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The internationalisation of monetary policy

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ABSTRACT

The case for formal central bank cooperation remains limited, and practical considerations make its implementation difficult. That being said, central banks need to be engaged in a constant dialogue so as to remain ready for rapid coordinated action in exceptional circumstances. Also, they should strive to strengthen the global financial safety nets within their monetary policy mandates so that they can better address global or regional liquidity crises, thereby limiting the case for self-insurance.

1. Introduction

The discussion about the international dimensions of monetary policy is not a new topic: the literature has built up throughout the last century, and stretches back as far as David Hume and the price-specie flow mechanism. Yet, the current environment raises several fresh issues that warrant renewed attention. What is new, in particular, is that central banks in advanced economies have adopted highly accommodative monetary policies, using quantitative easing and other unconventional measures, while interest rates are close to the effective lower bound. This has revived the debate on the channels for monetary policy spillovers, both among advanced economies and from advanced to emerging economies. For example, the rise in longer term interest rates in the US before the summer of 2013 was correlated with upward pressure on forward rates in the euro area. This led the ECB to engage in forward guidance, quite successfully in my view, as evidenced by the decoupling between US and euro area forward money market rates. The volatility in capital flows to and from emerging economies in 2013 was also mainly related to the “taper tantrum”, i.e. expectations of a tighter US monetary policy – although a number of studies have shown that countries with lower external imbalances experienced less capital flow volatility (Eichengreen and Gupta, 2014). At the same time, ECB policy has also generated spillovers particularly on neighbouring economies such as Denmark or Switzerland.

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In the light of these events, there have been claims that *ex ante* monetary policy coordination would be less disruptive in terms of capital flows. The argument goes that individual countries cannot insulate themselves from monetary policy actions in other jurisdictions, or that they can only do so by accepting costly trade-offs. Thus policy coordination has become mutually optimal. In this article, I would like to reflect on whether this argument holds. I will first elaborate on the theory of institutionalised coordination, and will then discuss why it is almost never applied in practice. I will conclude with some suggestions for how international monetary policy coordination could be improved without overhauling it fundamentally.

2. Coordination in theory

What does theory tell us about the need for central bank coordination? Models have existed for decades showing that national policy-makers who blindly pursue domestic objectives may reach a collectively suboptimal Nash equilibrium. Under these assumptions, international policy coordination is necessary to reach an optimal equilibrium. Yet, this hardly settles the debate. Quantitative studies before the crisis suggested that domestically optimal policies could lead, under normal circumstances, to an equilibrium that is very close to the global optimum (Obstfeld and Rogoff, 2002). According to these findings, policies aimed at national macroeconomic stability could also produce international macroeconomic stability. The intuition behind this is that central banks have sufficient tools to neutralise the adverse impact of disturbances abroad without compromising their domestic policy targets. If business cycle fluctuations could be reduced by targeting medium-term inflation, one instrument (the short term nominal interest rate) would be sufficient to offset foreign shocks while maintaining price stability. This is an example where the policy trade-off is limited. Indeed, the workhorse new open-economy model describes a benign environment with limited policy trade-offs and moderate macroeconomic interdependence across countries.

In light of the recent crisis, more research is warranted to assess whether these findings still hold. The reality of monetary policy spillovers is more complex. Nevertheless, we need to see evidence of *large* policy trade-offs and *large* cross-border effects, matched by a paucity of monetary policy instruments, to conclude that monetary policy with a domestic focus creates large losses (Blanchard et al., 2013). Only under these circumstances is formal monetary policy coordination, at least in the light of the research mentioned above, likely to lead to significantly better outcomes.

One factor that could alter the magnitude of trade-offs and spillovers – and hence require greater central bank coordination – is globalisation. The world economy has achieved an unprecedented degree of economic and financial integration. Are the benefits of coordination increasing in a monotonic fashion with economic and financial integration? The studies on this topic are in my view not conclusive so far. Some argue that trade and financial integration strengthens the impact of foreign shocks through exchange rate and asset price channels (Coenen et al., 2009; Dedola et al., 2013). There is also evidence of a global financial cycle characterised by large common movements in asset prices, gross flows and leverage (Rey, 2013). As a result, everything else being equal, a higher level of globalisation calls for a higher degree of policy coordination. Others argue, however, that globalisation allows for further diversification and insurance opportunities such that the impact of foreign shocks in fact diminishes. As a result, it is easier to achieve domestic targets and the need for coordination falls (Edmond et al., 2012; Hoxha et al., 2013). In general, it is difficult to predict which of these effects will dominate. Globalisation may equally foster the creation of new markets and means of financial risk-sharing, but it may equally bring about new types of shocks and new channels of transmission. The euro area is a case in point. During its short history, the European monetary union has already provided evidence of both the former and the latter effects, before and after the crisis respectively.

What is more, it is not necessarily the case that all economic policies will be equally affected by globalisation. It may well be the case that globalisation increases the need for cooperation on longer-term structural policies, yet reduces the need to coordinate short-term stabilisation policies. For example, in the financial domain, cooperation may shift from traditional stabilisation-oriented interest rate policies, and their cross-border spillovers on exchange rates and capital flows, towards an implementation of financial regulatory reform that maintains open and well-functioning international capital markets, avoiding financial fragmentation, excessive risk taking and volatile capital movements. This would