Hearing at the European Parliament's Committee on Economic and Monetary Affairs

Introductory statement
delivered by Christian Noyer
Vice-President of the European Central Bank

Brussels, 27 September 1999

Reproduction is permitted provided that the source is acknowledged.

It is a pleasure for me to attend today's hearing with your Committee. This is the first time that I am able to represent the ECB in the regular exchange of views between our institutions. As I was told, this is also the first time that most of you are participating in these particular hearings following the election of the new European Parliament and the setting-up of the new Committee on Economic and Monetary Affairs. I suppose that I am right in understanding that the establishment of this new Committee underlines the importance that the European Parliament rightly attaches to economic and monetary developments. Moreover, I should like to express my conviction that the new format of your Committee will contribute to improving further the quality of our discussions. I should also like to assure you once again of the great importance that the ECB attaches to these regular hearings.

For me, representing the ECB at today's hearing is all the more satisfying now that economic developments point to a much brighter outlook for the euro area economy than was the case earlier in the year. I should like, first, to present the ECB's views on these developments. Following this I shall reflect on how we can seize this opportunity to ensure that the current recovery becomes a prolonged phase of non-inflationary economic growth and employment creation, to the benefit of all European citizens. As usual I should also like to report briefly on the current activities of the Eurosystem.

Recent economic developments and prospects

The euro area economy is in the process of recovering from the slowdown in output growth which had been observed around the turn of the year 1998-99. This process is expected to gain momentum with a sustained strengthening of real GDP growth in the second half of this year and next year. The provisional

result of a slightly lower real GDP growth rate in the second quarter of 1999 compared with the first quarter, which is likely to reflect some distortion in the quarterly pattern, does not contradict this projection. Overall, data for the first semester of 1999 point to a moderate growth of real GDP in the euro area, laying the basis for an acceleration in the second part of 1999 and the year 2000.

The recent cyclical movements of production have been driven by export opportunities, which are now beginning to benefit from a recovery in world trade, enhanced by a favourable competitive position. The expectation of further export growth in the period ahead finds support in the recently improved assessment of export order books by manufacturing firms. Moreover, the risks to the outlook for the world economy have become more balanced. While the possibility of a pronounced slowdown of the US economy with negative repercussions on world trade cannot be excluded, such a scenario appears, at present, unlikely. At the same time, there is the possibility of a stronger economic recovery in Asia. Overall, the brightening external environment should be expected to support the euro area economy.

As regards the domestic side, prospects are for continued strength in domestic demand. While industrial confidence has recovered to its long-term average level, consumer confidence has remained fairly close to the all-time highs reached at the turn of the year. This indicates that a broadly based recovery is under way, extending to both the services sector and industry.

With regard to employment in the euro area, we have seen continued job creation in the first quarter of 1999, but a slight slowdown in the second quarter. However, it is expected that the slowdown of economic growth around the turn of the year will have only limited negative effects on employment growth. And I should stress that this has to be ascribed to the moderate wage developments of the past few years. It is clear that a continuation of wage moderation will be a prerequisite for translating the expected growth recovery into a significant

growth of employment. However, as we have emphasised on many occasions, a substantial and sustained reduction of unemployment in Europe is contingent on accompanying comprehensive structural reform measures aimed at increasing flexibility in the labour and product markets, a point to which I shall return in a moment.

To some extent, the improved outlook for the euro area economy is mirrored by the upward trend in long-term government bonds in recent months. At present, the average level of 10-year bond yields in the euro area stands at around 5.2%, or about 125 basis points higher than the level seen at the end of April 1999. Euro area stock markets also indicate growing optimism about the prospects for economic activity in the euro area. The increase in share prices in recent months, which occurred against a background of rising long-term bond yields, tends to suggest that financial market participants have raised their expectations about the prospects for corporate profitability in the euro area, in conjunction with their expectations of accelerating output growth.

While the prospects for economic activity are thus relatively favourable at present, chances for continued price stability are also good. However, consumer price increases have seen some upward pressure in recent months, rising from 0.9% in June to 1.2% in August. This was mainly accounted for by a stronger increase in energy prices, reflecting the continued rise in oil prices. As regards the outlook for price developments, while some downward pressure may be expected to emanate from ongoing deregulation and increased competition, we expect consumer price increases to rise somewhat further in the near future, mainly as a consequence of higher oil prices and the lagged effects of exchange rate developments. Looking over a horizon of 12 months or so, we expect consumer price developments to remain below the ceiling we have defined as being compatible with price stability over the medium term. However, upward risks to the maintenance of price stability cannot be ruled out, in particular in view of the rapid growth in monetary aggregates and in credit to

the private sector and given the possibility of a more pronounced acceleration of economic activity than expected.

Indeed, monetary growth in terms of the broad aggregate M3 has been on a 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. This upward movement mainly reflected a continued strong demand for the most liquid components of M3. This may be explained to a large extent by the very low opportunity costs of holding these monetary assets, but perhaps also by the gradually improving economic conditions in the euro area.

At the same time, the growth rate of credit to the private sector remained high, fluctuating steadily around 10%. Our impression is that the high demand for bank loans is broadly based, originating from both households and corporations. The main factor behind the sustained growth of credit to the private sector appears to be the overall low level of bank lending interest rates. Moreover, the sustained growth of credit should have been supported by the ongoing economic recovery in the euro area. Furthermore, in some countries, the interplay of credit growth and rising house and land prices plays an important role, as well as the need to finance more intense merger and acquisition activity. Finally, I should mention that easier access to financing owing to the increased degree of competition in the banking industry since the start of Monetary Union may also have encouraged borrowing. All in all, monetary and credit developments signal that at present the liquidity situation in the euro area is rather generous, signalling a possible risk to price stability in the medium term, which the Eurosystem needs to take seriously.

Overall, taking into account both pillars of our monetary policy strategy, the following can be concluded:
While the prospects for continued price stability are good, it is necessary to remain vigilant with regard to upside risks. Against this background, the Governing Council of the ECB decided last week to keep the interest rates on

the monetary policy operations of the Eurosystem unchanged, as it did at all of its meetings after 8 April 1999.

Conditions for prolonged non-inflationary growth

Now that the outlook for the European economy has improved, I should like to reflect on the most essential requirements for the current recovery to become a period of prolonged, non-inflationary and employment generating output growth. In our view, a period of sustained higher output growth and lower unemployment would call, first of all, for more decisive measures to tackle the still existing imperfections, in particular inflexible market structures. Secondly, the consolidation of public finances, which has made considerable progress in the past few years, would have to be continued and in several cases intensified. In many areas, the implementation of these policy requirements will certainly require a break with often deeply rooted habits and allegedly acquired rights. However, the current economic upturn would provide a golden opportunity to make serious headway in these two areas.

This message may appear anything but original, since it belongs to our standard vocabulary. However, this by no means makes the message less relevant. Rather, the need to reiterate this message casts light on the persistence of the underlying problems and the difficulty of actually implementing structural adjustment policies even when they are widely recognised as being appropriate.

Politicians are constantly confronted with such difficulties, in particular, when policy adjustments interfere with so-called acquired rights. Therefore, it is hardly surprising that efforts to correct unsustainable deficits and welfare benefits do not meet with universal support.

Even though budgetary deficits and, to a lesser degree, also public debt-to-GDP ratios have been reduced over the past few years, we have to keep in

mind that this, to a large extent, was due to the low level of interest rates. At present, the budgetary situation of most Member States still needs further improvements. Beyond a further reduction of debt-to-GDP ratios, there are a number of other issues that have to be tackled by governments. These include especially the reduction of structural deficits, the reform of the welfare state and improvements to the composition of government expenditures and receipts.

Ultimately the pursuit of sound budgetary policies will by no means unduly restrict governments, but rather create the basis for an efficient conduct of fiscal policies. This, in turn, would certainly have a positive impact on economic growth and on the ability to maintain a stable and balanced social environment.

Under the Stability and Growth Pact, governments should maintain a budgetary position close to balance or in surplus over the medium term. The current economic recovery should help countries to achieve such a budgetary position more quickly than planned. In this regard, it seems imperative that higher tax receipts are used to intensify the consolidation process via the setting of more ambitious deficit targets. Indeed, the so-called automatic stabilisers should also operate during cyclical upturns and not only be regarded as relevant in periods of sluggish growth.

As regards the role of governments, I should also like to stress their particular responsibility in the setting of the overall conditions for a smoothly functioning economy. This applies not only to tax and expenditure reforms that are conducive to growth and employment creation, but also to the need to reduce rigidities in labour, product and service markets. These impediments, which have severely constrained output and employment growth in recent years, definitely need to be overcome.

The emphasis with which I am calling for such reforms stems not least from our overriding commitment to maintain price stability across the euro area over the

medium term. In this regard, it seems worth recalling that rigidities in the functioning of markets are among the main triggers of an early resurgence of inflationary pressures in the event of adverse supply and demand shocks. Moreover, as a result of spillover effects, this often applies even in cases where such imperfections are restricted to only a few areas of the economy.

The attention that I have drawn to the public sector, which, in terms of spending, accounts for about half of GDP in the euro area, is also due to the fact that monetary policy is most effective when it is supported by responsible policies on the part of other economic actors. This also applies to the social partners, as they are largely responsible for the setting of wages. With regard to the latter, the key message is that wage increases which are not matched by productivity gains are undoubtedly an important source of inflationary pressures and higher structural unemployment.

It is the primary responsibility of the Eurosystem to set the monetary policy that best serves the maintenance of price stability in the euro area. In this regard I should like to stress that the Governing Council of the ECB is in a permanent process of reviewing the risks to price stability on the basis of a broad set of economic variables, whereby monetary growth plays a prominent role. These ongoing assessments include all aspects of the domestic and external economic and financial environment. Consequently, they take into account the overall performance of and outlook for the euro area economy.

Setting the monetary conditions so as to maintain price stability in the euro area is certainly the best contribution that the Eurosystem and the single monetary policy can make to creating an economic environment conducive to growth and employment. In this respect, however, we shall need the support of other policy areas. Whether the euro area will see a prolonged phase of non-inflationary and employment generating output growth depends on whether we shall be able to avoid repeating past mistakes and to decisively address still unresolved problems. If other policy-makers were to contribute to the efficient

functioning of the economy by addressing the largely structural problems now, the objectives of the Community, including, inter alia, sustainable and non-inflationary growth and a high level of both employment and social protection, would be best served.

In order to enhance the understanding of what is actually required and to promote the pursuit of appropriate policies, it is certainly of use to have an open exchange of views among all macroeconomic policy actors. This should be carried out in such a way as is envisaged in the newly established macroeconomic dialogue, in full respect of the independence and prerogatives of the actors involved and without blurring the division of responsibilities in the individual fields of competence. I am convinced that the dialogue between our institutions will also contribute to a better understanding of the macroeconomic policy requirements.

Current activities of the Eurosystem

Before I finish, I should now like to draw your attention to some other important activities of the Eurosystem. To save time, I shall mention these only very briefly. However, should you be interested, I would be glad to provide you with more details on these and other Eurosystem activities at a later stage.

First of all, I am pleased to say that a little over two months ago we began the production of euro banknotes and coins. The banknotes are being produced in accordance with specifications of the very highest standard and will include a wide range of security features. Moreover, as you are already aware from your meeting last week, we have also launched a Europe-wide information campaign, in co-operation with the European Commission, to raise public awareness prior to the introduction of euro banknotes and coins on 1 January 2002.

As regards the Eurosystem's preparations for the transition to the year 2000, we are now approaching the final phase of our testing activities. I am happy to report that our testing of the applications necessary for the conduct of monetary policy has so far proved these systems to be year 2000 compliant. As far as our monetary policy framework is concerned, we are convinced that it is flexible enough and has the built-in mechanisms designed to deal with any level of liquidity demand that might arise, even under the most exceptional circumstances. Just last week, the Governing Council decided that the main refinancing operations of 21 and 30 December 1999 will be lengthened to three weeks so that no such operation will be initiated or mature during the first week of the year 2000. Moreover, in the interests of smoothing the transition, not only for EU central banks, but also for other financial institutions, we have decided to close the TARGET system on 31 December 1999. This will allow a full day for end-of-year operations and making full back-ups of all the relevant systems.

As far as TARGET is concerned, I should like to express satisfaction that the system is now widely used, as intended, for both domestic and cross-border large-value payments. The system now processes approximately 3.5 million domestic and cross-border payments per month to a value of around EUR 20 trillion. The system has clearly increased the use of real-time gross settlement in the EU since the introduction of the euro. Moreover, cross-border payments now represent around 20% of the total and 40% of the value of all TARGET payments.

While on the subject of cross-border payments, I should also like to draw your attention to the publication of the ECB's report on "improving cross-border retail payment services in the euro area". This report, which forms part of the Eurosystem's ongoing efforts in this field, outlines a number of objectives for improving the efficiency and quality of cross-border payment services.

Other recent publications by the ECB include a report on the effects of technology on EU banking systems and the so-called "Blue Book" on payment systems in countries that have applied for membership of the EU. I should also

like to recall that the beginning of June saw the launch of the ECB's Working Paper series. Seven working papers have already been published, including most recently, to mention but one, "a cross-country comparison of market structures in European banking". To end, let me add that, in the interests of transparency, we intend to put together a compendium of ECB legal acts, which should also be published in the near future.

I am now at your disposal to answer any questions that you might have.