

Overview

Jean-Claude Trichet

Thank you, Mr. Chairman. First of all let me say how impressive it is to be before such a distinguished audience. With the permission of Alan Greenspan, I would like to remind everyone about a response he made once in the U.S. Senate, according to the report we received in Paris. Alan was testifying before a Senate hearing and after he spoke, a senator responded, “Then Alan, I understand that you are very likely to increase (or decrease) rates in the year to come.” And the quoted answer Alan gave was, “Senator, if you think you understood what I just said, I probably made a mistake somewhere.”

Let me say a few words about the French experience seen from three particular angles: first, our experience in bringing down inflation during the 1980s; second, central bank independence which, for the last three years, has been a particularly telling experience for us; third, our experience with monetary targeting, which is important here. And after having been as concise as possible on these three matters, I would like, as did the Chairman, to express my personal views on what kind of lessons can be drawn from this extraordinary colloquium.

First, our experience in bringing down inflation. In France over the last seven years, we have brought inflation down from about 9 percent to around 2 percent. What I consider absolutely key in this

process, which became a regular process year after year, was that as we diminished inflation each year we gained confidence in the efficiency of the process. We based it on a set of economic policy operational tools. First of all, of course, was our monetary policy. In our perspective, monetary policy was based upon two intermediate targets. We first set nominal money targets based upon appropriate monetary aggregates. We also considered our belonging to a multi-lateral framework, the exchange rate mechanism (ERM), as being important to that process. In our European perspective, these two tools were mutually re-enforcing and were extremely helpful from the monetary policy standpoint for embarking on this disinflationary process.

But *monetary policy* actions alone, of course, could not suffice. We also embarked on an *appropriate fiscal policy* over that time. I would say that we pursued a tighter fiscal policy from 1983 until 1988. So, over that five-year period, our tightening of fiscal policy mutually re-enforced our monetary policy. In our case, and I think it is important to be reminded of this, we also attached great importance to revenue and wage policies. We had some sort of *a priori* vision of the wages developments, which has proven extremely useful in our disinflation process. I think it would be a mistake not to mention that as fully part of the process. On top of that, we implemented a number of structural reforms of major importance, including price liberalization, exchange control liberalization, credit liberalization, privatization, and so forth. I think these structural reforms were the fourth policy element, which was undoubtedly key in that process.

We observed that this recipe was working and we could tell very early in the process that we could get where we wanted to go. We don't suggest, of course, that this is a universal model that could be applied everywhere. But it might be interesting to analyze it in the perspective of this colloquium.

The second point I would like to make relates to the independence of the central bank. I understand that at one end of the spectrum of the analysis of this problem, some believe there is a similarity

between independence and transparency. They believe both could be considered close substitutes. There might be a hint on the fact that central bank independence is not necessarily the most important question or even an accurate question. Others insist that instrument independence is sufficient because they believe there are several ways to design central bank incentives to achieve the optimal policy—a policy that would timely respond to shocks while maintaining long-run price stability. I think that others are claiming that instrument and goal independence should be the norm. In our experience, we have a lot of both instrument and goal independence. The law states the Bank of France shall formulate and implement monetary policy with the aim of ensuring price stability. It is more or less the same wording that is in the Maastricht Treaty as it regards the overall goal of the future European System of Central Banks (ESCB) and European Central Bank (ECB). From our perspective, we consider this formulation to be a good one because ensuring price stability is the goal. I would say practically that there is as much independence of monetary policy embodied in working out the right formulation on the goal on one hand and the right implementation on the other.

I would insist that in our case today, and not only during the disinflationary process, we are basing our monetary policy on two intermediate indicators. One indicator was domestic and based on monetary aggregates targeting, and the other was the participation in a multilateral exchange rate mechanism. Today, we still consider it worth continuing on this path even after we have worked out an appropriate level of low inflation. The formulation of our present monetary policy is threefold. First, the monetary policy council of the Bank of France provides a target figure on inflation because we think doing so is important for anchoring expectations of economic agents. Measured consumer price index (CPI) must remain at or less than 2 percent. For us that is the ultimate goal and we mention it as part of our monetary policy. But we don't consider it as directly targeted. To reach that ultimate goal we have two intermediate targets that we formulate in the following fashion. We monitor the appropriate monetary aggregates, which in our case remains M3, even though it is highly volatile. We target a 5 percent growth for

M3 in the medium run. This figure of 5 percent is based on an inflation rate of 2 percent or less and a GDP in volume terms of 2.5 to 3 percent. For the medium run, we also look at other indicators such as M1, M2, and total domestic debt. In particular we consider domestic debt as an important additional indicator, which is, to my knowledge, also the case in the Fed's perspective. We believe that we must look over all these indicators. Nevertheless, we consider monetary aggregate targeting key in a medium-term perspective. We also pursue a second intermediate target, which is a stable external value of the currency in relation to the most credible currencies in the exchange rate mechanism. That is the way we formulate our policy.

Now let me tell you about something we insist very much on, and that is the medium-term perspective. We can see that growth of M3 appears to be highly volatile, due, in part, to financial deregulation which has spread all over the world, particularly in Europe and in my country, to tax regulation. Therefore, the medium-term perspective of monitoring M3 seems to be of extreme importance. We would not like to annually target M3 because we think it would be difficult to fit exactly with the volatility of this aggregate.

Now that I have talked about the French experience, let me say a few words about provisional conclusions that I would draw from this stimulating colloquium. I think there is a large consensus on the following five points.

First, there is wide agreement on the remarks that Alan Greenspan made regarding the definition of price stability—a situation where inflation is not taken into account in the decisions of economic agents. I totally agree with this definition, as I believe many others do.

Second, there is support that inflation is a very complex phenomenon and its measurement is extremely complicated. In a number of countries there is a belief that the underlying true inflation rate is less than the measured CPI. I think we are going to have to live with this situation, one which is probably triggered by very rapid techno-

logical changes. Nevertheless, I don't think we should depart from our present measurements. And what is important is to ensure that there is consistency in the measurements of inflation across countries so that the comparison between the various economies remain valid, whether or not there is a systematic bias in all economies. By the way, we cannot help mentioning that if there was an important bias between real inflation and apparent inflation it would also mean that real growth in volume terms was much more important than apparent growth.

Third, there is strong consensus that there are no "monetary free lunches." I must confess, Martin (Feldstein), that your presentation was agreeable music to the ears of a central banker. I think there is real consensus that there are no magical solutions. One of the authors clearly warned in his paper to beware of magical solutions. I totally agree with that, as I assume most of us do.

The fourth point is very important from the perspective of a central banker, and I think there was also a consensus on it. It is that sound and credible medium- and long-term objectives are absolutely necessary. I believe this is the case irrespective of whether direct inflation targeting, inflation targeting, or monetary targeting is pursued. In any case, we have to run sound and credible policies not only in the short run but in the medium and long run. Credibility in the medium and long run is of the essence in our own central banking concepts. If we are not credible in the medium and long term, the benefits of what we are doing in the short term are lost in a very large part. As practitioners, we are influencing medium- and long-term rates only if we are credible in the medium and long term. I think some of the volatility we see at the long end of the yield curve, in this economy and elsewhere, is something which is intriguing and probably highly challenging in the perspective of this concept of long-term credibility.

I would also like to say that one of the provisional lessons I've drawn from what I heard here is that modesty is also of the essence. I would say this is true both in central banking and in academic circles when analyzing central banking. Reality is a permanently

challenging tool. Reality is changing not only because technological trends are absolutely vibrant, but also because they have triggered this moving reality by changing the behavior of economic agents. I'm struck that we have to permanently cope with various changes of behaviors. It may be one of the reasons why we permanently invent new theories and discuss a lot of various theories. We as practitioners have to try to make sense out of the reality we have in front of us, and which is permanently changing. We are not living in a world where we can know in advance what the likely reactions of our citizens will be. Again, this is a permanent challenge.

I would like also to make a few general points about the concept of transparency. I put myself in between the two schools that I have observed here—those who say total transparency is absolutely of the essence and those who argue for a very large degree of discretion. Alan (Greenspan) in his response to the senator gave the best illustration of the latter, that a central bank must keep some degree of “mystery.” To reconcile the two schools you have to be extremely transparent and visible as regards your medium- and long-term goals, but you have to retain a large deal of unpredictability in your short-term actions. This seems to be very important regarding financial markets. If you are totally visible and mechanistically predictable, I don't think you're necessarily doing a good job, given the present state of the world and with the financial markets the way they are. I would like to use the metaphor of sailing. When you sail from North America to Europe in some kind of trans-Atlantic race, you know where you're going, say, from Quebec to St. Malo. You know you're going to St. Malo. That is very clear, you are extremely visible in your goal, and you try to get to this harbor as soon as possible. But, of course, you are not totally predictable on a day-to-day basis. I mean, the wind is not totally predictable, the sea is not totally predictable, and you have to cope with a lot of problems in your ship and so forth. Again, a large degree of predictability in the long- and medium-term goals and a good deal of unpredictability in the short-term actions are the right blend in my eyes.

Now I would like to say a few words about the reasons why strict rules for the use of instruments should be viewed with some reserve.

I see the merit of the concepts that have been raised here and I see the benefit of analyzing those models, but I don't think that a mechanistic approach would be good.

Regarding inflation versus price level: From the practitioners' point of view, the price level concept is a difficult level to cope with and I would suggest looking at yearly inflation and not the price level.

I would also like to reflect on the issue of the external side of the coin. The open economy aspects of our economies seem to be a little bit under-assessed in a large number of analyses. Part of it is because we are in the United States, where the size of the economy permits a lot of the analysis to somewhat disregard the open economy aspect. But from the perspective of a country like France where the size of GDP is big, but not that big, one-fourth the size of the United States, the fact that we have an open economy is important. In France, the medium- and long-term rates are absolutely key for monetary policy action, not only the short-term rates. Again, in an open world where the arbitrage between investments at all maturities is made permanently by the financial markets, it is absolutely key that you account for your long-term credibility—not only from the perspective of domestic agents but also from the perspective of global investors. They can choose between these investments without any kind of restrictions. I would like to mention to the professors here that there might be a lot of very interesting subjects in reflecting on this interaction. The United States, Japan, Germany, France, the United Kingdom, and all the other countries are under arbitrage. We have to take that into account.

I'm not surprising anyone by telling you that I prefer monetary aggregate targeting to direct inflation targeting for a lot of reasons. One reason, which I think was mentioned by Mr. Issing, is that it fits better with the independence of the central bank. Direct inflation targeting is a concept that necessitates a discussion with the executive to reach an agreement. Monetary aggregates targeting is fully in the hands of the central bank. I think that is one of the reasons why monetary aggregate targeting will likely be adopted by the ECB.

I would like to conclude by saying that what is true for the Bank of France and for our monetary policy is totally true for the future ESCB and ECB. Long-term credibility of the ECB and ESCB is absolutely key. Already our ten-year interest rates are incorporating two and one-half years of the French franc and seven and one-half years of the new future European currency. I assume the same is true of German interest rates. The ECB and the ESCB will have the legacy of the track records and credibility of key European central banks. These are banks that global investors know pretty well. In the case of Europe, monetary stability and credibility can be illustrated by one very simple point. Seven countries have not realigned their currencies one vis-à-vis the others for nine and one-half years. And these seven countries represent about 170 million inhabitants. So you already have an enormous core in Europe backing the credibility of the future ESCB and future ECB.