SUMMARY

Part 1. – International coordination of monetary policies – concepts and consequences

1. The assumed negative impact of exchange rate volatility on foreign trade and employment is frequently used as justification for international monetary coordination efforts. Our analysis indeed identifies such a negative impact for the labour markets in both the US and – due to largely more rigid structures – in the euro area.
2. However, we consider this finding insufficient to warrant international monetary policy coordination in an environment of "excessive" volatility. To the extent that a rule-based monetary policy delivers higher growth and employment than a discretionary policy, the gains to be derived from coordination would decline substantially.
3. Increased global financial integration diminishes the gains from policy coordination. As economic conditions overseas become increasingly important in setting domestic policies, the incentive to enact a "beggar-thy-neighbour" policy declines, even in the case of no coordination.
4. It should be noted that the relation between monetary policy and exchange rate volatility is complex and non-linear in nature. As a result, it is difficult to determine the monetary policy necessary to reduce exchange rate volatility to a predetermined level. That said, the ECB should not assign a role to the EUR/USD exchange rate other than that of a variable in the second strategy pillar.

Part 2. – Does the ECB follow the US Fed?

1. There is a widely held believe that the ECB has followed the US Fed in setting interest rates. Our empirical analysis, however, paints a different picture: there is no systematic evidence supporting the hypothesis of the ECB tracking the Fed. Other than making parallel moves in times of crises, the ECB has pursued an independent policy.
2. The differences in the central banks' objectives can be seen to support this finding: whereas it is the Fed's aim to deliver maximum employment and stable prices, the ECB's primary objective is maintaining price stability.
3. Furthermore, there are marked differences in monetary policy: whereas the Fed pursues a business cycle-oriented approach, the ECB tends to pursue a more trend-oriented policy.
4. It should be noted that periods of parallel changes in short-term rates cannot *per se* be interpreted as evidence for policy coordination; both central banks appear to have reacted in a similar way to shocks hitting the financial markets.

Part 3. – Stock prices – a challenge for central banks

1. Our analysis suggests that increases in stock market returns exert a slightly, albeit temporary, positive impact on output, whereas an increase in stock market volatility has a slightly, again temporary, negative impact.
2. However, these findings do not lead us to recommend that the ECB should react to changes in stock market valuations, for at least three reasons: central banks (i) cannot influence stock prices according to pre-determined policy goals; (ii) lack knowledge on the correct valuation level; and (iii) may provoke the "moral hazard" problem simply by pledging to support stock markets through monetary policy actions.
3. In view of insufficient data on the price level of the economies' total stock of wealth and weighing the costs and benefits of taking stock markets into account when setting monetary policy, a credible, price stability-oriented monetary policy appears to be the dominant strategy.

Part 4. – ECB monetary policy – review and outlook

1. In the euro area, the velocity of money has declined markedly so that the money overhang has not yet spilled over into output and price increases. Given a trend-stable money demand function, however, price effects have to be taken into account. Our P-star model forecasts inflation to rise towards 2.5% by the end of 2003.
2. In view of the weakness in the euro area's growth rates, calls for an easier monetary policy can be expected to continue. However, further rate cuts, and thus increases in credit and money supply, should be incompatible with keeping future price level rises in line with the ECB's envisaged inflation paths.
3. Excessive easing is unlikely to be in the interest of a stability-oriented monetary policy: it could well remove economic incentives to encourage badly needed reforms, potentially adding to the costs of reversing the structural growth decline. Ultimately, this could be expected to provoke even louder calls for lower interest rates.