Benoît Cœuré: The global and European aspects of policy coordination

Speech by Mr Benoît Cœuré, Member of the Executive Board of the European Central Bank, at the Global Research Forum on International Macroeconomics and Finance, Washington DC, 14 November 2014.

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For a central banker from the euro area, the notion of policy coordination and cooperation has a somewhat different meaning than it does for policymakers from other advanced economies.

On the one hand, it has a global dimension capturing the difficult questions of whether and how to align monetary policies so as to achieve an optimal international policy mix. But on the other hand, it has a meaning as well in our domestic environment: within the euro area we are also involved, in a sense, in international policy cooperation. We have to achieve price stability in an environment of different national fiscal and structural policies.

Thus, in my remarks this afternoon I would like to discuss these aspects from a euro area perspective: the implications of policy cooperation internationally and domestically.

In doing so, it would seem natural to build on the insights coming from open economy macro literature for the international aspects, and closed economy macro literature for the domestic ones. But because of our unusual environment, I will need to draw from a third field as well, and one which is still under development: the “macroeconomics of monetary unions”. And as I will show, our natural experiment in the euro area is now starting to produce some very clear and important findings.

The global aspects of the policy mix

Starting with the global aspects of the policy mix, let me say from the outset that I belong to the “sceptical” school and see limited scope for, and advantages to formal monetary policy coordination at a global level.

It is quite clear that there are *qualitative* benefits to coordination, due to cross-border spillovers. Moreover, those benefits are likely to be higher in crisis situations as coordinated actions provide signals that are significantly stronger than the sum of uncoordinated individual measures.

But coordination tends to happen anyway in such instances, as the direction of the necessary policy action is strongly positively correlated across countries, and all actors have a shared interest in removing unwelcome tail risks. The currency swap arrangements that were set up between a number of central banks during the 2007–08 crisis, including the ECB, are just one example of how explicit coordination is possible outside of a formal framework, at short notice and with great effect.

The question is therefore whether we need to formalise such interactions for less exceptional circumstances, when the directions of policies are not necessarily so aligned. But what I take from the academic literature is that, in such circumstances, the gains from coordination are likely to be *quantitatively* small.

Going back to the seminal contribution of Obstfeld and Rogoff (2002)[1], standard open-economy models predict that under normal circumstances gains from coordination relative to self-oriented policies – i.e. policies solely in pursuit of domestic policy objectives – are likely

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[1] Obstfeld, N. and K. Rogoff, 2002. “Global Implications Of Self-Oriented National Monetary Rules,” The Quarterly Journal of Economics, MIT Press, vol. 117(2), pages 503–535, May.

to be minor. And contrary to what one may think, this conclusion is not contradicted by increasing economic and financial integration, because integration in fact produces countervailing effects: on the one hand, it intensifies the effects of foreign shocks on the domestic economy; but on the other, the broadening and deepening of financial markets also improves diversification and insurance opportunities.

If one adds to this theoretical reasoning the challenges posed by practical and institutional arrangements, this tends to reinforce the "sceptical" view about the desirability of more formal coordination. The issues here are well known, so let me mention just three.

First, central banks typically operate under different mandates, accountability arrangements and effective time horizons, which makes establishing credible formal mechanisms complicated. Second, in real time decisions are made under a great amount of uncertainty about the nature of shocks and spillovers. This often makes the correct identification of those effects even within countries elusive, let alone across countries.

Third, at a time when policy space for demand policies is limited or exhausted, and when global policymakers are concerned about the risk of secular stagnation, supply-side policies come to the forefront. But coordination is difficult on structural reforms, which are different across countries.

From coordination to cooperation

In short, there are various political economy aspects to international policy coordination which are often not covered in simple models, and which bolster the case for leaving formal arrangements as they are. But this does not mean that central banks should not continue to cooperate in ways that add stability to the international economy. Indeed, if we hold a sceptical view of monetary policy coordination, we should favour *stronger* cooperation in some other policy areas.

Specifically, to ensure that Obstfeld-Rogoff findings hold even in a world of integrated financial markets, we must ensure that capital markets are indeed effective in delivering risk-sharing. Thus, the less we believe in formal coordination, the more we should strive to make international capital markets work. And this is a collective duty: central bankers should not leave this agenda to regulators and lawmakers, let alone to market participants, because it is crucial for the effectiveness of our monetary policies.

In the same vein, those of us who also are bank supervisors should endeavour to recognise and overcome possible conflicts of interest. There is a temptation to ring-fence our domestic financial systems under our domestic financial stability mandates. But the more we ring-fence, the more we limit financial risk-sharing channels, and the less efficient our monetary policies ultimately become.

There are many other fields in which central banks can fruitfully cooperate. We can work together to improve the understanding of spillovers and shocks. We can prepare the instruments which will allow us to act together in times of crisis, such as foreign currency swaps. And we should all strive to design transparent policy frameworks and clearly communicate our reaction functions. Thus, scepticism about formal coordination should not extend to pessimism about cooperation.

Going forward, a practical challenge I see is that the crisis has sizeably broadened the set of standard and non-standard monetary policy instruments, making the universe of central banking more complex than before. There will thus be a premium on clear communication, especially given the expected divergent monetary policy cycles across the Atlantic. In my view Stanley Fischer's recent speech on "The Federal Reserve and the Global Economy", which discusses the global implications associated with the normalisation of Fed policies, provides a very good example of how this can be done.

The euro area aspects of the policy mix

If we move from cooperation at the global level to cooperation (or the policy mix) within the euro area, the arguments about formal coordination change.

This is not so much a question of monetary policy coordination, as a question of the coordination of other policies *to be consistent with* monetary policy: the Maastricht Treaty enshrines the principle of monetary dominance. Indeed, price stability in the region as a whole is the single most important coordination device for other economic policies, reaching out into various policy domains across the member states of the euro area.

Despite this potentially wide remit for coordination, debates on the appropriate policy mix to ensure euro area price stability have traditionally focused on the interaction between the single monetary policy and a decentralised set of fiscal policies. Economic governance has hence been strongest in this domain, with a particular focus on preventing excessive and potentially inflationary deficits. *Ex ante* coordination of the stance of different national budgets to achieve an *optimal aggregate stance* was seen as largely unnecessary.

A policy mix for a low inflation environment

But today we face a new and challenging set of circumstances. Rather than preventing high inflation, the question is what policy mix is necessary to bring inflation *back* to 2%. While monetary policy can and should be used in full, it is clear that it cannot bear the entire burden of stimulating growth in the region in a context of weak aggregate demand conditions. And this yields two somewhat new policy conclusions.

The first is that the aggregate fiscal stance of the euro area needs to be taken into account, not just the compliance of national budgets with the fiscal rules. This implies that fiscal policy should be used where it is available, in particular to support growth in a "smart" way, i.e. by incentivising investment. And even where fiscal space is not available, budgets can be designed in all countries in ways that are friendlier to growth.

It is nevertheless clear that such measures alone will not be enough to improve demand conditions. In countries where there is no fiscal space one cannot claim to invent it and jeopardise our common rules – yet these are often the same countries where additional demand stimulus would be most effective. This leads to the second conclusion, which is that we need to boost the effectiveness of demand policies in *each euro area country*, and a key contribution to this is improving supply-side policies.

Impaired supply conditions hamper the effectiveness of demand stimulus through several channels. A debt overhang across sectors squeezes fiscal space and blunts the impact of monetary policy on investment and consumption. Capital market fragmentation disrupts the transmission of monetary policy, while product market fragmentation – such as high barriers to entry – weakens the effect of monetary policy on investment demand. And high structural unemployment constrains the positive impact of higher demand on jobs.

In other words, supply-side blockages mean that stabilisation policies become less effective in boosting demand, and an increase in demand becomes less effective in stimulating economic activity.

But by the same token, supply-side policies that tackle these issues can *empower* demand-side policies. By raising potential growth and hence future government income, they can help regenerate fiscal space. By making financial markets function better, they can improve the transmission of monetary policy. By reducing entry barriers and red tape, they can boost investment demand. And by reactivating and reskilling the workforce, they allow employment to respond faster to that higher demand.

The composition of structural reforms

This argument nonetheless comes with an important qualifier: *the success of structural reforms depends critically on their composition*.

I am of course aware of the view that, in current circumstances, structural reforms that expand supply capacity could have *contractionary* short run effects. With monetary policy at zero lower bound, so the argument goes, conventional monetary policy is unable to counteract the resulting downward price pressures, leading to higher real interest rates and lower private consumption and investment.[2] Some may argue that with inflation close to zero, the risks of any further fall in inflation are greater still.

However, structural reforms can also be shown to have *expansionary* short run effects. By raising potential growth they can increase future income and wealth, leading firms to bring forward investment and households to bring forward consumption.[3] And structural reforms can also increase the profitability of investment by reducing fixed costs and, more generally, the cost of doing business, thus boosting investment demand and stimulating activity and inflation.[4]

What matters for the short run effects is which set of forces dominates, and this is where the composition of reforms comes in.

For example, a staggered or incomplete reform package that leads to a relatively slow price adjustment – e.g. if labour market reforms precede market reforms – will tend to reinforce disinflationary expectations and negative real interest rate effects. And these effects are likely to be worse if such a package is dominated by reforms that create more disinflationary pressures. Changes in employment protection legislation, for instance, tend to have negative short-term impact on output even under normal monetary conditions.[5]

On the other hand, if reforms are designed in a more comprehensive way, such that price adjustment occurs quickly, the positive impact on future income and investment is likely to materialise more quickly, thus in part offsetting any contractionary effects. Moreover, several of the reforms that a comprehensive package would entail – such as improving the business environment – would have little disinflationary effects but a potentially strong impact on investment demand.

Indeed, this assessment seems to have been borne out by our experience during the crisis. Several countries had to undergo an internal devaluation to restore competitiveness, which necessitated a particular focus on reforms to make prices and wages more flexible. And notwithstanding different initial conditions, those that pursued a more frontloaded and comprehensive approach have on the whole fared better.[6] Similar arguments hold for those strategies that aim to achieve an internal devaluation via fiscal policies.[7]

We are now at a stage, however, where *all countries* need to boost output, and here reforms aimed at internal devaluation cannot be the answer. Internal devaluation shifts economic

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[2] Eggertsson, G., A. Ferrero, and A. Raffo (2014), "Can Structural Reforms Help Europe?" Journal of Monetary Economics, 61.

[3] Fernández-Villaverde, J., P. Guerrón-Quintana, and J. Rubio-Ramírez (2014), "Supply-Side Policies and the Zero Lower Bound," IMF Economic Review, 62(2), pp. 248–260.

[4] Cacciatore, M., G. Fiori and F. Ghironi (2013), "Market Deregulation and Optimal Monetary Policy in a Monetary Union", NBER Working Paper No. 19025.

[5] See Varga L., W. Roeger, and J. in 't Veld (2013), "Growth effects of structural reforms in southern Europe: the case of Greece, Italy, Spain and Portugal", European Economy Economic Papers, 511.

[6] For more on this issue see speech by B. Cœuré on "Structural reforms: learning the right lessons from the crisis", at the Bank of Latvia Economic Conference 2014, Riga, 17 October 2014.

[7] Farhi, E., G. Gopinath, and O. Itskhoki (2011), "Fiscal Devaluations," CEPR Discussion Papers 8721.

activity across sectors and countries, but does not create additional activity. It is by and large a zero sum game. Thus, I see it as imperative that we now shift our focus towards a different composition of reforms, comprising in particular those reforms that will raise investment demand.

Another way of saying this is that we need a new stage of structural reform in the euro area focused less on competitiveness and more on productivity. With weak demographics, it is productivity growth that will ultimately determine investment demand along the steady state path of the economy. But Total Factor Productivity (TFP) has been stagnant in the euro area since the crisis, while it has taken off in the US. So, we need a TFP shock in the euro area.

I hope very much that this is what the European Council will produce in December, based on President Juncker's input. This would not only benefit the euro area, it would also create positive spillovers for the rest of the world.

The governance of structural reforms

The argument I am making on the importance of structural reforms also has a further implication: if supply-side policies are necessary to empower demand-side policies, and stronger demand is today a precondition for higher inflation, it follows that we need to view structural policies as an equally essential part of the policy mix as fiscal policies. And this in turn has implications for *governance of structural reforms*.

Whereas fiscal policies are coordinated through strong rules, coordination on structural policies so far has been comparatively loose. We have more or less counted on the benevolence of policymakers to internalise the interest of the other participating countries. But insofar as reforms and inflation have become intertwined, these arrangements are no longer consistent with a monetary union based on price stability – if indeed they ever were.

Thus, euro area policy makers have a duty to coordinate structural and fiscal policies more closely. And in fact, they have a legal obligation to do so enshrined in the EU Treaty. Those euro area policymakers who believe that they are accountable only to their national parliaments have forgotten that they belong to a monetary union.

There is quite some scope to strengthen coordination in the current framework, by enforcing in a more consistent way the European Semester and the Country Specific Recommendations, which are today barely considered in the national process. But I am convinced that we will also need to take a step forward. There would be many benefits if governments were to coordinate in a more binding way their structural policies, and this would be in their own interest and in the interest of the Union.

Thanks a lot for your attention.