

Ignazio Visco: Divergence in monetary policies across the Atlantic?

Remarks by Mr Ignazio Visco, Deputy Director General of the Bank of Italy, at the policy panel of the CEDERS – 3rd Meeting on Open Macroeconomics and Development “The Euro Area, the Euro and the World Business Cycle”, Aix-en-Provence, 3-4 July 2008.

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In my remarks, I will first start with the basic question raised to the panel: are there differences in the Fed's and ECB's behaviour? I will then tackle two issues that have probably become more pressing in light of the current financial turmoil: i) are there obvious limitations in the monetary frameworks and how should they be addressed?, and ii) do we need some form of monetary policy coordination?

1. FED – ECB divergences

A popular belief is that the dual mandate of the Fed, as opposed to the overriding price stability objective of the ECB, is the major source of policy differences across the Atlantic. In this respect, if we take a medium- to long-term view, and we agree that over those horizons money cannot affect potential output (the Phillips curve is vertical), then the different mandate should not be relevant. Indeed:

- The track record of the Fed in the past 20 years, as well as the positions expressed repeatedly by its executives, speak by themselves of the centrality the Fed attributes to the price stability objective (see Figure).
- An important difference is of course that, contrary to the ECB, the Fed has not announced a quantitative definition of its goal: this may give the ECB some (slight) advantage in anchoring expectations, as some recent studies appear to suggest,¹ and thus perhaps a more favourable shorter-run trade off.

It is at the shorter horizons, in the strategic conduct of monetary policy by the two central banks, that we may more likely find some differences:

- A starting point in this respect is the observation that since the start of the euro in 1999 the volatility of policy interest rates in the US has been two times larger than in the euro area (see Figure).²
- Understanding why this is the case is not easy, as the difference may reflect differences in the conduct of policy, in the structures of the economy, in the size and nature of economic shocks. Indeed, the few analyses that have tried to address the

¹ M.J. Beechey, B.K. Johannsen and A. Levin (2007), “Are long-run inflation expectations anchored more firmly in the Euro Area than in the United States?”, CEPR Discussion Papers No. 6536.

² The standard deviation of the (target) Fed fund rate since 1999 is 1,83 percentage points, compared with 0,89 percentage points of the policy rate of the ECB. The average policy rate has been 3,6 for the Fed and 3,1 for the ECB.

issue in a systematic way give some hints that all of these factors may have played a role.³ In particular:

- *Shocks*: Differences in the type and intensity of shocks (especially productivity shocks) have probably played a major role in the last decade.
- *Structure*: Higher wage and price flexibility may explain part of the higher volatility of policy rates in the United States.
- *Policy*: The ECB may have, at least according to some estimates, a higher degree of policy inertia, which may grant it with more leverage on long-term interest rates.

There is however no crystal clear evidence of a significantly different response to measures of economic slackness, which may indicate that the different mandates do not impinge too much even in the shorter term. Besides this, we have to be very careful in judgement as we are far from being in a position to state how close to optimal is any of the two policies, given structure and preferences in the two economies.

The recent financial turmoil and the different policy responses across the Atlantic have once again spurred a debate (particularly in Europe) on whether the different mandate is the source of divergence (and political calls on the ECB to adopt a Fed-like response). Again it is likely that a combination of factors are at play:

- If we compare, for example, the change in the forecasts of the two central banks in the last year, we see that the Fed has changed its forecasts of growth for 2008 by much more than the ECB (-2% vs. -0,5%), while the reverse is true for inflation (+0,4% vs. +0,9%). These changes in the respective outlook go some way towards explaining a different policy response: after all, and notwithstanding the strict financial linkages, we should not forget that the sub-prime crisis originated in the US and it is linked to real economic problems in that country.
- The difference in the policy stance may also have accentuated the perception of differences in the liquidity provision policies followed by the two central banks. While some differences were certainly present (in terms of counterparties, instruments and facilities used for open market operations), overall the two banks did not inject more reserves than needed to maintain reference rates near policy rates and net injections were quickly reversed. However, while the ECB had to clearly (and successfully) distinguish liquidity provision from the monetary policy stance, in the Fed case active liquidity provision and more expansionary monetary policy went hand in hand.

2. Financial turmoil and monetary frameworks

According to some observers, financial crises are manifesting themselves with increased frequency also because of the success achieved by macro-stabilization policies and the better anchoring of inflation expectations in good and services markets. An aspect of this is that episodes of excess creation of liquidity and credit may fuel asset price bubbles, rather than increase consumption prices. In this respect:

³ See L. Christiano, R. Motto and M. Rostagno (2007), "Shocks, structures or monetary policies? The euro area and US after 2001", ECB Working Papers No. 774, and J.G. Sahuc and F. Smets (2008), "Differences in interest rate policy at the ECB and the Fed: an investigation with a medium-scale DSGE model", *Journal of Money, Credit and Banking*, vol. 40, March-April.

- It has been observed that in both the high-tech equity bubble of the late 1990s and in the more recent escalation of real estate prices a “too easy for too long” monetary policy stance may have had some responsibility.
- There are also claims that portfolio relocations and abundant liquidity may be causing episodes of bubbles in commodity prices for which future markets exist, with consequences for the prices of other commodities and final consumer prices.

By committing itself to closely monitor and to respond, if needed, to developments in monetary and credit aggregates, the ECB has probably made a step towards addressing this issue. Indeed:

- Excessive growth in monetary aggregates, credit and leverage may provide useful early signals of the building up of financial imbalances and their potential longer term implications for financial stability, macroeconomic volatility and price stability.⁴
- The ECB has also manifested a different attitude towards asset price bubbles, whereas it has not ruled out the possibility of “leaning against the wind” in the face of excessive asset price developments.⁵
- We should however acknowledge the enormous difficulties of defining what “excessive” means in this area and of designing a policy that aims at mitigating the risks of imbalances and crises in the financial sector while keeping it consistent with the preservation of price stability. We should probably also avoid asking too much to monetary policy; certainly frameworks and rules in capital markets need to be revised and other policies (regulatory, supervision ...) to be involved.

In this respect, is the adoption of a fully fledged “flexible inflation targeting” – a framework from which both the Fed and the ECB have differentiated themselves (perhaps for different reasons) – the right way to go? Nowadays flexible inflation targeting is understood as a framework in which the central bank announces (and specifies in quantitative terms) its price stability goal and designs an optimal policy to reach it. But then, one may ask whether this may be too general a framework to provide an actual guidance to monetary policy.⁶ Furthermore:

- Is there a role for asset prices in flexible inflation targeting (independently of their direct effects on inflation)?
- In particular, may asset prices play a role in the anchoring of price expectations that is nowadays recognized by policymakers as a paramount condition for achieving price stability?

Anyway, the real issue to me does not lie much in the policy framework, but rather in the limitations of the models we use to interpret economic data and to decide our policy. This is particularly true for how we treat asset prices. Let me just mention two points in this respect.

- First, we probably do not know enough about the effects of asset price misalignments and related imbalances in equity, real estate and currency markets, as well as in bank credit and government debt. My reading of the empirical literature is that normally these effects are found to be relatively small and asset price

⁴ See also, on this issue, the influential BIS view as exemplified for instance in C. Borio and P. Lowe (2002), “Asset prices, financial and monetary stability: exploring the nexus”, BIS Working Papers No. 114.

⁵ See for example O. Issing (2004), “Financial integration, asset prices and monetary policy”, speech at the Symposium concluding two years of the ECB-CFS research network on “Capital Markets and Financial Integration in Europe”.

⁶ On this see also my discussion of C. Bean (2003), “Asset prices, financial imbalances and monetary policy: are inflation targets enough?”, BIS Working Papers No. 140.

movements are found to play a relatively little role in the transmission of monetary policy. But this conclusion may be seriously biased, as these are often likely to be rare and extreme events. Even if they materialised in strong manner, in macroeconomic estimates they are likely to be dominated over the sample by “normal time” observations and frequently end up to be “dummied out”.

- Second, many of the effects associated with asset prices imbalances are likely to be highly non-linear and complex. The implicit monetary policy reaction function would also then be non-linear and complex and likely to depend on asset prices and financial imbalances.⁷

Let me just mention some of the weaknesses we need to address in the near future:

- Our models do not treat asset prices in any depth; we are unable to appropriately model movements in the risk premia over the cycle.
- We are not able to satisfactorily model interactions and feedbacks between the real and the financial sectors; this is particularly true for the non-linearities that emerge during crises.
- We lack a deep understanding of the potential link between monetary policy and asset price bubbles; this may, *inter alia*, require a departure from the rational expectation hypothesis (as recently suggested for example by Sims⁸).

3. Coordination of monetary policies

The financial turmoil has brought back at the centre of the international debate the issue of monetary policy coordination. In this debate, many feelings and perceptions mix together. At the bottom, there is the argument that the spectacular increase in financial integration implies a progressive decline in the effectiveness of domestic monetary policy. This combines with the perception that central banks may have lost their leverage on longer-term interest rates (see the discussion on the “saving glut”), as is evident from a lower impact of short-term interest rates on the yield curve, a higher correlation of interest rates across countries and a flattening of the Phillips curve caused by globalisation.

In this new global environment, it is argued by some, domestic monetary policies can do little in isolation; the only possibility is to join forces. I will structure my remarks on this issue along a few questions.

First, does globalisation (increased trade and financial integration) necessarily reduce the effectiveness of monetary policy?

- Here, I think worries are probably exaggerated. From a theoretical point of view, we have no reasons to think that because of financial and commercial integration domestic monetary policies should lose control of their statutory goal.⁹ As long as domestic currencies continue to be used as means of payments for the internal transactions the ability of monetary policy to control inflation is not affected and domestic inflation remains a domestic monetary phenomenon.¹⁰

⁷ See, among others, the example provided in Bordo and Jeanne (2002), “Boom-busts in asset prices, economic instability and monetary policy”, NBER Working Papers No. 8966.

⁸ C. A. Sims (2008), “Inflation expectations, uncertainty and monetary policy”, manuscript, mimeo.

⁹ See Woodford (2008), “Globalization and monetary control”, NBER Working Papers No. 13329.

¹⁰ Of course, to the extent that globalisation also increases the flexibility of prices and wages, it may hamper monetary policy ability to influence short-run output movements. But, in this case, this ability would not be needed any longer.

- A question may however remain whether domestic policies may have become more costly, in terms of their short-run effects on economic activity, due to the increased importance of external spillovers.
- Some of the evidence I just referred to (diminished impact of policy rates on longer term rates, flattening of the Phillips curve) may be explained by a higher degree of credibility of central banks, rather than globalization, and indeed we have some evidence that this may be the case.¹¹ This would reflect an increased, rather than reduced, effectiveness of monetary policy.

Second, even if we do not necessarily need to join forces to control domestic inflation, may coordination nevertheless be useful?

- Here the answer from theory becomes more blurred. The recent literature based on dynamic general equilibrium models with sticky prices has highlighted the importance of relative prices. Whether there is room for welfare improving monetary policy coordination depends very much on exchange rate pass-through behaviour. Overall, I take from this literature that targeting domestic inflation produces outcomes close to optimal in most cases.¹²
- If we add to this the real life complications of getting into (and respecting under changing conditions) formal agreements and the uncertainties surrounding the effects of monetary policy moves (for example on exchange rates), then the case for coordination becomes even more doubtful. Indeed, the experiences of the past (e.g. the Louvre – Plaza agreements) are not particularly encouraging.
- In any event, what cannot be compromised is the statutory mandate of our central banks to deliver the assigned objectives. Any formal agreement casting doubts on this principle and causing inflation expectations to slip away would be extremely costing. Considering all this, the road of coordination, understood as entering into formal and binding contingency plan agreements, appears quite narrow.

Finally, do we need more cooperation?

- The answer in this case is probably positive. Even if we do not necessarily need to coordinate ex ante to attain the final goal, it is quite evident that the increasing interdependencies among the economies complicate the conduct of monetary policies a great deal. In the new environment the case for reinforcing international cooperation is strong. And I do not exclude that particularly for small open economies this may mean a strong incentive to join or to create monetary unions (an extreme form of cooperation).
- We are seeing that forms of cooperation are becoming more and more crucial in many fields, such as in liquidity provision policies, in financial institution regulation and supervision, in order to tackle possible systemic crises, avoid regulatory arbitrage, ensure a level-playing field.
- In the monetary policy field, there certainly is a high degree of interaction among central bankers, for example through their frequent participation to BIS meetings in Basel. It is indeed essential to ensure a continuous exchange of views, full understanding of each other's goals, policy intentions and possible spillovers of

¹¹ See, for example, E. Gaiotti (2008), "Has globalisation changed the Phillips curve? Firm-level evidence on the effect of activity on prices", Banca d'Italia, Temi di discussione, No. 676.

¹² See, for example, M. Obstfeld and K. Rogoff (2002), "Global implications of self-oriented national monetary rules", Quarterly Journal of Economics, May, and G. Corsetti and P. Pesenti (2005), "International dimensions of optimal monetary policy", Journal of Monetary Economics, vol. 52 n. 2.

different policy options. In some cases this may lead to a common understanding that a particular direction of policy is in the interest of all parties involved.

I believe that the situation we are facing nowadays illustrates this case rather well.

- We are observing an emergence of strong inflationary pressures around the globe. Monetary policy at the world level appears to be quite expansionary. Short-term real interest rates are negative in the US and are very low or negative in many regions, particularly in emerging economies (for the total of emerging economies' real short-term interest rates are close to zero, they are positive for those that have an inflation targeting framework, and significantly negative for the others.)
- In many emerging economies, particularly in China, the pegging to the dollar implies importing US monetary policy even if internal conditions, especially domestic demand, are very different. On the one hand, this policy is fuelling liquidity and credit expansion, pushing domestic demand and pushing inflation rates in these economies towards double-digit values. On the other hand, through the increasing pressure on commodity prices (oil and food) it puts pressure to inflation rates also in main industrialised economies.
- In advanced economies monetary policy is directed to avoid second-round effects from commodity price increases, but it is unlikely to be able to address the sources of first-round effects (excess demand in large emerging economies), unless it creates so much slack in the advanced economies as to dampen exports and internal demand in emerging economies as well.

The need to come to a common understanding of the international situation appears therefore to be particularly pressing at the moment. Getting out of problems may be quite costly if done in sparse order.

