Two Views of International Monetary Policy Coordination

James Bullard

President and CEO, FRB-St. Louis

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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

- 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

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

Emerging-market stock indexes dropped

Evaluating the taper tantrum

- 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

- 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.
Conventional Wisdom
A traditional view

- Some literature reflecting a traditional view:
The international economy in a traditional view

- 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

- 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?

- 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.
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.
An Alternative View
An alternative view

- Literature reflecting an alternative view:
  - Written before the crisis, but possibly more relevant today.
The international economy in an alternative view

- 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

- 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

- 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

- 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?

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

- 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.
Conclusion
Difference between the two views

- 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

- 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

- 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.