Stanley Fischer: International effects of recent policy tightening

Speech by Mr Stanley Fischer, Vice Chair of the Board of Governors of the Federal Reserve System, at the IBRN-IMF conference "The Transmission of Macroprudential and Monetary Policies Across Borders", Washington DC, 19 April 2017.

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I appreciate your invitation to participate in this afternoon's panel discussion. In my remarks, I will discuss how U.S. monetary policy actions affect our foreign trading partners, with particular focus on how foreign economies have responded to the Federal Open Market Committee's (FOMC) ongoing normalization of policy rates.[1]

Spillovers from the Fed's Unconventional Policies

Extensive empirical research on spillovers—including by Federal Reserve and International Monetary Fund (IMF) staff members—indicates that spillovers from the actions of major central banks occur through several important channels.[2] While the exchange rate is a key channel of transmission and gets a great deal of attention in the public debate about monetary spillovers, it is not the only channel. U.S. monetary policy also affects foreign economies by influencing U.S. domestic demand and by affecting global financial conditions.

My reading of the evidence is that the Fed's highly accommodative monetary policy during the Global Financial Crisis and its aftermath probably raised foreign gross domestic product (GDP) overall.[3] While U.S. monetary easing caused the dollar to depreciate, which reduced foreign GDP by shifting demand toward cheaper U.S. goods, foreign economies benefited from a stronger expansion in U.S. domestic demand. Moreover, U.S. monetary easing also stimulated foreign GDP by depressing foreign bond yields and raising the prices of risky assets.

Of course, there were considerable differences in how foreign economies were affected by the Fed's policies. Because the advanced foreign economies (AFEs) also experienced slow growth after the financial crisis, their central banks adopted similar policies. By contrast, the Fed's accommodative policies put further upward pressure on asset prices and currencies in some emerging market economies (EMEs) that were already experiencing rapid output growth. Thus, EME central banks had to navigate between tightening policy more—and hurting exports through a bigger exchange rate appreciation—and maintaining an accommodative stance closer to the Fed's, but with a higher risk of overheating.[4] These tradeoffs faced by EME central banks underscore some of the challenges posed by monetary policy divergence with the United States—a tradeoff with which I am personally very familiar.

Spillovers from Recent Policy Tightening

Monetary policy divergence remains a familiar theme today, but the focus has obviously shifted to the consequences of tighter U.S. monetary policy for the global economy. Policy divergence is an ongoing concern given that most AFEs and many EMEs have continued to pursue highly accommodative monetary policies that remain appropriate in light of their weaker cyclical positions and subdued levels of underlying inflation. Many observers point to the "taper tantrum" in 2013 as illustrating how monetary tightening by the Federal Reserve can potentially have strong contractionary effects on foreign financial conditions. Subsequently, the expectation that a steadily improving U.S. labor market would call for tighter U.S. monetary policy—and hence imply greater monetary divergence with our trading partners—helped drive a sharp appreciation of the dollar between the middle of 2014 and the end of last year that was accompanied by capital outflows from many EMEs.

Against this backdrop and the concerns it raises, the reaction in financial markets to the FOMC's decisions to increase the target range for the federal funds rate following its December 2016 and March 2017 meetings—by a cumulative total of 50 basis points—seems benign. The yields on risky foreign bonds, especially in EMEs, have continued to decline to below historical norms, and global stock prices have risen. The dollar has depreciated since mid-December, especially against EMEs, and the EMEs have experienced capital inflows.

In my view, this favorable reaction partly reflects a view by market participants that the rate hikes are a signal of the FOMC's confidence in the underlying prospects for the U.S. economy that in turn has increased confidence in the global outlook: A strong U.S. economy is a major plus for the global economy. But the main reason for the positive market reaction is that foreign output expansions appear more entrenched, and downside risks to those economies noticeably smaller than in recent years. In Europe, unemployment has fallen steadily; inflation and inflation expectations are moving toward central bank targets; and, while Brexit entails many unknowns, so far it has not resulted in significant financial market disruptions. China's economy also appears to be on a more solid footing, which has helped stabilize the renminbi as well as support growth in other EMEs.

The IMF staff has taken these developments into account in the April 2017 *World Economic Outlook* (WEO) and forecasts that world GDP growth will be noticeably higher over the next two years than in 2016—a slight upward revision relative to the October 2016 WEO.[5] There may well even be some chance that foreign economies kick into gear enough that U.S. and foreign business conditions become reasonably well aligned, as occurred during the U.S. monetary tightening cycles that began in 1999 and in 2004. In both of those episodes, U.S. exports grew substantially against the backdrop of a brisk expansion in foreign activity and a stable or even slightly depreciating dollar.

Of course, it is hard to predict whether foreign economies continue to strengthen so that the global economy will move more in sync—as I hope—or if a substantial gap will remain between the business cycle positions of the United States and our foreign trading partners. However, even if monetary policy divergence remains substantial, there is good reason to think that spillovers to foreign economies will be manageable. First, I expect that the Fed's removal of accommodation will be driven by a continued expansion of the U.S. economy; thus, foreign economies are likely to benefit from the developments that induce the FOMC to tighten. Second, most foreign central banks should be able to mitigate an undesirable tightening of their own financial conditions through appropriate policy actions. An important lesson of the taper tantrum was that effective communication and actions by major central banks, including the European Central Bank and the Bank of England, were helpful in quickly pushing bond yields down to levels that these central banks regarded as appropriate to their economic situation. Third, many EMEs have markedly improved fundamentals—including smaller current account deficits and more anchored inflation expectations—that should allow them to better withstand the effects of U.S. tightening, though some vulnerabilities remain.

Finally, I expect that U.S. policy normalization will be gradual under likely scenarios for the evolution of output and inflation. A gradual and ongoing removal of accommodation seems likely both to maximize the prospects of a continued expansion in the U.S. economy and to mitigate the risk of undesirable spillovers abroad.

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2 There is a large empirical literature assessing the spillovers from Federal Reserve policy actions, including those from unconventional policies such as large-scale asset purchases—for example, Fratzscher, Lo Duca, and Straub (2013); Rogers, Scotti, and Wright (2014); Neely (2015); and Sahay and others (2014).

3 My November 11, 2016, speech (Fischer, 2016) provides a more detailed discussion of spillovers from U.S. monetary policy, including some quantitative estimates that draw on the analysis of Ammer and others (2016).

4 For a more detailed discussion, see Fischer (2016) and Bernanke (2015).

5 See International Monetary Fund (2017).