Introductory speech by Dr. Wim DUISENBERG
President of the European Central Bank
at the Sub-Committee on Monetary Affairs
Brussels, 19 April 1999

Once again it is my pleasure to be here at the European Parliament to have an exchange of views with your Sub-Committee. As you are aware, today is a special meeting. Three days ago the ECB released its first Annual Report, on which I shall report to you. I should like, however, to begin my statement by presenting the ECB's assessment of the current economic developments in the context of our recent monetary policy decisions. Finally, I shall summarise the most important decisions taken by the Governing Council of the ECB since our last hearing. As usual, I shall then stand ready to answer any questions that you might have.

A. Current economic developments and prospects

Since my last appearance before your Sub-Committee, the balance of risks of both price stability and economic activity has tilted downwards. Against the background of more subdued inflationary pressures in the euro area than expected, the Eurosystem deemed it appropriate to ease its monetary policy stance, with a view to maintaining the outlook for continued price stability. The Governing Council therefore decided at its last meeting on 8 April to reduce the interest rate for the ECB's main refinancing operations by 0.5 percentage point, setting the repo rate at 2.5%. In addition, with effect from 9 April, the interest rate on the marginal lending facility was lowered by 1 percentage point to 3.5% and the interest rate on the deposit facility by 0.5 percentage point to 1.5%.

Allow me to explain in some detail the rationale of this decision. As you are aware, the ECB's monetary policy strategy focuses on the primary objective of price stability, which is defined as a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%. Furthermore, this strategy is based on a two-pillar approach, including a prominent role for money and a broadly based assessment of the outlook for price developments and the risks to price stability on the basis of financial and other economic indicators .

With regard to the first pillar, the acceleration in growth of monetary aggregates seen in January 1999 was partly reversed in February. In addition, there was also a moderate slowdown in the growth of credit to the private sector in February 1999. The 12-month growth rate of M3 declined from 5.6% in January to 5.2% in February. This largely reflected a moderation in the rapid growth of overnight deposits, presumably resulting from the unwinding of the influence of special factors related to the start of Stage Three of EMU and the introduction of the euro. Yet, as the February figures were somewhat higher than those observed in late 1998, the three-month moving average of annual M3 growth in the period from December 1998 to February 1999 increased to 5.1%. This was slightly higher than in the previous three-month period, but the result was still close to the reference value for M3 growth of 4½%. This fact and the consideration that the deviation may to some extent mirror the specific environment at the start of Stage Three led the Governing Council to hold the view that current monetary trends are not conveying a signal of upcoming inflationary pressures.

With regard to the second pillar, let me start with financial indicators.

After having risen somewhat in February 1999, in tandem with US bond yields, euro area government bond yields remained broadly unchanged during March. At the same time, the US dollar had strengthened further against the euro. In my view, the weakening of the euro against the US dollar over the past few months is mainly due to changes in the growth outlook for the euro area and the US economy. While growth forecasts for the euro area have been generally revised downwards, the US economy has shown unexpected strength and no signs of a slowdown so far.

Looking at consumer prices as measured by the HICP, the rate of increase on a yearly basis remained unchanged at 0.8% between November 1998 and February 1999. However, a more detailed analysis of this stable rate of *overall* price increase reveals slightly divergent developments at the level of services and goods prices. In February, price increases for services saw a further fall, mainly due to declining prices in the telecommunications area. This development in services prices was offset by a higher increase in goods prices, which was largely accounted for by developments in two components. First, prices for unprocessed food increased more than in the preceding months and, second, the fall in energy prices decelerated further. As oil prices increased strongly from mid-February onwards, developments in energy prices in the HICP may continue to add some upward pressure on industrial goods prices in the coming months.

While a higher volatility of price changes in energy or food products may be reflected in some upward movement of the overall level of price increase, these effects represent a return to earlier levels and, as such, could prove to be of a more temporary nature. More lasting effects on the outlook for future price developments came from less favourable developments in the overall economic environment. These have led to a downward revision of projections for both output growth and consumer price increases in the euro area.

Looking at developments in economic activity in the euro area, the prospects for overall growth worsened towards the end of last year, mainly due to a noticeable decline in export growth. Growth of real GDP, according to figures released by Eurostat, weakened in the fourth quarter of 1998. Related to the deterioration of the external environment, weakness is particularly apparent in the manufacturing sector. Production in this sector declined in the last two months of 1998 and industrial confidence continued to deteriorate in the first months of this year, largely reflecting a worsening in the assessment of export order books.

As regards the outlook for the external environment, the evolution of the world economy seems to have improved slightly, but not yet enough to expect a significant strengthening of the external performance of the euro area. The positive signs relate to the continuously strong growth of the US economy. Moreover, a mild improvement in the external environment is suggested by the gradual recovery in some Asian countries and indications of a stabilisation in Latin American countries. On the other hand, there are no definite signs as yet of a turnaround in the Japanese economy.

In contrast to developments in the more export-oriented sectors of the economy, the domestic sectors witnessed broadly sustained growth up to the end of last year, most noticeably reflected in the ongoing improvement in consumer confidence. This, in turn, is likely to have been supported by improved labour market prospects for the most part of 1998. However, most recent data for the fourth quarter of last year point to a further slowdown in employment growth in the manufacturing sector and a deceleration in the pace of net job creation for the euro area economy as a whole. Likewise, the rate of decline in unemployment has continued to slow down at the beginning of this year. The unemployment rate, according to data released by Eurostat, stood at 10.5% in February. This is the same level as in January and only marginally lower than the rate prevailing during the last months of 1998. Finally, the latest data suggest that consumer

confidence is no longer improving. After reaching a record high level at the beginning of this year, consumer confidence did not increase further in February and, according to preliminary results from the European Commission, it weakened slightly in March, the first time since August 1998.

In sum, weighing all the relevant indicators and taking a forward-looking and medium-term perspective, the Governing Council considered it appropriate to lower the interest rates on its monetary policy instruments. A main consideration underlying this decision was that monetary growth slightly above the reference value is at the moment not seen as a risk to future price stability. At the same time, the current economic environment puts downward pressure on inflation. The risk that HICP increases could exceed 2% for an extended period of time is considered to be small at this juncture.

With its recent decisions, the Eurosystem underscored its commitment to a stability-oriented monetary policy course, which is required for creating economic conditions that enable a full use of the growth potential of the euro area. In addition, the significant cut in ECB interest rates should help to reduce uncertainty about future economic developments and thereby restore confidence.

Having said that, let me make clear our position on the question of how other policy areas could contribute to further reducing uncertainty and restoring confidence. In particular with a view to continued reduction in unemployment, monetary policy needs to be accompanied by structural measures to improve the functioning of labour and product markets. For example, we need to make sure that welfare and tax systems do not make work financially unattractive for low-paid workers. This needs to be supported by measures to develop the skills and experience of the long-term unemployed workers to enable them to participate fully in the labour market. It is also crucial that the social partners take account of the need to reduce unemployment when negotiating pay agreements. The efficiency of such measures could be increased if they were accompanied by further budgetary consolidation focused on reducing spending rather than increasing the tax burden. They will also be supported by product market reforms, such as making it easier for people to start and run businesses and thus create new jobs.

It is important to note that the euro area countries at a more advanced stage in the structural reform process have been very successful in reducing unemployment. This points to the appropriateness of such an approach and suggests that these are examples which could be followed by other countries.

Let me add at this point that I fully share the concerns about the current level of unemployment prevailing in the euro area. I also agree with the assessment that the maintenance of social stability is an important objective, which plays a fundamental role in Europe's tradition and cohesion. It is my firm belief that the best contribution the ECB can make to support employment and social stability consists in fulfilling its primary objective defined by the Treaty, the maintenance of price stability.

Indeed, the pursuit of a stability-oriented monetary policy yields important social benefits. Most importantly, it contributes to fostering investment and, thereby, employment growth. Moreover, one must not neglect the fact that households at the lower end of the income spectrum are particularly vulnerable to inflation, since they are likely to suffer the most from a loss of value of their income and savings. Therefore, price stability and social stability are not conflicting, but supplementary and mutually reinforcing policy objectives. As economic policy-makers, we should keep this in mind when we formulate strategies to promote employment and social stability.

B. Annual Report of the ECB

I should now like to comment on the ECB's first Annual Report, which was published on 16 April 1999 and addressed to the European Parliament, the Council, the Commission and the European Council. As required by the EC Treaty, the Report gives a presentation of the activities of the ESCB and of the monetary policy of both the previous and current year.

In particular, the Report describes the macroeconomic environment that prevailed in 1998 and the monetary policy decisions taken in the EU. It recalls the major decisions of the Eurosystem in the framework of the preparatory work for Stage Three that paved the way for the successful launch of the euro. The Report also gives an account of the way in which the other tasks conferred upon the ECB by the EC Treaty have been carried out. Finally, the Report presents the annual accounts of the former EMI and the ECB, which have been approved by independent external auditors. If you have any questions related to particular issues dealt with in the Annual Report, I shall be glad to reply during the question and answer session of our meeting.

C. Other issues

Let me finally highlight a few aspects concerning the technical implementation of the third stage of EMU in some detail. First, the functioning of cross-border payment systems in Europe remains one of the most important technical pillars of EMU. Therefore, the development of the large-value payment system TARGET was one of the major projects in the run-up to EMU. It is my pleasure to inform you that TARGET is functioning well and stands as Europe's most important payment system in terms of the value of transactions processed. According to the latest available statistics, more than 3.6 million payment instructions were processed through TARGET in March 1999, amounting to a total value of nearly E20 trillion, of which 40% was cross-border activity.

Several transitional measures related to the standing facilities and TARGET have been terminated since my last appearance before your Sub-Committee. As envisaged, the initial narrowing of the interest rate corridor set by the standing facilities was not extended beyond 21 January 1999. On 4 February, the Governing Council of the ECB agreed to harmonise further the access to the standing facilities and the closing of TARGET. These decisions reflect the rapid progress in euro area money market integration.

I should now like to turn to the issue of the Year 2000. As you might be aware, the Governing Council of the ECB has decided to close TARGET on 31 December 1999. This decision, which accommodates frequently expressed requests by the European financial industry, was taken in order to facilitate a smooth transition of IT systems to the Year 2000 and to avoid possible disruptions in payment systems. This initiative was accompanied by a proposal by the ECB to the President of the ECOFIN to declare 31 December 1999 a non-business day throughout the European Union, which is also widely supported by market participants. Such a decision would be the most clear-cut and transparent way to facilitate the completion of end-of-year procedures and the full backup of all systems before midnight on that day.

Let me now turn to another topic, namely the development of euro banknotes and the preparation for the cash changeover in the euro area. As you might recall, the designs and technical specifications of the euro banknotes were already agreed by the EMI Council in February 1998. In February 1999, the evaluation of the pilot series of several million banknotes printed under normal operating conditions was completed successfully. National central banks of the Eurosystem are free to decide where their national supply of euro banknotes will be printed. A zero-production run was therefore necessary to ensure that all euro banknotes will feature the same high technical standards throughout the euro area.

In this context, a major concern of the ECB is the prevention of the counterfeiting of euro banknotes. To this end, the euro banknotes will be provided with the most up-to-date standard of security features. These security features should effectively impede falsification of euro banknotes, while, at the same time, being easily identifiable by the general public and banknote-accepting machines. The general public will be informed of the design and the security features of the euro banknotes in the framework of a broad information campaign that will be conducted by the ECB in co-operation with the European Commission and the Member States.

The Governing Council of the ECB has also agreed on the location of the analysis centre for counterfeit euro banknotes on the ECB's premises. The centre, which will take up its operational functions by 1 January 2002, will be responsible for the technical analysis and classification of new types of printed counterfeits. The centre's database will be available to the national central banks and the respective law enforcement authorities of Member States and at the European level.

Finally, I should like to address briefly another important issue related to the conversion of banknotes and coins of euro area Member States. It has been observed that some financial institutions and other operators (e.g. bureaux de change, travel agencies, etc.) do not clearly differentiate between the conversion rate and the banking fees applied to such transactions, thereby giving rise to confusion with regard to the proper use of the euro conversion rates. In addition, banking charges for the conversion of banknotes and coins of euro area Member States differ widely throughout the euro area. The members of the Governing Council of the ECB are concerned about such practices. However, it is felt that enhanced transparency and competition are the appropriate means of tackling and, ultimately, to solving these issues. I understand that the European Commission is intending to publish a report on this question around the end of this month.

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

***