Thoughts for PEIF talk – focus is on monetary and macroprudiential, and not fiscal policy.

Clarifications:

1. Sterilized versus unsterilized intervention. We often hear talk about "exchange-rate policy", but does that refer to monetary policy? In high-income countries with free capital mobility, sterilized intervention is not an option. It is a more an option in countries with capital controls, or in countries with foreign exchange markets that are not deep.

A distinction needs to be drawn between countries that can temporarily affect their real exchange rate or terms of trade using capital controls and sterilized intervention – countries whose capital controls are "gates", in Michael Klein's terminology – versus countries that can more persistently affect exchange rates independently of monetary policy who have capital controls that are "walls".

But even in the rich countries with free capital mobility, macroprudential policies can have similar effects and achieve similar goals as sterilized intervention. So perhaps we need to discuss the two together.

Two instruments are better than one.

2. A country does not insulate itself from "spillovers" by having flexible exchange rates. Contrary to a lot of informal discussion, macro models do not have this implication, even setting aside considerations of spillovers through the financial side.

For cooperation to be the right prescription, three criteria have to be met. First, spillovers have to lead to worse outcomes in other countries. Second, domestic policies must not be able to correct fully for these negative spillovers. And, third, there must be gains from cooperation that are quantitatively reasonably large in order to justify the costs (which may be primarily political) of setting up a mechanism for cooperation.

3. Sometimes policymakers defend themselves against charges of currency manipulation by saying something like "we are simply striving to achieve our goals of low inflation and full employment. We are not trying to manipulate the currency." But such a policy is the very definition of non-cooperative policy. Non-cooperative does not mean you are actively trying to hurt the other guy, but just that you are maximizing your own welfare taking the other guy's policies as given.

A related point is this: it seems like in some circles, policy cooperation is understood to mean that we give up something in order to make other countries better off. But that is a fundamental misunderstanding. The argument for cooperation is that there are circumstances where cooperation has the potential to make everyone better off (as in the Prisoner's Dilemma.)

“Competitive Devaluation”

The traditional concern about competitive devaluation is not well understood. Barring other circumstances, which I will discuss in detail, competitive “depreciations” are not really a problem under floating exchange rates.

Suppose the policymaker’s goal is to get things just right – an economy that is neither too hot nor too cold. Adjusting the thermostat might have spillovers to other countries, who may in turn adjust their thermostat, which then may feed back onto the first country. If the U.S. has unemployment, it may follow an expansionary policy that causes a dollar depreciation. That may cool off the European economy too much. The ECB might respond with an expansionary policy that depreciates the euro. But then the Fed could expand more, the ECB could expand more, etc., until they both reach full employment. There is no danger here of some spiral into high inflation – both expand their policy until they reach full employment.

Under the Bretton Woods system, and especially under the gold standard, devaluing was costly. It was difficult to change the peg, but that is not so under floating exchange rates.

There may be problems, however, even under floating exchange rates with adjusting the policy instrument. Even when we are away from the ZLB (I will return to the case of the ZLB below), the ECB for example, might believe it is cumbersome to have to respond to the dollar depreciation. After all, central banks do tend to change interest rates smoothly.

When is the Exchange-Rate Spillover from Monetary Policy a Problem?

1. It may be that policymakers have goals or targets beyond the traditional mandate of low inflation and full employment. The exchange rate may be an explicit target. If two countries have different targets for the same exchange rate, there is a problem, and there can be gains from cooperation.

When would countries explicitly have an exchange rate target? The literature provides one example, though it is not very persuasive in my opinion. It is analogous to the “optimal tariff” argument. A country may want to appreciate your currency in order to exploit its monopoly power in export markets. Note this is the opposite of the “competitive devaluation” argument. Here, you are willing to accept some temporary unemployment and/or inflation below target in order to improve your terms of trade temporarily.

There are other reasons, not really explored in the literature, that are more plausible. Even at full employment, the mix of traded/nontraded employment may be skewed and inefficient. For example, in the late 90’s through 2000, we had low inflation and low unemployment. But the dollar was strong, and that tended to harm exporters and favor, relatively, nontraded sectors such as construction. The Fed could have, but did not, considered "overly expansionary" policies to correct the traded/nontraded imbalance, even if it meant missing the inflation target.

Another consideration is wealth effects. The U.S. both borrows abroad and lends abroad in instruments primarily denominated in dollars. But many other countries tend to borrow in foreign currency (often dollars), and have an imbalance (on their consolidated private + public balance sheet) between their dollar liabilities and their dollar assets. If the dollar appreciates, they become less wealthy.

Export promotion seems to be another reason for having an exchange rate target. This has been underexplored. There is an old literature that links exchange-rate policy to an infant industry argument for encouraging exports. But more recent trade literature has emphasized that export industries are more productive firms. A currency depreciation may boost employment in these productive industries (while also allowing a more modest, and less desirable, entry of less productive firms into export markets.) Such a policy would have temporary effects, and could not be sustained on average, except in countries with capital "walls".

Finally, to some extent (though perhaps exaggerated), the exchange rate influences current account balances. Policymakers might have concerns about current account imbalances, perhaps because they lead to excessive debt accumulation or the reverse.

2. The ZLB may offer a special case. Some argue that quantitative easing only has effects through the exchange rate. The basis for this argument is unclear, but let's grant it for the moment. In that case, exchange-rate policy would be a zero sum game. In fact, it would be a negative sum game, because it would lead to potentially dangerous expansions of high-powered money and central banks' balance sheets that might be difficult to reverse.

Nobody is sure through which channels quantitative easing works. It might not work at all. If it does work, it is not obvious why it would only work through the exchange rate. Whatever argument there is for an influence on the exchange rate might also apply to other asset prices such as stock prices. So the exchange rate might not be the only channel of influence.

Still, the ZLB might be similar to the old argument against competitive devaluations – there is a cost to implementing the policy. The benefits might not be zero sum, but they might be small, and not worth the cost. So there might be a case for cooperation.

3. Liability dollarization. I'm not sure whether this constitutes a special case, but there is certainly concern that dollar appreciations have the potential for causing financial crises in emerging markets because both government and corporate debt is largely denominated in dollars.

Note that Brazilian finance minister Guido Mantega's original accusation that the U.S. was engaging in a "currency war" was for the traditional situation – he was concerned about the impact of a dollar depreciation on export industries in Brazil.

It might seem like emerging markets are whiners because they complain about both dollar depreciations and appreciations, but as Rajan (2014) says, "Recipient countries are not being irrational when they protest both the initiation of unconventional policy as well as an exit whose pace is driven solely by conditions in the source country. Having become more vulnerable because of leverage and crowding, recipient countries may call for an exit whose pace and timing is responsive, at least in part, to the conditions they face."

Forms of Policy Cooperation

1. In the literature, we tend to model cooperation as a benign policymaker maximizing the sum of utility of all countries. In practice, the way cooperation might work is more like bargaining. If we get central bankers together to discuss how policies might change to improve the welfare of the many, it might be that some countries are in a position to wring out more benefits than others. In other words, everyone (or at least many) might gain from "cooperation", but some might gain a lot more than others.

2. Although this is rarely discussed, one benefit of a currency union such as the Euro Area is that it moves us from a regime of non-cooperation to a cooperative regime (albeit one in which cooperation might look more like the bargaining game I just described.) There are very few other cases (the Plaza Accord, perhaps?) in which monetary policy cooperation has been successfully implemented.

3. As Frankel notes, one obstacle to cooperation is disagreement on the effects of policies – disagreements about the "model". It is hard to see how to resolve this. There are innumerable opportunities for exchanges between policymakers in different countries, and between economists in different countries, but they don't seem to do much to resolve these differences.

4. A new wrinkle comes from the observation that most international trade is denominated in U.S. dollars. A dollar depreciation might be temporarily expansionary for all exports. That puts a special onus in cooperation on the role of the U.S. monetary policy.

A similar asymmetry arises from the idea that there is a "shortage" of safe, or liquid assets in the world – especially a shortage of safe dollar assets. The role of the Fed in increasing the supply of dollar reserves (but possibly reducing the supply of other dollar assets) might require special attention.

5. It may be clear that a global (Rawlsian) policymaker wants to maximize the sum of world welfare. As macroeconomists, we tend to express the goals of policy not directly in terms of welfare, but instead in terms of some indirect objectives such as inflation, the output gap, the trade balance. But in these terms, the goals of the global policymaker might not be the same as the (weighted) sum of the country policymakers.

Macroprudential Policy

There is not enough time for a full discussion that includes macroprudential policy. But there are three general points that relate to the discussion of monetary policy cooperation.

1. Macroprudential policies might include regulation and capital requirements for banks and other financial institutions, as well as capital controls. These policies have macroeconomic effects, which in turn have implications for the conduct of monetary policy. They could complement and assist the work of monetary policy, or make it more complicated.

They could also increase or decrease the need for cooperation on macroeconomic policies.

2. When thinking of macroprudential policies, we need to recognize that they introduce not only additional policy instruments, but also additional policy goals, such as financial stability.

It may not be possible, these days, to separately consider monetary policy and financial policy. In fact, in some instances – such as the lender of last resort function of central banks – they are intrinsically inseparable.

3. Macroprudential policy considerations bring up new issues for coordination versus self-oriented policies. For example, macroprudential leakages are a major concern. (That is, financial institutions might move their activity to the country whose policies they most prefer.) That could lead to a "race to the bottom" in prudential policies, analogous to state corporate tax policies.

Conclusions

In the end, there are so many issues to consider that it is hard to conceive of a single economic model that would give appropriate weight to all of them (which may be why there is the disagreement on models that Frankel discusses.) The questions we need to try to answer are:

1. What are the primary sources of gains from monetary policy cooperation?

2. In what form would one envision that policy coordination taking place? Bernanke noted in his Mundell-Fleming lecture that the heads of the worlds' central banks meet constantly, all over the world. To suggest that there be more meetings would not move things forward. Concretely, there needs to be a framework for how policy decisions are made. (A global board of governors? Bargaining among central bank leaders?) Any framework would have to ensure and make clear that cooperation is a Pareto improvement. Would it be desirable to have more currency blocs, which effectively mandate cooperation within the bloc and perhaps reduce the complexity of global cooperation?

3. Are the gains from cooperation great enough to warrant the trouble?