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# Two Views of International Monetary Policy Coordination

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*Any opinions expressed here are my own and do not necessarily reflect those of the Federal Open Market Committee.*

# Introduction

## Re-emergence of the policy coordination debate

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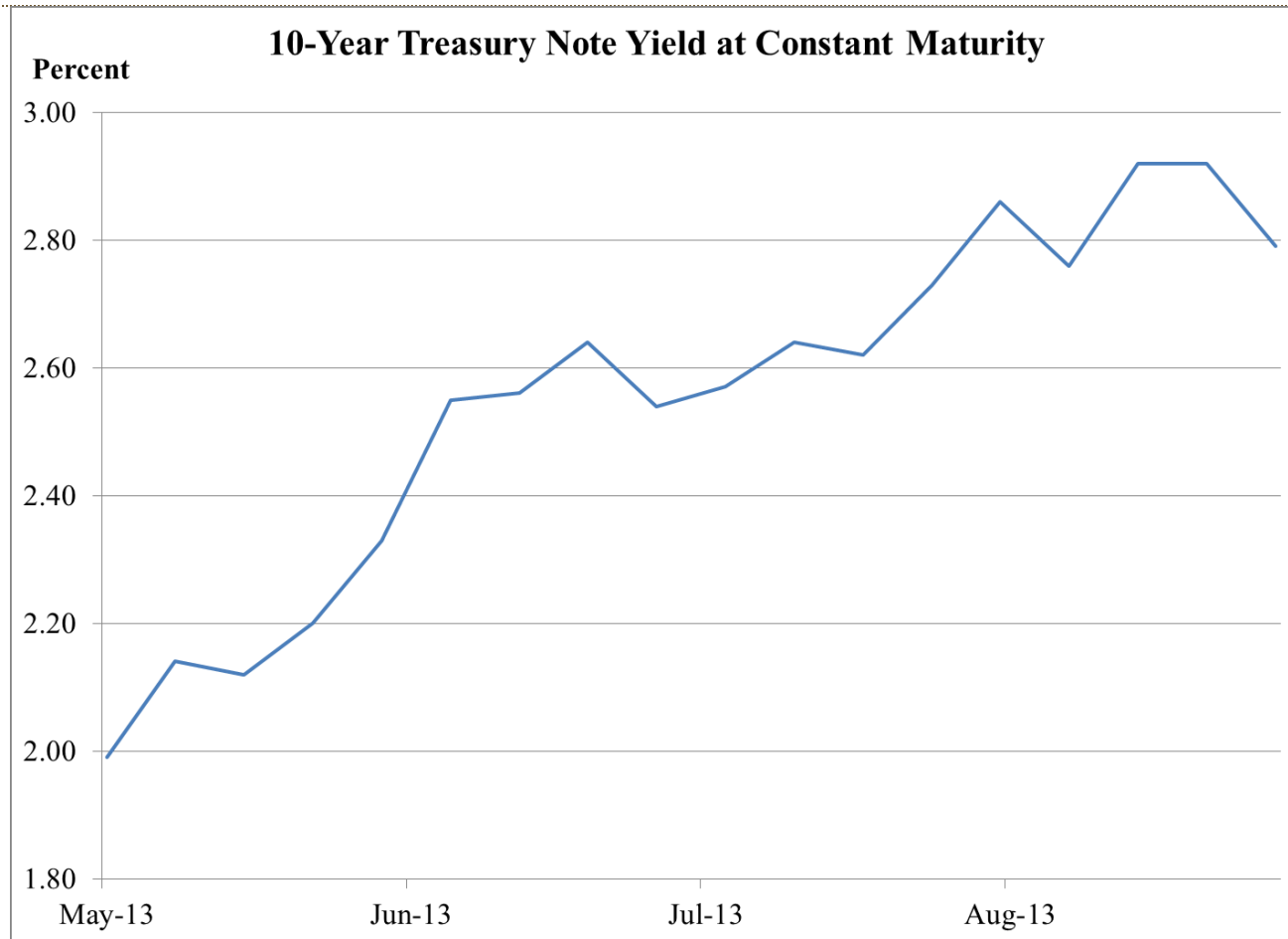
- Should monetary policy be better coordinated across countries?
  - A classic question in international macroeconomics.
- In recent years, this question has again moved to center stage.
  - Unconventional monetary policy in the U.S., in particular, has been met with criticism from emerging markets.
  - The “taper tantrum” of the summer of 2013 re-energized the debate.

## The taper tantrum

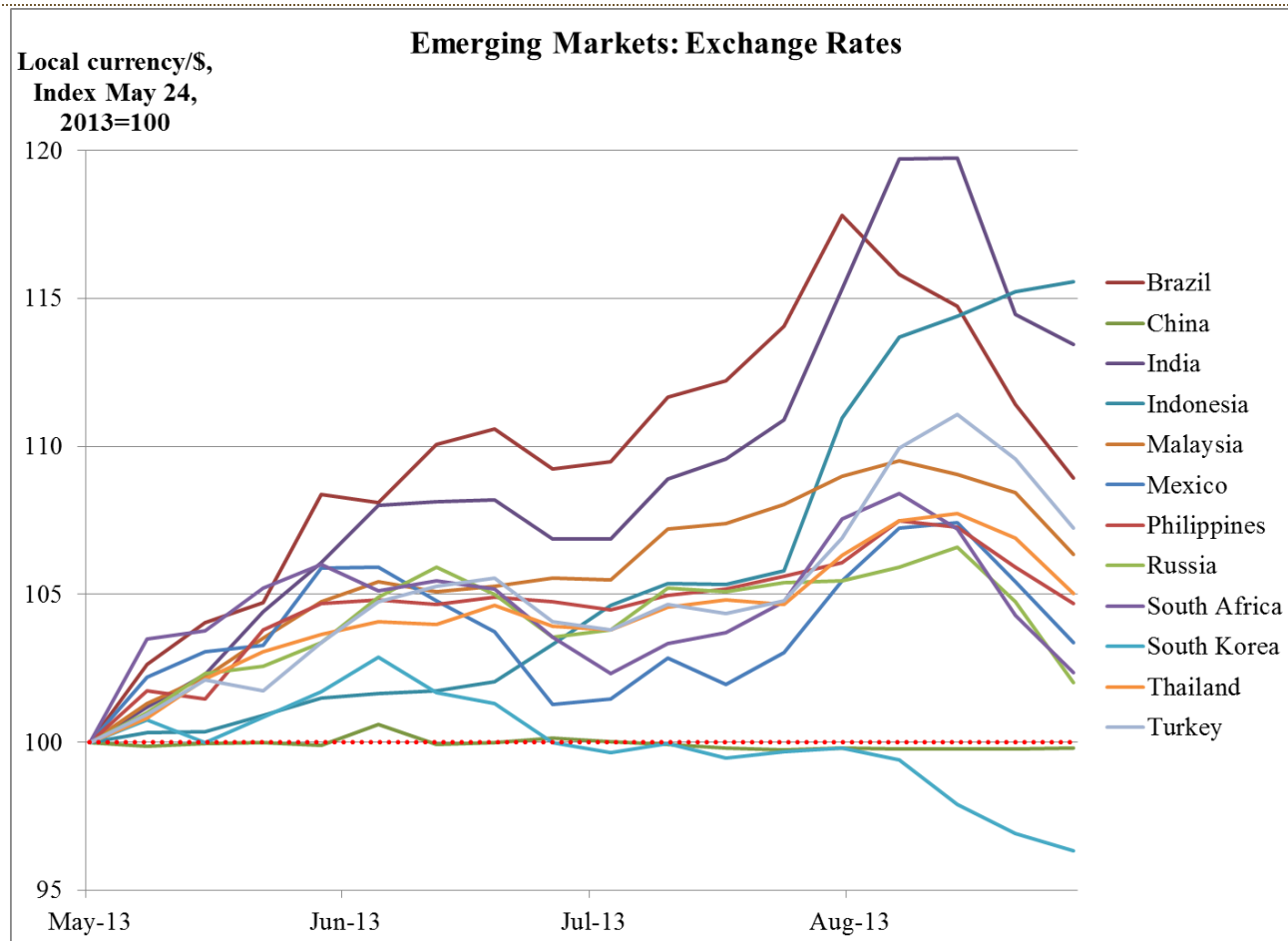
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- What happened during the “taper tantrum” in the summer of 2013?
  - U.S. interest rates increased.
  - Emerging-market currencies depreciated against the U.S. dollar.
  - Capital flowed to the U.S.
  - Emerging market equity prices declined.

## Longer-term U.S. interest rates increased

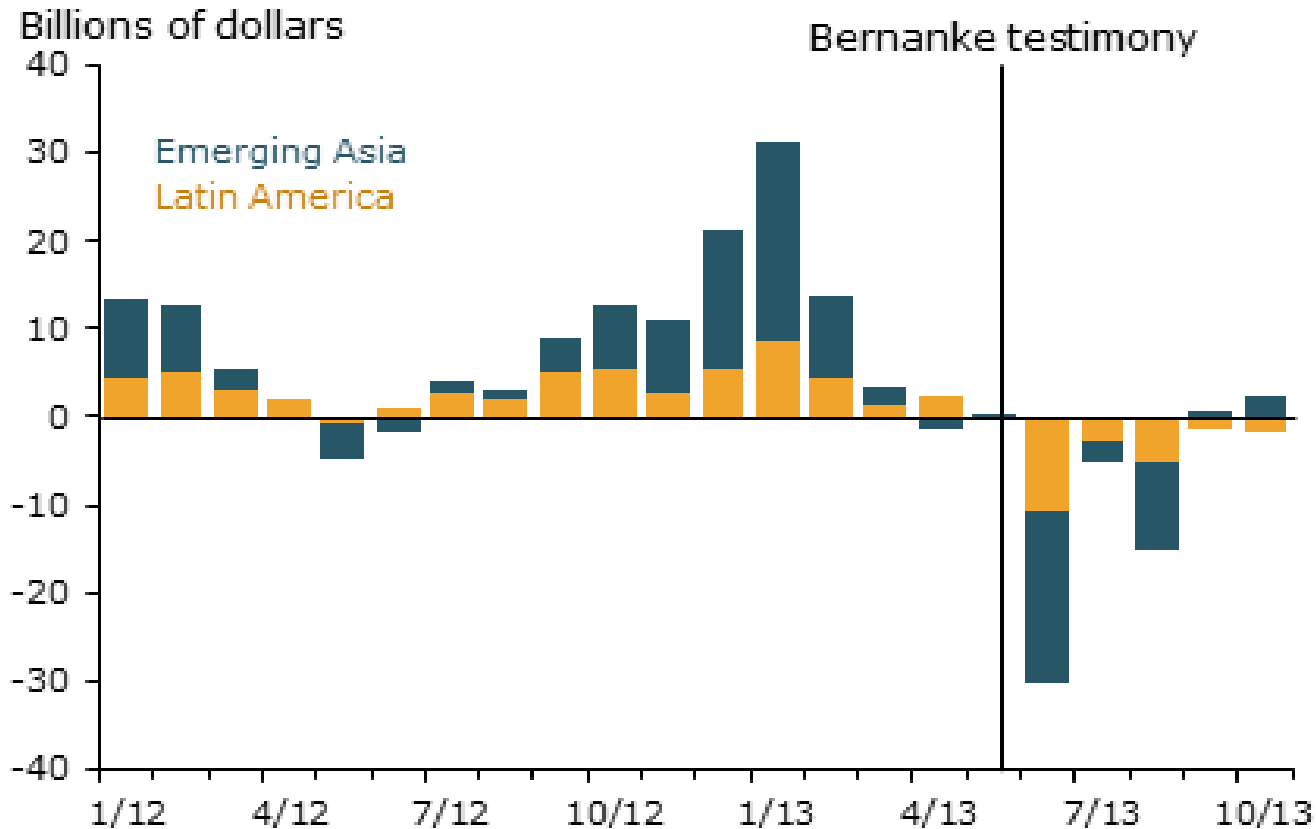


# Emerging-market currencies depreciated



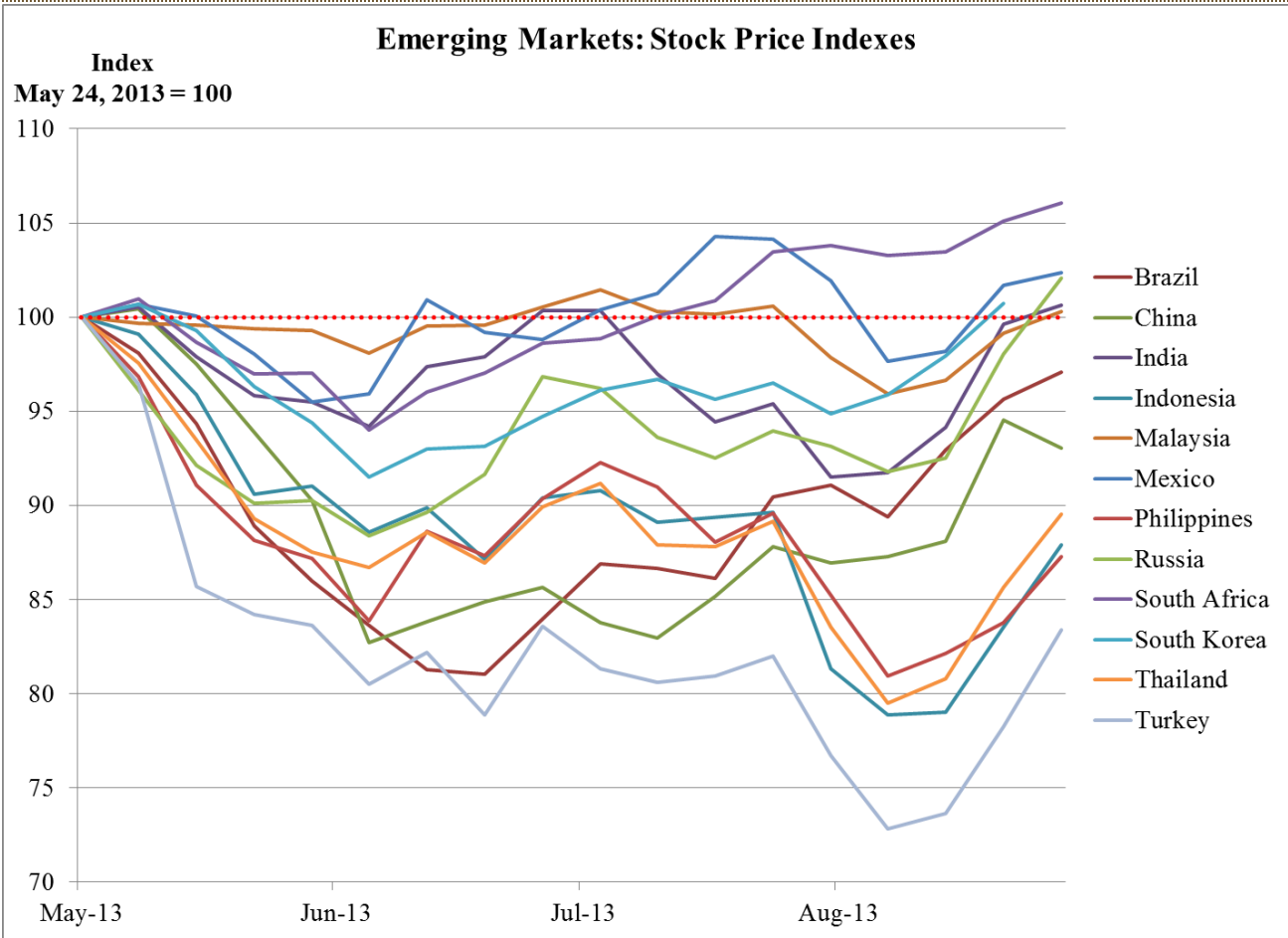
# Emerging-market capital inflows reversed

## Emerging Markets: Bond and Equity Fund Flows



Source: Nechio, Fernanda. "Fed Tapering News and Emerging Markets." Federal Reserve Bank of San Francisco Economic Letter No. 2014-06, March 3, 2014.

# Emerging-market stock indexes dropped





## Evaluating the taper tantrum

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- How should we think of these developments?
- In a traditional view, this is merely the global macroeconomic equilibrium in action.
- In a more radical and less widely-accepted view, this may represent unnecessary volatility.
- In this talk, I will describe these two views.

## This talk

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- I will first describe the traditional view.
  - The gains from international monetary policy coordination in this view are small.
  - My description is similar to John Taylor (2013, BIS).
- I then turn to the alternative view.
  - The worldwide equilibrium may be unnecessarily volatile due to U.S. policy.
  - This view may better fit the emerging markets' perspective.
- I endorse the first view, but I think that there is considerable room for debate.

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# Conventional Wisdom

## A traditional view

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- Some literature reflecting a traditional view:
  - Obstfeld, Maurice and Rogoff, Kenneth. “Global Implications of Self-Oriented National Monetary Rules.” *Quarterly Journal of Economics*, May 2002, 117(2), pp. 503-35.
  - Clarida, Richard; Galí, Jordi and Gertler, Mark. “A Simple Framework for International Monetary Policy Analysis.” *Journal of Monetary Economics*, July 2002, 49(5), pp. 879-904.

## The international economy in a traditional view

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- Many interacting “New Keynesian” economies.
- Capital is mobile internationally.
- All exchange rates are perfectly flexible.
- Independent monetary policy characterized by a Taylor-type policy rule in each country.
- “Good policy” obeys the Taylor principle: Nominal interest rates are adjusted more than one-for-one with deviations of inflation from an inflation target.
- Shocks occur at the country level.

## Monetary policy cooperation in a traditional view

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- Policymakers follow “good” policy focused on only domestic variables.
- The nature of the results:
  - Worldwide equilibrium is unique.
  - The payoff to international policy coordination is small.

## What are these small gains?

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- Any gains from policy cooperation stem from taking into account the effect of foreign economic activity on the domestic marginal cost of production.
  - Under cooperation a central bank should respond to foreign inflation, as well as domestic inflation.
- But policymakers do almost as well with respect to their goals by simply ignoring this effect.
- Hence the gains are small.

## Conclusion for the traditional view

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- Many have concluded from this line of thinking that it does not pay to worry about international monetary policy cooperation.
- Possible gains are small, and it would be hard to get the world's policymakers to play the cooperative equilibrium.



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# An Alternative View

## An alternative view

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- Literature reflecting an alternative view:
  - Bullard, James and Singh, Aarti. “Worldwide Macroeconomic Stability and Monetary Policy Rules.” *Journal of Monetary Economics*, October 2008, 55(Supplement), pp. S34-S47.
  - Written before the crisis, but possibly more relevant today.

## The international economy in an alternative view

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- All the features of the international economy are the same as in the traditional view.
- The only difference is that monetary policymakers in one or more countries are not following “good” policy.
- This means that at least one of the national policymakers does not adjust the degree of policy accommodation more than one-for-one in response to deviations of inflation from target.
  - That is, monetary policy does not obey the Taylor principle in at least one country.

## The suboptimal policy assumption

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- Is it reasonable to assume that some countries are not obeying the Taylor principle?
- Maybe.
- These are not “normal times” for monetary policy in the U.S. economy.
- In particular, it is difficult for policy to respond to declines in inflation when the policy rate is subject to the zero lower bound.
  - QE and forward guidance may or may not substitute effectively.

## Monetary policy cooperation in an alternative view

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- Suppose some national policymakers do not follow “good” policy.
- The nature of the results:
  - Worldwide equilibrium is no longer unique.
  - This means many volatile equilibria exist that are all consistent with market clearing and rational expectations.
  - Observed volatility may be much larger than what would be observed if key central banks were following more normal policies away from the ZLB.

## Conclusion for the alternative view

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- Under the alternative view, the problem is that some countries are not following the Taylor principle.
- The result is potentially a lot of extra volatility in the global economy.
- Whether the U.S. is following the Taylor principle or not hinges on what one thinks about unconventional monetary policy.
  - If unconventional monetary policy is ineffective, then the global equilibrium may be overly volatile.

## Reasonable?

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- The alternative view might be one way to represent the emerging markets' criticism of U.S. monetary policy.
- To ensure that overly volatile worldwide equilibria are avoided, the U.S. would need to make sure that unconventional policies are aggressive enough to replicate the Taylor principle.
- I think the FOMC is doing this, but there is certainly room for debate.

## Relation to Taylor

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- John Taylor (2013, BIS) interprets recent monetary policy developments in the U.S. and other advanced economies (zero short-term interest rates and QE programs) as a deviation from rules-based policy.
- Deviations from rules-based policy at some central banks create incentives for other central banks to deviate.
- This results in an inefficient global equilibrium.
- This idea has a similar flavor to the one presented here.



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# Conclusion

## Difference between the two views

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- The traditional view provides a good description of the commentary of many defenders of U.S. monetary policy, including me.
- The more radical, but less established, second view may be one way to describe the view of some emerging markets' commentators.
- The difference between the two views is essentially a judgment on whether unconventional U.S. policy is effective or not.
- “Effective” means “replicates the Taylor principle.”

## What hinges on unconventional policy effectiveness

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- If unconventional U.S. monetary policy is effective, the traditional view is more nearly correct and the gains from international policy coordination would be small.
- If unconventional policy is ineffective, the alternative view is more nearly correct and the global gains from the U.S. shifting to a better policy may be large.

## Bottom line

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- I think unconventional U.S. monetary policy has been sufficiently aggressive to replicate the Taylor principle.
- However, I admit that there is plenty of room for debate on this issue.



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