Jean-Claude Trichet: Monetary policy in challenging times

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the 2008 International Monetary Conference, Barcelona, 3 June 2008.

*   *   *

First of all, let me say that I am in the purdah period, so that nothing I will say should be interpreted in any respect as signalling intentions of the Governing Council as regards the monetary policy stance.

Economic policymakers are currently grappling to understand the root, duration sand impact of a number of significant and sizeable shocks affecting the world economy, including rising commodity prices – of which sharp increases in world food and oil prices have been prominent components – as well as a period of prolonged financial turbulences associated with an adjustment in financial market perceptions of risk. Understanding those economic shocks and how they affect the economy is plainly a vital challenge for policymakers. In my remarks today, I would like to stress that, rather than a single deep correction with a single source, the global economy in which we live is facing a multiplicity of interdependent shocks in key areas. A proper understanding of the nature of these shocks and their interrelations is a precondition to examine the required reaction of economic and, in particular, monetary policies.

Whilst I consider the achievements of science and the acceleration of technological progress key to decipher the present world developments, the range of other factors at stake are well illustrated by considering the drivers behind the recent sharp increases in global agricultural commodity prices. Underlying some of those factors is what we might characterise as a change in our operating environment. From a world of seemingly unlimited resources, mankind is gradually accustoming itself to the earth as limited, crowded and finite space – with limited resources for extraction and a narrowing capacity for waste disposal or pollution. The economics of that world, one that is increasingly pushing at the boundaries of development, requires an adjustment in our outlook and recognition of the complexities of the interactions in the global system.

Focusing specifically on developments in commodity prices, continued population growth and improving living standards have put pressure on global food supply capacity. In particular a move towards a more protein-rich diet – for example, China's per capita meat consumption has doubled since 1990 – has also raised the demand for livestock feed, further magnifying the demand for food commodities. Growth in those economies has at the same time pushed up the demand for energy, most obviously manifest in rising oil prices. At the same time growing concerns about consequences of emissions from burning fossil fuels for climate change, have stoked demand for alternative, potentially cleaner, energy sources such as bio fuels, prompting production to switch from food to fuel crops and further adding to the pressure on food prices.

Other factors are also playing a role in driving global commodity price developments – supply disruptions owing to unfavourable weather conditions have also made the food shortfalls more acute. Differing competitive conditions in the retail and distribution sectors have contributed to diverging patterns in price changes across countries. That aside, the example serves to illustrate that the current collection of shocks facing the world economy cannot be viewed in isolation and that the interactions are varied and numerous.

The pressure on global commodity prices is, of course, just one facet of the globalisation process affecting economic developments. We cannot provide a comprehensive picture of the impact of the globalisation without also acknowledging the dis-inflationary effects associated with the attenuation in prices of imported manufactured goods in recent years. Increased trade with low costs countries and the growing share of these countries in the rest of the world's imports has in particular put downward pressure on developed economies' manufacturing import prices over the past decade. The net effect of these two forces – the attenuation in imported manufacturing goods' prices and the accentuated increases in commodity and food prices – is difficult to judge; the effects also differ across countries. However, a tentative consensus seems to have emerged amongst economists and academics that in the recent past the overall effect of globalisation has been a small net dampening of euro area inflation. The outlook is perhaps more uncertain: indeed, there have been recently signals that the dis-inflationary impact of low-cost countries on euro area import prices may be weakening. Inevitably, the process of unpicking and understanding shocks and complex interactions affecting the economy is an ongoing task.

And that raises the challenging question of how the monetary policymaker should respond to this changing environment. Clearly we need to be sure that the analysis underpinning policy decisions incorporates an appropriate understanding of the complexities of our global system. The success of monetary policy at the ECB depends on our ability to take into account – in our economic and monetary analysis – this rapidly changing environment.

But while our analytical processes have new challenges to cope with, the responsibilities are unchanged. Challenging as the present global economy may be, the rules for monetary policy-making are not altered. Also in our globalised world, inflation is a monetary phenomenon in the long term and price stability is the essential responsibility of the monetary authorities. The task is complicated by interaction with the other factors – for example, by the impact of global resource constraints or the growing concerns about climate change – but monetary policy stays firmly focused on delivering price stability, which is important for the efficient working of the market system and the optimal allocation of resources. By maintaining price stability over the medium term, which means pinning down trend inflation and ensuring that inflation expectations are firmly anchored, central banks contribute to the smooth functioning of the economy, to sustainable growth and to job creation. The ECB with its mandate for price stability is firmly focused on this policy goal.

As one dimension of the complexity of the present global economy is the financial market turbulences, let me elaborate a little bit on the actions taken by the ECB. At the Eurosystem we made a clear distinction between setting the monetary policy stance to maintain price stability over the medium term and its liquidity decisions taken in the course of implementing this stance. This distinction serves to isolate signals of the monetary policy stance from the noise introduced by liquidity movements and volatility in very short term rates. Since the onset of financial tensions in August 2007, the actions of the ECB have fully respected this principle.

In both "normal" and "turbulent" times, the primary objective of Eurosystem's open market operations is to keep the overnight rate as close as possible to the minimum bid rate. However, during the recent period of turbulence open market operations aimed also at ensuring the continued access of solvent banks to liquidity notably by contributing to smoothening the impaired functioning of the money market.

From the very first day of the financial market turmoil, in an environment of increased liquidity risk and in response to banks' changed liquidity demand pattern, the ECB has achieved these objectives through relatively minor, technical changes to the way in which it supplies liquidity in normal times, while at the same time utilizing the latitude given by its framework for monetary policy implementation.

First, the Eurosystem has adjusted the distribution of liquidity supplied over the course of the maintenance period, by frontloading the supply of liquidity at the beginning of the period and reducing it later, so that the total amount of liquidity over an entire maintenance period is unchanged.

Second, during the turmoil the Eurosystem has applied different open market procedures for supplying liquidity to the banking system. More specifically,

1. The use of fine-tuning operations has been more frequent than in “normal times” because of the unpredictability of the liquidity demand.

2. The amount of refinancing provided via longer-term refinancing operations (LTROs) has been increased significantly with a view to smooth conditions in the term money market. The amount of refinancing provided via the one-week main refinancing operations (MROs) was reduced correspondingly, so that the total amount of outstanding refinancing has remained unchanged.

As a result, the average level of EONIA has remained close to the minimum bid rate even if its volatility has at times been higher than normal and our assessment is that our operations have had a positive impact – in particular in diminishing volatility – on term money market conditions.

The Eurosystem did not have to change its collateral framework at the time of the financial turbulences because, since its inception, it accepted relatively broad ranges of collateral and it granted a large number of counterparties access to rather large refinancing operations. We consider that the operational framework of the Eurosystem has in itself provided notable stability during the turmoil.

It is important to recall that, as the turmoil went on, central banks strengthened their cooperation, first through enhanced information exchange and collective monitoring of market developments and later on by coordinated steps to provide liquidity. Since December 2007, the ECB has, in cooperation with the US Federal Reserve and together with the Swiss National Bank, been conducting several term auction facilities – so-called TAF-operations – in which it provides USD liquidity, on behalf of the US Fed, to euro area banks. These liquidity-providing operations do not have a direct effect on euro liquidity conditions, but are conducted to address the availability of US dollar funding for euro area banks and aimed at improving global funding conditions.

I would sum up by noting again the challenging environment within which economic policymakers are currently operating. The global economy is undergoing a range of interdependent shocks across various facets of the global system. In part, they are associated with a change in our operating environment in which resources constraints are more pertinent; technological progress is accelerating; and interactions are more complex. Understanding the shocks and their interrelations in this system is vital and ongoing part of our economic analysis and decision-making.

Thank you for your attention.