Jean-Claude Trichet: Key issues for monetary policy - an ECB view

Keynote address by Mr Jean-Claude Trichet, President of the European Central Bank, at the National Association of Business Economics, Philadelphia, 5 October 2004.

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Mrs President, Ladies and Gentlemen,

It is a great pleasure to share some thoughts on monetary policy issues with members of the National Association of Business Economics gathered here in Philadelphia for their 46th Annual Meeting.

Only six years ago Europe engaged in a grand enterprise of institutional design that irreversibly tied together the monetary destiny of eleven, then twelve, nations. The European single currency, the euro, has in the meantime become a visible token of Europeans' drive towards unification. Historically, currencies have been rightly regarded as one of the fundamental components of sovereignty. The Euro is a very powerful symbol of the European identity. I guess the rest of the world sees the euro not only as Europe's single currency, but also as a symbol of Europeans' strong determination to plan their future and to realise their dreams.

Taking issue with this historical transition to the European single currency, I intend to focus my remarks on the challenges presented by the creation of the euro and the execution of monetary policy in a rapidly changing world: a world in which high-speed structural change - whether spurred by spontaneous economic forces or institutional evolution - may put tested economic models at risk and defy policy-makers' searches for well-trusted policy recipes.

Although in my remarks I will take a European perspective, at the end of my considerations I will attempt to draw a comparison between the monetary policy concept adopted by the European Central Bank (the ECB) and the one adopted by the US Federal Reserve System.

Central banks and uncertainty

The ECB, like all central banks, is faced with several dimensions of uncertainty. The economy is often hit by disturbances that are difficult to identify in real time. Even when policy-makers are able to correctly assess the source and the nature of a disturbance affecting the economy, tracking its propagation profile and working out its final impact on the key variables of interest is a highly-demanding task.

Econometric theory has spent decades devising sophisticated tools to isolate different types of shocks hitting the economy. But inference is often non-robust across various alternative identification schemes. As a consequence, central bankers are given little guidance by theory in their daily endeavour to filter out noisy data.

The task of policy-makers is further complicated if they suspect that cyclical movements are compounded by an ongoing change in the deep structure of the economy. For one thing, structural changes amplify the identification problem. It becomes more difficult to ascertain whether new developments are going to be reversed and eventually vanish, or will become ingrained in the underlying economic mechanism for many years to come. But more importantly, if a structural change is truly under way, macroeconomic relationships derived from empirical regularities and historical averages are bound to loose significance. A new set of relationships would need to be estimated and tested. But serious diagnostics for structural stability rarely give definitive answers, and re-estimation requires sufficiently extended spans of data that simply do not yet exist.

Structural changes over recent years

The past decade, on both sides of the Atlantic, has not been kind to policymakers' aspirations to a comfortably stable set of structural relations usable for policy analysis. At the very least, the second half of the 1990s and the early years of this century have sent us stark reminders that the economic structure does not hold still for long. Our recent experience in coping with economic changes has provided more than one stress test of the macroeconomic models that are in use in our institutions.

Let me mention some sources of structural change that are specific to Europe. The setting up of a true single market out of the various economies member of the European Union is a very ambitious endeavour, which has no historical precedent and is triggering large scale structural changes in the European economy.

Fully part of these bold transformations are reforms in the labour and goods markets. These reforms aim to reduce distortions induced by regulation, strengthening the euro area's competitive position and its resilience to shocks. This ongoing process to create a single economic entity that would itself be flexible - thus improving the potential for the economic structure to self-correct - is likely to bring about notable changes in macroeconomic relationships based on past observations.

One recent additional source of structural change in Europe lies with the enlargement of the European Union that took place in May 2004. The European Union has witnessed its greatest ever enlargement with the accession of ten new countries, mainly from eastern and southern Europe. The ten new Member States will eventually adopt the euro, when the time is right, namely after nominal and real convergence is performed, affecting in turn the euro area aggregate through a change in trade patterns, capital and labour flows and a higher level of competition.

Enlargement has already provided new opportunities for trade and investment. These effects are visible in a high degree of economic integration between the new and the old Member States. Trade integration is already visible in the share of these ten countries in the previous 15 Member States' exports and imports, which stands at around 12-13 % - an increase of some 50% since 1995. Capital integration has also increased dramatically over recent years, as the share of the new Member States in the old Member States' total FDI outflows amounts to around 12 %. But both economic theory and empirical records lead us to believe that more is to come. Lower trade costs and an increase in competition associated with the enlargement of the European Single Market can have a significantly positive impact on growth in the European economy as a whole, as recently found by several economic studies.

It should nonetheless be recognised that Europe and its institutions are not new to having to cope with rapid change. The introduction of the single currency, the euro, has been a defining experience which has trained policymakers and the citizens of Europe alike to be careful planners and skilled managers of uncertain circumstances.

Ambitions were undoubtedly high. The measure of success that Europeans had set themselves was not easy to match or to even come close to. It was absolutely key to the political feasibility of the whole project that the new currency was seen to preserve the same attributes of solidity and credibility as the most credible of all the currencies it was replacing.

The aim of creating a currency that could meet the highest standards was for a long time seen to be at odds with perceptions and beliefs at the time. World investors and market participants - who determine hierarchies of credibility and trust, as well as interest rate levels - had been lukewarm and hesitant vis-à-vis our project for most of the 1990s. Until the end of 1997 they seemed convinced that the future single currency would display the average - not the best - characteristics of the currencies that it was designed to replace. Notwithstanding the strict legal requirements set out in the Treaty for joining the new single currency - which I will come back to in a minute - many observers and investors had considered it impossible that the new single currency would deliver from day one on its promise to perform in a similar way to the best-performing constituent national currencies.

Gradually, from the end of 1997, investors, savers and market participants in Europe and throughout the world changed radically the way they viewed the transition. All along the yield curve - from three months, the five-year and ten-year benchmarks, to the 30-year segment - the future euro area market interest rates became aligned with the lowest market rates available denominated in the most credible currencies.

On 4 January 1999, the first working day after the euro's launch, Europe's financial markets showed that the transition to the euro had been an ostensible success. The letter and the spirit of the Maastricht Treaty had been fully vindicated, along with the promise made to Europe's people and its impact on the financial markets. The euro area's 300 million inhabitants benefited immediately from the best yield curve, possible financial environment.

The conditions for success

No doubt, a great deal of the success had a solid foundation. On the one hand, national governments were solemnly committed to respecting a number of clear and transparent convergence criteria before they could qualify to adopt the euro. These criteria ensured a level of quality in the management of public finances and - more broadly speaking - a fair pace of economic and monetary convergence among the economies that were to unify into a single currency area.

On the other hand, the Treaty which had established the European Community had laid down in stone the fact that monetary policy would be conducted with the aim of maintaining price stability and that the new central bank would be fully independent. These provisions were designed to ensure the long-lasting credibility of the euro.

I will now try to expand on these institutional requirements more analytically.

Price stability objective for monetary policy

First, the Treaty establishing the European Union assigned the ECB the primary objective of maintaining price stability. It was particularly important that this key objective was clear and unambiguous, since for the national central banks with the most credible currencies and lowest market interest rates, price stability was enshrined by national law as their own primary objective. In any case, far from being a novel aspect of the European institutional system, as it is sometimes claimed, price stability is defined as central banks' primary responsibility in almost all industrialised, emerging and transition economies, with a particular emphasis being attributed to this notion in all economies that have adopted "direct inflation targeting". I recognize that the United States has chosen to present its objective of monetary policy in a different format. But, as I will argue in a while, I do not believe that the US approach differs fundamentally from the concept we have adopted.

Central bank independence

Second, the Treaty made the ECB fully independent. Economic research has shown that central bank's independence from other institutions and pressure groups is crucial in ensuring its credibility, and therefore in creating the conditions for inflation expectations firmly anchored upon the announced definition of price stability. The importance of independence for sheltering the decision-making body of a central bank from all forms of interference has proven key in securing the trust of the public and in anchoring inflation expectations in the long run.

As a counterpart to its independence, and to foster and maintain a broad constituency for stability and monetary prudence in Europe, the ECB was made accountable to the European people. This requirement is met in particular through the regular and frequent appearances - at least five per year - of the ECB's President and members of the Executive Board before the European Parliament. Accountability is not just a vital democratic requirement, it is also crucial in ensuring that the central bank operates according to the provisions set out by the Treaty. Furthermore, it creates and maintains a line of trust between the central bank and its public; this trust is also enhanced by a transparent communication, an issue which I will also come back to. By comparing actual euro area inflation with the stated objective of price stability, European citizens provide a powerful incentive to policy-makers. In political democracies, which are also vivid opinion democracies an independent institution is ultimately responsible vis à vis the public at large.

Fiscal governance

Third, monetary policy is supported by clear rules on fiscal governance. European citizens took a bold step in creating a single currency in an economic area without a genuine political federation or federal government. In order to make up for the lack of federal government and budget, the Treaty establishing the Economic and Monetary Union has introduced rules to prohibit monetary financing of fiscal deficits and to discourage free-riding among national governments. In addition, a framework was set up to ensure sound fiscal positions in individual countries. Fiscal rules like those enshrined in the Maastricht Treaty and in the Stability and Growth Pact are essential in any single currency area as key for the economic rationale and consistency of the economic and monetary union.

The ECB's monetary policy concept

Although these institutional requirements were necessary to ensure the credibility of Economic and Monetary Union and of the single currency itself, I contend that they were not sufficient alone. Our challenge was that the euro had to benefit from the highest levels of credibility and trust available within the future euro area, since this was vital to European growth and job creation. To meet this challenge, the ECB designed a specific monetary policy strategy. In November 1998, before the single currency came into existence on 1 January 1999, the ECB defined the following four fundamental characteristics of this strategy.

Quantitative definition of price stability

First, the ECB provided a quantitative definition of price stability - a year-on-year increase in the Harmonised Index of Consumer Prices of below 2% over the medium term. We further clarified that in the pursuit of price stability the ECB aims at inflation rates below but close to 2%. This provides a sufficient safety margin against the risk of deflation. These announcements had not only the advantage of anchoring inflation expectations and enhancing the ECB's transparency and accountability, but were also instrumental in preserving continuity at the time of transition from the previous national currencies to the euro: the euro area was given the very same definition of price stability adopted implicitly or explicitly by the most credible national currencies. A different definition of price stability would have immediately led to higher inflationary expectations, therefore higher market interest rates all along the yield curve, and to additional substantial risk premia to protect against higher uncertainty over future inflation.

Medium-term orientation

Second, the ECB has adopted a medium-term orientation, thereby preserving monetary policy from short-termism. Constantly faced with economic news, a central bank risks being swamped by the latest indicator and by its conjectures concerning markets' likely reaction to the latest indicator. This can gradually steer monetary policy away from its foremost role of providing a firm medium-term anchor for the economy.

Instrumental in this steady-hand framework is our notion that the appropriate horizon for monetary policy is the "medium term". In this respect, the time horizon over which price stability has to be re-established needs to be tailored to the circumstances prevailing in the economy. Sometimes, notably if there is a suspicion that asset prices are moving up or down substantially, it pays to look very far ahead, beyond the average lag of monetary transmission. In other cases, the economy may need to return to price stability within a shorter horizon. In general, the horizon should depend on whether the shocks are temporary or permanent, whether they emerged on the supply or demand side, whether they are domestic or external, on their potential for becoming entrenched in pricing decisions and on their implications for the fragility of the financial system. In all events, the central bank has to preserve its credibility, thus ensuring that expectations remain consistent with the declared policy objective.

Comprehensiveness of the analytical framework

Third, the ECB opted for a comprehensive analytical framework. A central bank, in its daily operations, has to filter an enormous amount of information. It routinely seeks to identify the state of the economy as new data become available and to evaluate their implications for risks to price stability. As I tried to argue above, this is a highly demanding exercise, because shocks do not come about with labels and the economy is potentially always subjected to structural changes. As a consequence, it is clear for all central banks that no simple rules linking policy to one or two privileged indicators can replace an accurate examination of economic developments in all their decisions and forecasts.

From the beginning, the ECB felt the need to endow itself with a conceptual framework that could help it sort through the wealth of conflicting statistics and organise the various pieces into a reliable road map for internal analysis and communication with the public. This called for the adoption of a framework that concentrated more on picturing the economy as a large, complex and permanently evolving system rather than on trying to condense this complexity into simple summary statistics and models.

As a result, our monthly economic analysis is as comprehensive as possible. It is not constrained by equations, systems of equations or mechanisms based on a simplified representation of reality. The ECB's Governing Council reserves the right to include any piece of information, statistic or analysis that it considers relevant. This desire for comprehensiveness in our economic analysis is common with that of the US Federal Reserve.

A constituent element of this encompassing framework for processing information - and an ongoing reminder of the complexity of reality - is our "binocular" perspective over the economy, namely the cross-checking of the economic analysis with a monetary analysis based on the evolution of the monetary aggregates. This policy framework, which came to be known as the "two-pillar approach", allows the notion of a diversified analysis to be conveyed and, in our view, ensures that no information is lost in the assessment of risks to price stability.

An important rationale behind the two-pillar approach relates to the difference in the time perspectives relevant for analysing price developments and for forming private inflation expectations. Empirical analysis has shown that the inflation process can be broadly decomposed into two components. One is associated with the interplay between demand and cost factors at a high frequency. The other is connected to more drawn-out and persistent trends. The latter component demonstrates an empirical association with the trend growth of money on a long-term basis.

The short to medium-term "economic analysis" - with its focus on real activity and financial conditions - is well-equipped to study shorter-term deviations of inflation from its long-term trend. However, it often fails to track the mechanisms by which monetary factors are responsible for such trends over extended horizons. As a consequence, a monetary policy framework exclusively centred on such an analysis would leave a 'loose end' in the formation of expectations, to the extent that it would offer no anchor to anticipations of price developments as the horizon lengthens.

Despite the fact that the ECB had a specific arithmetic definition of price stability, it deliberately chose not to mould its own monetary policy strategy as one of "inflation targeting." To be sure, the concept of "inflation targeting" is not always a clearly defined concept. However, if it is understood as a framework that makes macroeconomic forecasts the statistical input feeding the policy-making process, then we would consider it too narrow a description of what monetary policy should look at.

A central bank needs to maintain appropriate flexibility in the way it responds to shocks, taking decisions which are robust across a set of different plausible scenarios for the future. In this respect, it has been increasingly recognised that a central bank that focuses on inflation forecasts at around two-year horizons would not be able to appropriately take into account the formation of financial imbalances, as they generally exert effects on price developments at longer horizons. Given the substantial uncertainty over the sustainability of asset-price developments in particular, it may be advisable to set interest rates with a time-frame extending well beyond conventional forecast horizons.

However, the mere extension of the time horizon for inflation targeting may still fail to adequately guard against the detrimental effect that large asset-price swings could exert on price stability. The Japanese experience of the 1980s shows that it may take many years before asset-price movements can affect consumer-price inflation to any great extent.

Our monetary analysis, with its focus on money and credit developments, can be valuable in such situations. As it has been extensively documented in several recent economic studies, asset-price booms and busts - especially the ones that have led to the worst macroeconomic and financial imbalances - have generally been accompanied by excessive money and credit growth. Thus, a monetary policy that ensures that money and credit do not grow unchecked may also help, as a side-effect, to reduce the likelihood of those abnormally large asset-price swings, with their medium and long term adverse consequences on price stability.

Transparency

The final principle that we have adhered to since the ECB was established is the importance of open and transparent communication with investors, savers, market participants and the public at large. This is a prerequisite for appropriate accountability and enhances the markets' understanding of how the central bank conducts its monetary policy, thereby enhancing substantially policy effectiveness. We are transparent in displaying our monetary policy two pillars concept. We are transparent in publishing our arithmetic definition of price stability.

Communication with the public and the markets has also been facilitated by the fact that our assessment of the economic situation and the risks to price stability are published regularly and that monetary policy decisions are explained in a press conference held after each monthly meeting in which monetary policy is discussed. In this respect we have been bold. In 1999, central banking communication, with only very few exceptions, involved presenting the bank's diagnosis by publishing the minutes with a delay of five or six weeks. The ECB was one of the first central banks to give a real-time detailed analysis and assessment and to organise regular press conferences.

Our commitment to transparency has been effective in making the ECB highly predictable in its decisions and actions. As a matter of fact the combination of the display of our monetary policy concept and of our definition of price stability together with a candid real time explanation of our successive diagnostic makes us at the highest level of predictability according to research.

The comparison of two central banks

Let me finally explain how I see our European monetary policy concept in comparison with the US Federal Reserve monetary policy concept. I will not dwell on what is from time to time presented as the major difference, namely the legal objective assigned to the central bank. The US legislator mentions the objectives of price stability, growth and job creation. My understanding is that the Congress does not mean that the central bank can choose between two contradictory objectives, namely price stability and growth! Rather I understand it is assuming that these objectives are not contradictory but complementary - price stability being a necessary condition for sustainable growth and job creation: the central bank is called upon to deliver price stability and to be credible in the medium and long term delivery of price stability, thereby contributing to maximizing sustainable growth. By the way empirical studies have convincingly established that a central bank enjoying a large degree of credibility can deliver price stability efficiently thereby maximising long term sustainable growth and minimizing output volatility. This is what the Federal Reserve stresses when it says frequently that price stability is a condition for a sustainable high level of growth. This is for the same reason that an overwhelming majority of central banks in the world have price stability as their primary objective, whether they have adopted a monetary policy concept close to the ECB or whether they have adopted an "inflation targeting" concept.

As you see, my understanding is that, conceptually, we are much closer than is sometimes underlined. On top of that I see two major similarities:

First, both the ECB and the Fed place strong emphasis on the transparency of the decision-making process, on the transparency of the analysis made by the responsible decision-making body, on explaining in real time the economic assessment to the public and market participants, and on accountability vis-à-vis the respective parliaments. And I am called upon the European Parliament exactly as frequently as the President of the Federal Reserve Board is invited on the Hill.

Second, and it is perhaps a decisive common feature of our monetary policy concepts, both the ECB and the Fed try to be as comprehensive as possible in their analyses. Neither the Fed nor the ECB base their decisions on the mechanical result of a system of equations or a simple policy rule. We both believe that we need all pertinent information, modelling and forecasts, as well as judgements enlightened by the collegial wisdom and experience of the decision-making body.

To be complete, I also see two differences, which may explain why, despite our strong similarities, observers sometimes argue that the ECB and the Fed have adopted different monetary policy concepts.

First, we have made public our precise quantitative definition of price stability whereas the Fed has not done it so far. Given its long track record, the Fed may be in a different position than other central banks. It is not for me to judge. Let me only point out the reasons for the ECB's position. Providing a definition of price stability fosters transparency: everybody knows precisely what we are aiming at. This is beneficial for meaningful accountability: the public can judge whether or to what extent we are achieving our goals in comparison with the yardstick we have set ourselves. This is also beneficial for medium and long-term credibility: inflationary expectations can find an anchor more easily.

The second difference with the Federal Reserve as I touched upon previously, is the explicit cross-checking, from a medium to long-term perspective, of our economic analysis with a detailed monetary analysis. We see three advantages to this approach. First, it reflects that inflation is ultimately a monetary phenomenon, a notion very widely acknowledged by central bankers and

academics. Second, by preventing abnormal abundance or the drying-up of liquidity, it may, at least to some extent, prevent abnormal boom-bust episodes in asset prices. Third, and perhaps most importantly, it helps better anchor medium to long-term inflationary expectations, which is of vital importance for all central banks and all the more important for the ECB which could not rely on a long track record.

Having said that, I understand that trends in money demand have not been as stable in the United States as they have been in the euro area. This may partly explain the differences in our approaches.

All in all, it seems to me that our similarities are more important than our differences. Above all, there is no simple escape for a central bank from a rigorous analysis of the shocks hitting the economy and the underlying changes affecting the economic structure. Similarly to the Fed, we believe that the central bank needs realism and pragmatism in its assessment of the rapidly changing financial and economic environment. Policy decisions must ultimately be based on a judgement and must be clearly explained to the public in a transparent manner. Since its beginning the ECB has striven to score highly on each of these points and will continue to do so in the face of the challenges that lay ahead.

Thank you very much for your attention.