

Simon M Potter: Is there room for more monetary cooperation?

Panel discussion remarks by Mr Simon M Potter, Executive Vice President of the Markets Group of the Federal Reserve Bank of New York, at the Global financial stability in a new monetary environment conference, hosted by the Bank of France, Paris, 30 September 2016.

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It is my pleasure to participate in this final session. I would like to express my appreciation to our host, the Banque de France, for its gracious hospitality, and to the organizers, the China Finance 40 Forum, the Euro 50 Group and CIGI, and all of the participants for very interesting discussions.

My remarks will focus on a question at the very core of this meeting: would individual countries benefit from coordinating their policy stances to jointly achieve their macroeconomic objectives? This naturally leads to another question: have we entered a stage in the history of the international monetary system that requires new institutional and policy solutions to the evergreen issue of how to insulate an economy from external shocks? And if the answer to these questions is yes, or even a partial and qualified yes, what are the next steps for policy design and implementation?

To get the ball rolling, let me recapitulate some of the themes underlying the current debate on policy coordination, and highlight a few open issues of particular relevance for our meeting today. It is worth emphasizing that these are my personal views, and need not reflect the views of the Federal Reserve Bank of New York or the Federal Reserve System.

Stated in abstract terms, macroeconomic coordination implies an arrangement to give up – at least partially – independence in policymaking to achieve objectives not otherwise in reach. Traditionally, gains from coordination are deemed to arise from avoiding “beggar-thy-neighbor” externalities that policymaking in one country or region can impart onto the rest of the world.

The modern theoretical case for coordination was formalized in a number of path-breaking re-visitations of the Keynesian Mundell-Fleming model through the lens of game theory. It is a pity that Richard Cooper was unable to join us today, because his work, along with that of his colleagues since the late 1960s, has posed the scientific basis for an insightful and ambitious research agenda.

In practice, though, once the Bretton Woods system ended, there were no attempts to revive a global framework of coordinated exchange rate or interest rate policies.¹ The general view in the policymaking community was that the potential welfare net gains from cooperation were modest and difficult to achieve, relative to the outcomes attainable within an orderly, yet

¹ The case for limiting competitive devaluations was paramount, for instance, in Europe – leading to the Exchange Rate Mechanism of the European Monetary System and providing the key underpinning of the “one market, one money” vision. But post-Bretton Woods attempts at coordination among advanced economies, such as the Plaza Agreement of 1985, were limited in scope and short-lived. And while the episodes of financial turmoil in Mexico and Asia during the 1990s challenged global policymakers’ capacity to coordinate their responses to crises, and led to calls for refocusing outreach to engage the major Emerging Market (EM) economies in new forms of diplomacy, the academic and policy debate kept calling into question the relevance of monetary compacts, arguing that coordination at best achieved little, and at worst led to counterproductive outcomes. For a recent survey see Kahn, Robert B., and Ellen E. Meade (2016), [International Aspects of Central Banking: Diplomacy and Coordination](#), Finance and Economics Discussion Series 2016–062. Washington: Board of Governors of the Federal Reserve System.

uncoordinated regime, where central banks and fiscal authorities pursued their domestic objectives.²

However, renewed calls for coordination have recently re-surfaced on a number of occasions. Why now? Is this old wine in new bottles, or does the new case for cooperation have its merits? I will focus on two significant forces that might lead one to reexamine the benefits to cooperation. The common theme is the restriction on providing monetary accommodation at the zero lower bound (ZLB). I will also briefly touch on the growing importance of emerging market economies.

First, over the last two decades, nearly all advanced economies have witnessed trend declines in their long-run real natural interest rates³, defined as the hypothetical rates required to balance national saving and investment in a full-employment equilibrium over the longer run. Lower longer-run natural rates reflect a number of slow moving structural factors, such as the aging of advanced economy populations and lower fertility, which are unlikely to reverse any time soon. With the success in anchoring inflation expectations at levels consistent with price stability, the low levels of the natural rate going forward imply a likelihood of more visits to the ZLB, or at least market participants placing more weight on such visits even for relatively small demand shocks.

Second, the global financial crisis was a sufficiently large demand shock that the short-run equilibrium real rate became very negative, and central banks were required to implement a number of unconventional policies to provide accommodation at the ZLB to mimic a highly negative nominal policy rate. Further, the zero bound has proved very sticky, as headwinds from the aftermath of the global financial crisis, such as consumer uncertainty boosting precautionary saving, tighter lending standards, lower business appetite for risk-taking, and at times fiscal consolidation, have restrained aggregate demand.⁴

In these types of environments, exchange rate depreciations may be deemed to be a particularly effective channel of monetary policy transmission as they raise foreign demand for domestic products. National policymakers may be tempted to deliberately weaken their exchange rates as a countercyclical instrument of demand management. Further, some of the transmission mechanisms of unconventional monetary policies, such as portfolio rebalancing, can generate strains on financial stability in other parts of the globe.

A question naturally arises whether a coordinated strategy would reduce the risks of exchange rate depreciation that can export disinflation and stagnation, and better promote global financial stability. Of course, a necessary condition for a positive sum game would be that joint policy can be effective through channels other than the exchange rate and portfolio rebalancing, or perhaps through better balanced combinations. To be clear, an expenditure-switching component is always associated with monetary accommodation in one country, at

² Exchange rate adjustments, far from being part of the problem, were to a large extent deemed as part of the solution, as they provided insurance against cyclical shocks allowing a country to target appropriate financial conditions and achieve the desired policy stance. One-off episodes of multi-country foreign exchange intervention or simultaneous interest rate cuts by central banks worldwide (as most notably in October 2008 in response to the Great Recession) did not substantially alter this picture.

³ See, for example, Holston, Kathryn, Thomas Laubach, John C. Williams. 2016, [Measuring the Natural Rate of Interest: International Trends and Determinants](#), Federal Reserve Bank of San Francisco Working Paper 2016–11, and Rachel, Lukasz, and Thomas D Smith. 2015. “Secular Drivers of the Global Real Interest Rate,” Bank of England, Staff Working Paper No. 571, December.

⁴ Crucially, the distance between inflation-adjusted market interest rates and the equilibrium real rates provides a metric to assess whether monetary policy provides sufficient accommodation or restraint. In many countries nominal policy rates have reached their zero or effective lower bound and have remained there for quite a while. But to the extent that real equilibrium rates remain low and are not expected to move back quickly – if at all – to historical levels, national monetary policies are unable to sufficiently spur domestic demand growth by lowering real borrowing costs below the equilibrium real rates and supporting asset prices.

the expense of its trading partners. Likewise, through their impact on the term structure, conventional and unconventional monetary policy both produce some degree of portfolio rebalancing and spillover to financial conditions elsewhere.

The problem is that in a global ZLB environment this expenditure-switching effect may turn out to be stronger than usual – in fact, strong enough to dominate the positive spillovers of national monetary stimulus inducing an expansion in demand for world output. The point is that, in a ZLB regime, the negative spillovers abroad may be compounded by the inability of the trading partners to respond to exchange rate shocks and restore cost-competitiveness by easing their policy stances effectively.

But while press accounts have often focused on negative externalities – alleged currency wars and the like – there is also a question of potential positive externalities – specifically whether, and how, authorities in one country might improve their own prospects by moving in concert with their counterparts in other countries. Indeed, some have suggested a global policy compact is needed to provide additional countercyclical stimulus to boost demand and make up for the loss of effectiveness of conventional and unconventional national policies. Some have argued that in this context, fiscal coordination could be at least as impactful as monetary, as it provides a different channel for accommodation and can, if applied with some care, also push up longer-run natural rates of interest. Absent coordination – the argument goes – there is little hope that a country can escape its ZLB sandtrap on its own, if the rest of the world is also simultaneously stuck in a liquidity trap. Of course, this is just an argument at the moment and we have little concrete evidence that this is empirically true.

As an illustration of this potential sandtrap, consider the case of a country experiencing an earlier recovery than others from a large financial crisis that had pushed it and its trading partners to the ZLB. This country will exhibit relatively better fundamentals, and a relatively higher real equilibrium rate, than its trading partners. Absent coordination, the country would be expected to run a relatively tighter monetary policy. This tighter stance would trigger net capital inflows as market participants respond to “search for yield” opportunities, leading to a stronger real exchange rate and tighter financial conditions. Contractionary and disinflationary pressures would then deteriorate the country’s medium-term outlook and offset its initial comparative advantage. The final outcome could be a return to the ZLB prevailing amongst its trading partners.⁵ This illustration critically depends on all the countries being relatively equal on structural supply issues. If the country recovering more quickly has a more flexible supply side entering the financial crisis or successfully implements supply reforms after the crisis, it is less clear the argument holds.

Going forward, coordination could also play a role as insurance against future downturns in a global environment of low natural real interest rates. In such an environment, average policy rates over the long run will be relatively low. Facing cyclical disturbances, national monetary authorities will have little leeway to cut their policy rates and provide effective monetary easing. But expected coordinated efforts to avoid beggar-thy-neighbor spillovers while supporting global demand through simultaneous easing may reduce the probability of hitting or staying at the ZLB for a prolonged period of time.

The question of financial stability spillovers has taken on particular prominence with respect to the emerging market economies, or EMEs. It has been argued, for example, that accommodative unconventional monetary policies in the advanced economies expose the EMEs to excessive and potentially destabilizing fluctuations in capital flows. And conversely, it has been argued that efforts by some EMEs to resist currency adjustment have posed

⁵ Similar considerations appear in Eggertsson, Gauti, and Lawrence Summers (2016). “Secular Stagnation in the Open Economies: How it Spreads, How It Can Be Cured”, *VoxEU*, July 22. See also Eggertsson, G., N. Mehrotra, S. Singh, and L. Summers (2016), “A Contagious Malady? Open Economy Dimension of Secular Stagnation,” mimeo, Brown University.

financial stability risk to other countries, both advanced and emerging, by contributing to a global savings glut. An often heard case for cooperation is that a more favorable and sustainable global allocation could be achieved if policymakers in both advanced and emerging countries were willing to internalize the externalities they impose on each other, instead of acting unilaterally according to domestic mandates.

But while these various arguments for increased cooperation are suggestive, they hinge on many theoretical and empirical assumptions that would need to be more rigorously quantified and validated. And of course, there is the thorny issue of how joint decision-making could be coordinated in practice, given likely difficult and hard to measure tradeoffs among and across various countries' interests, not to mention all the complexities of real-world policymaking and national accountability.

But with changed global circumstances, the potential gains from enhanced coordination do appear worth exploring. Academic economists are starting to address the issues I have discussed, using models that better capture the current international situation. The results from their analysis will be useful in assessing whether there are increased benefits to cooperation, given this new environment of low natural rates and the growing size of the emerging world.

Let me conclude by underscoring the continuing importance of the forms of cooperation that we do see today among central banks, the ones so vitally supported by Claudio and his colleagues at the BIS: the information sharing, the exchange of perspectives based on differing experiences, and different frameworks.

While perhaps not as sexy sounding as designing a new architecture for international coordination, this ongoing cooperation has certainly produced numerous benefits, and we are all better off for it. It merits continued nurturing, including through gatherings such as this.

Thank you.