Comment on International Policy Coordination: Present, Past and Future by John B. Taylor

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John Taylor's critiques of post 2000 ultra-loose monetary policies are well known and have been widely discussed. His ideas are a subject of ongoing research, with no firm conclusion as yet. This paper, however, breaks new ground and makes important new points. It should command attention even from those, such as myself, who continue to believe aggressive monetary easing is fully warranted in the aftermath of a once in eight decades financial crisis.

Taylor's basic point is this: during normal times, when economies aren't overleveraged and global credit markets are fully functioning, there is a good case to be made that international monetary coordination is a second-order problem. Yes, there are potential gains, but if individual central banks are keeping their own house in order, one gets a pretty good outcome without going to extra effort of trying to coordinate policies across countries.

After the financial crisis, howeer, monetary policy has deviated far from any recognized norm (let's say the Taylor rule). When monetary policy strays from the conventional, we no longer can point to the same body of literature that argues that monetary coordination is a second order issues.

And we must acknowledge our uncertainty. No one really quite fully understands how quantitative easing works theoretically, much less empirically. So, as of now, we cannot possibly fully understand the spillover effects of QE. Hence, policymakers need to be alert to the possibility that we are in a period where lack of international monetary policy coordination just might be a much bigger problem than anyone realizes. This is a thought-provoking argument that applies whether or not one believes in QE, though Taylor cogently the problem is especially big if, as he believes, QE has become counterproductive even for countries such as the United States. A logical corollar is that monetary policymakers in the core countries should be more cautious about deviations from Taylor rules, since the potential costs of the deviations might be considerably magnified through international spillovers.

It helps to follow Taylor and briefly review the theory

Many studies have shown that as long as each individual central bank is doing a good job managing domestic output and inflation tradeoffs, the further theoretical gains to international coordination of monetary policies are relatively small. Taylor explains this point neatly by noting that for many kinds of shocks, international monetary spillovers have two effects that are roughly offsetting. Marginally looser home country monetary policy does have an expenditure switching effect because the home currency depreciates. But it also raises global demand, and just enough of this demand spills over to the foreign country to roughly offset the exchange rate effect. This effect has been demonstrated in many theoretical and empirical models, although of course there are counterexamples. Taylor described the Great Moderation period as one where it was (almost enough) for central banks to keep their own house in order.

Now it should be noted that some of theoretical models Taylor surveys presume a very high degree of international capital market and good market integration. In my 2002 QJE paper with Obstfeld, we show that if there are significant international capital market perfections, the case for international policy coordination becomes somewhat stronger. The basic point, of course, is that the less agents can diversify local risks across international markets, the greater the case for coordination. Coordination, by the way, in this literature, does not necessarily imply that every central bank does the same thing at the same time. Coordination (or cooperation) definitely does not necessarily mean stabilizing the exchange rate. Exchange rate stabilization is optimal only when countries are hit by a common shock. Even so factors such as international investment positions or production differences can introduce asymmetries implying that exchange rate stabilization is no longer optimal.

Taylor gives a couple very simple and nice theoretical examples of why spillovers in monetary policy might be second-order. He goes on to use several illustrative small-scale macroeconomic models to show that these are likely also small in practice, at least in normal times.

Unfortunately, we cannot simply apply these same principles in periods of widespread QE, because we simply understand too little about the transmission mechanism to the domestic economy much less international spillovers. Taylor gives several illustrations of why spillovers might be problematic, especially for emerging markets. The upshot of his analysis is another reason for caution in QE, one that is rarely emphasized except occasionally when talk of "currency wars" heats up. Towards the end of his paper Taylor give very fair and balanced assessment of Bernanke's view that the generalize move to QE is simply the realization of a generalized monetary expansion necessary with the global economy so weak.

One issue Taylor assumes away is fiscal policy. Of course, there is a case for sustained accommodative fiscal policy during a deep recession, particularly spending on productive infrastructure or education. But the fiscal authorities also need to provide a clear long-run anchor for the trajectory of debt, one that frees up monetary policy to be more pro-active. Long-run fiscal stability reduces concerns that either inflation expectations or interest rate risk premia will become a problem in the future. In general, while there may be a case for greater international monetary policy cooperation after a financial crisis, there may simultaneously be a case for greater coordination of fiscal, regulatory and even reform policy. And there is every reason to suspect that all of these are interlinked.

Lastly, it has to be noted that a big difference between the Great Moderation period and the financial crisis period is the collapse of credit. As many have noted, weak bank balance sheets deeply compromise the normal monetary transmission channel, and potentially upend standard monetary policy rules; see for example, Reinhart and Rogoff (2013). Surely a major difference between the United States and Europe today is the fact that the US authorities were much more pro-active in cleaning up bank balance sheets and recapitalizing where necessary. In Europe, by contrast, prolonged excessive forebearance has forced banks into a prolonged retrenchment period, and a generalized retreat from lending. Of course, the US also has the advantage of having much deeper bond markets, and therefore less reliance on the banking system as a whole. Credit market imperfections are essentially swept under the rug in standard macroeconomic models, which therefore perhaps underestimate the importance of credit in the functioning of monetary policy. Credit is endogenous and depends of course on the state of the economy. But there have been huge swings in the intensity and quality of regulation as well, and these can have a dramatic effect on overall monetary conditions that might not be fully incorporated into standard monetary policy rules. More research is needed to see if there are constructive and relatively tractable ways to take into account monetary conditions in a generalized Taylor rule.

In sum, this is a useful and thought-provoking paper. At the margin, it seems to strengthen the case for following more conventional Taylor rules, although of course there are many complex considerations. Regardless, Taylor's paper invites a reassessment of the widespread presumption that international monetary coordination is a second order problem, especially in the aftermath of a huge financial crisis.

References

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