Alberto G Musalem: International spillovers and policies

Remarks by Mr Alberto G Musalem, Executive Vice President of the Integrated Policy Analysis Group of the Federal Reserve Bank of New York, at the People's Bank of China-Federal Reserve Bank of New York Joint Symposium, Hangzhou, Zhejiang, China, 15 Mach 2016.

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Good morning. Thank you for the opportunity to speak here in Hangzhou about the important theme of international spillovers. By exchanging perspectives and experiences we can forge relationships and a shared understanding that can lead to better economic outcomes. I will focus mostly on the interaction of international spillovers with policy frameworks within and across countries. I will do this from the vantage point of a domestic economy experiencing foreign spillovers. I will then briefly turn to considerations from a U.S. perspective. As always, my remarks reflect my own views and not necessarily those of the Federal Reserve Bank of New York, the Federal Open Market Committee (FOMC), or the Federal Reserve System.[1]

International spillovers encompass a broad topic with respect to their sources and channels. Before narrowly focusing on monetary sources and associated channels, it seems appropriate to first take a broader view of the various sources. Foreign spillovers can emanate from monetary, fiscal, regulatory, currency or trade policies. Spillovers can also arise from endogenous productivity changes, from financial stability developments, and from a global financial cycle.[2]

The Mundell-Fleming logic remains relevant for thinking about policy options of open economies. It provides lessons on channels of transmission, basic tradeoffs across objectives, and the effectiveness of policy responses.[3] The channels of macroeconomic and financial transmission among open and interdependent economies occur through the current account of the balance of payments, the capital account, or both. From the vantage point of the domestic economy, there are three main channels of transmission: the exchange rate; the external demand; and the interest rate or risk-premia channel. The last can be more broadly defined as the financial conditions channel.

The intensity of transmission of spillovers will depend on the monetary policy, currency policy and the real and financial openness of the economy being affected by external developments. Other relevant characteristics include the flexibility of labor and product markets; the depth, safety and soundness of the financial system; and the economy's position as an international creditor or debtor.

The Mundell-Fleming framework suggests that a country with a high degree of capital mobility and a flexible currency will be in a favorable position to use monetary policy to attain its internal growth and inflation objectives. When foreign interest rates increase and financial conditions tighten, changes in relative prices brought about by currency fluctuations can help to absorb the external shocks. The positive expenditure switching effect from currency depreciation improves the trade balance and supports demand. It is sufficiently larger than the negative investment demand effect from higher interest rates, such that internal balance is attained and monetary policy is able to pursue domestic inflation and growth objectives.[4]

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1 Linda Goldberg, Paolo Pesenti, Joseph Tracy and Matthew Higgins contributed to these remarks.

2 A global financial cycle refers to the global co-movement of credit by banks and capital markets, asset prices, term premia, and risk premia.

3 Fleming (1962) and Mundell (1963).

4 Krugman (1999). The balance sheet effects imparted from a large international debtor position may work against achievement of an improved external balance and attainment of internal balance.

Different policy options are available to a country with a high degree of capital mobility and a preference for currency stability. A country may prefer currency stability as an effective nominal anchor, or because of concerns about the broader uncertainties associated with currency volatility. Regardless of the reason and because the exchange rate is not available to absorb external shocks, this country will be in an unfavorable position to achieve domestic macroeconomic objectives by using monetary policy. Instead, monetary policy is aimed at external adjustment. Tighter foreign monetary policy and financial conditions need to be validated by tighter domestic monetary policy to maintain currency stability. With domestic monetary conditions effectively imported from abroad, they may sometimes conflict with domestic growth and inflation objectives. Simply put, currency stability is prioritized.

These policy considerations are summarized in the well-known international policy trilemma. It says that a country cannot simultaneously maintain independent monetary policy focused on domestic objectives, a high degree of capital mobility, and currency stability. Any two of these regime characteristics can be chosen, but not all three. While the trilemma suggests sharp tradeoffs, additional policy tools can soften the tradeoffs.

Fiscal policy is one tool that serves this purpose. When foreign credit conditions tighten, expansionary fiscal policy can allow a country with a high degree of capital mobility, and a policy preference for currency stability, to effectively manage towards domestic macroeconomic objectives and internal balance. In fact, fiscal policy can also be used to rebalance the composition of demand towards the desired mix of investment and consumption.

Softer tradeoffs than implied by the trilemma are suggested by some of the empirical evidence on interest rate co-movements. For example, there is ample evidence that domestic short-term interest rates become progressively less correlated with short-term interest rates in large foreign countries, and that monetary policy is more autonomous, as countries move from high capital mobility to low capital mobility, and from rigid currencies to flexible currencies.[5]

Using foreign exchange reserves to support currency stability is unlikely to be as effective in enabling the country to attain domestic growth and inflation objectives. If losses of foreign reserves are not sterilized, the effect will be similar to that of domestic monetary tightening, and as already discussed, might work against domestic growth and inflation objectives. If reserve losses are sterilized and the underlying cause of capital outflows is not addressed, reserves losses can be persistent.

Macroprudential policy provides an additional tool that can add degrees of freedom and help soften the tradeoffs of the trilemma. Macroprudential policy can potentially temper spillovers by modulating the type of buildup of financial imbalances that contributed to the Asian crisis of 1997, countless other emerging market crisis, the global financial crisis of 2008 and the subsequent euro area crisis of 2011. Progress continues to be made in designing macroprudential policy frameworks, in definition of objectives, and in developing appropriate instruments, calibration and communication.

Capital flow management can be viewed as the part of the macroprudential toolkit that operates across borders. Over the last five years, capital flow management has received increased attention, first in managing inflows and, more recently, in managing outflows.[6] A consensus has emerged that capital flow management can be useful as part of a broader set of policy tools. In fact, the effectiveness of capital flow management may be limited if not appropriately supported by monetary, fiscal, exchange rate and prudential policies, or the

5 Obstfeld, Shambaugh and Taylor (2005), Goldberg (2013), Klein and Shambaugh (2015) and Obstfeld (2015).

6 G20 (2010), IMF (2012), Farhi and Werning (2014) and IMF (2015).

warranted macroeconomic adjustment. Also, capital flow management practices that are transparent, temporary, and targeted seem to work best.

Spillovers from foreign countries are not confined only to conventional monetary policies, nor is the U.S. the sole source of transmission. There also is evidence that the unconventional monetary policies of the ECB and the BOJ have spilled over onto the U.S. yield curve and broader financial conditions.[7] This is interesting because all three monetary areas share the characteristics of flexible currencies and capital mobility.

I will now conclude with a few related comments from the U.S. perspective.

The Fed's statutory mandate, like that of other central banks, is domestic. The Federal Reserve Act states that the Fed should "promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates". Within this mandate, there are good reasons to consider the international effects of monetary and regulatory policies. The U.S. economy and the economies of the rest of the world have important feedback effects on each other, and adverse international spillovers can harm U.S. prosperity.

Like other central banks, the Federal Reserve can help promote global prosperity and stability, by promoting growth and stability at home. The FOMC has taken a number of steps in recent years to increase transparency and improve communications, to effectively convey policy intentions to market participants and policymakers. The Fed has also made considerable progress in strengthening the safety and soundness of the U.S. financial system, through improved regulation and supervision of banks and a broader group of systemically important institutions. A stronger U.S. banking system better protects against future shocks, provides a more solid foundation for domestic growth, and therefore also enhances prospects for growth and financial stability abroad.

I look forward to a discussion with fellow panelists and also to engaging with conference participants over the next two days.

Thank you for your attention.

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7 http://www.federalreserve.gov/aboutthefed/section2a.htm.

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