Strong case for coordinating global monetary policy

RAKESH MOHAN AND MUNEESH KAPUR

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Janet Yellen, chair of the US Federal Reserve Board: 'highly accommodative' monetary policies in the United States and elsewhere have encouraged capital outflows to emerging market economies.

SINCE the onset in 2008 of the North Atlantic financial crisis (NAFC), more often known as the global financial crisis, central banks in the US and the other major advanced economies have pursued highly accommodative monetary policy, including through unconventional policy actions. Policy rates have been near zero in these economies for almost five years, and both short-term and long-term interest rates have touched historic lows. These low interest rates encouraged the search for yield and, consequently, large amounts of capital flowed out of these reserve-currency economies to the still relatively fast-growing emerging-market economies (EMEs), complicating their macroeconomic management.

Capital flows to the EMEs are well known for their volatility over the past three decades. This volatility was again in evidence in May–August 2013, when the US Federal Reserve first hinted at tapering its unconventional monetary policy, and again in January 2014 after tapering began. However, stronger macroeconomic and financial policies and the buffers built by EMEs over the past decade have helped them to avoid a full-blown financial crisis. The tapering episode has nonetheless hurt their near-term growth prospects significantly, while also illustrating the potential underlying vulnerabilities in the international monetary system.

Developments since 2008 have put a spotlight on the impact that monetary policy in the reserve-currency countries has on the rest of the global economy.

Given these spillovers, there is a renewed debate on the merits of monetary policy coordination among the major central banks. The current stance of monetary policymakers in advanced economies is that there are no significant cross-border spillovers from their accommodative monetary policies, that they are indeterminate, or that they are in fact positive overall for EMEs. There is also a view that the mandates of monetary authorities are such that they can only take account of the domestic impacts of their policies: taking a cross-border global view would be beyond their mandates.

In contrast, the regulatory architecture of the banking sector has been characterised by international cooperation for a number of decades now—the Basel I, II and III standards are the well-known outcomes of this approach. The financial crisis provided an impetus to international economic and financial coordination, especially regulatory coordination and 'unprecedented and concerted' fiscal expansion. The G20 leaders' initiatives led to a significant strengthening of financial-sector regulations and regulatory architecture, including the establishment of the Financial Stability Board in April 2009.

The G20 initiatives also led to a noteworthy increase in International Monetary Fund (IMF) resources and lending capacity in 2009 and again in 2012, a critical step in restoring global financial stability. And, overall, there have been welcome G20-led initiatives to improve international economic and financial coordination since the onset of the financial crisis, playing a critical role in providing some stability to the global economy while avoiding a repeat of the 1930s Great Depression.

But as far as international monetary policy coordination is concerned, the traditional view of domestically oriented monetary policy is still seen as the optimal arrangement, although there are some calls for a reassessment.

It is not the case that there has been no coordination at all. In the aftermath of the NAFC, the activation of swap lines by the US Federal Reserve with central banks in major advanced economies and a few select emerging markets is an example of some coordination, but this effort appears to have been motivated by the likely adverse impact of liquidity in these advanced economies suddenly drying up on these economies themselves. Coordination does not appear to have been motivated by the likely impact of advanced economies' monetary policies on the EMEs.

If the prevailing view held by advanced-economy monetary policymakers does not change, EME authorities will have to manage these spillovers on their own. This would involve a combination of various policies to promote financial stability in their economies. Judicious capital account management to reduce the domestic impact of volatile capital flows would be a significant element in such policies. There is now near unanimity on the desirability of maintaining flexible exchange rates, but this is tempered by the desire to contain volatility in the face of significant disturbances in global financial markets. Thus capital-account management would need to be accompanied by appropriate foreign exchange intervention, while maintaining exchange-rate flexibility, and building up adequate precautionary foreign exchange reserves. Such macro-management would only be effective in the presence of prudent monetary and fiscal policies, and the continued development of domestic financial markets along with active financial regulation.

Advanced economies' central banks need to explicitly acknowledge and appreciate the spillovers resulting from their unconventional monetary policies

But the possible effect of such uncoordinated policy action on the part of both advanced economies and EMEs could be potential fragmentation of global financial markets. EMEs might be forced to pursue more inward-looking policies, which will then have a negative impact on global demand and growth.

What is the alternative to such outcomes? Advanced economies' central banks need to explicitly acknowledge and appreciate the spillovers resulting from their unconventional monetary policies. Only then can an approach to international monetary coordination be devised. The IMF, in its role as the guardian of the international monetary system, could foster this understanding through its analytical work and then initiate discussions on possible forms of international coordination.

Central banks of the advanced economies have already set up standing mutual swap facilities. Similar arrangements could be explored by the reserve-currency central banks with other significant EMEs through the G20 process, with the IMF's assistance. Risk-mitigation measures would have to be found to protect the reserve-currency central banks from potential losses that could arise from extending such swap facilities to include currencies that are not freely convertible. EME central banks already have large holdings of reserve-currency sovereign debt securities: up to an point, ways could be found to use such securities as collateral for risk mitigation.

There is also a proliferating set of mutual swap arrangements between various EME central banks and with some reserve-currency central banks. Regional financing arrangements are also being developed to manage the consequences of volatile capital flows. This points to the need for greater international monetary coordination with the IMF in a synchronising role, rather than the alternative of increasing financial fragmentation on a global scale.

Increasing communication among monetary authorities, and the transparent availability of such liquidity facilities, could do much to actually curb volatility in global financial markets and hence in capital flows to EMEs, thus obviating the need for them to take defensive policy action. Although the comfort of the availability of such swap facilities from the reserve currency central banks runs the risk of encouraging an even greater volume of capital flows to EMEs in the boom period, the existence of such swap facilities is expected to be positive for the global economy. EAFQ

Rakesh Mohan is the Executive Director and Muneesh Kapur the Adviser to Executive Director at the International Monetary Fund, Washington DC. The views expressed in the paper are those of the authors and not necessarily those of the institutions to which they belong.