

Benoît Cœuré: Domestic and cross-border spillovers of unconventional monetary policies

Remarks by Mr Benoît Cœuré, Member of the Executive Board of the European Central Bank, at the SNB-IMF Conference “Monetary Policy Challenges in a Changing World”, Zurich, 12 May 2015.

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Accompanying charts can be found at the end of the speech or on the European Central Bank's [website](#).

Summary

Discussion has recently emerged on the global financial market implications of diverging monetary policy cycles. Central banks in large advanced economies can free themselves from the global financial cycle and regain monetary independence, provided that they show clarity in purpose and resolve in implementation. The global exchange rate adjustments should be therefore seen as a natural by-product of such move towards monetary policy independence and divergence. Monetary policy always has unintended consequences, no matter where it is pursued. At the ECB we take our decisions with a view to attaining our primary objective of price stability. But without prejudice to this objective, we take financial stability risk seriously and monitor closely whether severe imbalances are emerging in the financial sector.

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Dear Managing Director, dear President, ladies and gentlemen,

In recent years, there has been an intense discussion, both at the national and the international level, about the potential financial market implications of unconventional monetary policies.

At the international level, policy makers have been particularly concerned with the surge in capital inflows, and the resulting exchange rate appreciation pressures in emerging markets. More recently, amid monetary policy normalisation in the United States and additional monetary policy easing in the euro area, including through the launch of the public sector purchase programme (PSPP), a new, but conceptually related discussion has emerged on the global financial market implications of diverging monetary policy cycles.

At the national level, the main concerns were spillovers to equity and real estate markets, and the worries about the emergence of asset price bubbles as a result of unconventional policy measures.

As responsible central bankers, we should be mindful of these two concerns. In my presentation today, I would like to share my views with you on both.

International spillovers of diverging monetary policy cycles

Over recent quarters, macroeconomic conditions have diverged across major advanced countries, with solid economic growth in the United States and the United Kingdom being accompanied by a tepid recovery in Japan and until recently in the euro area. Given that the central banks of the countries I have just mentioned have clear domestic mandates to fulfil, this had inevitably led to diverging monetary policy cycles among major advanced economies. At the same time, many emerging market economies (EMEs) are displaying

slowing growth rates, while also partly benefiting from the disinflationary impact of the decline in oil prices, which creates additional leeway for monetary easing.

Taken these developments into account, the global economy is currently characterised by an environment of diverging monetary policy cycles. While the US Federal Reserve (and to a lesser extent the Bank of England) has signalled its willingness to embark on steps towards monetary policy normalisation, many central banks across the world are on an easing bias – in fact, more than 20 central banks have eased monetary policy since the start of 2015.

This pattern of global monetary policy divergence has per se not been unprecedented. In fact, when considering interest rate level differentials between the United States and the euro area as a simple indicator of differences in global monetary policy cycles, it appears that current divergences are not out of line with what was happened in the past: while differences in short-term policy rates currently do not reveal the full amount of divergence (see Chart 1, black line) due to the zero lower bound, long-term interest rate differentials can give us a better gauge for measuring differences in global cycles (see blue line). According to this yardstick, global monetary policy divergence is indeed elevated, with the spread between the US Treasury and German 10 year yields being today north of 150 basis points. But we have had comparable episodes in the past, in particular when Europe was lagging behind the US cycle, which happened in the early 2000s and again in the mid-2000s.

Importantly, global monetary policy divergence is also a sign of monetary policy autonomy. In fact, while there has been a lot of discussion in recent years about a loss of monetary policy independence in the presence of a global financial cycle (which H el ene Rey famously referred to as the “dilemma, not trilemma”)¹, recent interest rate developments vividly illustrate the independence of ECB monetary policy. You can think of the recent development as a two stage process, triggered by the successive monetary policy decisions of the ECB. In the first stage, short-term euro area interest rates were clearly de-coupled from US rates in the summer 2013 when the ECB, in the wake of the Fed’s taper tantrum, decided to issue its own forward guidance. In the second stage, since August 2014 when the ECB announced various credit easing packages and in particular since the announcement of the ECB’s PSPP in January, ECB unconventional monetary policy has become the main driver of long-term interest rates in the euro area. Long-term rates have declined considerably in response to the announcement, in line with our intention to further ease financing conditions in the euro area, rising somewhat very recently as part of market correction of earlier gains (see Chart 2). In this regard, the ECB’s PSPP programme is having effects on notably term and inflation risk premia that are similar to those witnessed previously in the United States. The ensuing de-coupling of long-term interest rates can also be seen in dynamic correlations between yields on 10 year German Bund and US Treasury bills which have declined (see Chart 3).

The de-coupling of long-term rates shows that the well-known trilemma in the international macro is still relevant, at least for large advanced economies. This holds true despite recent evidence that argues in favour of a dominant global financial cycle triggered by the economic centre’s monetary policy (namely that of the United States), which influences other countries’ national monetary policies mainly through capital-flows, credit growth, and bank leverages, making the types of exchange rate regime of the non-centre irrelevant. But as I have argued above, predicting the end of the dilemma was maybe pre-mature in the case of large advanced economies.

¹ See Rey, H. (2013) “Dilemma not Trilemma: The Global Financial Cycle and Monetary Policy independence”, paper presented at the 25th Jackson Hole symposium, Wyoming, August 2013. Mundell (1963) outlined the hypothesis of the monetary trilemma as a policy trade-off between the choices of monetary autonomy, exchange rate stability, and financial openness. See Mundell, R. A.: “Capital Mobility and Stabilization Policy under Fixed and Flexible Exchange Rates”, *The Canadian Journal of Economics and Political Science*, Vol. 29, No. 4 (November, 1963), pp. 475–485.

The lesson from our recent experience is that central banks in large advanced economies can free themselves from the global financial cycle and regain monetary independence, provided that they show clarity in purpose and resolve in implementation.

For emerging markets and smaller advanced economies, there is also evidence that while the global financial cycle has indeed been a dominant factor for the last two decades, the arrangement of open macro policies such as the exchange rate regime and financial openness still have direct influence on sensitivity to the financial cycle².

Explaining the difference in this respect between large advanced economies and EMEs would take us far beyond today's discussion. Let me only suggest that the existence of deep, diversified local currency denominated capital markets makes a crucial difference to help decouple from the global financial cycle. This incidentally suggests that Capital Market Union as it is currently planned in Europe, on top of its allocative benefits, can help strengthen our economic and monetary independence.

The global exchange rate adjustments should be therefore seen as a natural by-product of such move towards monetary policy independence and divergence. While the exchange rate is not a policy target for the ECB, it is nonetheless important for growth and price stability. Also, the exchange rate movements we have seen over the past few months are not unprecedented relative to the experiences of other major central banks with regards to announcements of quantitative easing policies (such as QE2 and QE3 in the United States and QQE in Japan, as well as the Bank of England's APF).³

This notwithstanding, global policymakers need to be mindful that global monetary policy divergence can also lead to some tensions that are due to global monetary policy spillovers. Many discussions in the context of global monetary divergence have centred on the issue of monetary policy spillovers and the exposure of emerging market economies to volatile capital flows.

Yet, as I have argued elsewhere⁴, there is no broad international consensus on the size and persistence of such spillovers.⁵ More generally, there is little evidence that capital flows to emerging markets have been excessively volatile over most recent years, contrary to what is often claimed. They have been strong since the global financial crisis, decreased somewhat

² See Aizenman, J., Chinn M. and Ito. H, (2015) "Monetary Policy Spillovers and the Trilemma in the New Normal: Periphery Country Sensitivity to Core Country Conditions", NBER Working Paper No. 21128, April 2015.

³ QE 1 which was implemented at the height of the financial crisis was followed by a sharp appreciation of the US dollar. Similarly, the euro appreciated after the announcement of outright monetary transactions (OMT). In both cases the main channel of transmission was a reduction of (global) risk aversion.

⁴ See "Policy coordination in a multipolar world", remarks by Benoît Cœuré, Member of the Executive Board of the ECB, 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.

⁵ See also Chen, Q., Filardo, A., He, D. and Zhu, F., "International Spillovers of Central Bank Balance Sheet Policies", Working Papers, Bank for International Settlements, November 2011. It studies the macroeconomic effects of US QE on 17 advanced and emerging economies in the period from 2007 to 2013. The authors find that the estimated effects of US QE on the emerging economies – while quite diverse across countries – are in many cases larger than those in the advanced economies, including the United States. In the case of the ECB's unconventional monetary policy, international spillovers are likely to be more limited, however – at least the empirical evidence available so far suggests that it did not lead to international portfolio rebalancing across regions and assets. This may, however, have changed after the launch of the PSPP. See also Fratzscher, M., Lo Duca, M. and Straub, R., "ECB Unconventional Monetary Policy Actions: Market Impact, international Spillovers and Transmission Channels", paper presented at the 15th Jacques Polak Annual Research Conference hosted by the International Monetary Fund, 13-14 November, 2014; and Georgiadis, G. and Gräßl, J., "Global Financial Market Impact of the Announcement of the ECB's Extended Asset Purchase Programme", Working Papers, No 232, Federal Reserve Bank of Dallas Globalization and Monetary Policy Institute, March 2015.

during the taper tantrum in 2013 and do not appear to have been markedly influenced by recent signals by the Federal Reserve towards monetary policy normalisation. With regard to the PSPP, there is also no evidence that recent ECB measures have led to increased international portfolio re-balancing from the euro area to emerging market economies.

While we need to keep an eye on international spillovers, it is not clear whether monetary policy coordination would lead to a superior outcome. In particular, from a theoretical perspective, it is not clear whether an optimal domestically oriented monetary actually leads to more international spillovers.⁶

As recently argued by Charles Engel, research on monetary policy coordination is too scarce to draw any firm conclusions⁷. In particular, it is not clear whether the optimal non-cooperative policy leads to more spillovers than would occur under a cooperative policy. In addition, examples of successful co-ordination in the real world are few and limited to exceptional crisis times as documented in an IMF study by Ostry and Gosh (2013)⁸, quite apart from the political and institutional obstacles to such co-ordination, starting with the fact that central banks have domestic, not global mandates.

But taking a sceptical view of formal policy coordination does not imply that the central banks of the large advanced economies should not be mindful of the consequences of their actions. This brings to mind two policy consequences. First, clear and consistent communication is of the essence. Forward guidance has proven relevant and useful and it remains a valuable asset in today's uncertain environment. Second, knowledge of monetary policy spillovers can be enhanced. At the ECB, we are still learning about the transmission channels of our asset purchase programme and their international consequences. And the extent to which the spillovers from this programme to EMEs will offset those from US monetary policy normalisation is yet to be understood. There remains much to be learnt by the global central bank community when it comes to monetary policy spillovers.

Domestic spillovers

Turning to domestic spillovers, another question that has frequently been raised after unconventional policies were launched is whether they are prone to create financial stability risks in general and asset price bubbles in particular. Some have even argued that asset price bubbles were necessary condition for economic recovery in the early 2000s.⁹ So, are bubbles an unintended consequence of unconventional monetary policies that we should live with?

First of all, monetary policy always has unintended consequences, no matter where it is pursued. By altering short-term interest rates, central banks affect the inter-temporal decisions of households. Inter-temporal redistribution is at the heart of monetary policy that is aimed at ensuring price stability, and it thus has effects on the income distribution of savers and spenders.

But monetary policy also affects the distribution of income along the intra-temporal and spatial (cross-country) dimension. Changes in short-term interest rates affect consumption, savings and wealth in different ways, depending on the characteristics of individual

⁶ See in particular the seminal paper by Obstfeld, M., and K. Rogoff (2002), "Global implications of self-oriented national monetary rules," *Quarterly Journal of Economics*, Vol. 117, No 2, pp. 503–35.

⁷ See Engel, C. "International Coordination of Central Bank Policy", NBER Working Paper 20952, February 2015. <http://www.nber.org/papers/w20952.pdf>

⁸ See Ostry, J.D. and Gosh, A.R. "Obstacles to International Policy Coordination, and How to Overcome Them, International Monetary Fund Staff Discussion Note, SDN 13/11, December 2013.

⁹ Summers, L. (2014), "U.S. Economic Prospects: Secular Stagnation, Hysteresis, and the Zero Lower Bound", *Business Economics* 49(2).

households in different jurisdictions. But all these effects can be considered temporary, indirect and unintended, i.e. a side effect of a strategy that is aimed at ensuring price stability in the economy.¹⁰

That said, it would be a logical fallacy to conclude that all domestic spillovers are acceptable. Bubbles are a case in point. Bubbles are a possible, but not an inevitable result of unconventional monetary policies. And if they are welcome at all, then only in a severely constrained, second-best world. But in this case, we should ask ourselves how we can overcome the constraints that prevent better policy outcomes, rather than settling for bubbles to temporarily mask the constraints.

Let me elaborate.

Facing the threat of a persistent low-growth and low-inflation environment and a binding floor on standard policy rates, many central banks have resorted to unconventional measures. These measures were aimed at further pushing down nominal interest rates along the maturity spectrum to track the secular decrease in the natural, “Wicksellian” real rate of interest. Thereby, they helped induce firms and households bring forward their investment and consumption spending in comparison with that in a no policy-change scenario and, ultimately, bring the natural rate back to more normal levels.

I am convinced that there is no alternative for us than acting this way in order to deliver on our mandate. Yet, there is a danger associated with the temporary, yet potentially extended period where low interest rates are needed to stimulate investment and consumption. With real interest rates below potential growth, private agents may just borrow to purchase assets in limited or rigid supply (e.g. real estate property). In this dynamically inefficient¹¹ world with structurally weak growth prospects, this may actually become an attractive way for savers to generate returns on their savings that investments in the productive sector are unable to generate.

In this case, we end up with a “rational bubble”, which – as you will have noticed – follows the dynamics prominently highlighted by Jean Tirole¹². While unconventional monetary policy is not a necessary condition for this type of bubble to emerge, it may render it more likely – and more violent in the event of its materialising.

So what are the consequences of such bubble?

In the short-term, it may indeed generate a temporary boost to the economy. And for a while this boost would be difficult to distinguish from the regular workings of asset purchase programmes, which actually embed asset price increases as a desired effect, which passes on the initial impulse to broader financing conditions via portfolio rebalancing.

But this boost would ultimately be very costly. Not only does it come with welfare-decreasing macroeconomic instability, but it also brings about an arbitrary redistribution of wealth that may, in the worst case, undermine social cohesion and trust that the central bank is acting within its narrow price stability mandate. And moreover, it can create financial stability risks elsewhere, generating negative spillovers from what should otherwise be a normal international adjustment process.

Against this background, it would be wrong to treat bubbles as a welcome replacement therapy to a sustainable growth model. Instead, macroeconomic and structural policies have

¹⁰ See “Monetary policy in a fragmented world”, speech by Benoît Cœuré, at the 41st Economics Conference of the Oesterreichische Nationalbank, Vienna, 10 June 2013.

¹¹ Constellations of dynamic inefficiency imply, from a long-run perspective, that the real growth rate exceeds the real interest rate on physical capital.

¹² Tirole, J. (1985): “Asset Bubbles and Overlapping Generations” *Econometrica*, Vol. 53, No. 6 (Nov., 1985), pp. 1499–1528.

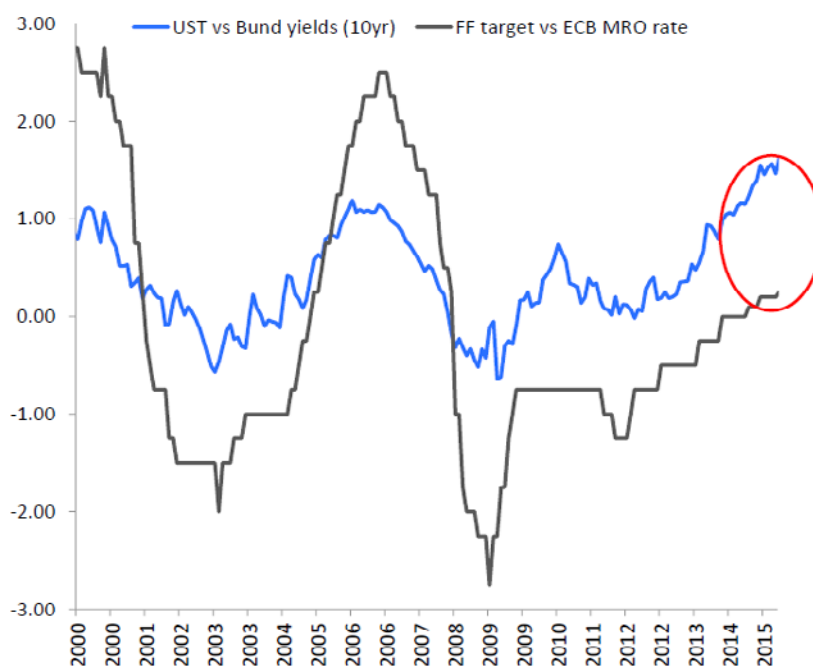
to set the necessary conditions so that investment in productive sectors becomes attractive again and investment in bubble-prone areas is discouraged, so that total factor productivity is increased and the natural rate of interest ultimately reverts to what is normal.

These principles underlie our views on the right policy mix for the euro area.

We take monetary policy decisions with a view to attaining our primary objective of price stability. Thereby, we establish a stable nominal anchor for the private sector, which in turn is a fundamental precondition for overall macroeconomic stability.

Without prejudice to this objective, we take financial stability risk seriously and monitor closely whether severe imbalances are emerging in the financial sector. In this context, we consider the financial stability risks related to our policy measures to be contained. Should risks emerge, macro-prudential policy is best suited to safeguard financial stability. Macro-prudential instruments can be targeted more efficiently to those sectors and countries where systemic risks may be materialising¹³. Finally, we encourage national authorities to do whatever is in their power to place the euro area on a more dynamic growth path, thereby creating attractive investment projects that generate high, but fundamentally justified, returns. These are the conditions for unconventional monetary policies to bring economies back to a stable and sustainable growth path, both at home and abroad.

Chart 1: Long-term and short-term interest rate differentials



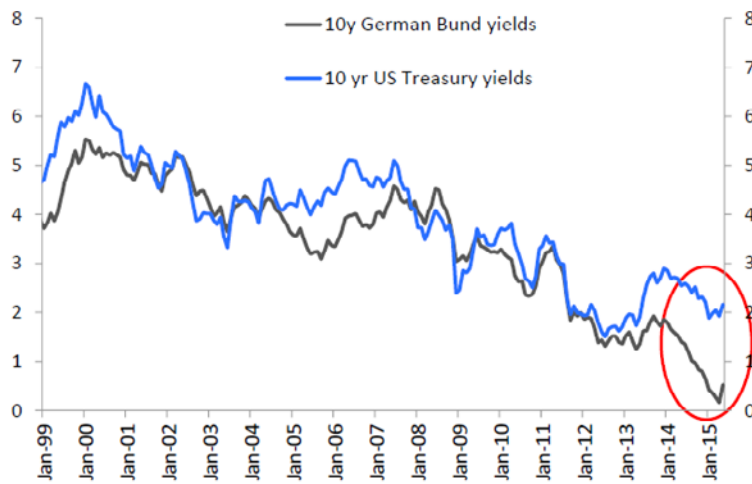
Source: Bloomberg.

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¹³ "Reinforcing financial stability in the euro area", speech given by Vítor Constâncio, Vice-President of the ECB, at the OMFIF City Lecture, London, 8 May 2015.

Chart 2: 10Y interest rates

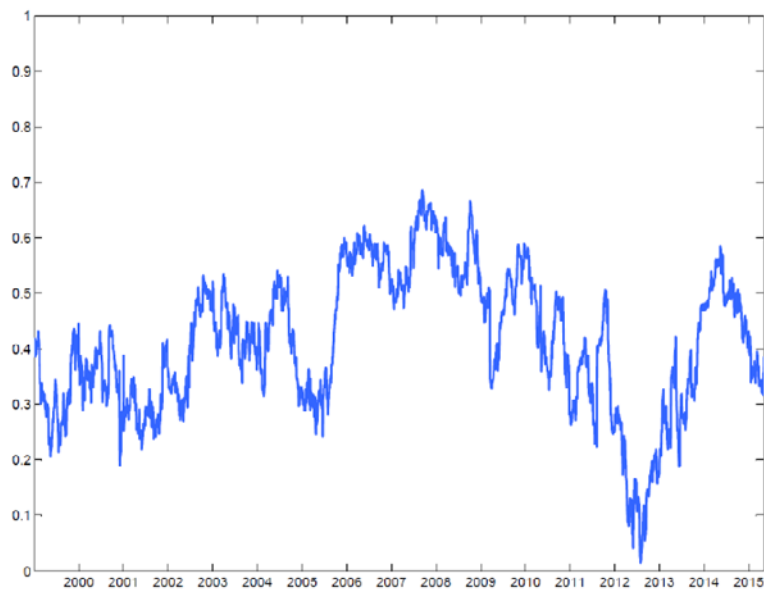


Source: ECB, US Federal Reserve

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Chart 3: DCC time-varying correlation of 10yr Bund and Treasury yields



Source: Datastream and ECB staff calculations based on Engle (2002) using daily data, last observation 8 May 2015

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