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Policy Coordination Among Central Banks

Remarks by

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at the

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The Euro at Ten: Lessons and Challenges

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I am pleased to be here in Frankfurt today to celebrate the 10th anniversary of the euro. The euro's introduction was a remarkable achievement. As an academic, I did a bit of consulting for the European Monetary Institute, the European Central Bank's (ECB) predecessor, on monetary transmission mechanisms; I thus played a part, albeit an extremely small one, in this grand project. I mention this only as a reminder that the creators of the euro drew on monetary expertise from around the world, an early example of the international cooperation that has since proven to be one of the hallmarks of the ECB. Indeed, the run-up to the euro's establishment and the experience of the past decade have been associated with an unprecedented degree of policy coordination among the sovereign states within the euro area, including cooperation in the areas of fiscal and regulatory policies as well as monetary policy.

The current financial crisis and global economic slowdown likewise have been an occasion for unprecedented international policy coordination, within Europe but also globally. For example, in its regulatory capacity, the Federal Reserve has worked closely with regulators and supervisors from a number of European nations, and we are active participants in the international Financial Stability Forum and the standard-setting bodies operating under the aegis of the Bank for International Settlements. My focus today, however, will be cooperation in monetary policy and, especially, in the meeting of the liquidity needs of our increasingly globalized financial markets.

As you know, financial markets remain under severe strain. The proximate cause of the financial turmoil was the end of the U.S. housing boom and the attendant losses on mortgages and mortgage-related assets by many institutions. However, more fundamentally, the turmoil was the product of a global credit boom, characterized by a

broad underpricing of risk, excessive leverage by financial institutions, and an increasing reliance on complex and opaque financial instruments that have proven to be fragile under stress. The unwinding of this boom (and the associated financial losses) has led to the withdrawal of many investors from credit markets and deleveraging by financial institutions, both of which have acted to constrict available credit to households and businesses. This credit squeeze is, in turn, a principal cause of the economic slowdown now taking place in many countries.

Central bankers have been working closely together throughout this period of financial turmoil. Personally, I have found the opportunity to share views regularly with President Trichet and other leading central bankers at various international meetings extremely valuable. We are all in frequent contact by phone as well. Our consultations allow us to keep abreast of developments in other countries, to compare our analyses of developing trends, and to draw on each other's experience and knowledge.

The merits of coordinated monetary policies have been discussed by policymakers and academics for decades, but in practice, such coordination has been quite rare. However, on October 8, the Federal Reserve announced a reduction in its policy interest rate jointly with five other major central banks--the Bank of Canada, the Bank of England, the ECB, Sveriges Riksbank, and the Swiss National Bank (SNB)--with the Bank of Japan expressing support. Last month's joint action was motivated by the abatement of inflationary pressures and increased indications of economic slowing in our respective economies. In addition, the coordinated rate cut was intended to send a strong signal to the public and to markets of our resolve to act together to address global economic challenges.

As you know, however, monetary policy actions have not resolved the ongoing strains in financial markets, including interbank funding markets. The Federal Reserve has responded to the strong demand for funding by banks and primary dealers by dramatically increasing the amount of term funding that it auctions to banks, providing new lending facilities for nonbanks, supplying high-quality securities for use in repurchase agreement (repo) markets and for other collateralized lending, and funding purchases of commercial paper. Elsewhere, including Canada, the euro area, and the United Kingdom, central banks have introduced or expanded similar measures to boost the provision of liquidity in their local currencies. In addition to these measures, governments in many countries broadened deposit insurance coverage and announced plans to inject capital into their banking systems and to guarantee bank debts. All of these steps are consistent with the principles agreed to by the Group of Seven finance ministers and central bank governors in their October 10 communiqué.

Although the range of mechanisms we have used has been broad, our provision of liquidity conforms to a central bank's traditional role as the lender of last resort. However, a novel aspect of the current situation is that the balance sheets of financial institutions have increasingly come to include instruments denominated in foreign currencies. The need for currencies outside an issuing country's markets arises primarily from the global role played by key international currencies, such as the dollar and the euro. For example, over the past decade, international loans and deposits have grown tremendously, as has the issuance of international debt securities--that is, bonds, notes, and money market instruments sold outside the borders of the borrower's country and sometimes denominated in foreign currencies. These developments have posed new

challenges for conventional central bank liquidity and lender-of-last-resort policies. For example, injecting euros or sterling into national money markets may not be sufficient to restore market function in these economies when funding shortages are in dollars.

Indeed, a significant feature of the recent financial market stress is the strong demand for dollar funding not only in the United States, but also abroad. Many financial institutions outside the United States, especially in Europe, had substantially increased their dollar investments in recent years, including loans to nonbanks and purchases of asset-backed securities issued by U.S. residents.¹ Also, the continued prominent role of the dollar in international trade, foreign direct investment, and financial transactions contributes to dollar funding needs abroad. While some financial institutions outside the United States have relied on dollars acquired through their U.S. affiliates, many others relied on interbank and other wholesale markets to obtain dollars. As such, the recent sharp deterioration in conditions in funding markets left some participants outside the United States without adequate access to short-term dollar financing.

The emergence of dollar funding shortages around the globe has required a more internationally coordinated approach among central banks to the lender-of-last-resort function. The principal tool we have used is the currency swap line, which allows each collaborating central bank to draw down balances denominated in its foreign partner's currency. The Federal Reserve has now established temporary swap lines with more than

¹ See Patrick McGuire and Goetz von Peter (2008), "International Banking Activity amidst the Turmoil," *BIS Quarterly Review*, June; also see ECB (2008), "The International Role of the Euro," July, www.ecb.int/pub/pdf/other/euro-international-role200807en.pdf. The ECB report noted that investment banks based in the United States and financial institutions based in the United Kingdom have been among the top non-euro-area issuers of euro-denominated bonds; it also said that banks in Europe and some firms located mainly in the United Kingdom with business concentrated in the securitization of residential mortgages have been among the top non-U.S. issuers of dollar-denominated bonds.

a dozen other central banks.² Many of these central banks have drawn on these lines and, using a variety of methods and facilities, have allocated these funds to meet the needs of institutions within their borders.³ Although funding needs during the current turmoil have been the most pronounced for dollars, they have arisen for other currencies as well. For example, the ECB has set up swap lines and repo facilities with the central banks of Denmark and Hungary to provide euro liquidity in those countries. The terms of many swap agreements have been adjusted with the changing needs for liquidity: The sizes of the swaps have increased, the types of collateral accepted by these central banks from financial institutions in their economies have been expanded, and the maturities at which these funds have been made available have been tailored to meeting the prevailing needs. Notably, in mid-October, the Federal Reserve eliminated limits on the sizes of its swap lines with the ECB, the Bank of England, the SNB, and the Bank of Japan so as to accommodate demands for U.S. dollar funding of any scale. Taken together, these actions have helped improve the distribution of liquidity around the globe.

This collaborative approach to the injection of liquidity reflects more than the global, multi-currency nature of funding difficulties. It also reflects the importance of relationships between central banks and the institutions they serve. Under swap agreements, the responsibility for allocating foreign-currency liquidity within a jurisdiction lies with the domestic central bank. This arrangement makes use of the fact that the domestic central bank is best positioned to understand the mechanics and special features of its own country's financial and payments systems and, because of its existing

² The central banks include those in Australia, Brazil, Canada, Denmark, the euro area, Korea, Japan, New Zealand, Mexico, Norway, Singapore, Sweden, Switzerland, and the United Kingdom.

³ Some other countries with extensive accumulated stocks of dollar reserves have made these dollars available in their economies through auctions and regional arrangements.

relationships with domestic financial institutions, can best assess the strength of each institution and its needs for foreign-currency liquidity. The domestic central bank is also typically best informed about the quality of the collateral offered by potential borrowers.

The efforts by central banks around the world to increase the availability of liquidity, along with other steps taken by central banks and governments, have contributed to tentative improvements in credit market functioning. However, the continuing volatility of markets and recent indicators of economic performance confirm that challenges remain. For this reason, policymakers will remain in close contact, monitor developments closely, and stand ready to take additional steps should conditions warrant. In times like these, we are especially aware of the importance of having close working relationships with our central bank colleagues around the world. These relationships are fostered by the ties established in forums like this one and in the many venues where policymakers regularly gather.

The 10th anniversary of the euro is an opportunity not only to celebrate an impressive and historic achievement, but also to reaffirm our commitment to cooperation as we address the challenges of an increasingly integrated global economy. Central bankers and other policymakers around the world must continue to work together to address disruptions in credit markets and to promote a vibrant global economy.