Comments On Known Unknowns:
The Global Transmission of Monetary Policy to Emerging Markets, and an Application to Chile,
Pierre-Oliver Gourinchas

by

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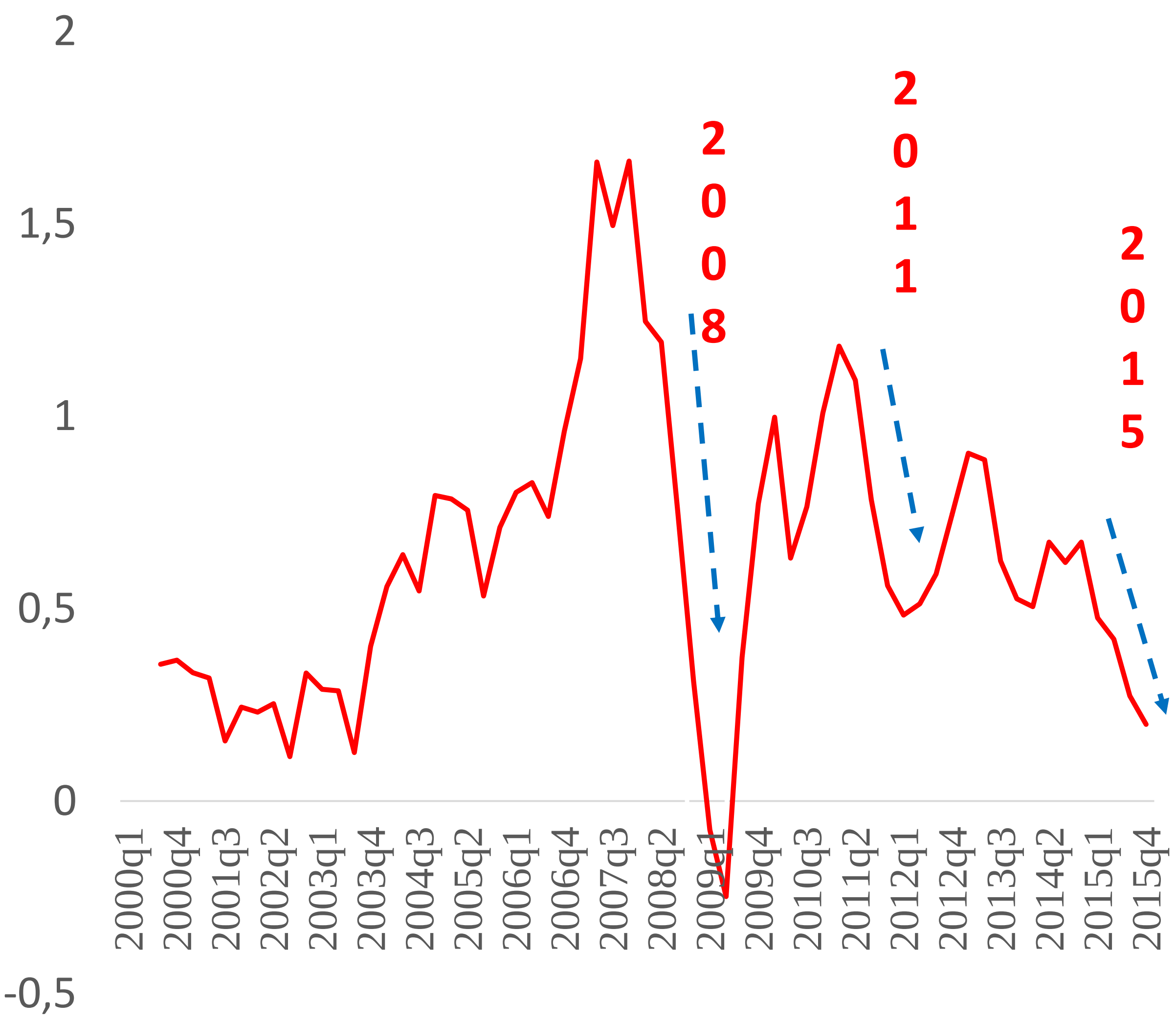
The Views are Personal

Issues

- Are "small open economies" condemned to ride the global financial cycles, especially triggered by the US monetary policy: Tight US monetary policy tightens global funding conditions. Appreciates the US dollar, and may be expansionary or contractionary abroad; effect depends on expenditure switching, income, and financial spillover effects
- Should exchange rate flexibility be of first order importance in surfing these cycles: Exchange rate flexibility important in adjusting to the shock, but not sufficient.
- What role should/can the monetary policy play in response to the US monetary : The optimal monetary response to a US policy tightening can be domestic tightening or easing depending on the net effect. At a certain level/range of financial spillover the optimal response is to not mimic US monetary policy, but to ease countercyclically
- Context similar to Rey (2013), but she suggested a larger role for macroprudential policies; capital account policies; and coordination of monetary policy

1. Capital Flows seem to have become more volatile, and global financial cycles do inflict emerging countries

- Capital flows have become particularly volatile since 2008—the Lehman episode (after a period of tranquility when emerging markets attracted large capital flows)
- There have been three episodes of enmasse reversals from emerging markets in last decade--2008, 2011, 2015!
- Besides there have been "milder events" such as tapering Talk and Brexit!



1. What triggered these events: US monetary policy? Not really

None originated in the US policy (or of other advanced economies), but were due to a confluence of factors.

2008 erupted with the collapse of Lehman;

2011 with the sovereign debt crisis of Europe;

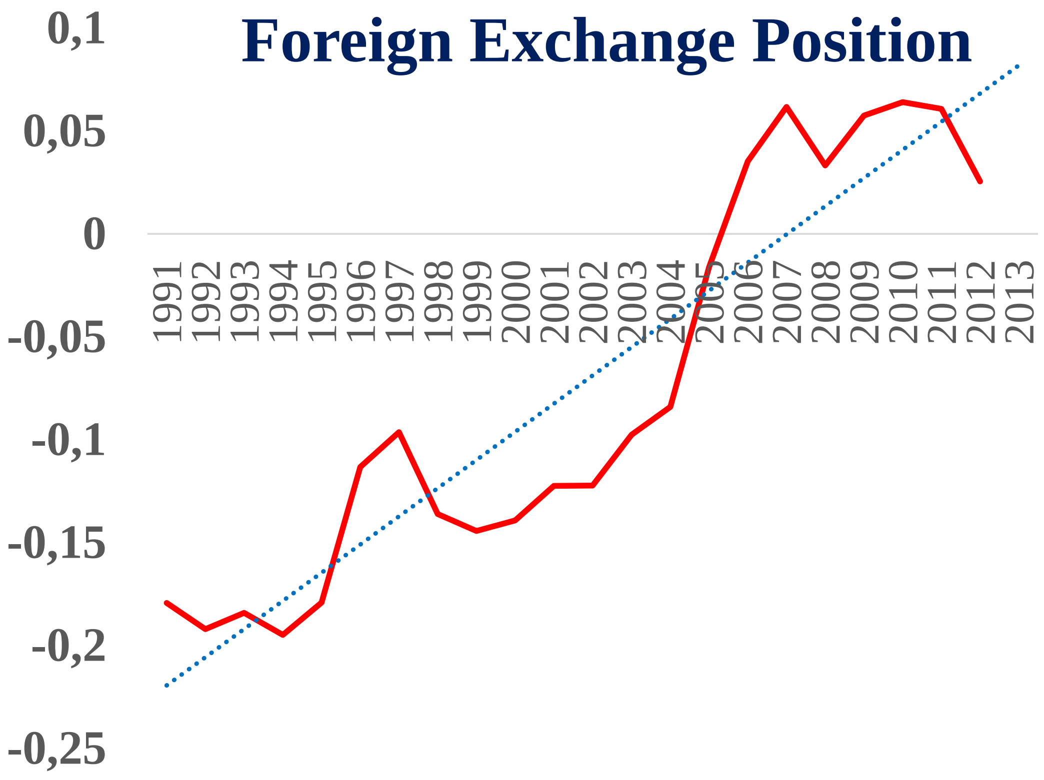
2015 coincided with oil prices, slowdown in the Chinese economy, and expectation of US tightening its policy rate

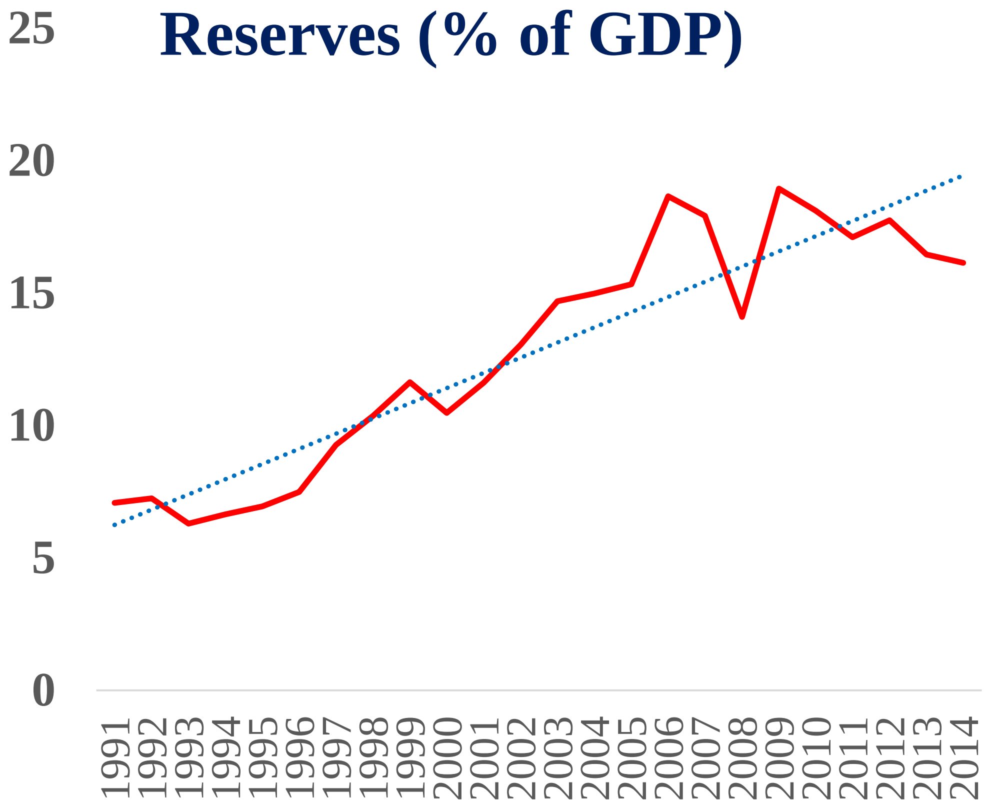
Except for Lehman they did not have an exact date when they started, each one lasted for about three quarters (rather longer drawn).

1. There are different kinds of shocks; and the cycle is not symmetric around the buildup and reversal phases…

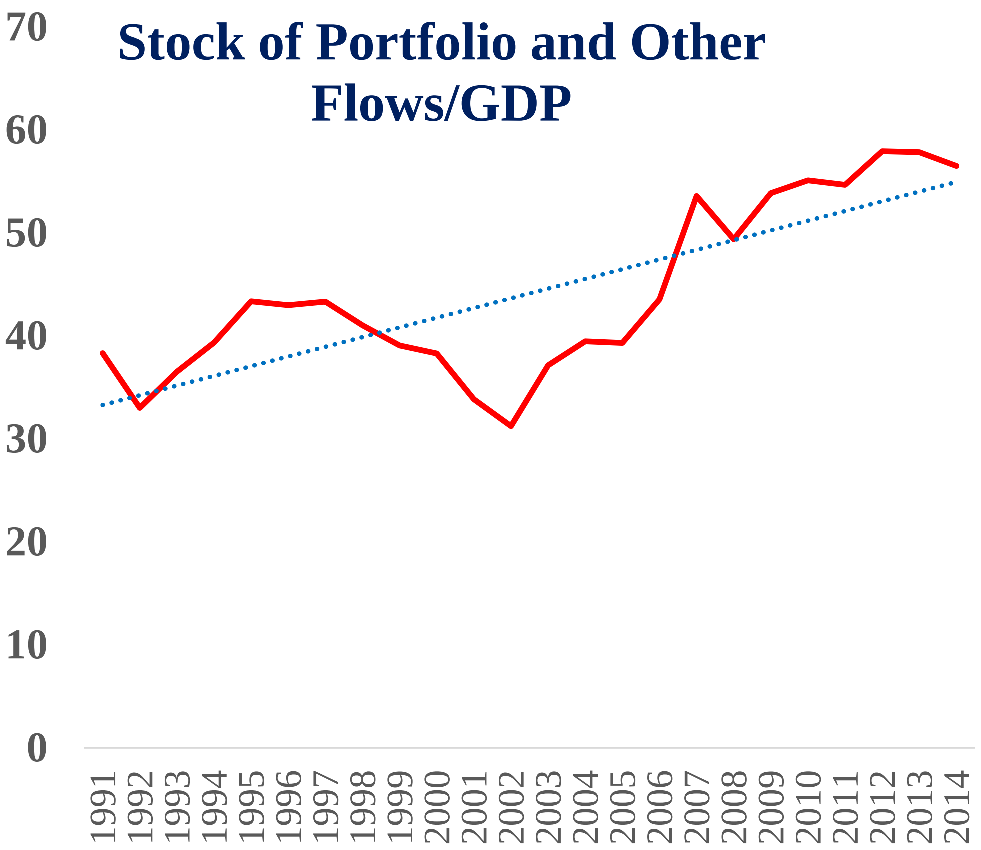
- Brexit– quite unexpected and had a very short term impact
- Tapering– lasted a quarter. The impact larger, but still short lived
- Rebalancing events: Lehman 2008, 2011, 2015. lasted 3 quarters on average--more room to react
- Sudden stops–the old kinds when country specific factors mattered and US monetary policy mattered; and the new kinds which are similar to rebalancing events (Eichengreen and Gupta, tomorrow)
- Asymmetric phases: The build up phases are longer, when a larger array of policy tools can be deployed. But the reversals can be shorter and sharper events requiring rapid response.

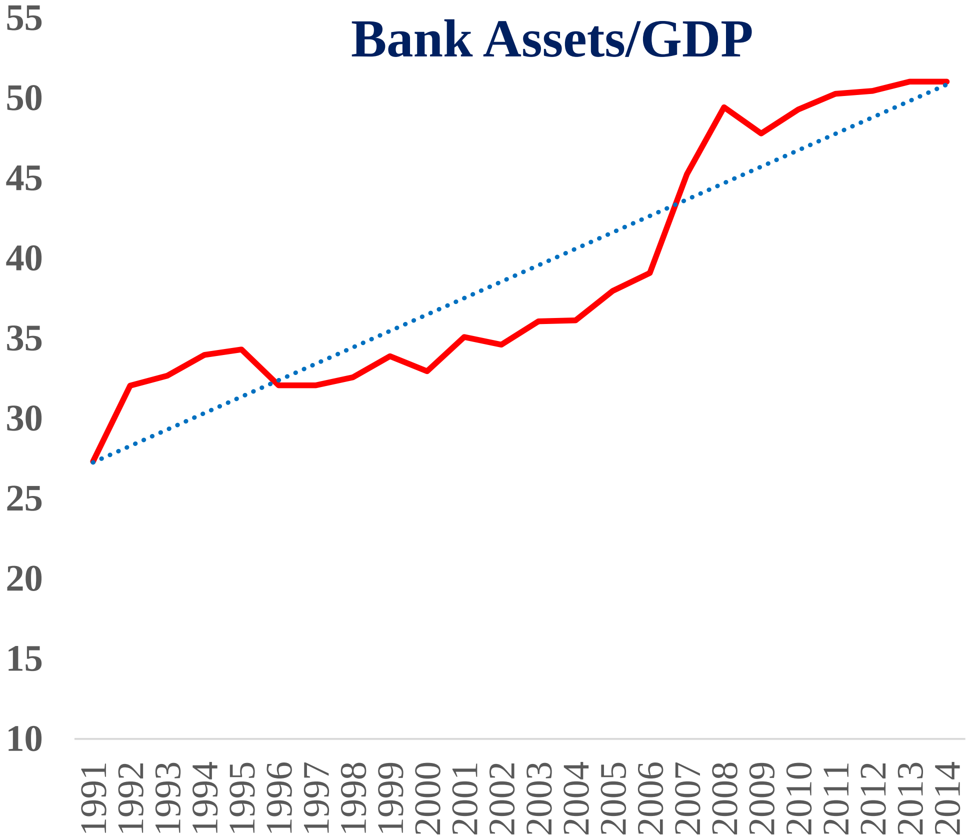
2. Financial spillover—due to liability dollarization? Emerging markets have lowered the currency mismatch. To think of financial spillovers as the negative effect of liability dollarization is less relevant.





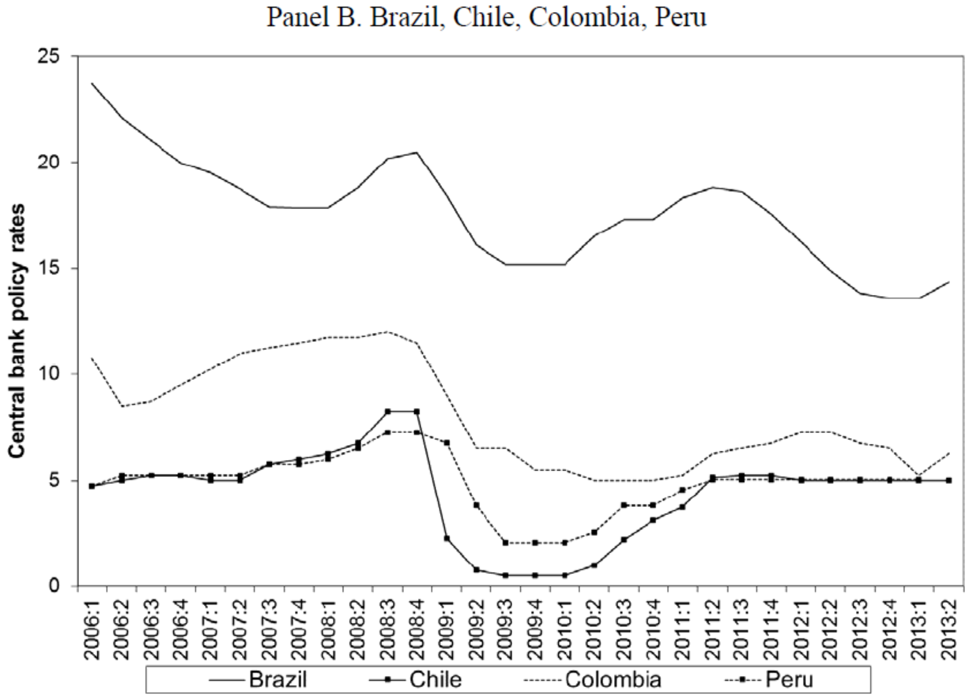
2. Instead financial sectors are larger, and mediate larger amounts of capital. Capital outflows affect them more than before.





3. Monetary policy in EM has increasingly become countercyclical (Vegh and Vuletin, 2012)

- Because of improved net foreign currency positions over time, Benetrix et al. (2014)
- Perhaps also because of the larger role banks play in the economy; and larger flows mediated through the banks
- Because of inflation targeting frameworks, as noted in McGettigan et al (2013).



3. Monetary policy is also implemented through required reserve ratio (Vegh and Vuletin, 2012)

Figure 10b: Cyclicality of interest rate policy (2005-2011)

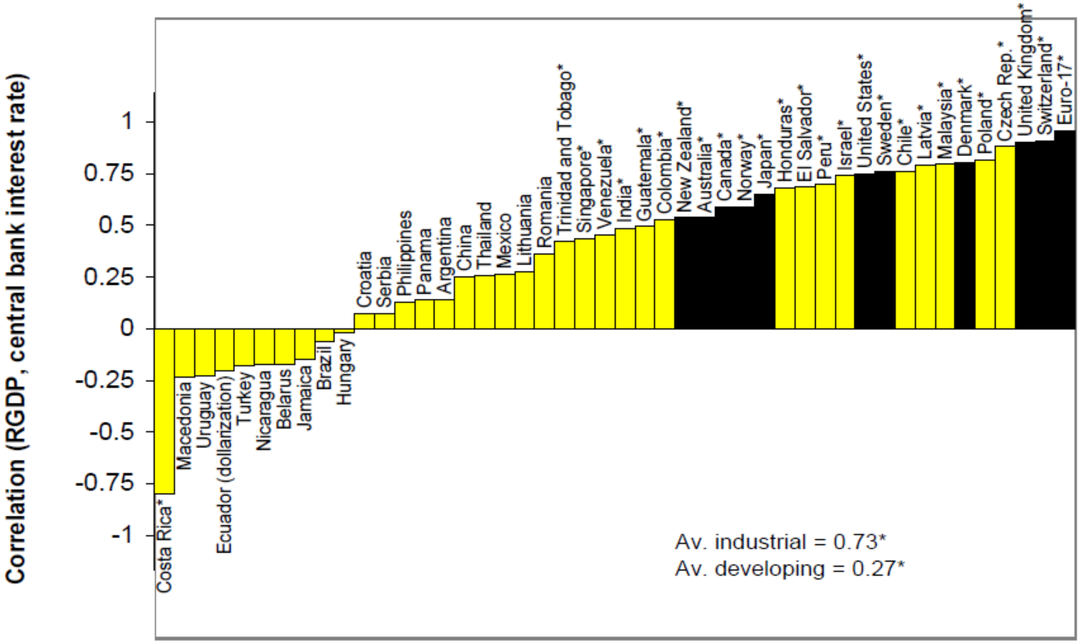
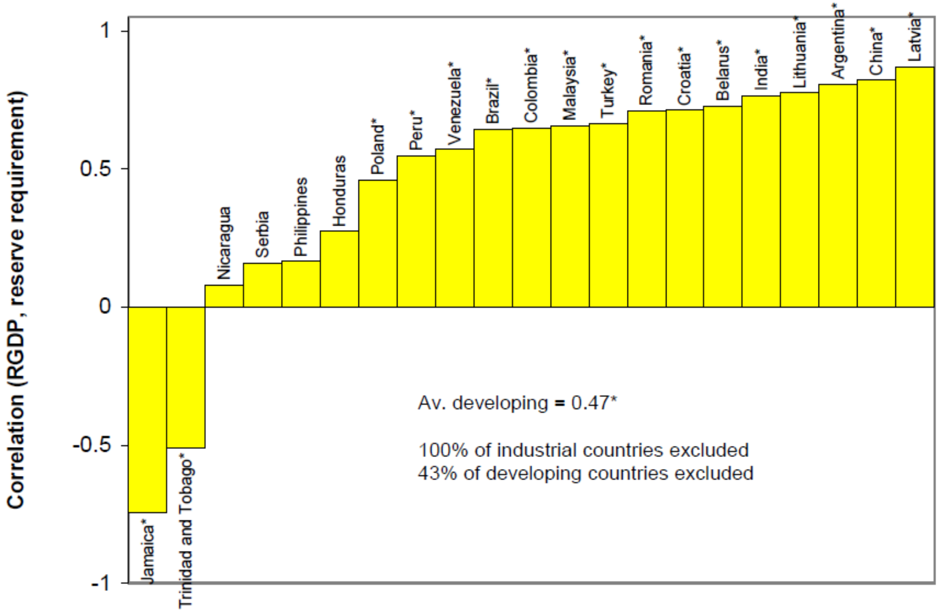
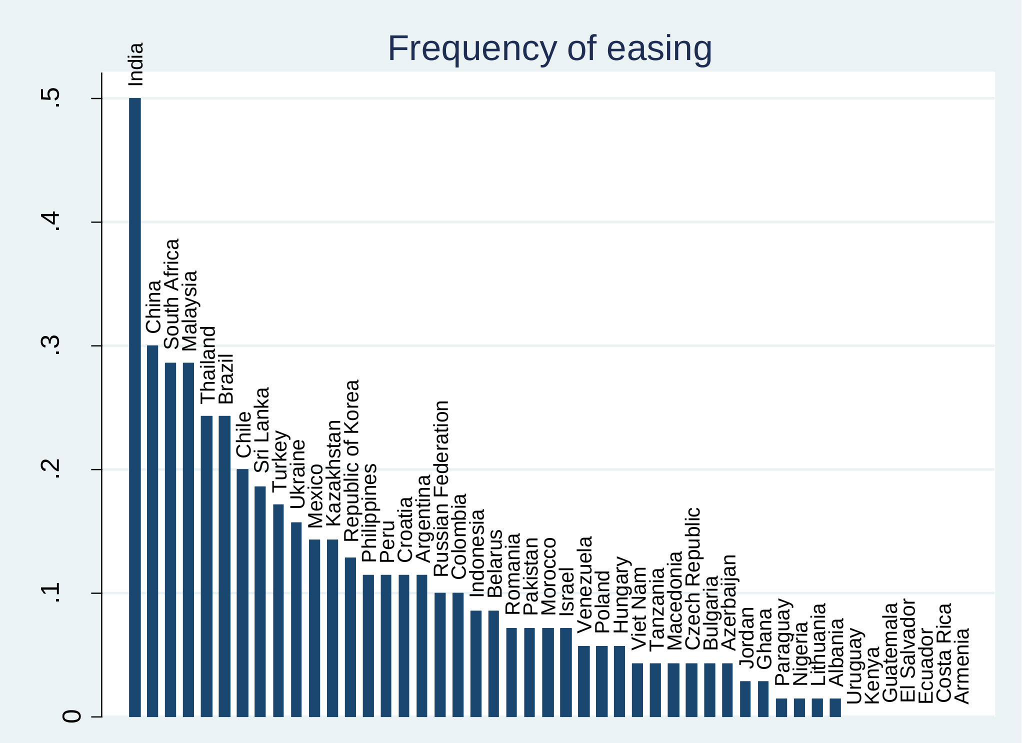
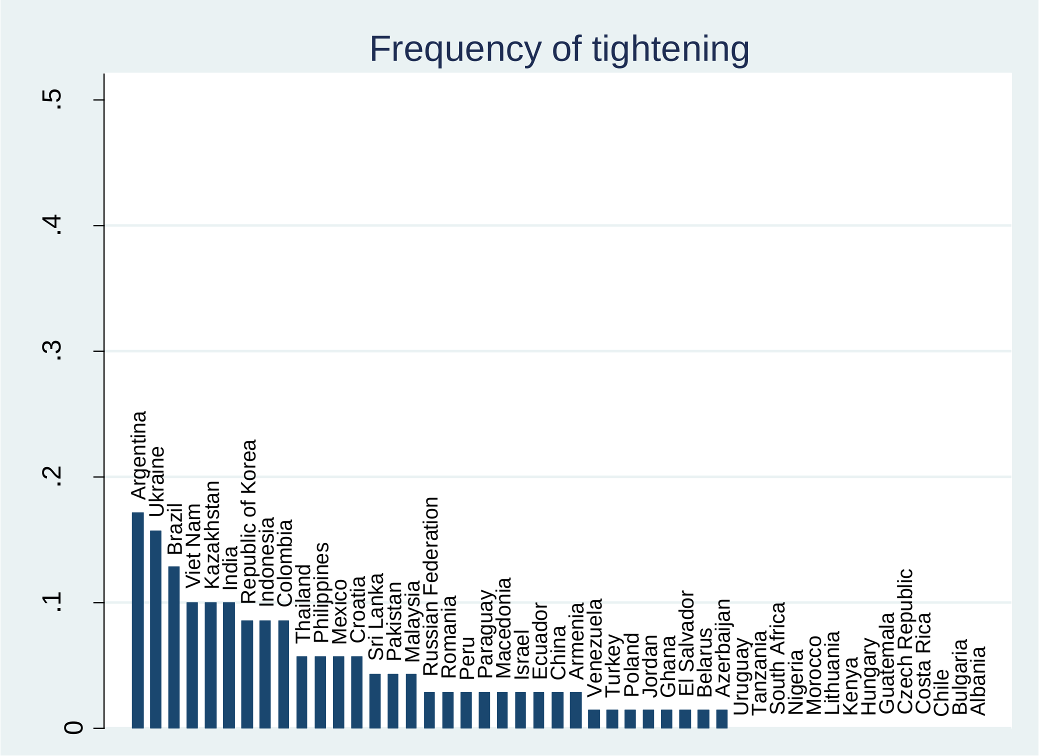


Figure 5b: Cyclicality of reserve requirement policy (2005-2011)



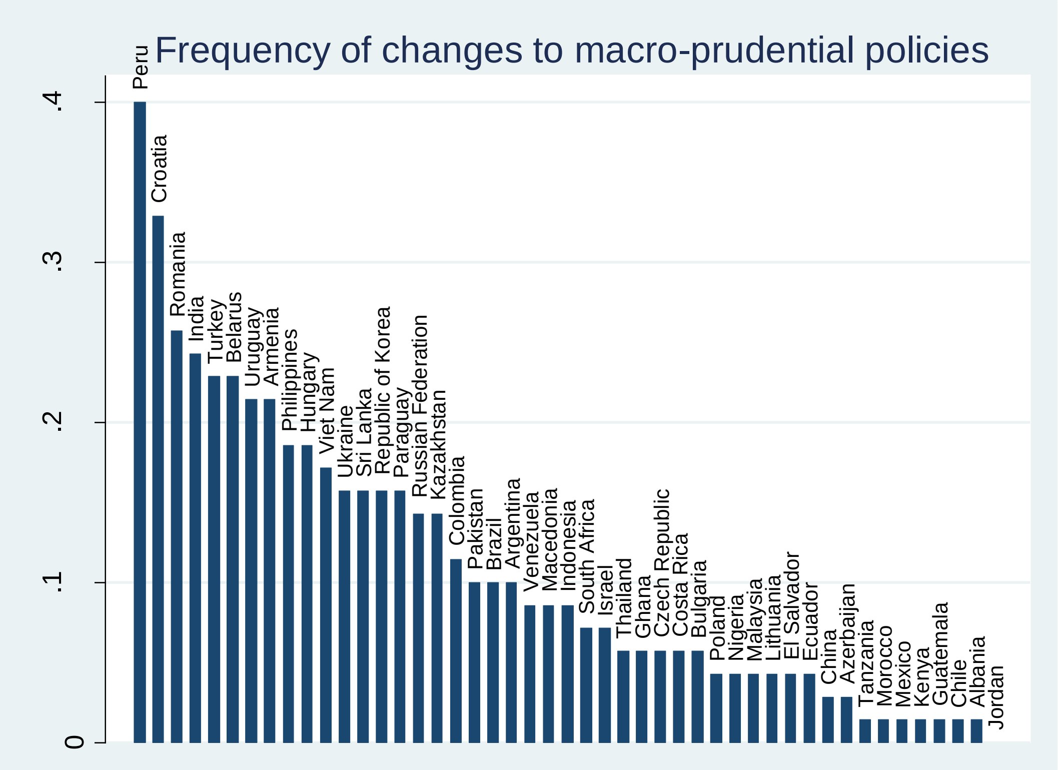
4. Capital account measures not used at business cycle frequency; easing is much more common than tightening





- ➢ median frequency of easing (0.071) is higher than the frequency of tightening (0.028)
- ➢ On average countries reduced restrictions on capital flows over the sample period

4. Macro-prudential regulations not used at business cycle frequency either; and used less frequently than the capital account measures



- The median frequency of changes to macro-prudential regulation is 0.085. This translates into on average one change every 11.7 quarters
- Macro-prudential regulations are thus less frequently changed than CFM

5. Might be useful to think of different types of shocks and differently phases of the cycles

- When capital flowing in

Exchange rate appreciates, but some modulation through reserve accumulation; monetary policy tightening if needed, including through required reserve ratio, strengthening macro prudential, liberalization of capital inflow slow down; outflows by residents liberalized

- When capital stops flowing in, but a fast and short event (Brexit, tapering)

Exchange rate depreciation; liquidity measures; and possibly some monetary easing

- When capital flows stop, a longer event, similar to rebalancing

Exchange rate depreciation; reserves to avoid overshooting and undue volatility; liquidity measures; and possibly some monetary easing including through required reserve ratio; macrorpeudnrtial easing; further liberalization of capital inflows by non-residents; and no further liberalization of outflows by residents.

5. What policy kit do EM deploy in practice during rebalancing?

	(1)	(2)	(3)	(4)	(5)	(6)
VARIABLES	% change in exchange rate	% Change in Reserves Reserves	Capital account liberalization (inflow)	Capital account liberalization (outflow)	Macro prudential	Interest Rate
Global Drought	4.744***	-5.820***	-0.009	-0.039**	-0.184***	-1.453**
	[14.18]	[-8.38]	[-0.57]	[-2.42]	[-4.60]	[-2.57]
Constant	0.363***	4.311***	0.037***	0.052***	0.084***	9.839***
	[2.95]	[16.64]	[6.54]	[8.75]	[7.29]	[46.52]
Observations	2,753	2,869	2,838	2,838	1,680	2,798
R-squared	0.069	0.024	0.000	0.002	0.013	0.002
Countries	43	45	43	43	28	45

main points

1. Yes global financial cycles have become important. Different kinds with different speed and duration. And the policy response needs to be specific to these.
2. The build up phase and the reversal phase seem asymmetric and not clear if the policy response can be symmetric.
3. No denying the fact that exchange rate flexibility is important, but how much flexibility (Obstfeld and Gourinchas, 2012). Is there a role for tempering large fluctuations and if so what role do reserves play
4. The role that financial sectors play—in mediating flows and their reversals and how they affect the notion of financial spillovers and the role of monetary policy.
5. Macro prudential and CFM used less frequently and not fully flexibly in both directions; but can play a role in the build up phase of cycles

Thank You!

- What is the nature of global cycles?
- Financial spillovers: liability dollarization, the role that financial sectors play in the global financial cycles
- Recent evidence on monetary policy
- Role for reserves, macro prudential and capital account liberalization

How flexible should the exchange rate be

The model assumes that the volatility of exchange rate does not have an additional effect of itself.

That the tradable sector is nimble enough to shrink in response to an appreciation and expand as exchange rates depreciate.

Too much exchange rate volatility can be a rea

What the paper intends to show

- Tight US monetary policy tightens global funding conditions….appreciates the US dollar, and may be expansionary or contractionary abroad; effect depends on expenditure switching, income, and financial spillover effects
- The optimal monetary response to a US policy tightening can be domestic tightening or domestic easing depending on the net effect.
- At a certain level/range of financial spillover the optimal response is to not mimic US monetary policy, but to ease countercyclically
- Exchange rate flexibility plays an important role in adjusting to the shock, but not sufficient.
- Context similar to Rey (2013), she suggested a larger role for macroprudential policies; capital account policies; and coordination of monetary policy