European Central Bank. Annual Report 2002

2003/2102(INI) - 28/02/2003 - Non-legislative basic document

PURPOSE : to present the European Central Bank's Annual Report 2002. CONTENT : this report covers the ECB's monetary policy and economic developments in 2002 and presents the activities of the Eurosystem in the various areas of its competence. It also includes a special chapter on the enlargement process. The conduct of monetary policy in 2002 was characterised by a high degree of uncertainty with regard to the economic outlook. Average inflation, measured in terms of the Harmonised Index of consumer prices (HIPC) was 2.2%, slightly lower than in 2001 (2.4%) but still slightly above levels consistent with the ECB's definition of price stability. The average annual growth rate of the broad monetary aggregate M3 increased to above 7%, from around 5 1/2% in 2001, considerably exceeding the reference value of 4 1/2%. This development was the result of high volatility in financial markets, and largely reflected investors' preferences for short-term liquid and less risky financial assets. It also reflected the relatively low interest rates in the euro area in 2002. Overall, however, in view of the relatively subdued pace of economic activity and given hat some of the portfolio shifts into M3 were likely to be only of a temporary nature, monetary developments in 2002 were not seen as pointing to risks to price stability. Economic growth in the euro area was lower than expected in 2002, leading to relatively low, but still positive, real GDP growth of 0.8%, compared with 1.4% in 2001. Weak economic conditions prevailed as a number of factors contributed to an unusually high level of uncertainty: geopolitical tensions and their impact on oil prices and confidence, adverse financial market developments (which did not, however, threaten financial stability in the euro area) and the persistence of global imbalances. In this context, and given the gradual strengthening of the euro in 2002 and early 2003, upward pressures on inflation abated. The Governing Council cut the key ECB interest rates by 50 basis points in December 2002, and by another 25 basis points in March 2003. Despite these subdued economic conditions, the inflation rate in the euro area remained relatively high. However, prices were pushed up in 2002 by a number of temporary: base effects, increases in indirect taxation and adverse weather conditions. Furthermore, real wage growth remained very strong despite the rise in unemployment, a factor pointing to persistent structural rigidities in the labour markets. It is acknowledged that some of the price increases in some euro area countries were associated with the euro cash changeover. However, the perceived impact of the euro cash changeover on inflation was much greater than the actual impact. Moreover, coincident but independent upward pressures on prices, such as those resulting from adverse weather conditions in the winter of 2001/02, were erroneously associated with the euro cash changeover. The introduction of the euro will help to keep price increases low in the medium term, as the new currency has increased crossborder price transparency in the euro area, thereby intensifying competition. In early 2003, the prospects for price stability in the medium term look rather favourable, provided that wage developments remain moderate. The pace of structural reforms must be stepped up. This is because more flexible labour and product markets leadto faster price adjustments and, more generally, to lower price increases. The low level of long-term inflation expectations and risk premia currently prevailing in bond markets would seem to suggest that economic actors have confidence in the ECB's ability to maintain price stability in the medium term. Fiscal developments in the euro area were generally disappointing in 2002. The average budget deficit increased to 2.2% of GDP, from 1.6% in 2001. Most countries failed to comply with the fiscal targets set in their stability programmes. The ECOFIN Council declared, in November 2002 and January 2003 respectively, that Portugal and Germany had excessive deficits. ECOFIN also adopted a recommendation in January 2003 giving an early warning to France to try to prevent the occurrence of an excessive deficit. In 2002 France's budget deficit exceeded the 3% reference value for the deficit-to-GDP ratio as laid down in the Treaty. Contrary to what is often claimed, the Stability and Growth Pact is not a straitjacket committing countries to pursue pro-cyclical budgetary policies. Instead, provided that countries achieve a medium-term budgetary position close to balance or in surplus, the Pact provides flexibility for the full functioning of automatic stabilisers. Countries that are now struggling did not reduce their budget deficits sufficiently in previous years when economic conditions were relatively favourable. Countries that did adhere to the rules of the Stability and Growth

Pact are now experiencing fewer budgetary difficulties and are benefiting from the smooth operation of automatic stabilisers. To remedy the current fiscal imbalances, countries with a deficit close to or exceeding 3% of GDP should embark on growth-fostering fiscal consolidation measures to bring their budgetary position into line with the requirements of the Stability and Growth Pact. With regard to enlargement the Eurosystem has been closely monitoring economic, legal and institutional policy issues in the accession countries, focusing particularly on macroeconomic developments, monetary policy and exchange rate strategies and financial sector developments. Furthermore, the ECB has started preparations to ensure the orderly enlargement of the ESCB and, at a later stage, the Eurosystem. The latter includes the ECB recommendation concerning the adjustment of the voting modalities in the Governing Council, and the launch of a Master Plan aimed at preparing the ECB for enlargement.