EUROPEAN CENTRAL BANK

Jean-Claude TRICHET
President

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Mr Josep Borrell Fontelles
President of the European Parliament
European Parliament
Rue Wiertz
B-1047 Brussels

24 November 2004

Dear President Borrell,

Further to my appearance before the plenary session of the European Parliament on 25 October 2004, I should like to thank Mrs Wagenknecht and Messrs Lipietz, Blokland, García-Margallo y Marfil, Hamon, Karas, Klinz, Lauk, Lundgren, Martin, Muscat, Radwan and Sánchez Presedo for their valuable contributions to the debate, and Mr Ryan for his written declaration.

As requested by you, please find attached my replies to those issues raised by Members of the European Parliament to which I was, due to time constraints, not able to respond and which I did not address in my introductory remarks. I would like to ask you to make this letter available to the Honourable Members. Moreover, I should like to add that, for reasons of transparency, the ECB will publish the answers on its website, in line with previous practice in similar cases.

I look forward to continuing the regular dialogue between our institutions.

With kind regards, ~~With kind regards,~~ With my best personal regards,

Suggestions that the ECB's definition of price stability be modified

On 8 May 2003 following a thorough evaluation of its monetary policy strategy, the Governing Council of the ECB confirmed its definition of price stability, adopted in 1998, as "a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%". In addition, it clarified that, in pursuing price stability, the ECB aims to maintain inflation rates "below but close to 2%". On that occasion, the Governing Council explained that this clarification underlined the ECB's commitment to providing a sufficient safety margin to guard against the risks of deflation. It also addresses the issue of a possible measurement bias in the HICP and the implications of inflation differentials within the euro area.

Let me stress that our definition corresponds to a demand for price stability on the part of European citizens and is based on sound economic principles and on state-of-the-art research.[1] It is also very close to, and of comparable magnitude with, the achievements, objectives or inflation targets of other successful major central banks.[2] Our definition, together with our strong focus on the price stability objective, has been a key element in the conduct of our monetary policy, which has been very successful overall. In particular, it has been instrumental in keeping inflation under control even in the face of substantial adverse shocks, and in keeping medium to long-term inflation expectations well anchored. Consequently, risk premia and therefore (real and nominal) interest rates have remained very low and provide the best financial conditions that euro area countries have experienced for a long time, thus promoting the conditions for high levels of economic growth and employment creation.

In line with all available studies on the subject, our definition of price stability also incorporates a sufficient margin to ensure that individual countries do not have to cope with periods of excessively low or negative inflation rates.[3]

Let me also add that differences in economic cycles and inflation across countries or regions are a normal feature of any monetary union. The ECB's single monetary policy, being an indivisible one, cannot (and therefore should not) address country-specific problems. High unemployment in the euro area is

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1 For the rationale underlying the ECB's definition of price stability, please see the following documents: "The outcome of the ECB's evaluation of its monetary policy strategy", ECB's Monthly Bulletin, June 2003; "The Monetary Policy of the ECB", ECB, January 2004; Issing, O. (ed.), "Background Studies for the ECB's Evaluation of its Monetary Policy Strategy", November 2003; Letters from Dr W. F. Duisenberg, President of the ECB, to the Chairperson of the Committee on Economic and Monetary Affairs, Mrs Christa Randzio-Plath, dated 16 October 2001 and 13 December 2001 (all documents are available at www.ecb.int).

2 For example, of the four central banks mentioned by Mr Lundgren, the Bank of England and Sveriges Riksbank have set their inflation target at 2% (the latter with a fluctuation margin of ±1%), and the Reserve Bank of New Zealand at 1%-3%, while the US Federal Reserve has not announced an inflation target or a quantitative definition of price stability.

3 See "Background Studies for the ECB's Evaluation of its Monetary Policy Strategy", op. cit., pp. 11-19.

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overwhelmingly structural in its origin. It is to a large extent due to excessive rigidity in labour and goods markets. Continued structural reforms by national governments in these areas will not only help to raise growth potential and employment in Member States, they will also increase the flexibility of national economies and their ability to respond to economic shocks, thus permitting them to fully reap the benefits of Economic and Monetary Union (EMU). The mid-term review of the Lisbon agenda – now being prepared for the European Council meeting in March 2005 – is a major opportunity to increase momentum in these fields.

Concerns that banks do not reduce their lending rates when the ECB lowers its policy rates

In general, many factors should be taken into account when assessing the reaction of bank lending and deposit rates to changes in the ECB's policy rates. As a result, a one-to-one relationship between bank interest rates and policy rates cannot be expected a priori. For example, the level of bank interest rates (and hence also bank interest margins) is likely to reflect a variety of factors such as maturity, credit risk and specific bank product characteristics.

In most countries, one can observe some delay (and incompleteness) in the pass-through of changes in the policy rate to bank interest rates. This may be due, for example, to the fact that banks face "menu costs" (i.e. transaction costs for changing their interest rates). Furthermore, with some bank products there may be an implicit risk-sharing agreement between the bank and its customer, which aims to ensure the customer of stable (or smooth) interest rate payments. In addition, banks may lack accurate information about the potential credit risk represented by an individual borrower. That is, they cannot be sure that the borrower will repay its loan and can only assess the borrower in a less than perfect fashion. Therefore, changes in perceived credit risk may add to the sluggishness of bank interest rate pass-through.

ECB studies suggest that in the recent phase of policy rate reduction the pass-through to most bank interest rates has been broadly in line with past experience. Some deviations were, however, observed: slower downward adjustment followed by quicker upward adjustment of monetary financial institutions' (MFI) interest rates on loans to non-financial corporations with a maturity of over one year and, conversely, a somewhat faster downward adjustment of MFI interest rates on loans to households for house purchases. These divergent developments possibly reflected differences in the pattern of perceived credit risk. In addition, the financial conditions of the banking sector at a given moment may have played a role.

Differences in the degree of pass-through across the euro area countries have also been observed in recent years. This heterogeneity may partly be explained by differences in the economic (and credit risk) cycle across the euro area countries as well as by national banking sector characteristics, such as bank product regulation, capital market development and, in general, the degree of competition in the banking sector.

As regards the latter, the ECB is clearly in favour of measures strengthening banking sector competition, both within countries and across borders, as this should favour a faster and more complete pass-through of its monetary policy actions, all other things being equal. At the same time, borrowers also have an important role to play in keeping competition pressures high in the banking sphere, by constantly searching for the best offers available in the euro area as a whole.

Concerns about the validity of the revised Greek public deficit data and call for measures to improve the reliability of statistical reporting on public deficits

We share the concerns expressed by MEPs about Greek fiscal data developments. Nevertheless, we are confident that Eurostat will clarify all the statistical issues.

The Greek case underlines that the compilation and reporting of reliable government finance statistics is of vital importance to the credibility of budgetary surveillance in individual countries and in EMU as a whole. Without a sound information base, the early warning role of fiscal surveillance cannot work and it would be difficult to determine the size of the correction of imbalances required to re-establish fiscal discipline and compliance with fiscal rules. The ECB therefore supports efforts to strengthen the statistical basis of budgetary surveillance.

At the same time, national authorities must consider concrete measures to guarantee the quality and integrity of their statistics as a priority matter, and apply the highest standards in the domain of statistics. These standards should reinforce the independence, integrity and accountability of the National Statistical Institutes and also help to inspire confidence in the quality of government finance statistics.

Call for the ECB to publish a study similar to the "Beige Book" of the US Federal Reserve System

Regarding the suggestion to publish a study similar to the Beige Book of the US Federal Reserve System, it should be recalled that the national central banks within the Eurosystem regularly monitor and analyse macroeconomic, fiscal and structural developments in their respective countries, and publish their findings in their monthly, quarterly or annual reports. These analyses clearly enhance our understanding of euro area developments. However, given its euro area focus, it is natural for the ECB to take a euro area perspective in its explanations of the single monetary policy.

Withdrawal of one cent and two cent coins and the possible ensuing inflationary effects

It is up to the national authorities to foster or discourage the active use of certain denominations, e.g. by issuing rounding rules for transactions. There are already arrangements for rounding all prices to five-cent multiples in the Netherlands and Finland, and reflections on similar plans in other Member States.

These arrangements should in principle not have a direct impact on measured HICP inflation. As prices of individual consumption items remain quoted in non-rounded figures, the statistical authorities are still able to take the non-rounded prices into account when calculating the price indices. However, there is a risk that rounding rules for cash payments would provide an opportunity for producers and retailers to round up the quoted prices of some goods, depending on the degree of competition at the retail level. Such a move would be captured in the measured HICP inflation as quoted prices would, in this instance, rise. Such effects should, however, remain limited as a result of competition in the retailing sector. At the same time, there is also a risk that consumers' inflation perceptions are affected. Consumers may perceive that these rounding rules lead to a wave of upward rounding of prices or even outright price increases, in the same way as the euro cash changeover was perceived to have led to significant increases in prices. Indeed, even if de facto rounding were symmetrical, there is a risk that consumers may focus only on prices that are rounded up, thus leading to an increase in inflation perceptions.

It may be useful to recall that, first, all euro banknote and coin denominations remain legal tender in Finland and the Netherlands and, second, the Dutch experience between 1983 and 2002 with the guilder and the Finnish experience from 1980 with the markka and since 2002 with the euro seem to confirm that there was no measurable impact from rounding cash payments on consumer price inflation, as measured by either the HICP or the private consumption deflator.

Call for the ECB to investigate abusive rounding practices following the euro cash changeover

Experience with the introduction of the euro in early 2002 in 12 euro area countries showed that the overall impact on euro area consumer prices was limited and temporary. As confirmed by Eurostat's estimations, the overall impact of the changeover on euro area inflation in 2002 was at most 0.3 percentage point. This result is very similar to that of the assessment carried out by the Eurosystem which had used different methods and information sources. However, consumers' inflation perceptions increased after the euro cash changeover. Consumers have sometimes had the impression that, despite the official conversion rules in all countries (which also covered rounding), and the fact that price setting is essentially left to free market behaviour, the cash changeover led to significant price increases, as illustrated by the "teuro" debate in Germany. As regards potential lagged effects, analysis by Eurostat found no evidence of any changeover effect on inflation in 2003. This experience should also be illustrative for future euro area members.

As pointed out by the ECB on previous occasions, the cash changeover effect on inflation was contained and temporary due to the functioning of increased price transparency and market competition. Importantly, in a competitive market environment with prices set by companies, consumers can signal their unwillingness to accept unjustified price increases through their consumption behaviour. In fact, experience shows that consumers and consumer organisations in the euro area played an important role in monitoring the transformation process from national currencies to the euro, thus preventing potentially larger effects on prices. At the same time, early and accurate information about the changeover, including a period of dual pricing, may have been helpful in preparing consumers for the new price structure.

Overall, given that the inflationary effect of the euro cash changeover in 2002 was rather small and transitory there appears to be no immediate need to prepare new studies or reports investigating ways to prevent inflationary effects associated with the introduction of banknotes and coins for future euro area members. In fact, the existing market mechanisms have been sufficient to prevent any strong inflationary effects and the same should hold true for future euro area members. At the same time, the ECB will continue to assess any potential impact in the context of the introduction of euro banknotes and coins in new euro area member countries.

Call for equal treatment in the application of the convergence criteria for the new Member States

The application of the convergence criteria for euro area entry will remain the same in future convergence reports as in previous reports. Indeed, in the 2004 Convergence Report published by the ECB on 20 October, it is clear, both from the text and the application of the criteria, that the examination is based on the same principles as used in previous reports, in order to ensure continuity and equal treatment. Consequently, no additional criteria for the adoption of the euro will be introduced in the future, nor will there be any relaxation of the criteria laid down in the Treaty.

Suggestions to issue €1 and €2 banknotes and to set up a working group of the European Commission and the ECB to investigate this proposal

After careful consideration, the Governing Council of the ECB has decided not to revise the earlier decision on the denominations of the euro banknotes[4] and consequently not to issue €1 or €2 banknotes.

The Governing Council has assessed all arguments put forward in the debate and concluded that, on balance, the negative aspects of introducing very low denomination banknotes outweigh the positive aspects.

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[4] See the ECB's press release of 12 September 1998

In particular, the insufficient demand for very low denomination banknotes by the majority of euro area citizens, the increased inefficiency the introduction would imply for most of the affected third parties, for instance the retail sector and the vending machine industry, and the high costs of printing and processing support the Governing Council's decision on this issue.

Suggestions regarding the design of the new euro banknote series

When approving some basic assumptions for the planning of the second euro banknote series, the Governing Council decided that the designs for the second series will be based on the "ages and styles" theme of the current series in order to signal continuity and taking into account the very high rate of approval of the first design by users all over the euro area. This decision was announced in the ECB's Annual Report of 2003.