responsibilities for financial stability.