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Editorial

International dimensions of conventional and unconventional monetary policy

1. Introduction

At the risk of oversimplification, following the initial phase of the Global Financial Crisis (GFC), advanced economies can be characterized as experiencing subpar economic growth with high public debts restraining fiscal stimulus. Facing very low inflation, monetary authorities in many countries have seen the need to introduce extraordinary measures. One visible manifestation of the unprecedented monetary policy responses is the sharp increase in the size of the balance sheets of the Federal Reserve, Bank of England, Bank of Japan and the ECB. The international repercussions of these unconventional monetary policies are not yet well understood. What are the international effects? Through what specific channels do the spillovers arise? Are the spillovers beneficial or harmful? Would there be benefits from international coordination of monetary policy?

The papers in this special issue explore these and other issues related to international dimensions of conventional and unconventional monetary policy. The seven papers were selected from those presented at the ECB-IMF Conference "International dimensions of conventional and unconventional monetary policy" held in Frankfurt am Main in April 2014.

2. Monetary policy coordination: perhaps desirable. . .but complicated

The GFC prompted a rethinking of monetary policy, spillovers and international coordination. In three keynote articles, Coeuré, (2015), Engel (2015), and Ostry and Ghosh (2015) cover a range of theoretical and empirical issues while presenting insights on monetary policy coordination. The three keynote contributions highlight the roles of financial and uncertainty shocks and frictions that were previously not emphasized.

2.1. Theoretical insights

The issue of monetary policy spillovers has been analyzed for quite some time. As Cœuré notes, the question was mentioned in the 18th century by David Hume in *Essays, Moral, Political, and Literary*. Since the mid-1980s, theoretical models have rigorously analyzed the international spillovers of monetary policy and reviewed the case for (and against) monetary policy coordination. In the more applied world, many multi-country models have addressed this issue over the last few decades (see Taylor, 2013 for a recent review in the context of the basic Mundell–Fleming model and the empirical

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findings of recent multi-country models). More recently, however, new elements have been introduced in analytical models of monetary policy, the implications of which have yet to be extended to international settings and incorporated in empirical analyses, let alone in policy-making.

As Engel reviews, the theoretical New Keynesian literature has long identified the role of real factors in driving monetary policy spillovers. Distortions typically included in New-Keynesian models are price stickiness, monopolistic competition, and pricing to market (see further the Corsetti et al., 2010 review and Engel, 2011). All three keynote contributions highlight, however, that when one calibrates these types of models to real world circumstances, spillovers from countries pursuing national macroeconomic stability tend to be small, suggesting limited scope for international cooperation.

Engel notes that the limited spillovers identified in the literature may have been due in part to the type of shocks considered, which, consistent with the modeling approach, were mostly cost push and productivity shocks. Recent models have included shocks to investment or preferences, as well as news and uncertainty shocks. While recent models can in principle lead to greater spillovers, few have been calibrated meaningfully, let alone used to consider the implications for policy coordination.

Another set of recent theoretical papers, inspired largely by the GFC, focuses on the effects of the zero lower bound (ZLB) and related unconventional monetary policy actions, such as Quantitative Easing (QE). In the presence of the ZLB, spillovers can be larger than in normal times and the gains from monetary policy coordination possibly greater (Cook and Devereux, 2013). A related hypothesis is a greater need of coordination when monetary policies are constrained by the ZLB (as well as some additional value from using macro-prudential policies; see Jeanne, 2014).

Both Cœuré and Engel note that important theoretical challenges remain, especially related to the role of financial globalization. Earlier papers on monetary policy spillovers largely assumed complete and perfect international financial markets. The GFC made abundantly clear, however, that international financial markets do not always operate as perfectly as assumed in many models. More recently, papers have modeled various forms of financial market incompleteness and integration. With the financial integration that has occurred over the past decades, both in terms of more countries being financially integrated and a larger flow and stock of international claims/assets, questions on how these deficiencies and developments affect spillovers are very relevant. Here, the analytical literature points to opposing effects.

Traditional models assume that increased financial integration improves market completeness and risk-sharing. If that enables greater diversification and insurance opportunities, adverse spillovers from monetary policy are less likely and the need for international coordination is correspondingly smaller. But theory also makes clear that in the presence of imperfections there can be offsetting effects of (increased) financial globalization. Depending on the exact form of incompleteness, results on the nature, degree and effects of international spillovers vary. Clearly, countries in financial autarky are less impacted by foreign monetary policy changes through direct financial channels, while financially open countries are more exposed. The form of financial integration, whether through equity markets or bond markets alone, or through both, can also matter. Finally, regarding the economic cost and benefits, the more general principle applies: if there is more than one distortion, removing or lessening only one does not necessarily lead to an improvement.

Theoretical advances to shed light on these trade-offs have focused on various financial frictions, which also help to clarify the channels through which spillovers may occur. Notably the roles of balance sheets and currency mismatches have received much attention. Here most work has focused on the small open economy case (Ostry and Ghosh as well as Engel review some key papers) and thus addressed mostly spillovers, but less so the issue of international coordination. A related strand of models analyzes how international shocks, including from changes in monetary policy in key financial centers, can lead to adverse effects because of externalities arising in financial markets, mainly related to asset prices and large capital flows.[1] While again rarely analyzing the issue of international cooperation versus non-cooperation, these sets of papers do highlight that countries are not likely able to manage their economies optimally using just monetary policy and fiscal policy in the face of changes in global monetary policy conditions, suggesting roles for macro-prudential and capital flow management policies.

[1] Somewhat related is the literature on the real effects of currency movements, i.e., Dutch disease and infant industry arguments.