Dinner Speech
by

Vítor Gaspar
European Central Bank[1]

Delivered at the
Bundesbank Conference on Real-time Data and Monetary Policy

Eltville, Germany, May 28-29, 2004

I would like to start by thanking the organisers Heinz Hermann, Athanasios Orphanides and Pierre Siklos for inviting me to address you this evening. Pierre can be excused for the poor choice - we have just met – but Heinz and Athanasios should have known better. The good news is that I will be short. In a dinner speech one is supposed to be brilliant and witty, perhaps speaking in rhyme. I cannot do that. What I will do is to steal some lines from brilliant European authors to motivate some remarks on the theme of the Conference.

Analysis in real time and policy-making is the topic of the Conference. Is it important? According to Machiavelli it is. He said (in *The Prince*):

“As doctors say of a wasting disease: at the start it is easy to cure but hard to diagnose. After a while it becomes easy to diagnose but hard to cure.”

All central banks have to follow up economic developments as they unfold, that is in real time. They must face up to uncertainty and come up with analysis providing ground for decision-making. They cannot rely on the privilege of time as their decision to maintain interest rates is as significant as a decision for changing them. In the case of the European Central Bank and the Eurosystem the relevance of uncertainty is exacerbated by the historically unique character of their creation, but also because they are part and parcel of the process of European integration which is – fundamentally – associated with structural change. One specific aspect, that has a very direct link with the topic of this Conference relates to the fact that, properly speaking, time series for the euro area started only with the creation of the euro area itself. Economists in the

[1] The views expressed are the author’s own and do not necessarily reflect those of the ECB or the Eurosystem.

Eurosystem had to figure out how best to approximate long time series for the euro area, on the basis of available national data.

Monetary policy under uncertainty and real time analysis are important priorities from a research viewpoint. The first international Conference organised by the ECB took place already in December 1999, it was co-organised by theCFS, Axel Weber was one of the organisers and Athanasios was one of the main contributors. Now, central banks in Europe are jointly involved in an important project on Real Time Data Analysis in the context of CEPR's Euro Area Business Cycle Network.

The present Conference, organised by the Bundesbank, is an early pioneer initiative, promoting discussion and dissemination of first rate research in this field.

Is analysis in real time an issue for specialised focus and narrow significance or is it instead a fundamental problem likely to be of perennial significance? To my mind the question is so important that I will engage the help of not one but two European writers. The first is Milan Kundera, I am quoting from his book *L'Ignorance* (which I read in French) – the translation into English is mine:

"Everyone is wrong about the future. Man can only be certain about the present. But can he really know the present? Certainly not. For if we do not know the future the present is leading us towards, how can we say whether this present is good or bad, whether it deserves our agreement, or our suspicion or our hatred."

The other author is Aldous Huxley, who in *Brave New World Revisited*, stated:

"(…) the relevant facts often elude us. As for the meaning of the facts, that of course depends on the particular system of ideas in terms of which you choose to interpret them. And these are not the only difficulties that confront the rational truth seeker. (…) it often happens that there is simply no time to collect the relevant facts or to weight their significance. We are forced to act on insufficient evidence (…)"

The message that I want to highlight is simply that purposeful action requires understanding. In our line of business, understanding is achieved through the use of models. During the course of today we discussed the properties of real time estimates of many unobservable variables like equilibrium real interest rates, output gaps, money gaps and inflation gaps. All these concepts require models in order to allow for unambiguous definitions allowing for empirical implementation and identification. It seems to me that the most important source of uncertainty around estimates for all these variables comes from model or conceptual uncertainty.

Monetary policy must be based on a view on the current state of the economy and prospects for price stability. It requires understanding on how monetary policy affects the economy. That is, it requires knowledge about the transmission mechanism of monetary policy. In other words, it requires a story about what is driving economic developments and about how these developments may be affected by policy actions. But it also requires a clear recognition that such a view is necessarily imperfect and provisional. That is why it is fair to say that policy makers must be prepared to bear the "burdens of judgement".

Are there any general principles to follow? Let us resort once again to Machiavelli, who, in the *Art of War* wrote:

"(…) you must never believe that the enemy does not know how to conduct his own affairs. (…) you have to use two diverse means, for you have to fear him in thought and order, but with words and with other extrinsic demonstrations, show that you despise him. For this last mode makes your soldiers hope more for victory; the other makes you more cautious and less apt to be deceived."

Machiavelli is indicating the need for flexibility aiming at the best possible combination of aggressive action and caution, boldness and prudence. For this it is essential to give due weight to reputation while at the same time retaining flexibility in thinking and analysing. Economic theory provides only limited guidance and no general results. Striking the right balance is the art of monetary policy.

It is, however, clear that imperfect knowledge and gradual learning characterise not only policy-makers but economic agents in general. The central bank may help by providing a stable standard of value thereby facilitating economic computation. This is all the more important when dealing with long term projects or large idiosyncratic disturbances that characterise structural change. A credible commitment to price stability and a central bank with a strong reputation also help to make the economy more stable thereby affording policy-makers longer to reckon with what is going on in the economy.

No better way to conclude my short selection of European writers than go to Goethe who in his Faust wrote (anticipating the lack of general results I have been alluding to):

Happy the central banker [man in the original] who still can hope
To swim safely in this sea of error
What we don't know is what we really need
And what we know fulfils no need at all

I raise my glass to: better data, better analyses and better models. Thank you.