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Exchange rates, monetary policy and international policy coordination

What have we learned from the crisis and its aftermath?

Czech National Bank conference on *The Future of Monetary Policy: What Can We See As the Dust Has Settled?*

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Lawrence Schembri

Deputy Governor
Bank of Canada

Pre-crisis consensus: Monetary policy framework and international policy coordination

Pre-crisis consensus: monetary policy framework

1. Flexible inflation targeting

- Objective: low, stable and predictable inflation; typically 2% target
- Flexible on horizon: mindful of output/employment volatility

2. Flexible exchange rate

- Market determined, but some scope for intervention to mitigate excess volatility
- Allows monetary policy to focus on achieving the inflation target

Academic: Comes closes to the flexible price equilibrium, given nominal rigidities

- Obstfeld & Rogoff (2000), Svensson (2000), Clarida, Gali & Gertler (2001), Gali & Monacelli (2005)

Policy: Now in place in roughly 40 countries

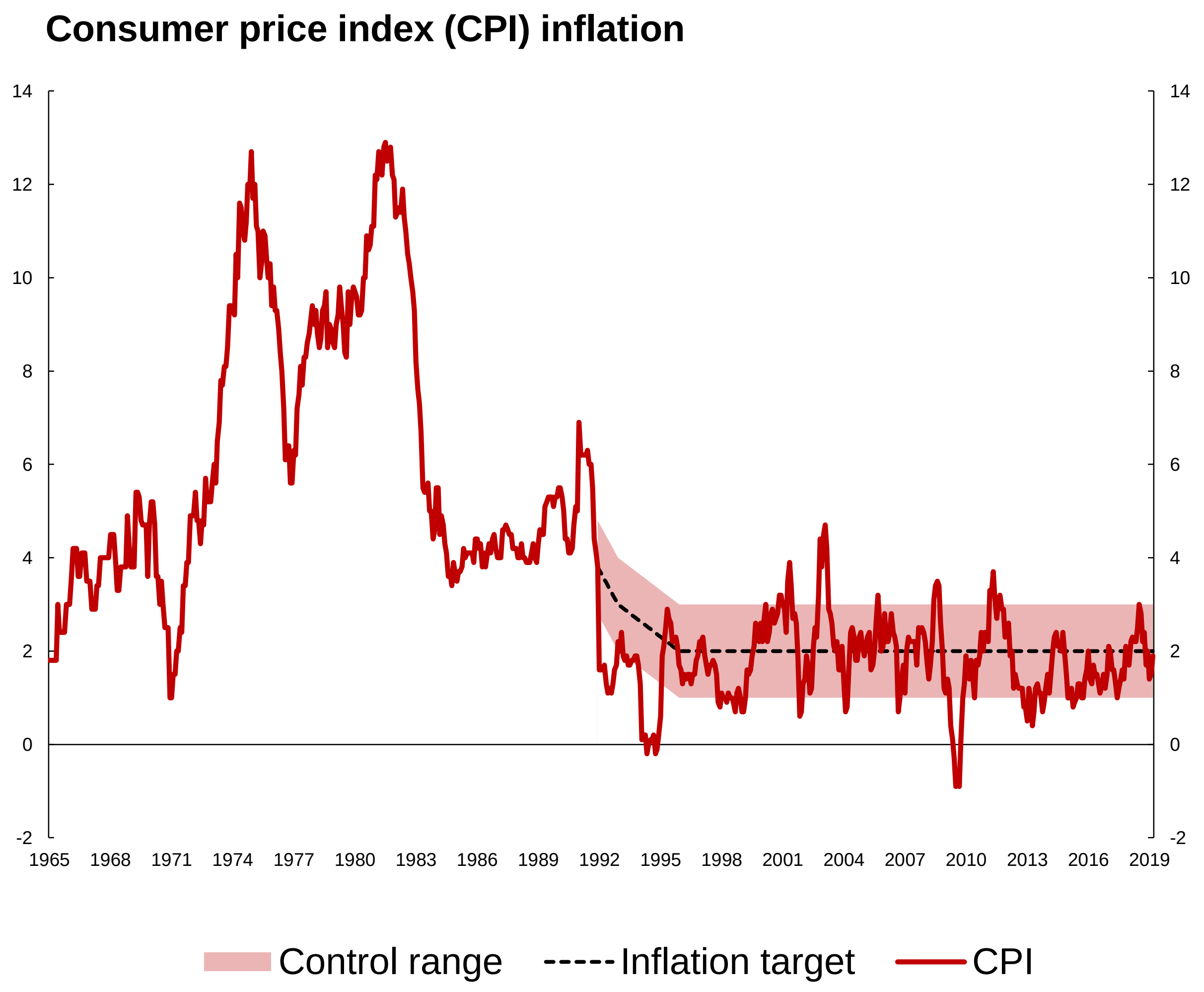
- Rose (2007): Most durable MP framework in postwar period; no country has abandoned it

Canadian experience: Inflation target agreement and performance

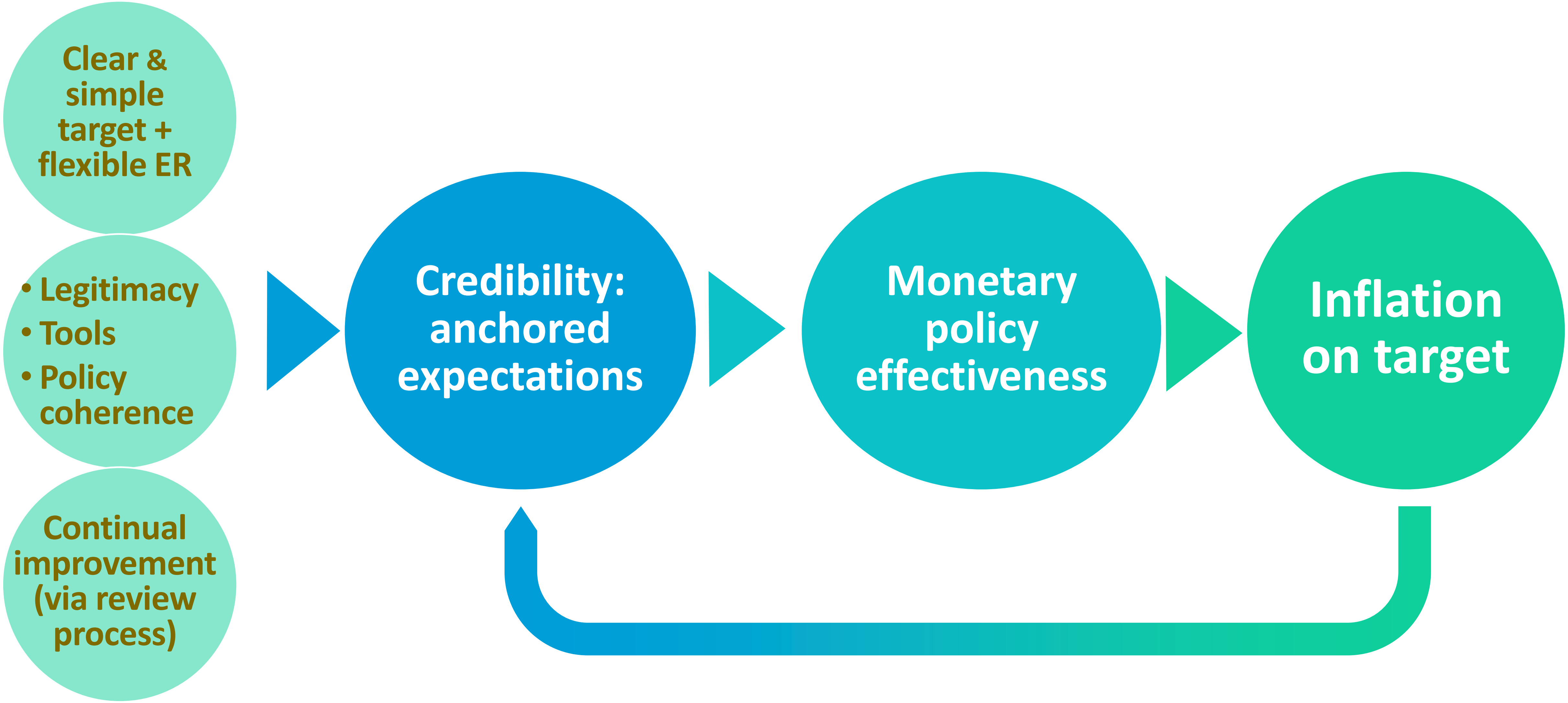
- Agreement affirms:

"…the joint commitment of the Government of Canada and the Bank of Canada to the inflation target"

- The inflation target is defined as:
  2 per cent midpoint of the 1 to 3 per cent control range
- ***Canadian experience not unusual***



Success of flexible inflation targeting: Anchored expectations



Pre-crisis consensus: International policy coordination

"Keep your own house in good order"

- Flexible inflation targeting + sustainable fiscal policy + strong financial framework

Academic: Benefits from coordination – uncertain and likely small

- Sachs & Oudiz (1984), Rogoff (1985), Obstfeld & Rogoff (2004), Blanchard (2016)

Policy: Stronger forms of macro-policy coordination rarely used

- For example, among G7 and G20 countries
- When used, success is not obvious. E.g., Plaza and Louvre Accords
- Softer forms of coordination, such as information sharing, are widely employed

Achieved Great Moderation – policy seemed to work

Global Financial Crisis and Great Recession

Global Financial Crisis: Causes and consequences

Causes

- Massive financial regulatory and supervisory failure
- Global imbalances, due to unsustainable fiscal positions and lack of ER adjustment
- Monetary policy not mindful of impact on financial vulnerabilities

Consequences: financial and real

- Numerous bank failures, including systemic banks
- Debt and credit markets seized due to lack of liquidity
- Pervasive fall in global output, investment & trade

Consequences: policy

- Simultaneous fiscal and monetary expansion; prolonged use of non-traditional MP tools
- Comprehensive program of global financial sector reform

Implications: Monetary policy framework

Flexible inflation target

- Should financial stability considerations influence monetary policy? ***(Devereux et al.)***
- Implementation: Build more financial features into central bank projection models
- Strategies and tools: How should MP be conducted at effective lower bound?

Flexible exchange rate

- Flexible exchange rate helped facilitate adjustment to the GFC, but did not offset it
- Some argue the extent of ER management should be contingent on financial market development
- Need to balance benefits (MP independence, faster adjustment and financial development) against costs (financial vulnerabilities due to currency mismatches)

Implications: International policy coordination

Staying out of trouble

- Pre-crisis “Keep own house in order” largely remains in tact
- With more focus on financial reform; inherently multilateral
- ***What about policy spillovers?***
    - Rajan (global expenditure switching) versus Bernanke (global growth)
    - ***Adler & Osorio Buitron paper***

Getting out of (global) trouble

- “Enlightened self-interest”
- Collective action in a global crisis
- Group support like “Weight watchers”, helps overcome political obstacles to achieve timely & material actions: 2008-09
- Reap benefits of acting simultaneously

Notes:

1. Getting out of “own trouble” rests with home jurisdiction (and the IMF?)
2. Strong form of coordination “taking one for the team” - little evidence

Adler and Osorio Buitron

Purpose: Examines impact of US monetary policy on trade balance

- Considers both traditional as well as non-traditional MP tools
- Methodology: Structural VAR

Key findings

- In US, monetary policy easing causes its trade balance to improve
- Transmission of this adverse spillover is muted in economies with a fixed ER

Comments

- General equilibrium effects are stronger and outweigh this trade channel (e.g., Canada)
- Ignores response of other countries; a flexible ER provides more scope to respond
- Does the immediate response of the trade balance reflect dominant USD pricing of trade?

Devereux, Engel and Lombardo

Purpose: Develop simple rules for MP that incorporate financial frictions

- Methodology: Two country DSGE model, with banking sectors. Approximate optimal rule using an SVAR on simulated data from the model.
- Data: US (AE) and New Zealand (EME)

Key findings

- Because of financial frictions, optimal monetary policy rule should also target credit spreads
- Cooperative and non-cooperative (Nash) optimal policy rules are similar

Comments

- Their "simple" rules are not simple for policy-making purposes
- Monetary policy should focus on inflation target and macro-stabilization; micro and macroprudential policies should be used to mitigate structural financial frictions
- Financial market development in EMEs should be promoted to help reduce financial frictions

Key messages

Updated consensus on monetary policy framework

- Flexible inflation targeting: more awareness of financial vulnerabilities and risks
- Need effective strategies and tools for the conduct of monetary policy at ELB, given lower equilibrium real interest rate
- Fiscal and micro/macro prudential policies should complement monetary policy

Updated consensus on international policy coordination

- "Keep own house in order", but with more rigorous surveillance and peer review
- Implement G20-FSB financial reforms for consistent minimum global standards
- Crisis management may require more active policy coordination