European Central Bank ECB. 1st annual report 2001

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PURPOSE : European Central Bank (ECB) Annual Report 2001. CONTENT : This Annual Report summarises the activities of the European System of Central Banks and the Eurosystem in 2001. It also reports on monetary policy in 2001 and early 2002 and highlights the many issues, sometimes of a technical nature, that arose in establishing and consolidating the Eurosystem as the central bank of the euro area. The President of the ECB praises the euro cash changeover, which went far more smoothly than could have been expected. The changeover followed a year in which inflation in the euro area, measured in terms of the Harmonised Index of Consumer Prices (HIPC) was 2.5%, 0.2% higher than in 2000. The slight increase in inflation was mainly due to developments in the more volatile components of the HIPC, energy and unprocessed food. The inflation rate reached its peak in May 2001 (3.4%) and declined to 2.0% in December. This turnaround was due to the unwinding of factors that had generated inflationary pressures in late 2000 and early 2001. Overall risks to price stability gradually declined. The terrorist attack of September 11 prolonged the downturn. Against a background of declining inflationary risks, the ECB lowered the key ECB interest rates four times, by a total of 150 basis points. At the turn of the year, the first signs emerged of renewed growth in the euro area economy. The level of long-term interest rates in the euro area indicates that financial markets have confidence in the ECB to maintain price stability in the medium to long term. The economic downturn in the euro area in 2001 also presented challenges for fiscal policy. The average budget deficit of the countries that have adopted the euro increased to 1.3% of GDP, as a result of both the working of automatic stabilisers and major tax cuts in some countries. It was the first time since 1993 that the overall fiscal position of the euro area has deteriorated. Most countries failed to meet the targets laid down in their stability programmes, submitted late in 2000. On average, these targets were missed by 0.7% of GDP. The rules of the Stability and Growth Pact allow, in principle, for automatic stabilisers to work if economic growth deviates from its trend rate. If countries have achieved over the medium term a balanced budget or a surplus, it is very unlikely that normal business cycle fluctuations would lead the budget deficit to exceed 3% of GDP, the threshold laid down in the Treaty. Thus, it is important that those countries that have not achieved a balanced budget in the medium term should try do so. The Pact was put under strain last year and early this year, but it kept working. If countries do not adhere to the Pact and were to fail to use the economic recovery to improve their fiscal position substantially, the credibility of fiscal policy would be seriously impaired, entailing adverse consequences for medium term growth and price stability. The rate of potential growth in the euro area, estimated at 2% to 2.5% per annum, can be raised only by structural reforms to improve the functioning of markets. A more flexible labour market and continued wage moderation are also of paramount importance in reducing the unacceptably high level of employment, which amounted to 8.3% last year. Overall progress has to be accelerated. This is the main challenge in the years to come. At the beginning of 2002, all information supported the view thatannual HIPC inflation should stabilise at levels below 2% over the medium term. The replacement of national currencies by the euro raises important issues concerning the distribution of monetary income in the Eurosystem, i.e. the ECB and the national central banks of the euro Member States, which collectively perform the central banking functions for the area as a whole. The ECB decided on the issuance of euro banknotes and the allocation of monetary income. It will issue, as from 2002, 8% of the total euro banknote requirement, while the issuance of the remaining 92% is to be divided between NCBs of the Eurosystem in accordance with their shares in the ECB's capital. The seigniorage income earned by the NCBs on euro banknotes issued will be included in the monetary income, which has to be pooled and redistributed in accordance with the provisions laid down in the Statute of the European System of Central Banks and of the ECB. In order to mitigate its impact on the relative finanical positions of the NCBs, the new regime will be phased in progressively during a transitional period ending in 2007. As from 2008, all monetary income earned will be distributed among the NCBs in accordance with their shares in the ECB's capital.