On Spillovers & Policy Coordination

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Olivier Blanchard’s Report

- EME’s may have a legitimate complaint about spillovers
  It depends on strength of AD vs FX effects.
- Fiscal policy is unlikely to do the job
- Little room for monetary policy coordination
  (Don’t be fooled by the model’s apparent simplicity!)
- We should explore capital controls as an alternative

The paper is about COORDINATION not just cooperation.
Benefits to monetary policy coordination likely small

Where is this new anger coming from?
  - Change in extent of financial linkages
  - Increase in gross flows
  - Change in composition – more bank flows
  - Change in size spillovers

Is there an alternative to capital controls?
  - Prudential regulation & financial stability policy
  - But that requires cooperation
In simple model, welfare gains are small
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Conjecture:

In the absence of strategic complementarities, welfare gains from coordination are always small.
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In the absence of strategic complementarities, welfare gains from coordination are always small.

Remember the envelope theorem:
At the optimum, first-order change in the state generate second-order welfare losses.
What has changed?

- Why was Guido Mantega angry?
- Why is Raghu Rajan advocating coordination?
International Investment Positions

As a percentage of world GDP

Increase from 50% to >150% of global GDP over 20 years!

Sources: IMF; BIS calculations.
Cross-border bank claims: EMEs

Bank flows are large and sensitive to US policy.
EME fund flows
(flows to EME-dedicated bond & equity funds, inflows positive)

Surge in fund flows

Chart 1
What has changed?

- Why was Guido Mantega angry?
- Why is Raghu Rajan advocating coordination?
- Finance has changed:
  - International asset positions are very large
  - Cross-border bank claims are large
  - EME fund flows have surged

EMEs took our advice & opened their capital markets
Financial spillovers from U.S. policy

- Cross-border transmission:
  - More powerful since crisis
  - Risk premia more sensitive to policy?
  - Increase heterogeneity of investors?
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- Impact of US policy easing on EMEs
  - Equity & bond prices up
  - Exchange rates appreciates
  - Gross inflows
  - AD effect is almost surely positive

- Impact on financial system leverage
Impact of own easing on leverage

Based on data for a total of 994 publicly listed financial firms 19 advanced economies plus Brazil, Mexico, and South Africa from 1998Q1 to 2014Q4.

Extended policy easing drives leverage up.

Source: Cecchetti, Mancini-Griffoli and Narita (forthcoming).
Impact of U.S. Monetary Policy Easing is much larger than impact of own policy easing! (Controlling for own policy.)

Source: Cecchetti, Mancini-Griffoli and Narita (forthcoming).
Financial spillovers of U.S. policy

- Cross-border policy transmission stronger
- Impact on financial system leverage large
  - Marginal unit of credit is cross-border
  - Global dollar financial system:
    Changes in USD interest rate change cost of doing business

Spillovers create financial stability risks.
Capital controls vs. prudential policy

- Capital controls are not the policy of first choice
  - Use them conditional other policies being right
  - And, only when there are overwhelming capital flows
  - Too tempting for politicians to use to cover other sins
  - Are they really effective?
Capital controls vs. prudential policy

- Capital controls are not the policy of first choice
- Risks arise from cross-border financial flows
  - Capital controls are the same as tariffs
  - Risk retaliation and a race to the bottom
Capital controls vs. prudential policy

- Capital controls are not the policy of first choice
- Risks arise from cross-border financial flows
- Is the problem bank and borrower leverage?
- Look for a more direct way to maintain resilience
  - Capital requirements
  - Changing risk weights
  - Maximum loan to value ratios
- But….

Dynamic macroprudential policy requires coordination.
Monetary policy coordination
  - Small benefits
  - Political barriers
Globalization has increased spillovers
Do we need to inoculate EMEs?
Capital flow management policies are last resort
Look to prudential policies alternatives
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