Comments: Monetary Policy in a Globalized Economy by Helene Rey

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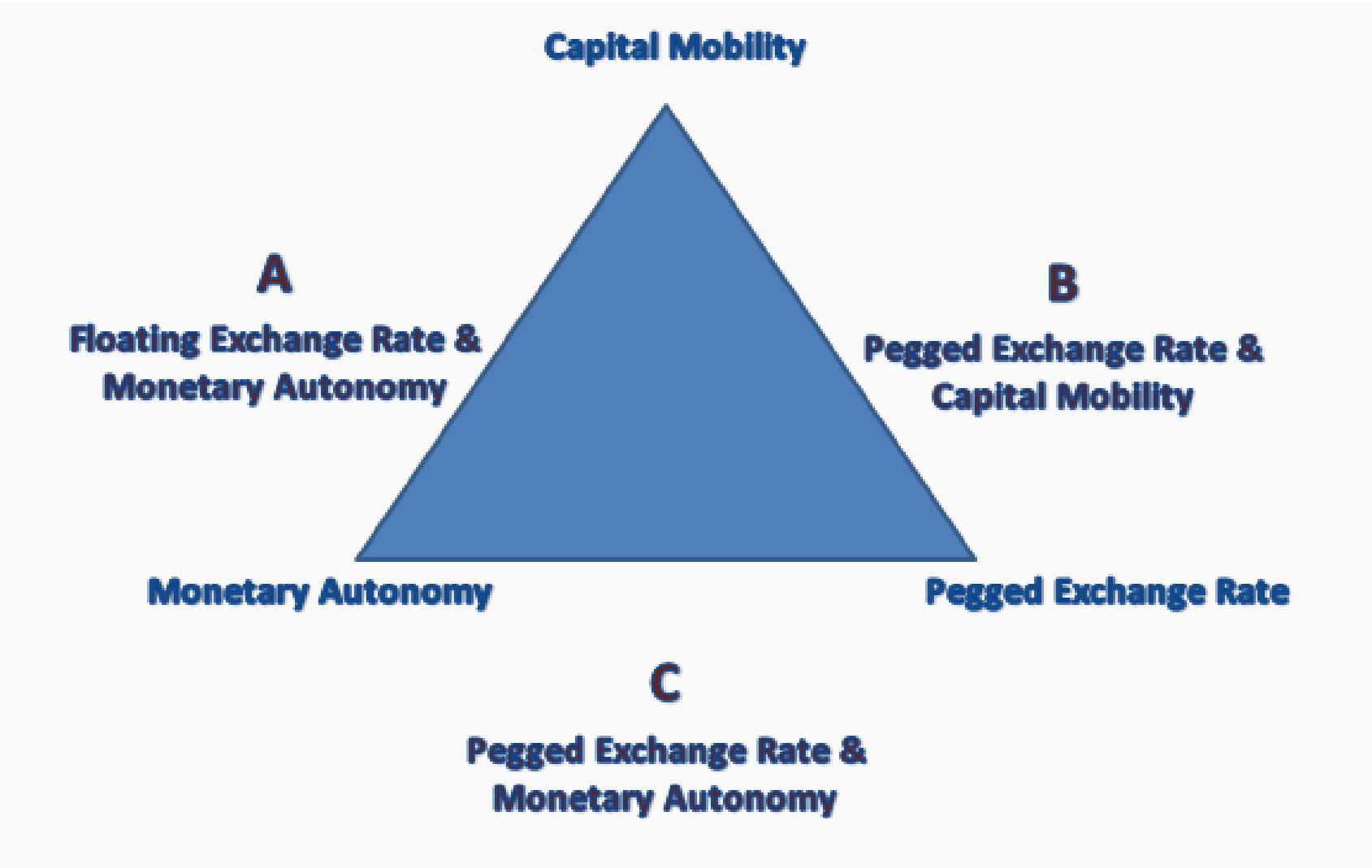
Agenda

The trilemma



Note: Klein and Shambaug (2013).

The dilemma

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- US monetary induces a global credit cycle.
- Relevant global spillovers. Gross capital flows and asset prices.
- Credit growth (booms) are the main predictors of crisis.

Cross-border flows and leverage of global institutions transmit monetary conditions globally even under floating exchange-rate regimes. (Rey, 2013, p. 310)

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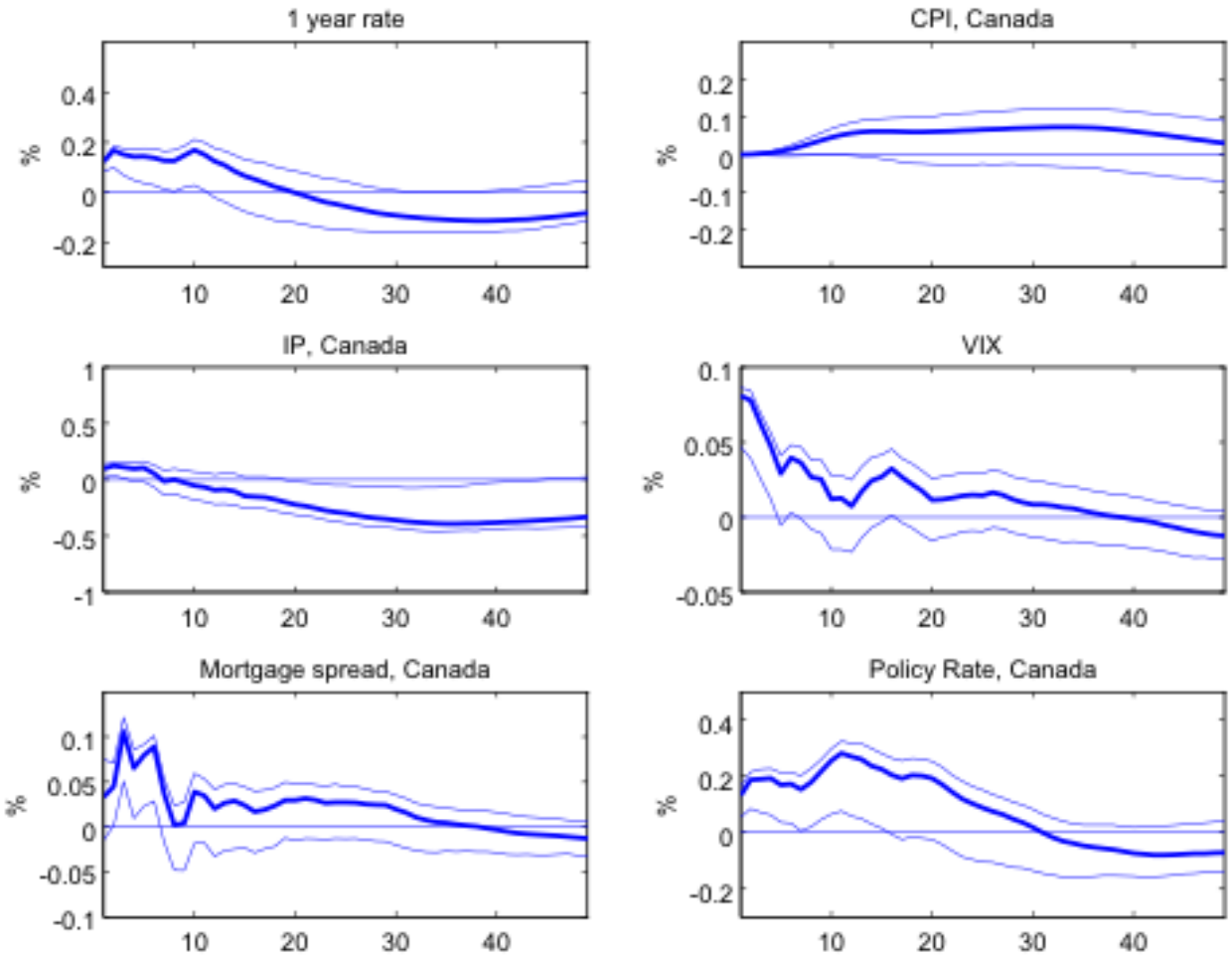
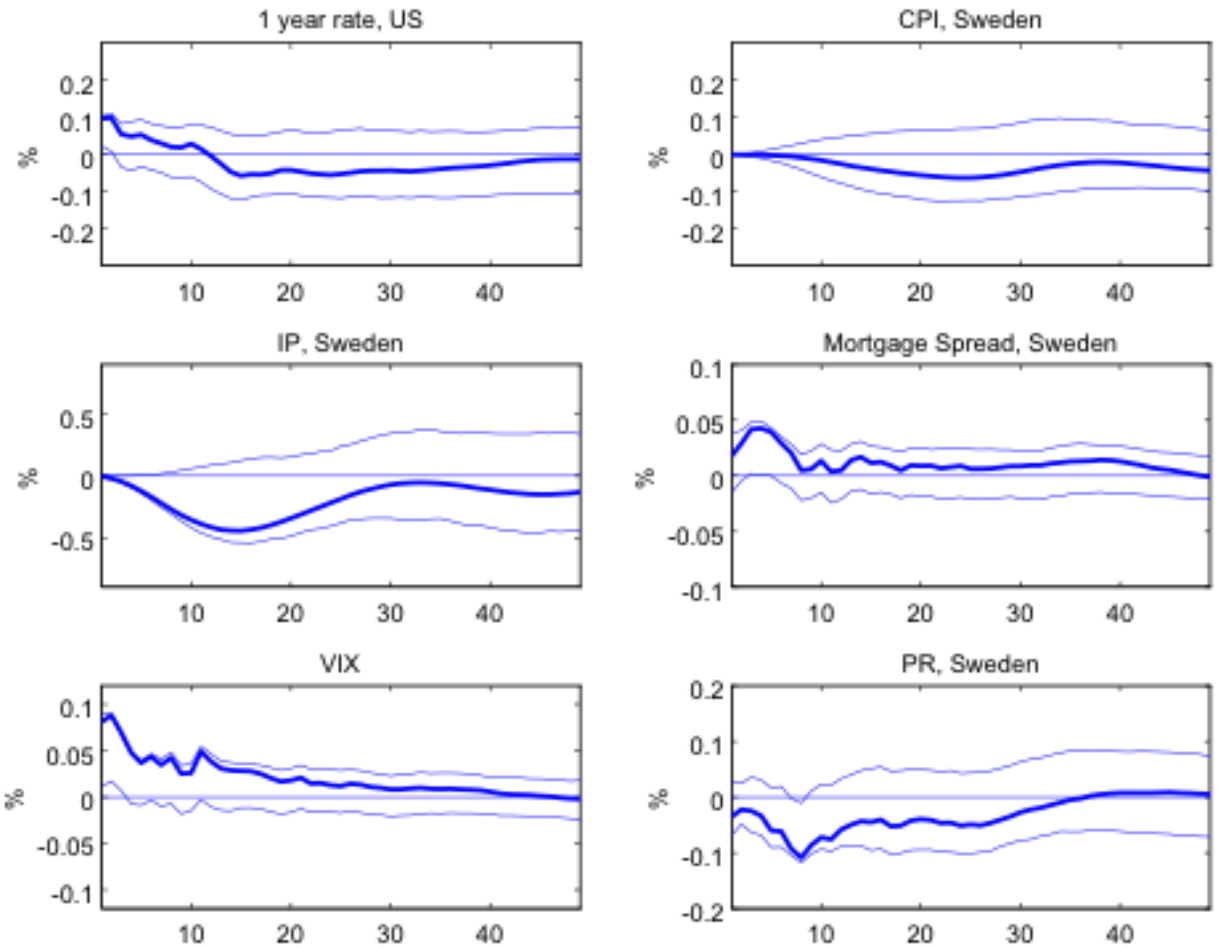
Issues

- Is this inconsistent with Mundell-Fleming?
- Can countries do something? This research suggests "capital controls" or "macroprudential tools."
- What about the exchange rate?

Response of Canada (% points) to a 20bp increase in the US one year rate (Rey, 2014)



Response of Sweden (% points) to a 20bp increase in the US one year rate (Rey, 2014)



Mundell-Fleming: the simplest version

Perfect capital mobility with instantaneous exchange rate adjustment:

$$i = i^*$$

Aggregate demand ($i = r$, $\pi = 0$)

$$y = A - \phi i^* + \alpha e + \eta$$

Money demand

$$m = ky - hi^* + \nu$$

- Domestic interest rate is fully given by foreign conditions. i^* is a summary for all global financial conditions, credit cycle, asset prices, etc.
- But still there is monetary independence! (m can change). An econometrician could say $i_t = i_t^*$ always and hence there is no monetary independence.
- The transmission mechanism is the exchange rate.

Comments

- An increase in i^*, for a given m, is expansionary and induces a depreciation.
- Perhaps if it induces a depreciation large enough it could result in increase in expected inflation and require some monetary tightening, reducing the expansionary effects (Canada?).
- In this simple model capital flows are undetermined, but if we allow for imperfect capital mobility or some other friction, an increase in i^* could induce a capital outflow that could generate some contractionary effcets (although the exchange rate could outweigh this effect).

Comments (cont.)

- I do not see a big difference with Mundell-Fleming. However it would be necessary to see at the impact on **exchange rates**, which is the adjustment variable.
- Evidence on exchange rate regimes and sensitivity of domestic rates with global rates (Obstfeld, 2015).

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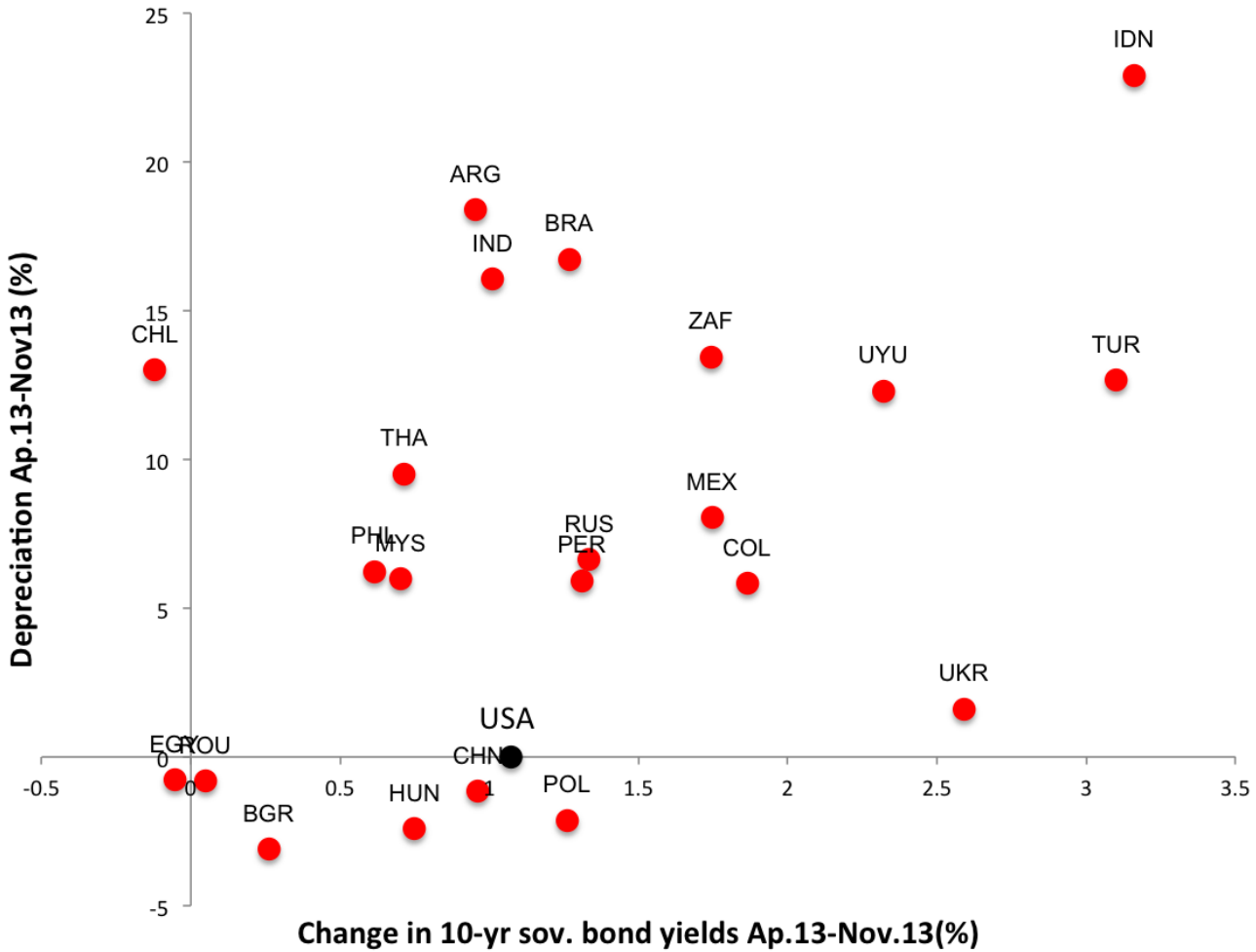
- Evidence on exchange rate regimes and sensitivity of domestic rates with global rates (Obstfeld, 2015).

Conclusion:

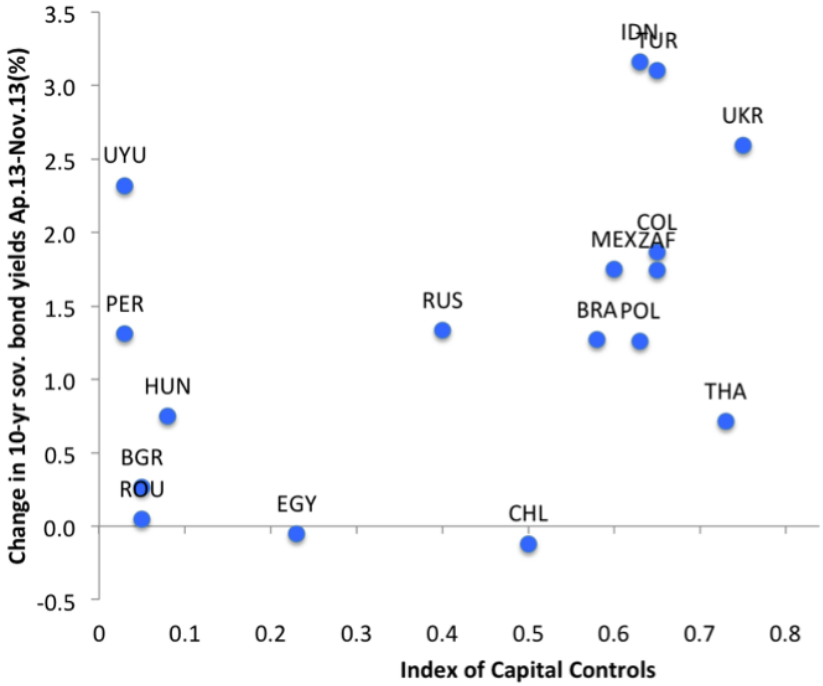
Mundell-Fleming is still well and alive.

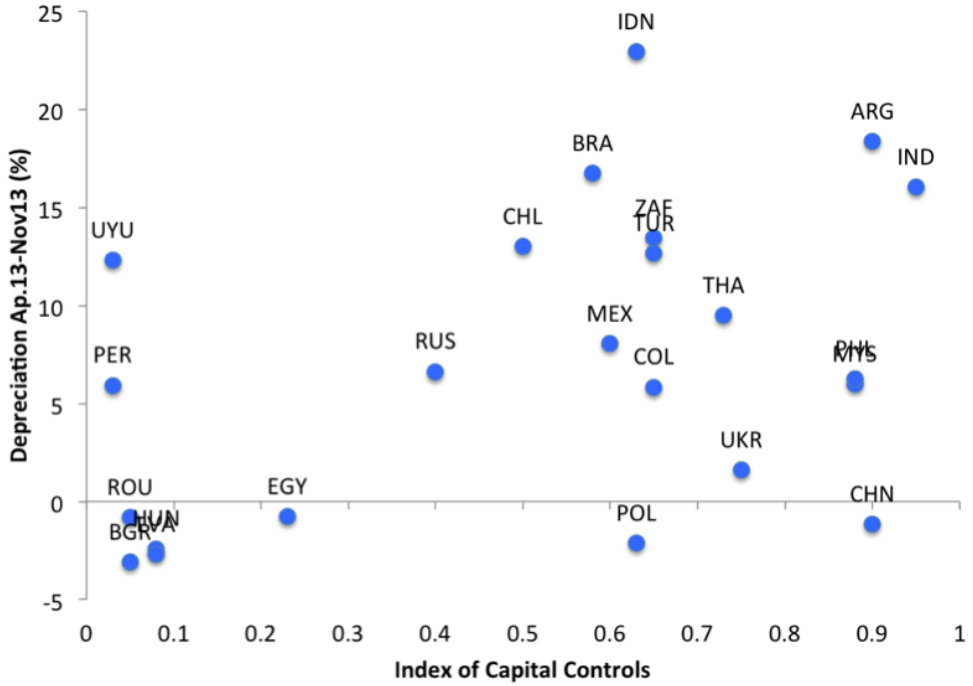
There is still a trilemma and limiting capital flows or abandoning monetary independence is a necessary condition to manage the exchange rate. The effectiveness of capital controls is not warranted, and there is a difference between "gates" and "walls" (Klein, 2012).

Evidence during taper tantrum



Evidence during taper tantrum: capital controls?



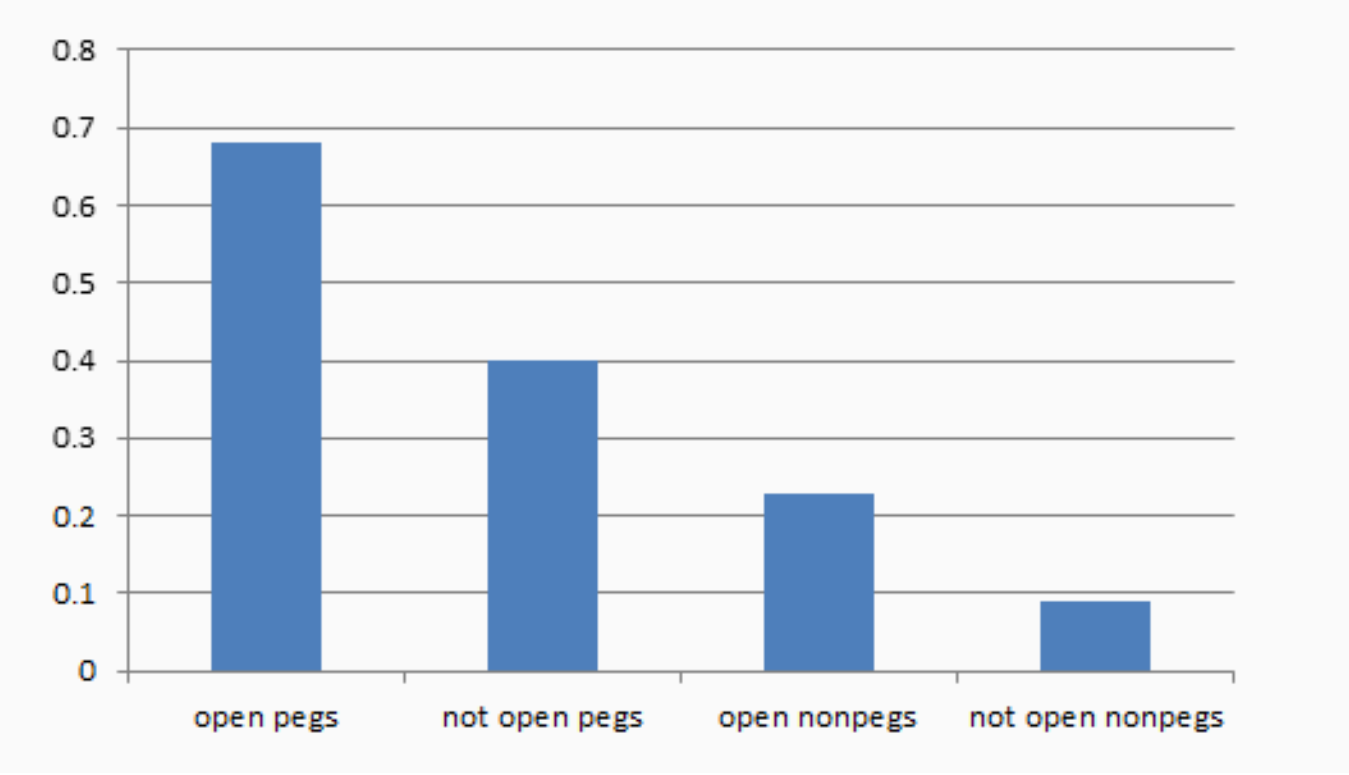


Note: Index of capital controls from Fernandez et al (2015, NBER WP 20970).
The index is between 0 and 1 where zero is full openness and 1 fully closed.

Obstfeld (2015)

"The results leave no doubt that countries that do not peg their exchange rates exercise considerable monetary autonomy at the short end of the term structure; but long- term interest rates are more highly correlated across countries, with little regard for the exchange-rate regime."

Klein and Shambaugh (2013), Response to base country interest rate change



Note: figure shows the coefficient from a regression of the change in the local country interest rate on the change in the base interest rate. Based on table 2 in Klein and Shambaugh (2013).

Concluding remarks

The central issue is between spillovers vis-a vis ability to conduct independent monetary policy.

The history of emerging markets has been full of spillovers episodes:

- Debt crisis - Volcker disinflation
- Tequila crisis - Tightening in the US
- Asian crisis - contagion
- Is there something new? Why now?

Stages in the spillover's discussion

- China and currency manipulation
- QE and currency wars
- China's deceleration and commodities
- Taper tantrum and financial spillovers

- Sound macroeconomic policies, strong financial systems and exchange rate flexibility allow to mitigate spillovers from changes in monetary policy in the center.
- However, there are also **financial spillovers**. They can threaten financial stability. and for this strong prudential regulation is needed.
  - Cross-border lending.
  - Regulatory arbitrage across jurisdictions.
  - Reach for yield.