

## Mario Draghi: The international dimension of monetary policy

Introductory speech by Mr Mario Draghi, President of the European Central Bank, at the ECB Forum on Central Banking, Sintra, 28 June 2016.

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In recent years central banks across advanced economies have been engaged in the same task, namely raising inflation and inflation expectations back to levels consistent with price stability. Each has faced conditions particular to its own jurisdiction. Each has deployed measures appropriate to its own context. And each has acted to fulfil the mandate laid down in its own constitution.

And yet, the fact that all central banks have faced a common challenge of low inflation is not coincidental. There are global factors at play. And this begs the question, what is the best way for us to deal with them?

At one extreme, central banks can take global conditions as entirely exogenous and set their policies accordingly. At the other extreme is explicit coordination of monetary policies. In between is a range of informal solutions.

Whatever one's views on these options, what is clear is that the question of the international dimension of monetary policy is becoming more pertinent, since the common factors affecting central banks are increasing.

### The global drivers of inflation

Indeed, a growing literature suggests that globalisation has created a common factor in inflation developments, which goes beyond fluctuations in energy or commodity prices. Higher import volumes have increased the importance of international prices and wages relative to domestic ones, making the global output gap more relevant.<sup>1</sup>

In that context there are two types of factors that are significant for the global low inflation environment we face today: more cyclical factors that have put downward pressure on prices; and more structural factors that have lowered the equilibrium real rate and slowed down the response of the economy to monetary policy.

The first type of factors includes the large negative output gaps generated by the financial crisis and its aftermath, which still average 1% among G7 economies today.<sup>2</sup>

This global slack has dampened in particular import and producer price inflation, both of which have been weak for several years among advanced economies. Prices set by producers in the euro area and those set by producers in trading partner countries are indeed highly correlated.<sup>3</sup>

Also depressing global inflation has been the slump in demand for energy and commodities linked to the slowdown in emerging markets. This has fed not just into lower headline

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<sup>1</sup> Inflation as a global phenomenon has been documented e.g. by M. Ciccarelli and B. Mojon (2010), "Global Inflation", *The Review of Economics and Statistics*, 92:524–535. Measures of global economic slack are good predictors of national inflation in advanced countries, as shown empirically e.g. by C. Borio and A. Filardo (2007), "Globalisation and inflation: New cross-country evidence on the global determinants of domestic inflation" BIS WP no. 227; and in New Keynesian open economy models e.g. by R. Clarida, J. Gali, and M. Gertler, (2002) "A Simple Framework for International Monetary Policy Analysis," *Journal of Monetary Economics* 49: 879–904.

<sup>2</sup> IMF estimates.

<sup>3</sup> See ECB (2015), "The impact of oil prices on euro area inflation", Box 3, Annual Report 2014.

inflation, but also into lower underlying inflation through its effect on costs and imported prices. Indeed, if one decomposes inflation for the average advanced economy, one finds that since mid-2014 there has been a notable rise in the global component, linked largely to oil and commodity price falls.<sup>4</sup>

These various factors may originate only in parts of the global economy – some originate more in advanced economies, other more in emerging markets – but in an integrated world they have global effects. Cyclical weakness has spilled over through various channels into a similar challenge for all.

The second type of factors is more structural in nature. They concern the global forces that have led to very low real equilibrium interest rates across advanced economies, and hence made it more complicated for monetary policy everywhere to provide the appropriate boost to global demand given an effective lower bound on nominal interest rates. In particular, this has led many central banks in the advanced economies to engage in large-scale unconventional policies.

That low interest rate environment is a consequence of a global excess of desired saving over planned investment, which results from rising net savings as populations plan for retirement; from increased demand for and lower supply of safe assets; from relatively less public capital expenditure in a context of slowing population growth in advanced economies; from the secular shift from industries intensive in physical capital to those more intensive in human capital; and from a slowdown in productivity growth that reduces returns on investment.<sup>5</sup>

Again, those factors may not be distributed homogeneously across economies, but their effects are global because they propagate through global financial markets. With internationally mobile capital, the clearing interest rate that balances saving and investment is more a global concept than a local one. And accordingly, estimates of the equilibrium interest rate suggest that it is very low, possibly even negative, in the euro area, the US and other advanced economies.<sup>6</sup>

None of this means that central banks should give up on pursuing their domestic price stability mandates. We have demonstrated with our unconventional tools that it is possible to engineer accommodative financial conditions even when the equilibrium interest rate is low. And we have shown that this can be effective in supporting domestic demand and stoking domestic price pressures even when disinflationary headwinds are blowing from the global economy.

But the global nature of low inflation does have two important implications.

### **Coping with monetary policy spillovers**

The first is that operating against persistent headwinds arising from abroad has forced central banks to deploy monetary policy with more intensity to deliver their mandates, and that in turn results in higher financial stability risks and spillovers to economic and financial conditions in other jurisdictions.

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<sup>4</sup> See Draghi, M. (2015), “Global and domestic inflation”, speech at the Economic Club of New York, 4 December 2015.

<sup>5</sup> See Constâncio, V. (2016), “The challenge of low real interest rates for monetary policy”, speech at the Utrecht School of Economics, 15 June 2016.

<sup>6</sup> See Holston, K., Laubach, T. and Williams, J. (2016), “Measuring the Natural Rate of Interest: International Trends and Determinants”, Federal Reserve Bank of San Francisco Working Paper Series, Working Paper 2016–11.

Such spillovers are not necessarily all negative for the global economy. On the contrary, by securing economic and financial stability in their own jurisdictions, advanced economies also help stabilise other economies through trade and financial linkages. The empirical evidence suggests that the net spillover effect of the measures taken during the crisis has been positive, especially at times – such as after the Lehman crash – when countries have faced common global shocks.<sup>7</sup>

At the same time, monetary policy has inevitably created destabilising spillovers as well, especially when business cycles have been less aligned. The large exchange rates fluctuations between major currencies, and the pressures some emerging economies have experienced from capital flows, are testament to that. This is not so much a result of the *measures* central banks have employed<sup>8</sup>, but rather of the *intensity* with which they have had to be used.

These negative spillovers have led to a revival of interest in the topic of monetary policy coordination.<sup>9</sup>

But formal monetary policy coordination is complex, for well-known reasons.<sup>10</sup> Central banks have national mandates, not global ones, and are accountable to their domestic parliament. This does not mean, however, that we cannot achieve a better global solution than we have today.

We have seen, for instance, how divergent monetary policies among major central banks can create uncertainty about future policy intentions, which in turn leads to higher exchange rate volatility and risk premia. That then has to be countered with more expansionary monetary policy, increasing spillover effects for others. We also know that competitive devaluations are lose-lose for the global economy, since they lead only to greater market volatility, to which other central banks are then forced to react to defend their domestic mandates.

So we would all clearly benefit from enhanced understanding among central banks on the relative paths of monetary policy. That comes down, above all, to improving communication over our reaction functions and policy frameworks.

The global economy could also benefit from cooperation among spillover-initiating and spillover-receiving economies on how to mitigate unwanted side effects.

One aspect that we need to understand better is how domestic monetary regimes affect the transmission of foreign monetary policy shocks. There has been a debate in recent years as to whether the famous “trilemma” of international macro has collapsed into a “dilemma”, whereby floating exchange rates no longer guarantee autonomy for domestic monetary policy, and policy independence is only possible if capital flows are in fact managed.<sup>11</sup> But

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<sup>7</sup> See Ammer et al. (2016), “International Spillovers of Monetary Policy” *IFDP Notes*. See Georgiadis (in press), “Determinants of global spillovers from US monetary policy”, *Journal of International Money and Finance*; Feldkircher and Huber (2015), “The International Transmission of U.S. Structural Shocks – Evidence from Global Vector Autoregressions”, *European Economic Review*, vol. 81(C), pages 167–188; Kim (2001), “International transmission of U.S. monetary policy shocks: Evidence from VARs”, *Journal of Monetary Economics*, vol. 48(2), pp. 339–372.

<sup>8</sup> See Ammer et al. (2016, op cit.).

<sup>9</sup> See Rajan (2016), “Towards rules of the monetary game”, Speech at the IMF/Government of India Conference on Advancing Asia: Investing for the Future, New Delhi, 12 March 2016.

<sup>10</sup> For a fuller discussion see Cœuré, B. (2014), “Policy coordination in a multipolar world”, speech at the 5th annual Cusco conference organised by the Central Reserve Bank of Peru and the Reinventing Bretton Woods Committee: “70 years after Bretton Woods: Managing the interconnectedness of the world economy”, Cusco, 22 July 2014.

<sup>11</sup> See Rey (2015), “Dilemma not Trilemma: The global Financial Cycle and Monetary Policy Independence”, *NBER Working Papers*, no. 21162; Miranda-Agrippino and Rey (2015), “World Asset Markets and the Global Financial Cycle”, *NBER Working Papers*, no. 21722.

there is also evidence that exchange rate regimes still matter. Various recent studies support the traditional view that exchange rate flexibility affords at least some degree of insulation from global shocks.<sup>12</sup>

Another aspect is understanding the role of domestic policies more broadly in mitigating negative spillovers. A large body of empirical work in recent years has shown that fiscal, macro-prudential, regulatory and supervisory policies can help mitigate the adverse effects of foreign monetary policy on domestic financial stability.<sup>13</sup> Indeed, the experience with the taper tantrum in 2013 showed how differences in domestic policy frameworks shaped how severely different economies were affected by financial spillovers.<sup>14</sup>

In other words, it has become clearer since the crisis that the famous “Tinbergen principle” which we apply at the domestic level also needs to be applied at the global level. Policymakers need to have sufficient instruments to deliver on their objectives. And when they do have them, they must use them.

### **The need for policy alignment**

The second implication of the global nature of low inflation is that there is a common responsibility for addressing its sources, whatever and wherever their origin.

Indeed, to the extent that the environment in which we operate is more affected by the global output gap, and the global savings-investment balance, the speed with which monetary policy can achieve domestic goals inevitably becomes more dependent on others – on the success of authorities in other jurisdictions to also close their domestic output gaps; and on our collective ability to tackle the secular drivers of global saving and investment imbalances.

In a recent speech in Brussels I made a similar point regarding the interaction between monetary policy and other policies at the *domestic* level, such as fiscal and structural policies.<sup>15</sup> I maintained that central bank independence could best be described as independence in interdependence, since monetary policy can always achieve its objective eventually, but it will do so faster, and with less collateral effects, if the overall policy mix is consistent.

What I am saying here is that the same applies at the global level. We may not need formal coordination of policies. But we can benefit from alignment of policies. What I mean by alignment is a shared diagnosis of the root causes of the challenges that affect us all; and a shared commitment to found our domestic policies on that diagnosis.

Today, for instance, the way in which domestic policies respond to a shortage of demand globally will vary: in some cases, the emphasis may be on increasing public investment; in

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<sup>12</sup> For a review see Frankel (2016), “International Coordination,” presented at the 2015 Asia Economic Policy Conference, Federal Reserve Bank of San Francisco.

<sup>13</sup> See, for example, Blanchard et al. (2015), “Can Foreign Exchange Intervention Stem Exchange Rate Pressures from Global Capital Flow Shocks?”, *NBER Working Papers*, no. 21427; Forbes et al. (2015), “Capital flow management measures: What are they good for?,” *Journal of International Economics*, vol. 96(S1), pp. S76-S97; Afanasieff et al. (2015), “Implementing loan-to-value ratios: the case of auto loans in Brazil (2010–11),” *Central Bank of Brazil Working Paper Series*, no. 380; Wong et al. (2015), “Using macro-prudential tools to address systemic risks in the property sector in Singapore”, *SEACEN Financial Stability Journal*, vol 4, pp. 27–41; Ostry et al. (2012), “Tools for managing financial-stability risks from capital inflows”, *Journal of International Economics*, vol. 88(2), pp. 407–421; Habermeier et al. (2011), “The effectiveness of capital controls and prudential policies in managing large inflows”, *IMF Staff Discussion Note*, SDN/11/14 ;Lim et al. (2011), “Macro-prudential policy: What instruments and how to use them? Lessons from country experiences”, *IMF Working Paper WP/11/238*.

<sup>14</sup> See Eichengreen and Gupta (2013), “Fed tapering and emerging markets”, [VOXeu.org](http://VOXeu.org).

<sup>15</sup> See Draghi, M. (2016), “On the importance of policy alignment to fulfil our economic potential”, 5th Annual Tommaso Padoa-Schioppa Lecture at the Brussels Economic Forum 2016, Brussels, 9 June 2016.

others, on supporting private demand through more growth-friendly tax and regulatory policy, and of course through monetary policy. The relative stance of stabilisation policies will differ across countries depending on cyclical positions. But the sign of the effect on global demand needs to be positive.

Similarly, structural policies that aim at raising participation and productivity may take different forms in different places, but they need to achieve the same outcome, which is to increase long-term growth rates and raise equilibrium interest rates.<sup>16</sup> Here fora such as the G-20 can play an essential role in bringing about the appropriate alignment of policies. It is key that what is agreed in those fora is translated in the concrete policy actions.

The disappointing outcome of the G-20 commitment to raise global growth by 2% with structural measures is one example of how intentions and actions can diverge. It contrasts with the more successful example that was provided by coordinated global fiscal expansion in 2008–09. Such fora of course cannot bind countries into specific actions. But mutual recognition of their common interest can act as a form of coordination device.

That common interest today is a faster closing of the global output gap, more stable global inflation, higher long-term global growth and greater global financial stability.

And such an improved policy mix would help reduce unwanted side effects of monetary policy, since the burden of stabilisation would be better shared across policies. For instance, in the current environment of global slack, the international spillovers from growth-friendly fiscal policies are likely to be wholly positive, since they primarily boost domestic demand in the home country. That is also true within regions, such as the euro area, where there are different local output gaps.

The upshot is that, in a globalised world, the global policy mix matters – and will likely matter more as our economies become more integrated. So we have to think not just about whether our domestic monetary policies are appropriate, but whether they are properly aligned across jurisdictions.

We have to think not just about the composition of policies within our jurisdictions, but about the global composition that can maximise the effects of monetary policy so that our respective mandates can best be delivered without overburdening further monetary policy, and so as to limit any destabilising spillovers. This is not a preference or a choice. It is simply the new reality we face.

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<sup>16</sup> For a discussion on the interaction between demand- and supply-side policies at the global level see Cœuré, B. (2015), “Paradigm lost: Rethinking international adjustments”, Egon and Joan von Kashnitz Lecture, Clausen Center for International Business and Policy, Berkeley, 21 November 2015.