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

Closing address by Mr Jean-Claude Trichet, President of the European Central Bank, 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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Ladies and Gentlemen,

It has been a great pleasure to host you at this fourth ECB central banking conference. Over the past day and a half, we have enjoyed several outstanding presentations and stimulating discussions, which have helped understand better the role of money in modern monetary policy-making.

The richness of the discussions stems in large part from the diversity of views that have been expressed. In selecting the leading participants at this conference, we did not hesitate to choose speakers who would challenge our established views and those of others. And we strongly believe in frank and candid exchanges of views and in the benefits of a close interaction with the academic community. At the conclusion of the conference, I certainly can agree with Prof. Woodford that there is indeed room for further refinement of the intellectual framework used as a basis for monetary policy deliberations. At the same time, I remain convinced that we should not lightly discard elements – such as monetary analysis – that have served central banks well in the past.

With these two points in mind, what are the main messages we should draw from the proceedings? At the very beginning of this conference, Jürgen Stark mentioned three issues:

> First, to what extent is analysis of monetary developments relevant for the conduct of a monetary policy aimed at the maintenance of price stability?
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> Second, how should the analysis of money be organised in the policy process leading to interest rate decisions about the policy rates?
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> And third, how should the monetary analysis and its implications for monetary policy be presented to the financial markets and public?

With the benefit of hindsight, let me take stock of what I have learned over the past couple of days.

With regard to the first question, Prof. Flandreau has demonstrated that, in assessing the success of central bank policy, the historical context always needs to be taken into account. Political, institutional, and economic circumstances need to be adequately considered. During the run-up to Monetary Union, money and monetary analysis played a crucial role in the experiences of most central banks in Europe. Viewed in this context, the ECB’s choice of strategy was a natural continuation of previous best practice, while at the same time incorporating insights from economic theory and the experience of other central bank. I think it is fair to say that the strategy has served us well.

The clearest evidence of this is the high credibility which the ECB has enjoyed since its inception. The historical fact that, at the time of the introduction of the euro, market interest rates on instruments denominated in euro all along the yield curve were to be aligned with the lowest – and not with the average – rates prevailing prior to the euro was not foreseen by many observers prior to Stage III. The historically low level of short, medium and long-term market interest rates was unthinkable in some countries, which had experienced much higher inflation in the past. In my view, the incorporation of monetary analysis into our monetary policy strategy served, in the eyes of the global market, as an anchor for expectations that in no small way contributed to our success in building and maintaining credibility.

The monetary policy strategy of the ECB announced in October 1998 explicitly recognises the monetary nature of inflation by assigning an important role to money in the formulation of monetary policy decisions aimed at the maintenance of price stability. As Prof. Issing explained to us in detail, there were and still are many good reasons to do so.

Milton Friedman’s famous dictum that “inflation always and everywhere is a monetary phenomenon” is one of the central tenets of economic theory. On the basis of the discussions at this conference, I draw the conclusion that there is no disagreement in the economics profession on this central tenet, but a lot of different views on how to organise the monetary analysis so that it has an appropriate influence on interest rate decisions. And this is the second issue mentioned at the opening of the conference.

As was pointed out by Prof. Christiano and his co-authors Rostagno and Motto, including informational asymmetries, transactions costs and financial frictions in “state-of-the-art” macroeconomic models allows to better reflect the role of money and credit aggregates within such frameworks. I found compelling the argument that monetary analysis be used to monitor (and possibly offset) macroeconomic risks which are not related to price stability at shorter horizons, but which may nevertheless have important consequences for maintaining price stability over the medium and long run, like risks to financial stability. On this point in particular Lucas Papademos’ remarks yesterday evening were particularly stimulating. Although the use of such models for policy purposes is in its infancy, their further development is a promising way forward and should, therefore, remain an important field of ongoing research.

However, at present the practical challenge of conducting the monetary analysis requires the adoption and employment of practical and fully operational tools. Conducting such an analysis has not always proven to be an easy task. But, as the paper by Fischer, Lenza, Pill and Prof. Reichlin demonstrates, the careful analysis of monetary developments in real time has helped the ECB to shape its assessment of the economic situation and the associated risks to price stability and to better identify the nature of the shocks impacting on the euro area economy. As I already said I can bear testimony that, over the past eight years, monetary analysis has helped the ECB to improve its policy decisions. At the same time, the importance attached to the monetary pillar has also signalled that the ECB’s monetary policy has an appropriate medium-term orientation. I strongly believe that this has contributed to shaping agents’ expectations in a manner which enhanced the credibility of the ECB.

In this context, the third issue raised by Jürgen – namely how monetary analysis should be presented to the public – is crucial. Presenting the monetary analysis in a manner that serves to stabilise private sector long-term inflation expectations by clearly signalling the ECB’s alertness with respect to risks to price stability at longer horizons is key.

Thus, it is particularly important that markets and the public at large have a good understanding of the systematic and conditional conduct of monetary policy by the central bank, so that expectations about future price developments and the path of policy rates are in line with the central bank’s mandate. Transparency enhances the effectiveness of monetary policy by helping to guide the expectations of economic agents and bring them into line with policy objectives and actions. For these reasons, the ECB has striven to be as transparent as possible, communicating clearly, and by a variety of means, its policy objective, its strategy, its assessment of the economic situation, and its view of the outlook for price stability and associated risks.

There is no doubt, however, that communication is a challenging task. I can assure you that we at the ECB – in light of the mandate that was assigned to us by the Maastricht Treaty and the trust and credibility we have earned from more than 313 million citizens – take this challenge very seriously.

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Chairman, Governors, Professors, dear friends, I have on behalf of the Executive Board and Governing Council of the ECB to thank all of you for having accepted our invitation and for having contributed so actively to the discussions. The ECB considers important to permanently guard against complacency and to remain open to criticisms and suggestions, to take regularly stock of the advances of academic research.

I thank you for your attention.