EUROPEAN CENTRAL BANK

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Testimony before the Committee on Economic and Monetary Affairs of the European Parliament

Introductory statement
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It is a pleasure for me to appear before your Committee today. I would like to start by briefly summarising the outcome of the Governing Council's reflections on the ECB's monetary policy strategy, as announced on 8 May. I will then report on our assessment of current economic and monetary developments and on our recent monetary policy decisions.

1. Reflections on the ECB's monetary policy strategy

After more than four years of conducting monetary policy for the euro area, we felt it would be useful to evaluate our monetary policy strategy in the light of past experience. Our discussion took stock of the public debate on our strategy, to which your Committee has actively contributed, and of a series of studies undertaken by Eurosystem staff. As a result of this thorough evaluation, the Governing Council confirmed the main elements of the strategy originally announced in 1998. However, we also recognised that some aspects of the strategy needed further clarification.

The Governing Council thus confirmed its definition of price stability "as a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%". It also confirmed that "price stability is to be maintained over the medium term". At the same time, the Governing Council clarified that in the pursuit of price stability the ECB aims at maintaining the inflation rate "below", but "close to" 2% over the medium term.

This clarification underlines the ECB's commitment to provide – within the range of inflation rates compatible with price stability – a sufficient safety margin to guard against the risks of deflation. According to all evidence, this safety margin appears more than sufficient to cover other considerations as well, such as the possible presence of a measurement bias in the HICP index and the implications of structural inflation differentials within the euro area.

The focus for monetary policy on a year-on-year increase in the HICP of below, but close to, 2% is fully in line with past conduct. Moreover, it is also consistent with the markets' understanding of our past monetary policy, as reflected in long-term inflation expectations in the euro area since 1999.

The second important clarification concerns the two pillars, i.e. the roles of economic analysis and monetary analysis, in assessing the risks to price stability. The **economic analysis** serves to identify short to medium-term risks to price stability. It includes an analysis of shocks affecting the euro area economy and projections of key macroeconomic variables. The **monetary analysis** focuses on the identification of the medium to long-term trends in inflation in view of the close relationship between money and prices over extended horizons. This analysis mainly serves as a means of cross-checking, from a longer-term perspective, the indications coming from economic analysis. This clarification has also been reflected in a new structure for the communication of our monetary policy decisions since May.

Finally, to underscore the longer-term nature of the reference value for monetary growth as a benchmark for the assessment of monetary developments, the Governing Council decided that it will no longer conduct a review of the reference value on an annual basis. However, it will continue to assess the underlying conditions and assumptions, and amend the reference value when necessary.

Overall, I am confident that the clarifications provided will foster understanding of the monetary policy of the ECB. Let me now turn to our recent monetary policy decisions.

2. Economic and monetary developments

Starting with our economic analysis, the first few months of this year were dominated by the uncertainty related to the escalation of geopolitical tension in the Middle East. This environment, which was also characterised by rising oil prices, was not beneficial for investment or, more generally, for economic activity in the euro area and at global level. This picture was confirmed more recently by the release of data showing the stagnation of real GDP in the first quarter of 2003. Moreover, while oil prices have since fallen and financial markets stabilised, the survey evidence for April and May did not suggest an immediate improvement after the resolution of the conflict in Iraq. Accordingly, economic growth in the first half of 2003 is likely to have been very weak, and expectations for annual average economic growth for this year and for 2004 have had to be scaled down. This is also reflected in the Eurosystem's staff projections contained in the June issue of the ECB's Monthly Bulletin which is published today.

Nevertheless, we expect a gradual strengthening of real GDP growth in the course of 2003, which should gather more pace next year. This outlook is underpinned by several factors. On the external side, the expected upturn in extra-euro area demand should compensate for the dampening effect of the appreciation of the euro exchange rate. Evidently, the significant and rapid appreciation of the euro over recent months will dampen external price competitiveness. However, the current level of the euro's real effective exchange rate, and thereby the international price and cost competitiveness of euro area exporters, is very close to longer-term averages. Thus, when put into perspective, current euro exchange rate levels are in line with economic fundamentals and with the ECB's interest in a strong and stable euro.

In addition, the negative effects of the appreciation of the euro on aggregate demand should be mitigated by the positive effects on consumption stemming from the significant improvement in the terms of trade, also related to the decline in oil prices from the highs of early 2003. The associated decline in import prices should increase the real disposable income of euro area households. Furthermore, there are no significant imbalances in the household sector as a whole that would hinder a recovery in consumption. At the same time, the contribution of investment to growth is likely to remain modest, although an improvement in the global economic environment and the historically low level of interest rates should contribute to an upswing.

Downside risks to economic growth remain, however. Notably, risks stem from the past accumulation of macroeconomic imbalances outside the euro area, while there is still uncertainty surrounding the economic impact of the SARS virus. A degree of uncertainty also remains as to the extent of the adjustment still needed in the euro area corporate sector to enhance productivity and profitability. A longer adjustment process could also have an impact on employment growth and thus private consumption.

Given this environment for economic growth, and taking into account the direct effects on inflation of the significant appreciation of the euro exchange rate, the outlook for price developments has become more favourable. Eurostat's flash estimate of the inflation rate for May was 1.9%. Annual inflation rates are expected to hover broadly around this level for the remainder of this year and to fall significantly in 2004. This assessment is based on the assumption of favourable import price trends, reflecting both oil price developments and the higher euro exchange rate, as well as on the expectation of lower domestic price pressure in the context of a moderate economic recovery. In particular, wage growth is expected to remain broadly stable. Coupled with productivity gains, this should result in a moderation of the rate of growth of unit labour costs.

In the context of our monetary analysis, we saw persistent strong growth in the broad monetary aggregate M3. Consequently, the euro area economy has continued to accumulate liquidity significantly above the amount needed to sustain non-inflationary growth. There are, however, several considerations that counterbalance concerns that this ample liquidity will lead to inflationary pressures over the medium term. In particular, monetary developments continue to be fostered by portfolio shifts, reflecting a sustained preference on the part of investors for liquid and secure assets. This is also indicated by the fact that loans to the private sector increased at a much more moderate pace than M3. The perspective that economic activity will remain moderate also reduces the likelihood of excess liquidity giving rise to increased spending. Nevertheless, one has to bear in mind that monetary growth is also supported by the low level of interest rates. Therefore, monetary developments need to be closely monitored with respect to their implications for price stability over the medium to long term.

Cross-checking the economic and monetary analyses in the context of our monetary policy strategy, we concluded at our Governing Council meeting on 5 June 2003 that the outlook for price stability over the medium term had improved significantly since our last decision to lower interest rates in March. As a result, we decided to reduce key ECB interest rates by 50 basis points. This decision aimed at maintaining inflation rates below, but close to, 2% over the medium term, providing some counterweight to the existing downside risks to economic growth. Looking ahead, we will continue to monitor carefully all factors relevant to our assessment of the risks to price stability in the euro area.

At this juncture, it may be particularly warranted to stress that monetary policy cannot by itself solve the problems underlying the weak growth and employment performance in the euro area. This calls for appropriate structural measures that address fundamental weaknesses and tackle urgent adjustment requirements. In this respect, sound fiscal policies have a great potential for fostering confidence and thereby supporting economic activity, even in the short run. The establishment of a well designed medium-term reform strategy, with appropriate consolidation efforts in those countries currently struggling with fiscal imbalances, would make a major contribution in this direction. This should imply comprehensive and growth-friendly measures including, in particular, a courageous reform of the structure and level of public expenditure. Curbing spending growth would eventually also create further room for manoeuvre to address future pressure arising from population ageing and allow scope for future tax cuts. Procedurally, it is crucial to underpin the fiscal policy framework with a decisive and consistent implementation of the rules of the Treaty and of the Stability and Growth Pact, and rigorous monitoring and peer pressure amongst Member States.

Similarly, governments should now make progress in the field of structural reforms in the labour and product markets. This would not only increase the euro area's growth potential and enhance its ability to better withstand external shocks, but it would also eliminate a great deal of the uncertainty currently overshadowing long-term planning and perspectives. This, in turn, would also have positive effects over the shorter term. There can be no doubt that addressing long-standing structural problems will greatly enhance the current attractiveness of the euro area for investment and could thereby provide an important stimulus for the economic recovery in the euro area.