Jean-Claude Trichet: The role of money – money and monetary policy in the 21st century (panel discussion)

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the panel intervention at the Fourth ECB Central Banking Conference "The role of money: money and monetary policy in the twenty-first century", Frankfurt am Main, 10 November 2006.

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Your first question was whether monetary analysis has helped us to anchor inflation expectations in the euro area. As I have stressed on previous occasions,[1] I am convinced that a thorough monitoring of monetary developments is important for the anchoring of inflation expectations. On the empirical side, there is ample evidence that there is a strong long-run link between money growth and inflation. This has recently been re-emphasised in the academic literature.[2] On the theoretical side, Professor Woodford very eloquently told us yesterday[3] that money does not play an important role in the conduct of monetary policy in standard modern-style macroeconomic models. And I have particularly appreciated his elegant and nuanced exposition of the present intellectual debate. I have noted also that Professor Christiano has pointed out in his convincing presentation that, when such models are extended in a realistic way, also good theoretical arguments in support of a clear commitment to take monetary developments into account in the conduct of monetary policy emerge. This is because it directly helps to stabilise long-term inflation expectations, and as Lucas also pointed out yesterday, because it can help to mitigate the effects of boom-bust cycles in asset markets.[4] In fact, the ability of monetary developments to indicate imbalances in the financial system and the implied potential risks to long-run price stability has recently been stressed in particular by the BIS[5] and is confirmed by recent research at the ECB.[6]

The money pillar of our monetary policy strategy constitutes a visible commitment to take the long-run link between monetary developments and inflation into account in monetary policy decisions. From my experience I can tell you that this has indeed played an important role in our success in anchoring inflation expectations in the euro area.

At the time of the transition to EMU, giving money an important role in our strategy ensured continuity with the most credible central banks joining the Eurosystem. I am convinced that the monetary pillar was crucial to stabilising inflation expectations in the euro area at the low level prevailing in the countries with the most stable currencies at that time. Given the historical dimension of the launch of the euro and the great number of watchers and academics, not to speak of market participants, who were very sceptical, to say the least, about EMU, it is surprising to me that the successful transition to the euro has received so little attention from academic researchers.

Stressing the importance of the monetary pillar at the time of the introduction of the euro must not be interpreted as suggesting that, now that the ECB has matured, we do not need it any more. In fact, in

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1 See, for example, Trichet (2005a,b)

2 See, for example, Assenmacher-Wesche and Gerlach (2006), Kugler and Kaufmann (2005) and Hofmann (2006).

3 See Woodford (2006).

4 Christiano and Rostagno (2001) present a theoretical framework showing that monitoring monetary dynamics can help to minimise the possibility that inflation expectations might settle on a point that is inconsistent with the central bank's inflation objective. In this context, a central bank commitment to systematically monitor monetary indicators and factor them into policy would act as an insurance device which prevents instability from arising in the first place. The interesting feature of this commitment is that, in equilibrium, such a central bank would not necessarily be observed to react to unstable dynamics in monetary aggregates, as these would never materialise in the first place. However, such a favourable outcome would presuppose, rather than disprove, the existence of the strategic commitment to act forcefully in the event of abnormal developments in monetary indicators. Christiano, Motto and Rostagno (2006) show that taking into account monetary indicators in the conduct of monetary policy can also alleviate the macroeconomic volatility arising from overly optimistic expectations. In an earlier paper, Christiano, Motto and Rostagno (2003) also showed that a monetary policy rule that assigned more weight to monetary developments would have substantially mitigated the severity of the Great Depression.

5 See Borio and Lowe (2002, 2004), Borio, English and Filardo (2003), Borio (2005) and White (2006).

6 See Detken and Smets (2004) and Adalid and Detken (2006). For a more detailed discussion see Trichet (2005c) and ECB (2005).

helping us to take good and timely policy decisions, the monetary analysis has played an important role in our success in fully preserving the achieved anchoring of inflation expectations over the last eight years.[7] This in turn has contributed to low macroeconomic volatility in the euro area.[8] When inflation expectations are well anchored, temporary deviations of inflation from levels consistent with the central bank's inflation objective are not expected to be long-lasting. As a consequence, macroeconomic shocks will have a smaller impact on inflation expectations and the evolution of inflation over time will be less persistent, with the result that inflation and economic activity will be more stable.

It is certainly true that other central banks which put less emphasis on monetary analysis have also achieved low and stable inflation expectations and low macroeconomic volatility. However, it is important to bear in mind that the uncertainty faced by the ECB has been much higher than that faced by other more established central banks. Our success in maintaining low and stable inflation expectations in a rather adverse macroeconomic environment is also due to the commitment to be continuously alert upon monetary trends built into our strategy by the money pillar.

This brings me to the second question, on the criticism that our policy actions have not corresponded to the announced role of money in our strategy. I know that this objection is sometimes put forward by critical observers who argue that there is no direct correlation between our policy rate decisions and monetary developments. This kind of criticism does not discomfort me, because the relevance of the monetary pillar can anyway not be judged based on the simple bivariate correlation of policy rates with the growth rate of headline M3 (or any other single monetary indicator). First, such a simplistic approach cannot reflect the crucial role of cross-checking the information derived from the economic and the monetary analyses that is a key feature of our monetary policy strategy. Second, it overlooks the broad-based and by no means mechanical character of the ECB's approach to monetary analysis, which Jürgen has also stressed yesterday.

Allow me to elaborate on the second point. Monetary data are contaminated by noise at higher frequencies blurring the signal from their low-frequency movements which provide information about medium to longer-run inflation trends. The ECB's monetary analysis aims to extract this low-frequency signal by assessing a large range of monetary indicators based on statistical tools and judgement in real time. Since the signal extracted from the monetary analysis refers to the low frequency it will not change much from month to month. As a consequence, it will, by its very nature, normally not be closely correlated with individual policy moves, but will rather influence the medium-term direction of policy rates. As Otmar has explained this morning,[9] money can be seen as a kind of anchor for the longer-term direction of our monetary policy.

As I mentioned before, the monetary analysis has played an important role in our success in anchoring inflation expectations and containing macroeconomic volatility in the euro area by helping us to take good and timely policy decisions. It is generally very difficult to disentangle the respective contribution of the two pillars of our strategy to monetary policy decisions. Nevertheless, let me give you three examples where I felt that the monetary analysis had a particularly decisive influence.[10] The first goes back to the period from late 2002 up to June 2003. At that time, some commentators were concerned that the euro area might be heading for deflation and called for a more aggressive loosening of monetary policy. Our decision not to follow these calls was also due to the observation that the underlying monetary expansion was fairly sustained and therefore clearly ruled out any deflationary pressures over the medium term. The monetary analysis therefore played an important role at that

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7 This is clearly indicated by the low level and low volatility of measures and indicators of long-term inflation expectations that are available from surveys and from capital markets. For instance, the average level of long-term inflation expectations for the euro area according to the long-term Consensus forecasts was 1.85%, which is in line with the ECB's medium term inflation objective. The volatility (measured by the standard deviation) of the long-term Consensus inflation forecasts was below 0.1 percentage point and thus among the lowest of the group of the major economies.

8 Since the start of EMU, the volatility (measured by the standard deviation) of annualised quarterly consumer price inflation in the euro area was 0.85 percentage point and the volatility of annualised quarterly real GDP growth was around 1.5 percentage points. For comparison, over the same period the volatility of inflation and real GDP growth in the United States was 1.3 and 2.1 percentage points respectively.

9 See Issing (2006).

10 For a more comprehensive account of the role of the internal monetary analysis for the direction of euro area policy rates see the narrative evidence presented at this conference by Fischer et al (2006).

time, preventing us from lowering interest rates more aggressively. With the benefit of hindsight, we know that this decision was right.

My second example refers to the long period during which we maintained rates at the level of 2%, from July 2003 up to December 2005. A period, by the way, during which we had made no pre-commitment to maintain rates at this historically low level during a "considerable period of time". On the contrary, the Governing Council had made it crystal clear that we could change rates at any time during 2004 and 2005[11] and the markets had pretty well understood that posture. My understanding of our decision-making during this period was that it was sometimes a very close call as regards the balance of risks to price stability stemming from the economic analysis. We experienced two periods, around the turn of 2003/2004 and around mid 2005 – before the slight recovery of early 2004 was perceived and when it became clear that this start of recovery had aborted – where the balance of risks to price stability from the economic analysis was starting in our minds to slightly tilt on the downside. On behalf of the Governing Council I made clear during these two periods, in the questions and answers of the press conferences, that all our options were open, including a decrease of rates. If this option did not materialise, it was in my understanding because the monetary analysis was not only not confirming the downward risks to price stability suggested by the economic analysis but was tilting in the other direction. We maintained rates at the level of 2% and again, with the benefit of hindsight, that decision seems to me clearly vindicated.

My third example refers to the recent sequence of policy rate increases. In December 2005, when we first increased policy rates, many commentators judged our move premature against the background of a seemingly fragile economic recovery. In fact, at that time the signals coming from the economic analysis were not yet so strong. But the continued expansion of money and credit through the course of 2005 gave an intensifying indication of increasing risks to medium- to longer-term price stability which played fully their role in our decision to start increasing policy rates in late 2005. In retrospect, the strength of the economic recovery unfolding in the course of 2006 has also shown that our decision was well timed. Without our thorough monetary analysis, we could have been in danger of falling behind the curve.

Your last question referred to the communication challenges related to monetary analysis. We have consistently communicated the results of our monetary analysis and any uncertainty surrounding it to the public. The conference paper by Fischer, Lenza, Pill and Reichlin helps in this respect. After all, a central bank that is not successful in explaining the principles guiding its monetary policy decisions will not be able to preserve its credibility. To me, the success of our policy and the high predictability of our policy decisions[12] suggest that we have probably been able to communicate our monetary policy strategy and, within that strategy, the role of the monetary analysis in a reasonably efficient way. And this conference bears testimony to our will to continue being as transparent as possible.

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11 See Trichet (2005d).

12 The evidence suggests that since the start of EMU, the policy moves of the ECB have been well anticipated by money markets (ECB, 2006).

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