Jean-Claude Trichet: International interdependencies and monetary policy – a policy maker's view

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the Fifth ECB Central Banking Conference "The Euro at Ten: Lessons and Challenges", Frankfurt am Main, 14 November 2008.

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Ladies and Gentlemen,

I would like to express my gratitude for having the opportunity to host this panel of distinguished experts and colleagues. Dear Ben, dear Stanley, dear Ning, and dear Guillermo: I greatly appreciate your willingness to participate in this conference despite the tremendous challenges we are all currently faced with. I would also like to use this opportunity to thank the conference organisers for a superb job and indeed all conference participants for their important contributions.

It is perhaps unfortunate that the current crisis distracts our minds from the subject of the Conference: the euro coming of age. In different conditions, I would have argued – as I did in the past – that, far from suppressing growth and entrenching divergences, the euro has spurred a spectacular drive of job creation virtually everywhere in the Union. By helping and fostering a long-due redressing of economic priorities and processes, the euro has enabled many countries participating in Monetary Union to do their best to compete successfully. We see signs that this restructuring is spreading to other parts of the Union that have been less successful so far in taking up the challenge.

Under normal circumstances, European Monetary Union – international integration in its most intimate form – would have been the subject of these remarks.

With the current crisis in the background, however, I want to address a different form of convergence and cooperation in the international arena, which involves central banks and crisis management.

Of course, this brings me quite far. With ever stronger global integration of goods and services trade and, in particular, financial markets there are increasingly stronger linkages among the world regions. As a result, economic and financial crises in one world region increasingly spill over to other regions. At the same time, corrective policy action in one region creates conditions and economic incentives that are felt and are acted upon elsewhere. How should policymakers around the world deal with this fact? In particular, is there a case for international coordination of macroeconomic policies?

I will try to give a tentative answer to these important questions. I will argue that we need to be careful with what we understand by international policy coordination. Policy coordination does not mean, of course, a unique policy stance for the entire world. Coordinated policy action is not a surrogate for domestic macroeconomic prudence. We are all convinced that monetary policies geared towards domestic price stability, sound public finances and flexible economic structures create the conditions for an international financial architecture that can last.

Are there areas in which policy *cooperation* can help strengthen domestic macroeconomic policies? My short answer is "Yes, there are". Before giving you concrete examples of beneficial cooperation, let me take a brief theoretical detour, which will make clear why aiming for a globally unified policy stance is undesirable, whereas other types of cooperation are more promising. In an influential paper a few years ago Obstfeld and Rogoff questioned the conventional wisdom that increased integration of goods and financial markets strengthens the case for policy stance coordination.[1,2] Their theoretical results even suggest that the need for policy stance coordination decreases with the level of international integration. The basic intuition is that integrated goods and financial markets provide a powerful risk-pooling mechanism, leaving policymakers free to focus on minimising the distortions that might hamstring their respective domestic economies. As I noted on previous occasions, the path of policy over the business cycle in the euro area relative to the United States has differed for a number of reasons – and this despite the common conviction that maintaining price stability is *the* prerequisite for sustainable job creation and economic success. The most important reasons for different policy paths are differences in underlying economic structures and differences in the timing, nature and duration of economic shocks.[3]

This being said, there is an interesting sideline in Obstfeld and Rogoff's paper, which seems to me to be very relevant for the current situation and which would be a fruitful area for future research. The result I mentioned earlier – that tight international linkages do not necessarily strengthen the case for international policy coordination – holds for what I would define as "normal times". In Obstfeld and Rogoff's words it holds "unless risk aversion is very high".[4] In the current generation of theoretical models, risk aversion is generally considered a constant parameter. I think that recent years and months have taught us an important lesson: attitudes toward risk not only vary over time – for example, following long-term trends – but they do so by waves and oscillations around trends. Phases of excessive risk taking can be followed by sudden reversals driven by abrupt global confidence shocks such as the one experienced in mid-September 2008.

The entirely exceptional joined interest rate cuts on 8 October 2008 and – in similar tense conditions – on 13 September 2001 have to be seen in this context. In both cases there was extraordinary uncertainty about the economic outlook and there was strong evidence that upside risks to price stability had diminished in many world regions at the same time. Joint action was first and foremost predicated on the need to respond to the *same* shock, a shock that was being transmitted around the globe with lags measurable in hours. This created the room for interest rate cuts, in all cases consistent with the mandate of the respective central banks. We chose to coordinate the timing of announcement because we wanted to mutually reinforce our message of confidence to the markets.

That being said, reflecting upon our very close relationship, I see all the hours spent on exchanging ideas with my fellow governors, reflecting on facts and prospects, has progressively consolidated an element of intimate confidence that is a major asset for the present and future. We have built a remarkable common ground of shared experience, mutual understanding and trust – in which today's consultation does not need a long preamble because it follows naturally from yesterday's discussion – that has facilitated action in many directions.

We have intimately cooperated in ways that cannot be easily integrated into theoretical models. For example, there is a continuous exchange of information that helps all of us to better understand the nature of the crisis and its intricate international propagation patterns.

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1 M. Obstfeld and K. Rogoff (2002), "Global Implications of Self-Oriented National Monetary Rules", *Quarterly Journal of Economics* 117 (2), 503-535.

2 A classic contribution to the literature on policy coordination, reflecting the conventional wisdom, can be found in G. Oudiz and J. Sachs (1984), "Macroeconomic Policy Coordination among the Industrial Countries", *Brookings Papers on Economic Activity* 1, 1-64.

3 See my intervention entitled "The Euro area and its monetary policy" at the Conference on "The ECB and its Watchers IX," Frankfurt am Main, 7 September 2007. See also the article entitled "Monetary Policy Activism" in the November 2006 issue of the ECB Monthly Bulletin.

4 Obstfeld and Rogoff (2002), p. 503.

We have cooperated intimately as regards the provision of liquidity in order to restore the normal functioning of interbank money markets around the world.

Since December 2007, the ECB, in cooperation with the US Federal Reserve System and other central banks, has been conducting term auction facilities – so-called TAF operations – in which it provides USD liquidity on behalf of the US Fed to euro area banks against ECB eligible collateral. These operations do not have a direct impact on euro liquidity conditions and are aimed at improving global funding conditions. In this respect I would like to stress that to my knowledge this was the first joint action of that kind ever taken by central banks to relieve pressures in the short term funding markets.

The world can count on a continuation of this fruitful cooperation among central banks and it can also count on the fact that this cooperation occurs fully in line with our respective mandates and, in exceptional times like these, can even strengthen their achievement.

I thank you for your attention.