The Federal Reserve in a Globalized World Economy

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What Monetary Theory Tells Us

- Economic research (at least since 1980s)
  - rules-based monetary policy leads to good economic performance in a globalized world economy
- Empirical multi-country monetary models with
  - highly integrated international capital markets
  - no-arbitrage conditions in the term-structure
  - forward-looking expectations
  - price and wage rigidities

Historical Validation of Theory

- Central banks moved toward more transparent rules-based policies in 1980s, 1990s
  - including through a focus on price stability
- Dramatic improvement compared with 1970s when policy was highly discretionary and unfocused.
- Mervyn King called it the NICE period
- But also a near internationally cooperative equilibrium (NICE)
- So Twice-NICE or NICE-squared.
- Eventually many emerging market countries joined
  - Including through Inflation targeting
  - Performance improved & contributed to global stability

But Then Situation Worsened

- The end of NICE in both senses of the word.
- Great Recession & Not-So-Great Recovery
- Large negative international spillover effects
- Emerging market countries vehemently complain
- Developed countries—Japan and Europe—express concerns about exchange rate effects.
- Small open economies take unusual actions
- Increased volatility of capital flows

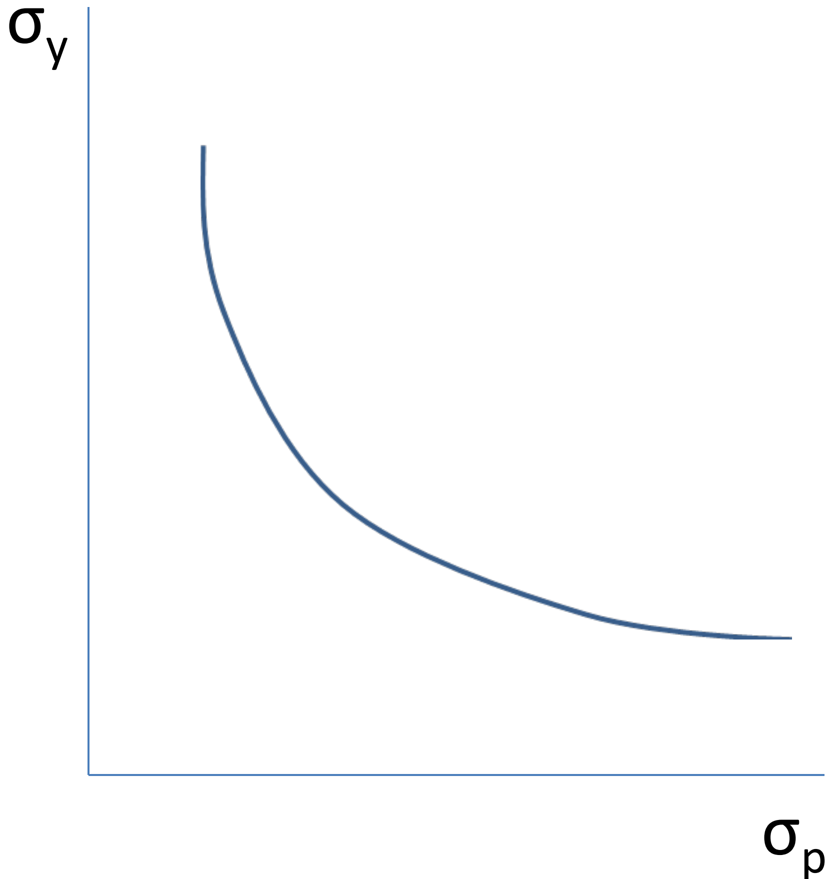
Calls for a New Approach

With “memories of a more orderly, rule-based world” Paul Volcker (June, 2014) asks:

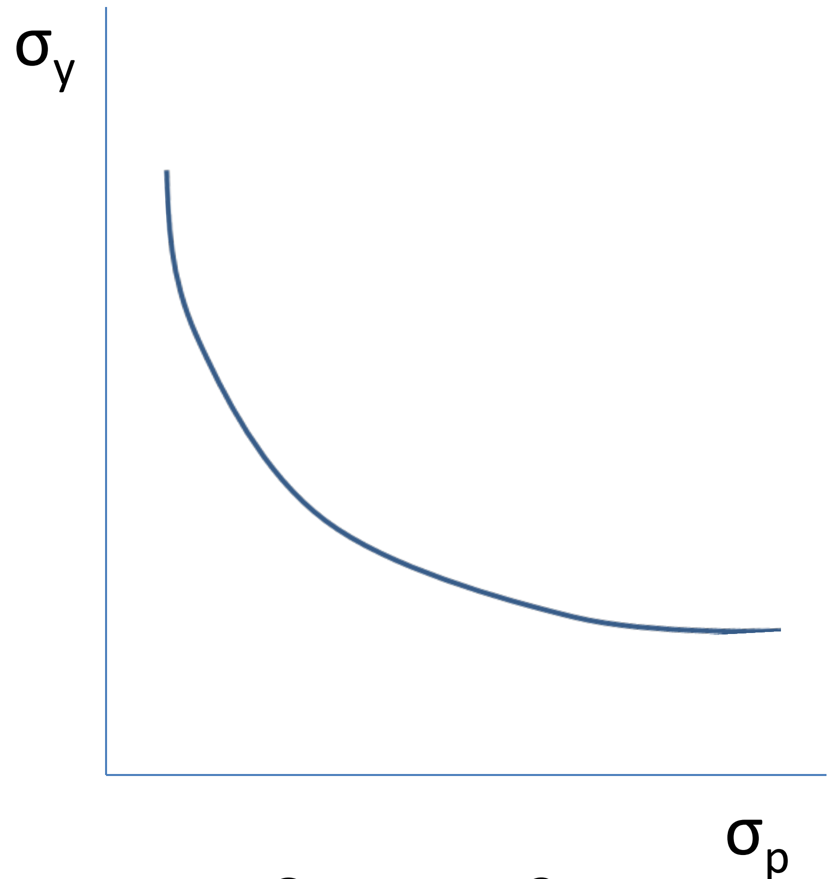
“What is the approach (or presumably combination of approaches) that can better reconcile reasonably free and open markets with independent national policies, maintaining in the process the stability in markets and economies that is in the common interest?”

The Problem

- Policy deviating from steady-as-you-go rule-like policies:
- History shows two big shifts
- Shift 1: Detected by Clarida, Gali, and Gertler, and later confirmed by others
- Shift 2: Detected by many, confirmed by Kahn, Taylor, others
  - A decade ago—*before* the financial crisis—too low too long
- Both shifts:
  - Econometrics: Nikolsko-Rzhevskyy, Papell, Prodan
  - History: Meltzer
- “Global Great Deviation” Ahrend, Hofmann & Bogdanova



Country 1



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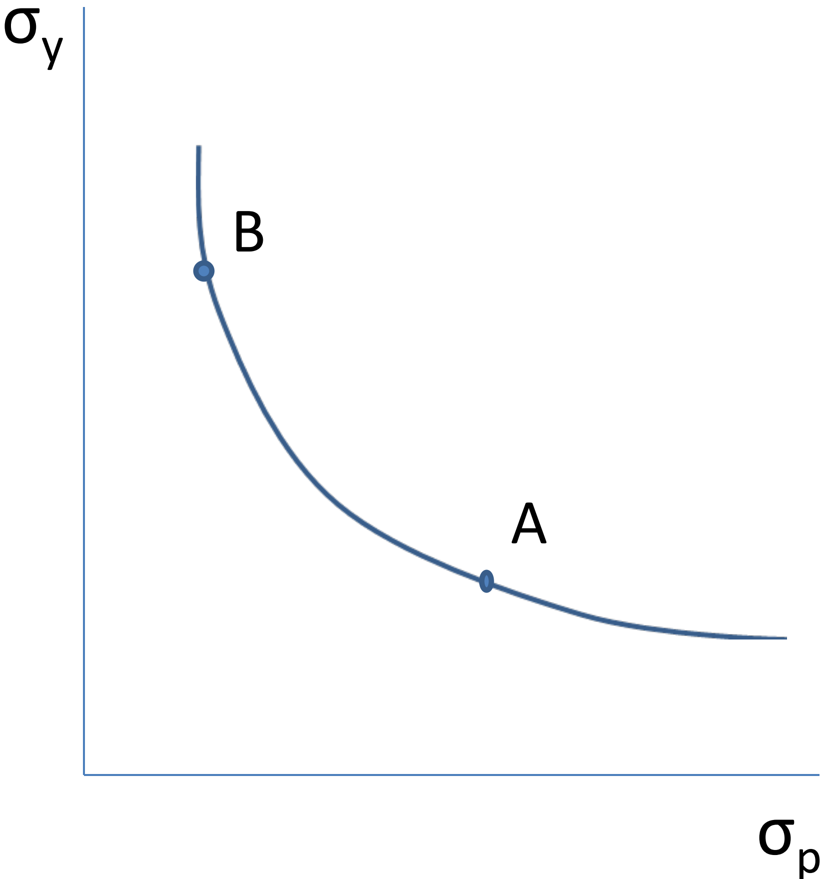

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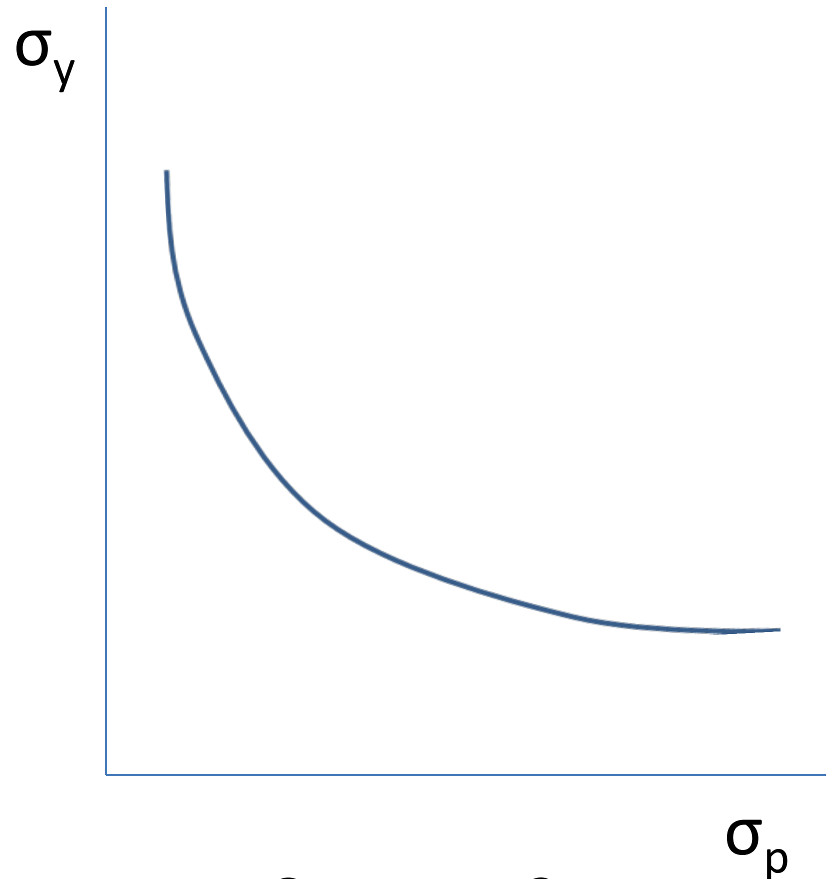

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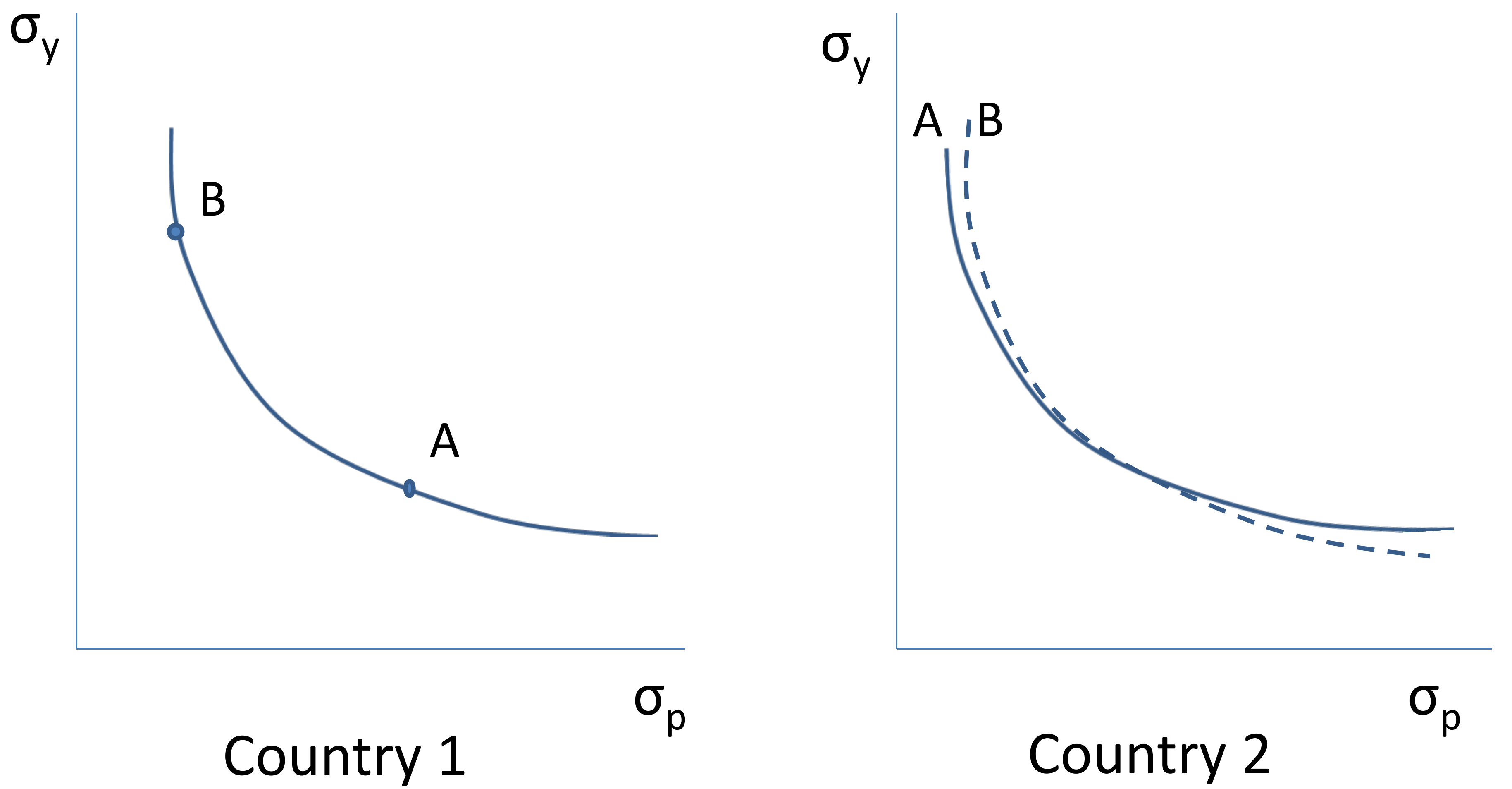
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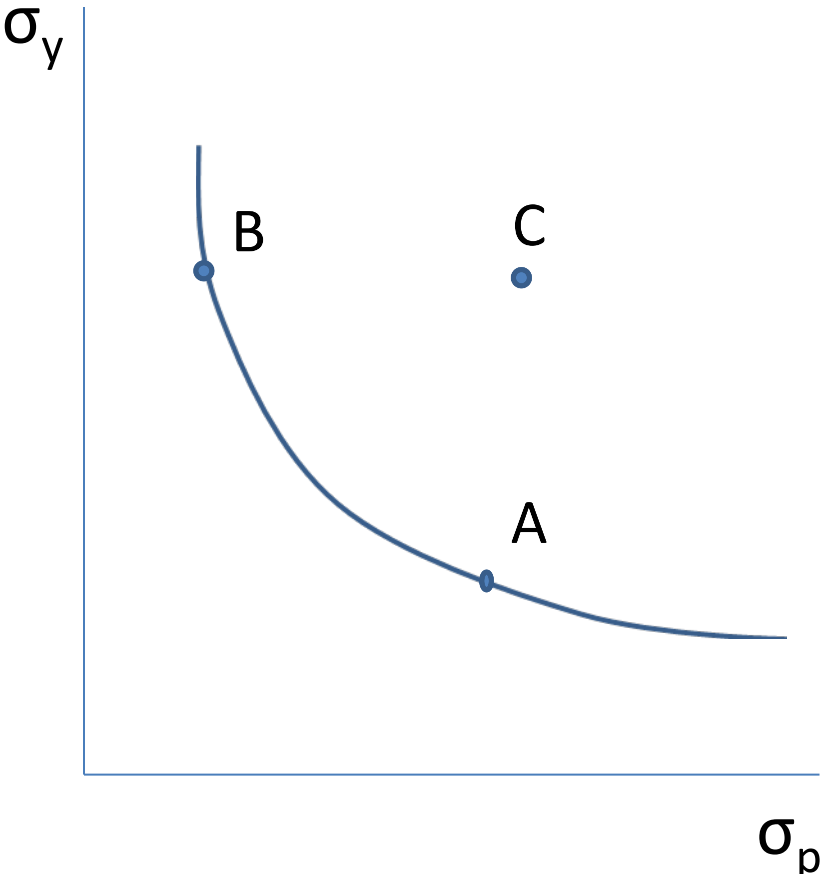

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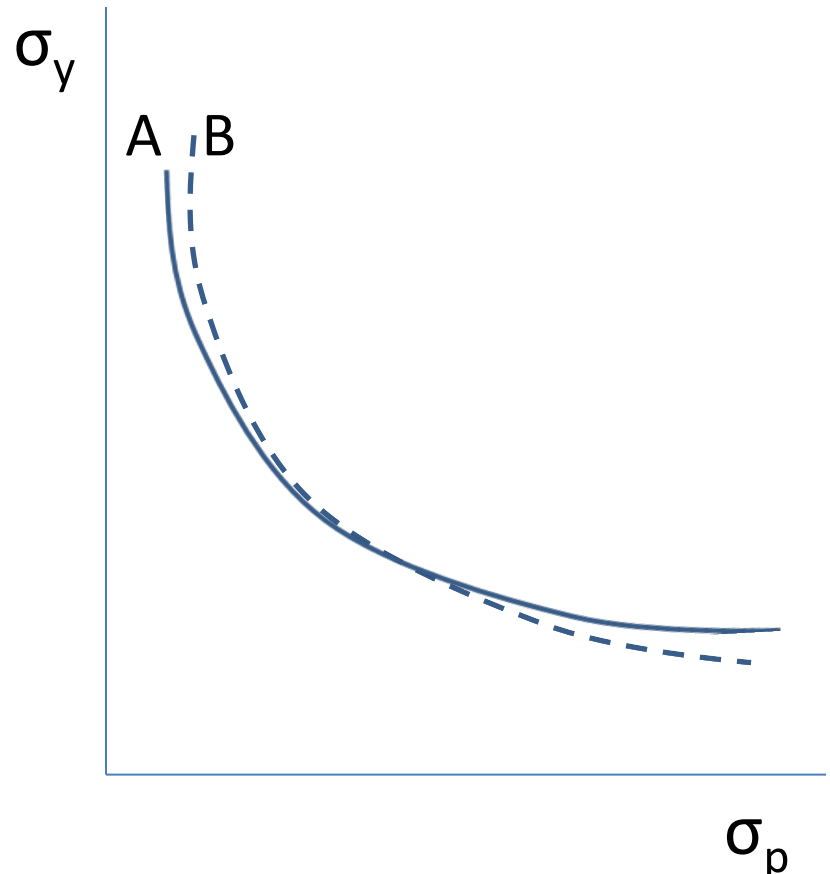

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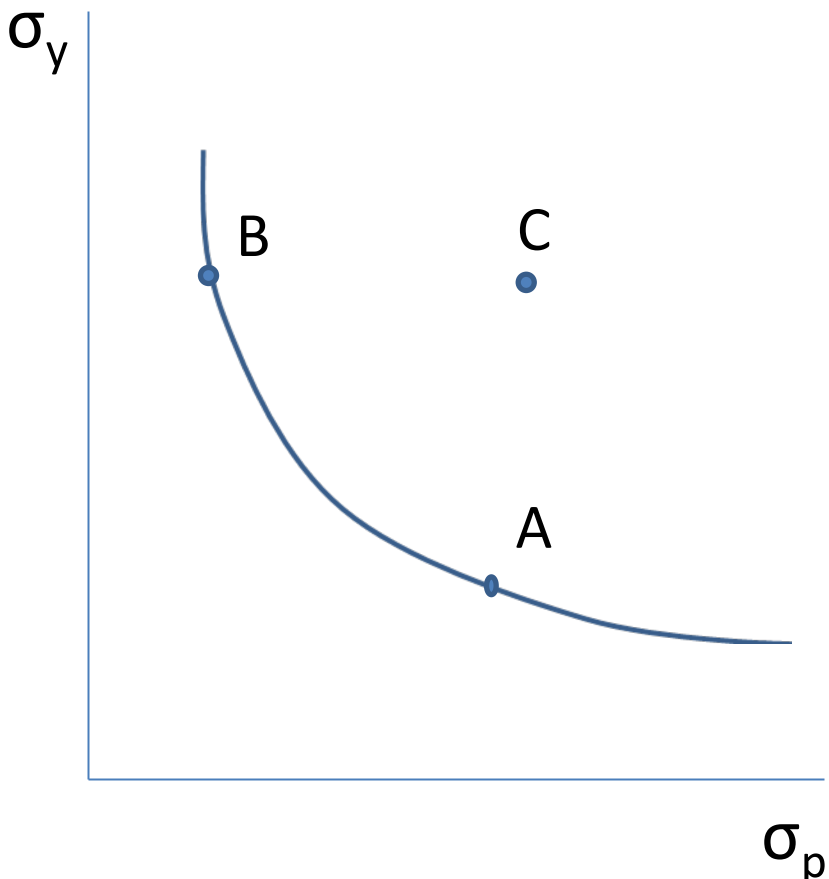

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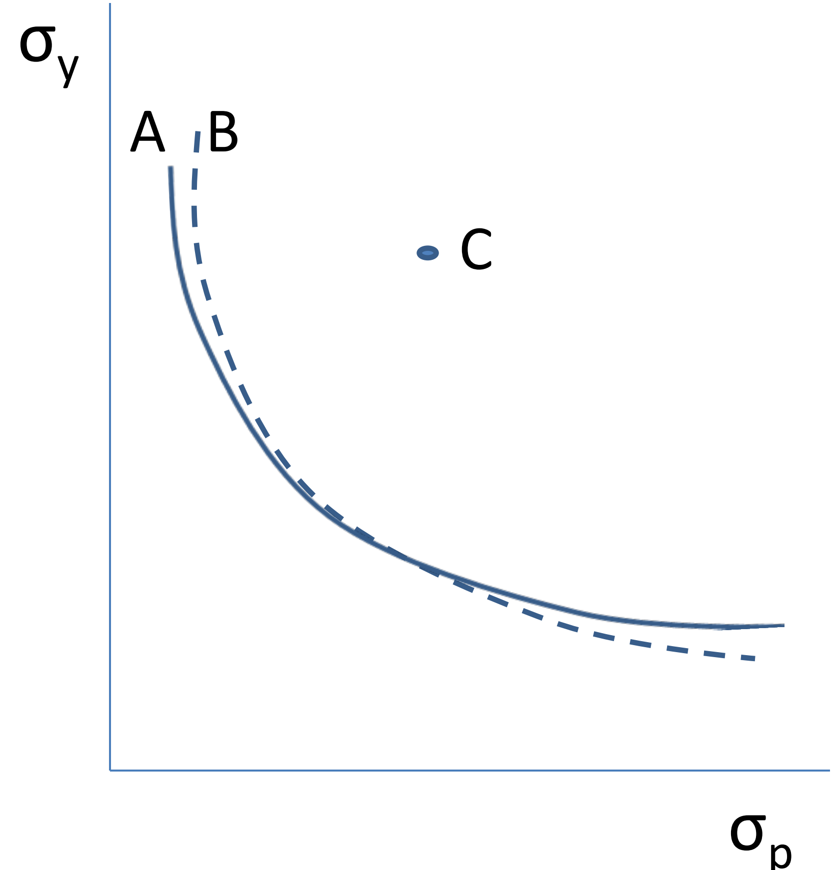

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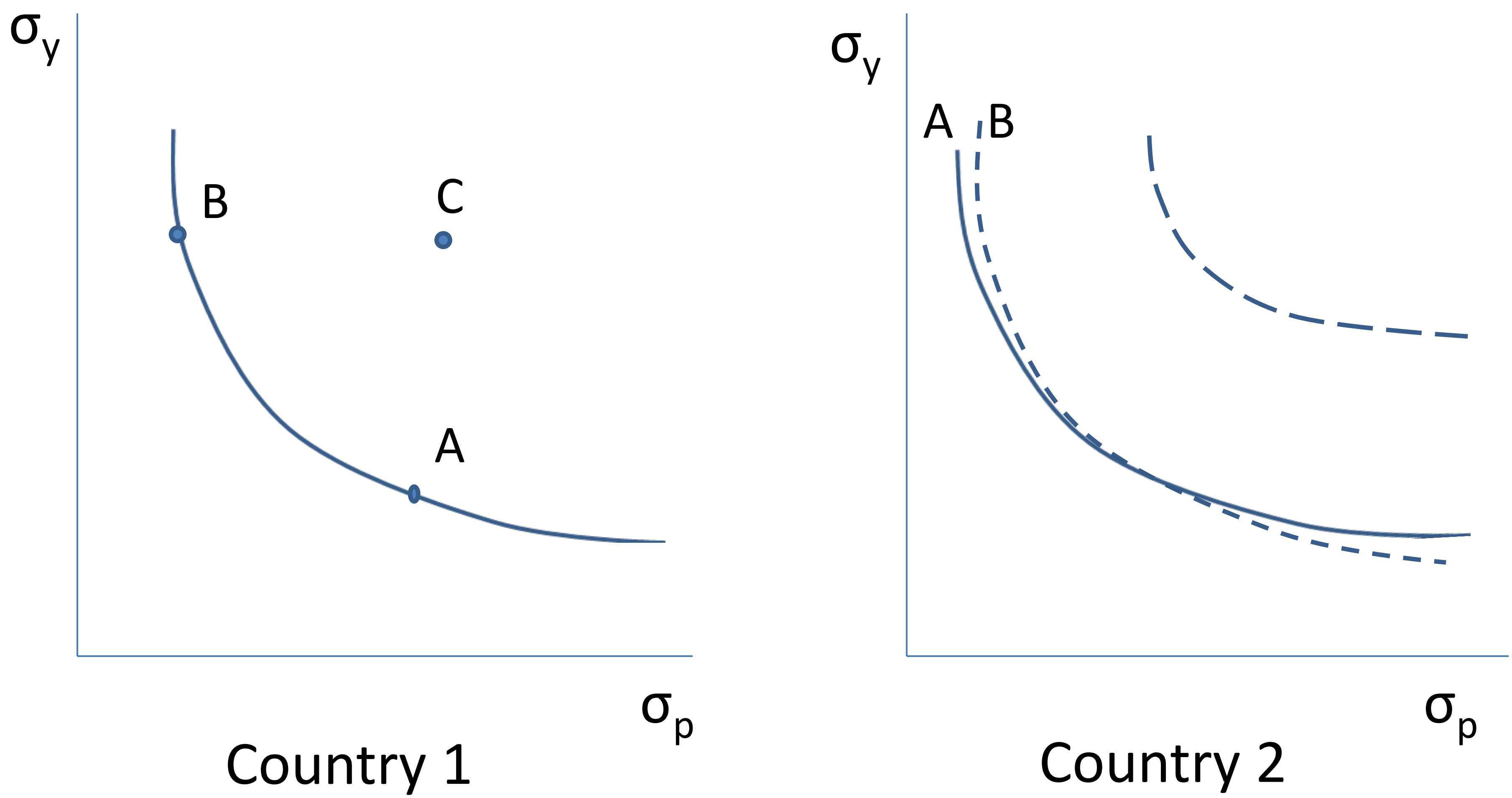

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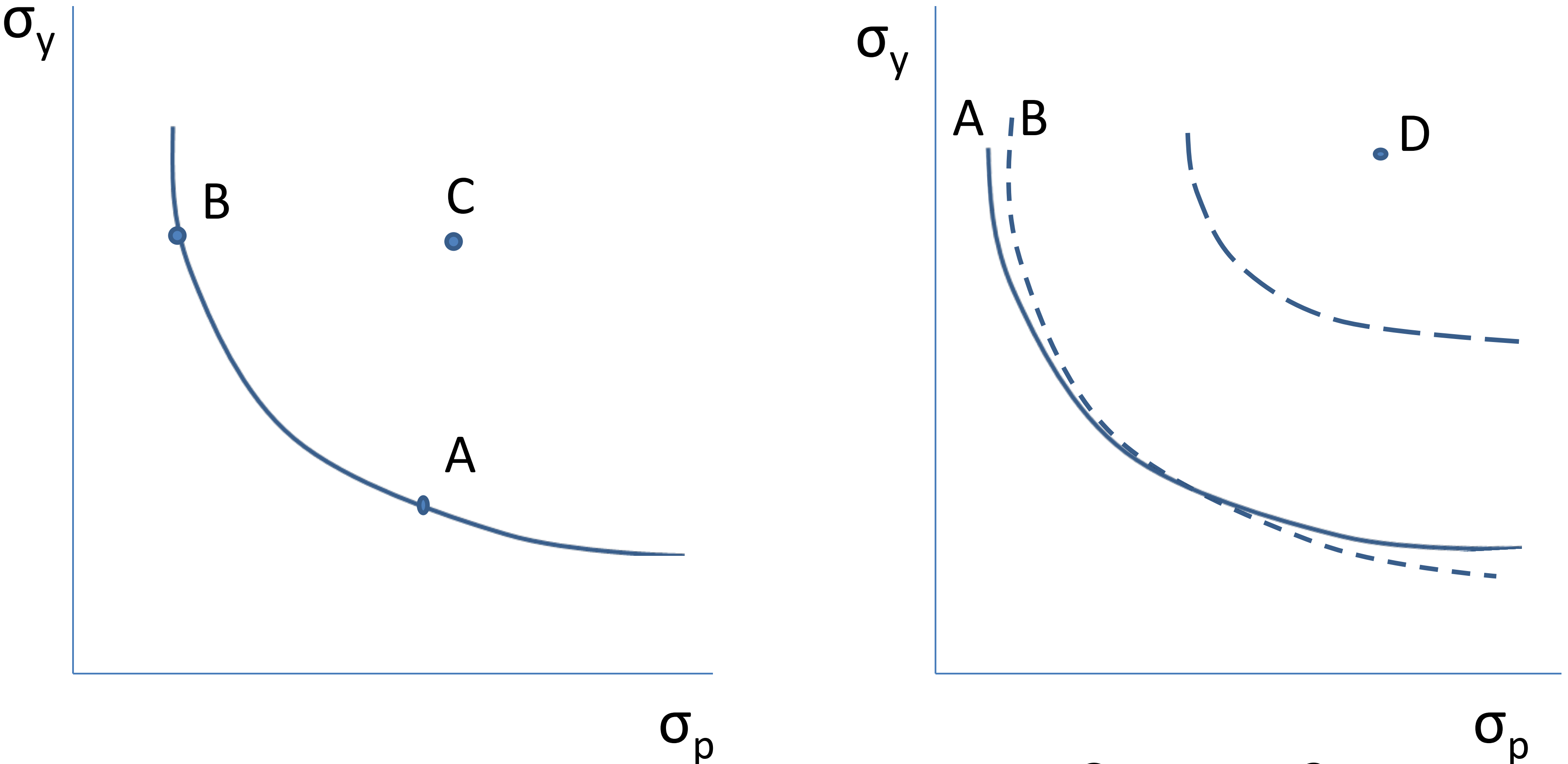
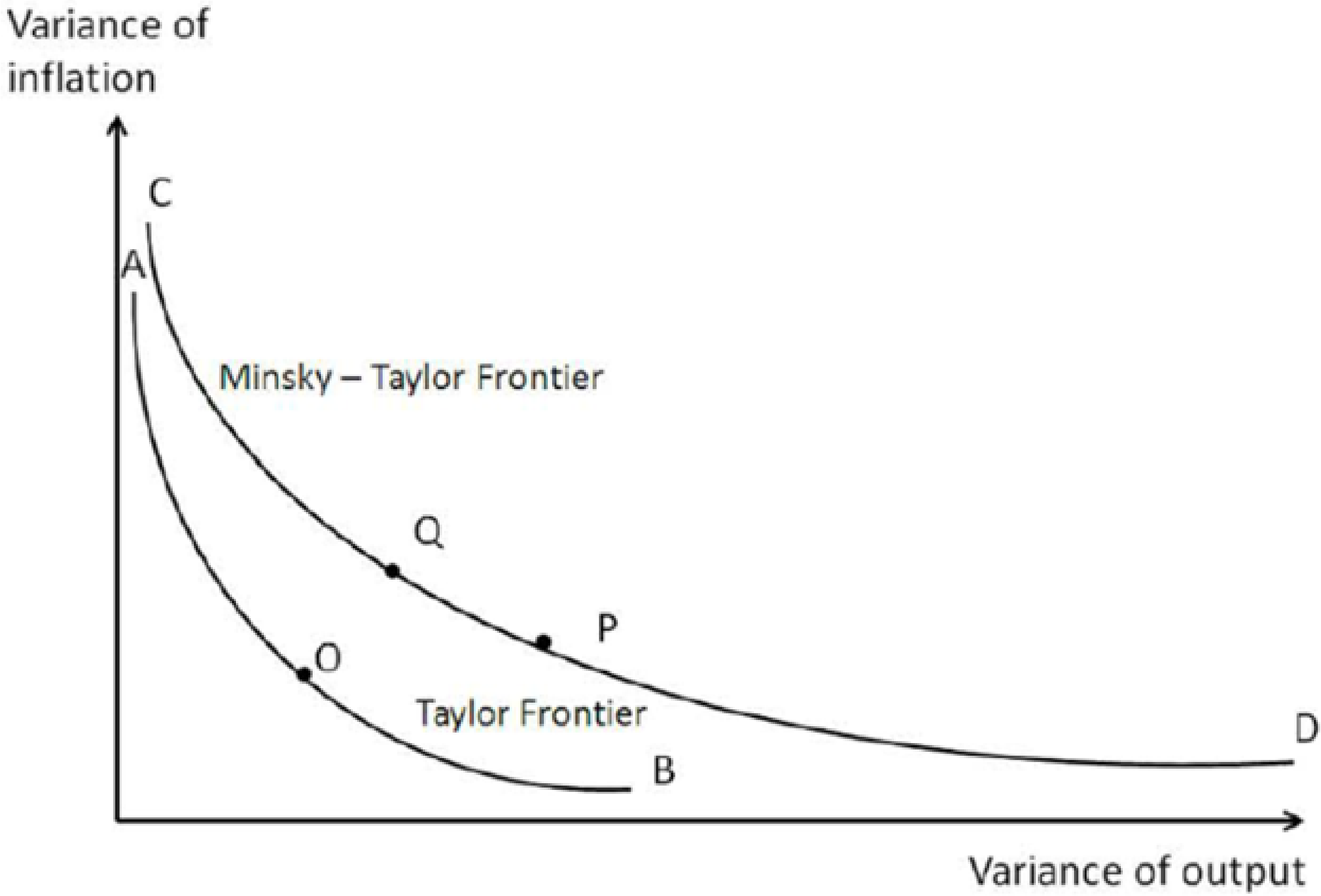
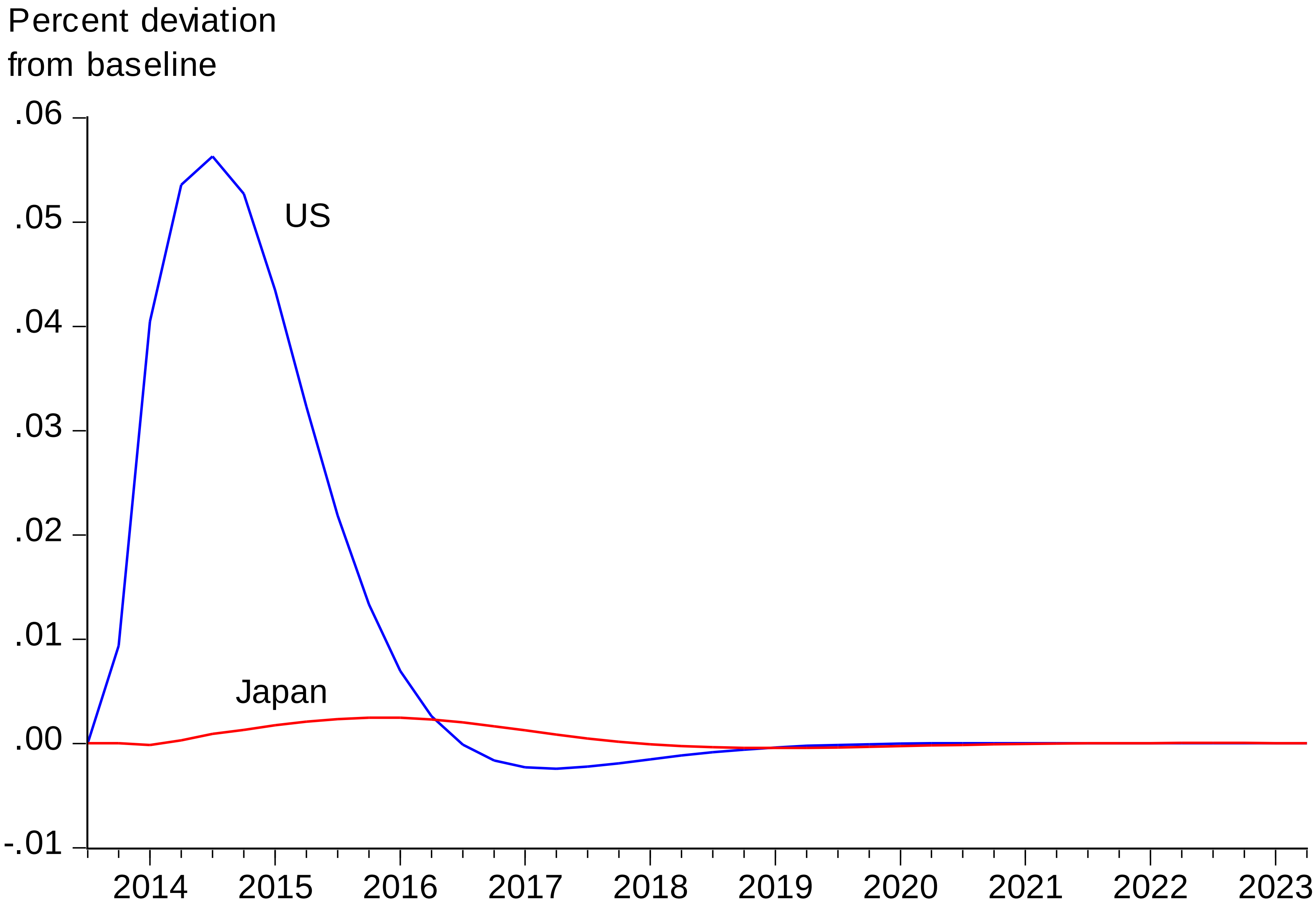


Country 1 Country 2

Alternative View: Curve Shifted for Other Reasons

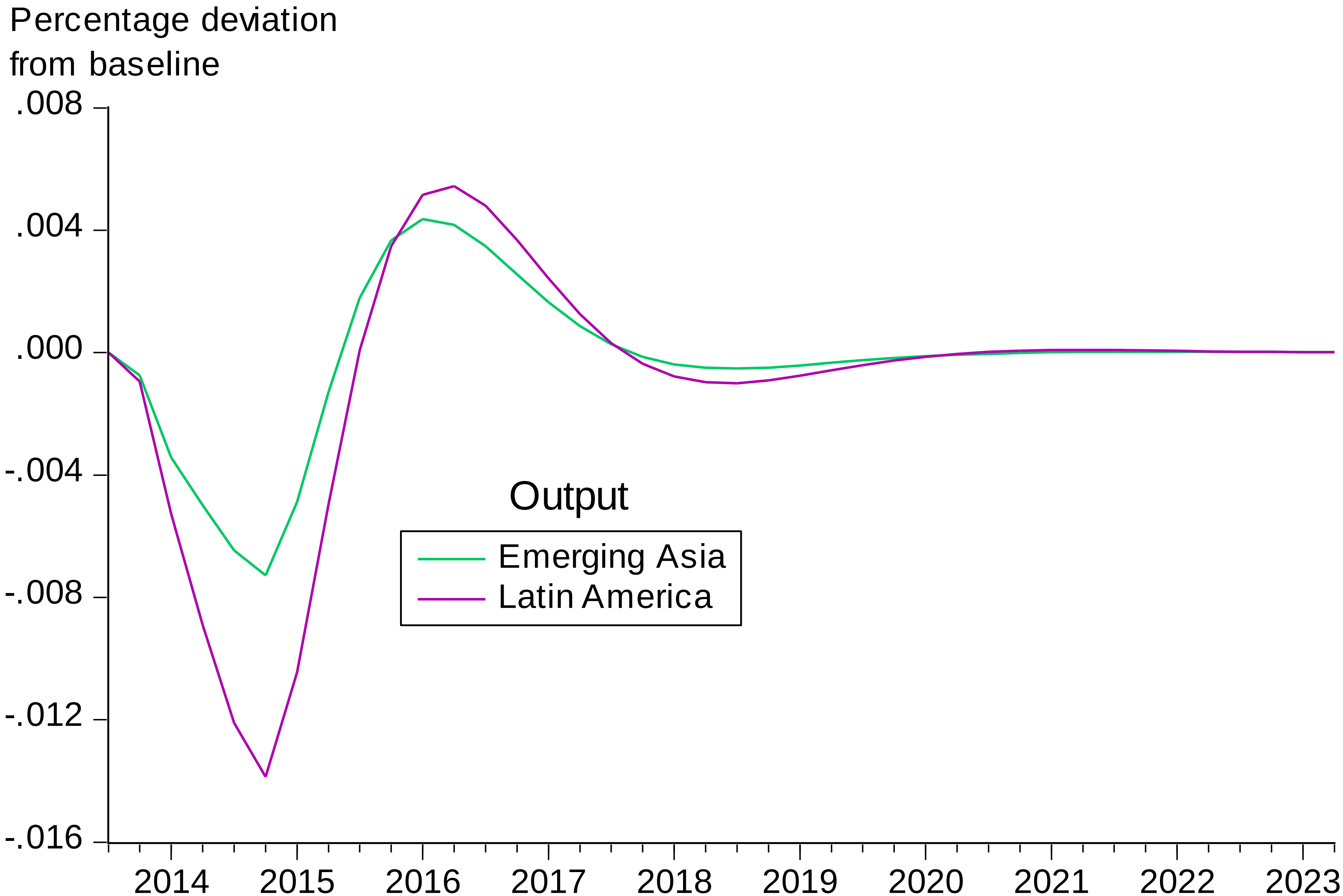


Source: Mervyn King's Stamp Lecture (2012)



Percent deviation
from baseline
.06
.05
.04
.03
.02
.01
.00
-.01
US
Japan
2014
2015
2016
2017
2018
2019
2020
2021
2022
2023

GPM6 - IMF


Percentage deviation
from baseline
.008
.004
.000
-.004
-.008
-.012
-.016
Output
Emerging Asia
Latin America
2014
2015
2016
2017
2018
2019
2020
2021
2022
2023

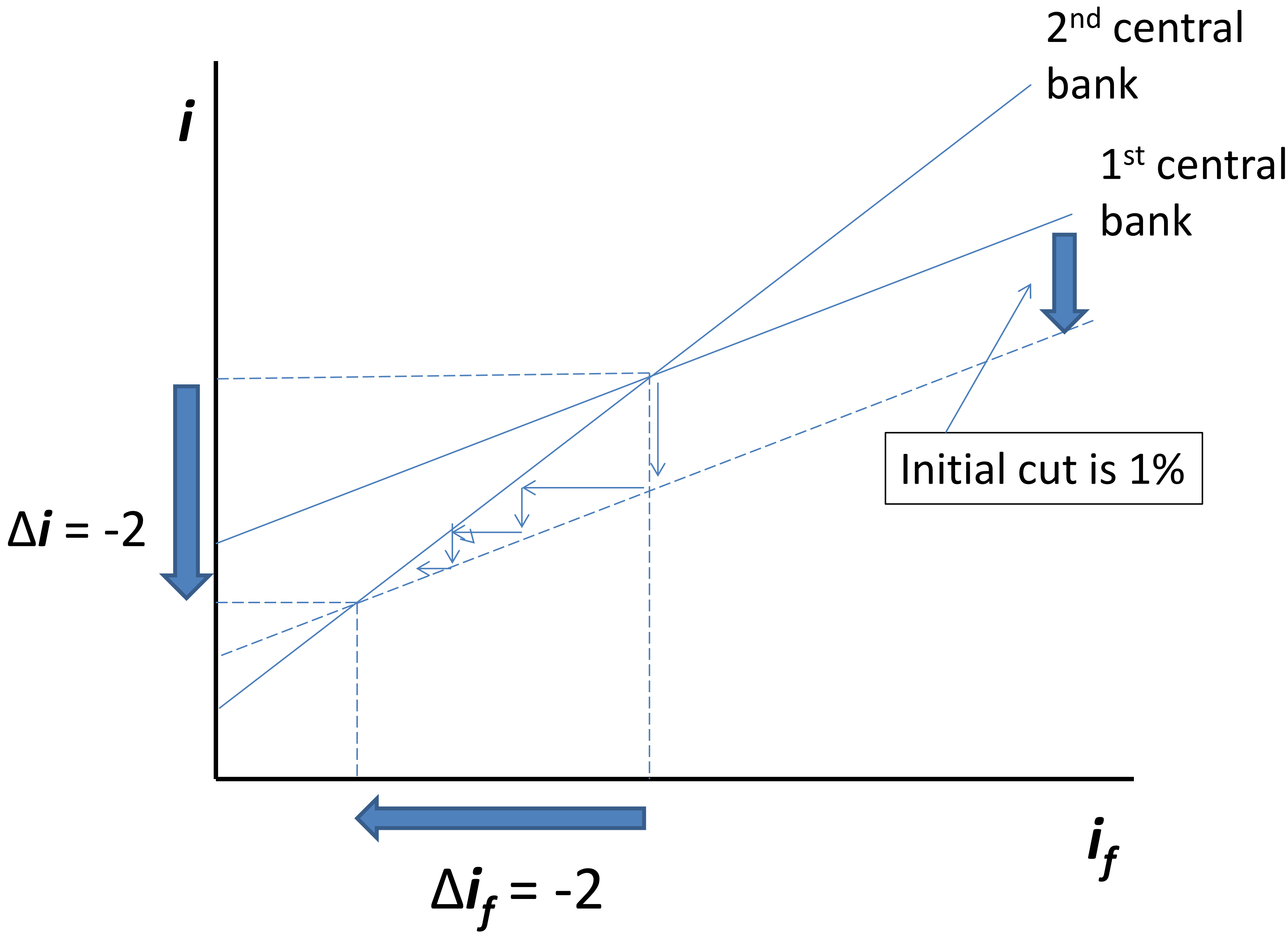
GPM6 - IMF

Monetary Policy Contagion

- Policy deviations (below rule) cause exchange rates to appreciate elsewhere.
- In emerging Latin America and Asia, the exchange rate effect dominates output effect
  - Beggar-thy-neighbor, not enrich-thy-neighbor
- Hence, many central banks tend to resist by reducing their own policy rate relative to rule
- Overwhelming evidence that this occurs
  - Central bankers admit it
  - Econometric regressions show it

Currency Wars Fought with Monetary Instruments

- Conventional monetary policy
  - Can be illustrated with a simple diagram.
- Unconventional monetary policy
  - Seems to work much the same:
    - Fed 2010
    - BOJ 2012
    - ECB 2014



2nd central bank
1st central bank
i
Initial cut is 1%
Δi = -2
i_f
Δi_f = -2

Currency Wars Fought with Monetary Instruments

- Conventional monetary policy
  - Can be illustrated with a simple diagram.
- Unconventional monetary policy
  - May work much the same:
    - Fed 2010
    - BOJ 2012
    - ECB 2014

Other Global Consequences

- Forces discretionary macro-prudential policy
  - Obvious in Singapore, Switzerland, Hong Kong,…
  - But also inflation targeting countries: Colombia,…
- Undermines inflation targeting principles
  - which had led to less intervention and more rules-based policy
- Provides excuses for more capital controls
- Creates increased intervention in currency markets
- May also infect other parts of economic policy

What to Do

- Return to more rules-based monetary policies similar to what worked during the 1980s, 1990s and until recently
- Be sure to include emerging market and developing countries.

Can anything be done to help it along?

- In the United States, legislation may be needed
- In fact, some legislation is underway.
- "Requirements for Policy Rules for the Fed" in bill recently passed by House Financial Services Committee
- Requires that the Fed report publicly its rule or strategy for the policy instruments
- The Fed, not Congress, would choose rule or strategy.

But what about other central banks in the globalized world economy?

- A clear commitment by the Fed would help
  - whether aided by legislation or not
- An international understanding would help further.
  - Major central banks have a common inflation target
  - Converging views about response of policy instruments.
- Ask the IMF or the BIS, or non-profit groups to monitor?
  - Need to recognize widely different institutional frameworks

Would the approach be enough to provide “stability in markets and economies”?

- Rey (2013) finds that destabilizing capital flows are induced by erratic swings in monetary policy; these would diminish
- Large capital flows due to “fear of free falling” exchange rates would be calmed too
  - Adoption of rules-based inflation targeting has had that effect (Vegh and Vuletin (2012))

Conclusion

Historical experience, informed by economic theory and research, shows that with this approach the Fed and each other central bank

- could choose its own independent rules-based monetary policy strategy
- contribute to global financial and economic stability
- avoid interfering with the principles of free and open markets.