BRANDEIS INTERNATIONAL
BUSINESS SCHOOL

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

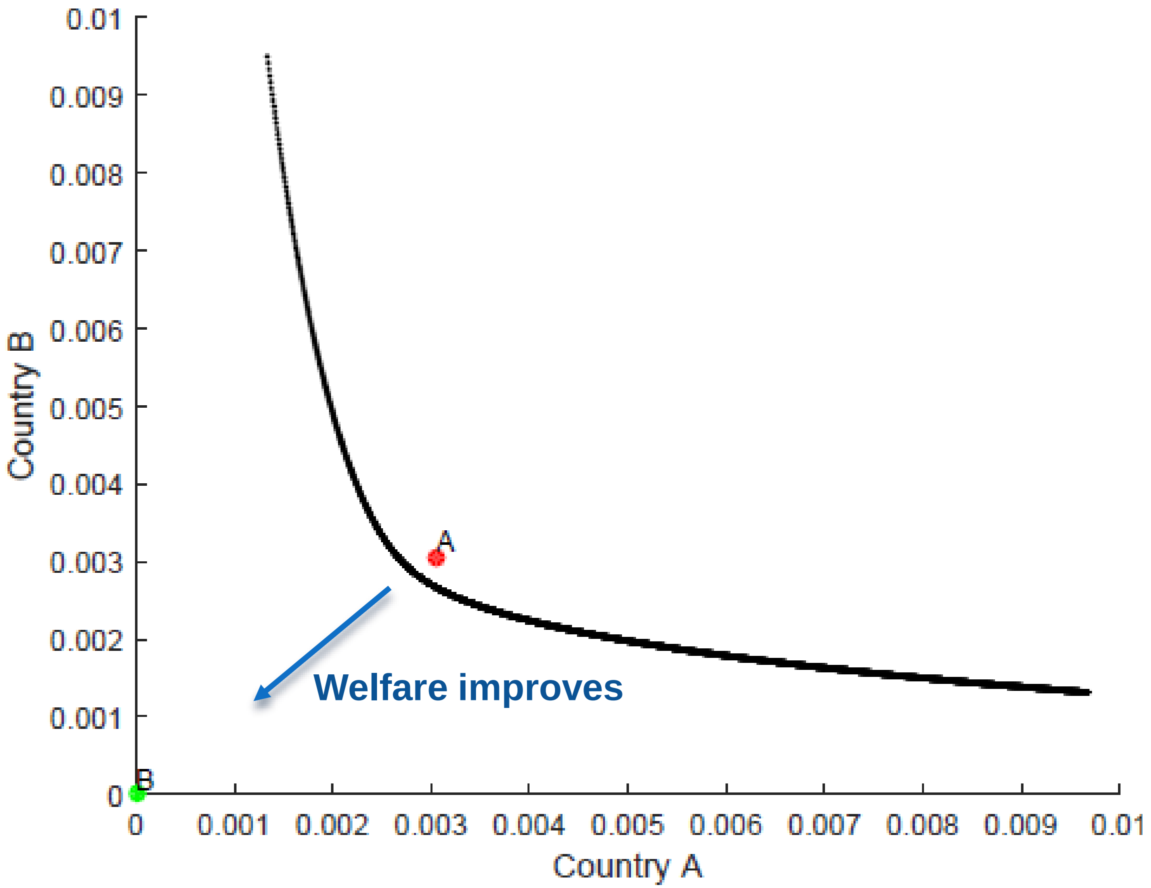
The paper is about COORDINATION
not just cooperation.

Comments

- 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

Coordination

- In simple model, welfare gains are small



Coordination

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  - Conjecture:

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

Coordination

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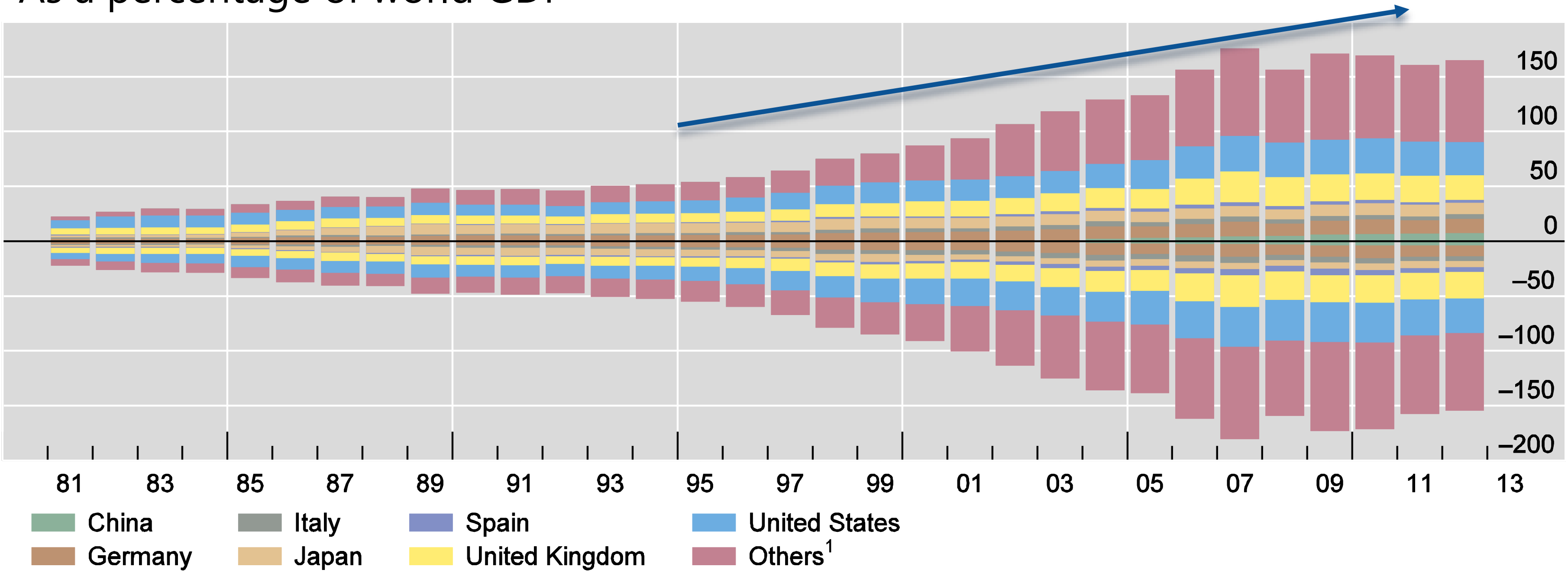
- Remember the envelope theorem:
  At the optimum, first-order change in the state generate second-order welfare losses.

What has changed?

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

International Investment Positions

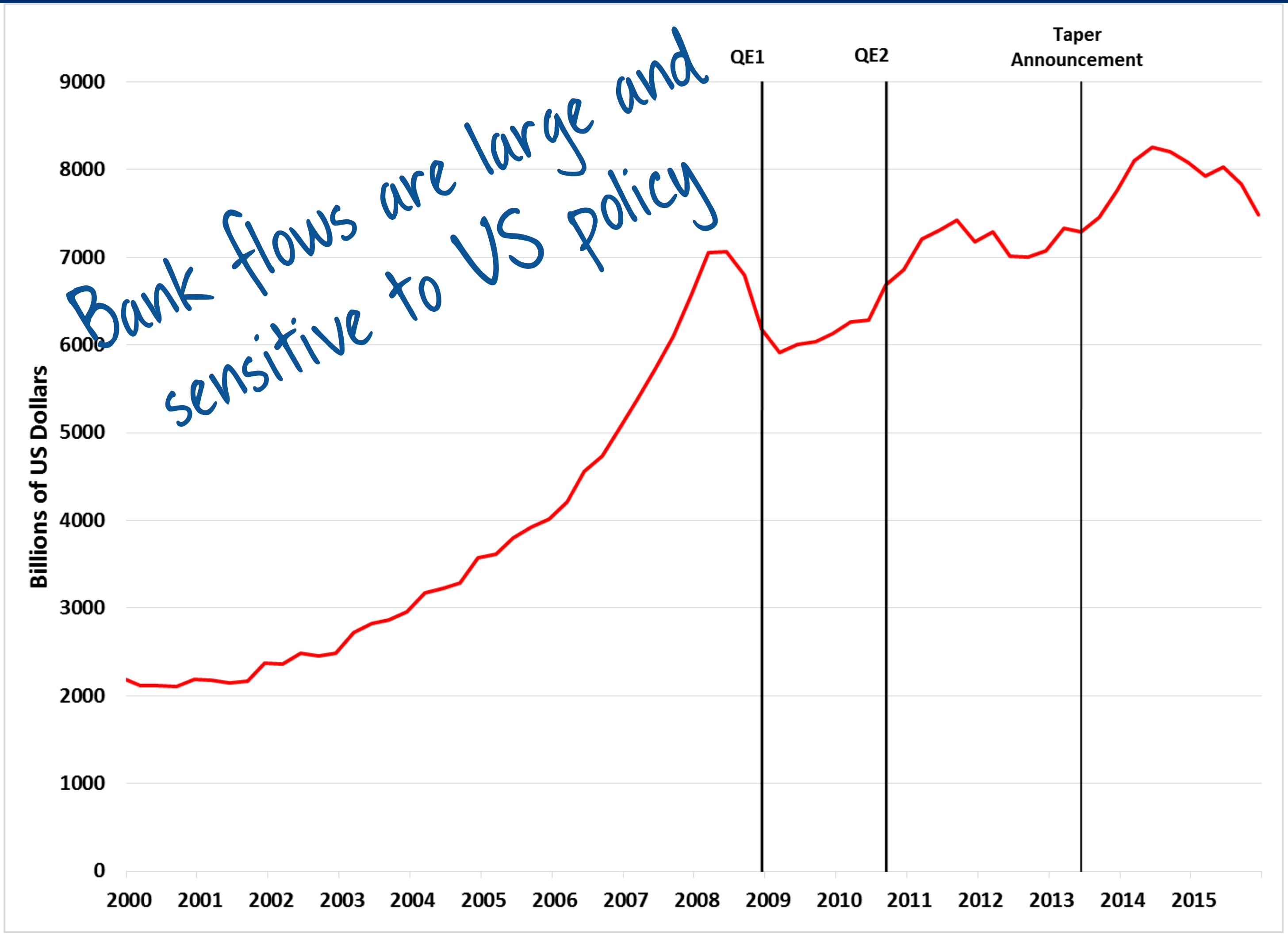
As a percentage of world GDP



Sources: IMF; BIS calculations.

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

Cross-border bank claims: EMEs



EME fund flows

(flows to EME-dedicated bond & equity funds, inflows positive)

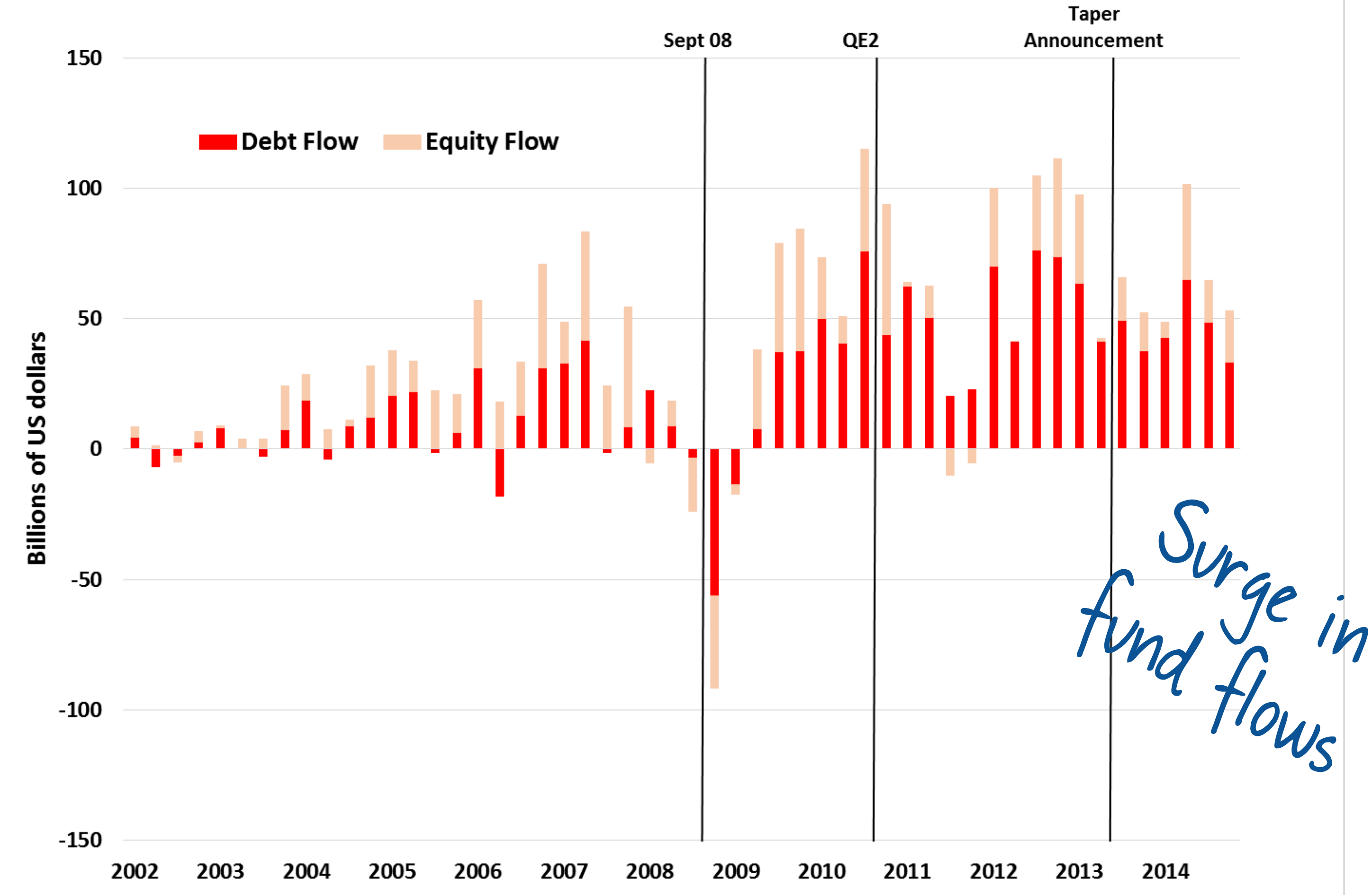


Chart 1

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

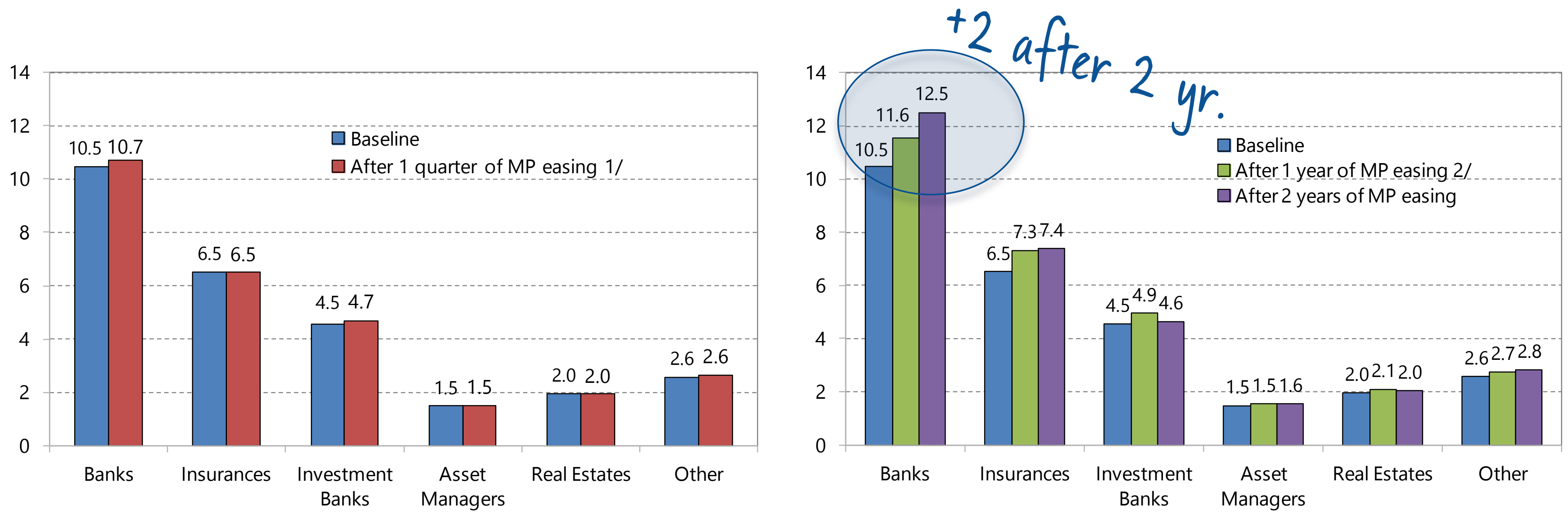
Financial spillovers from U.S. policy

- Cross-border transmission:
  - More powerful since crisis
  - Risk premia more sensitive to policy?
  - Increase heterogeneity of investors?

Financial spillovers from U.S. policy

- Cross-border transmission:
  - More powerful since crisis
  - Risk premia more sensitive to policy?
  - Increase heterogeneity of investors?
- 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

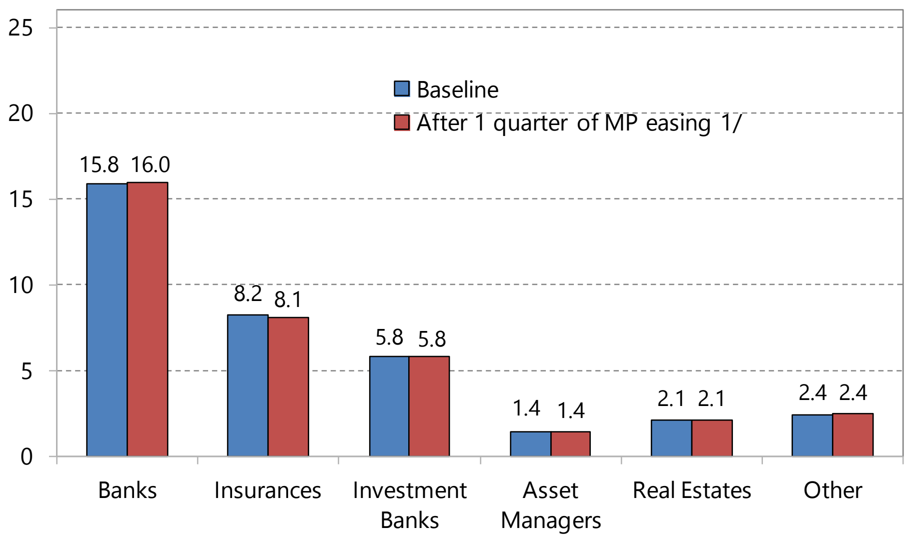


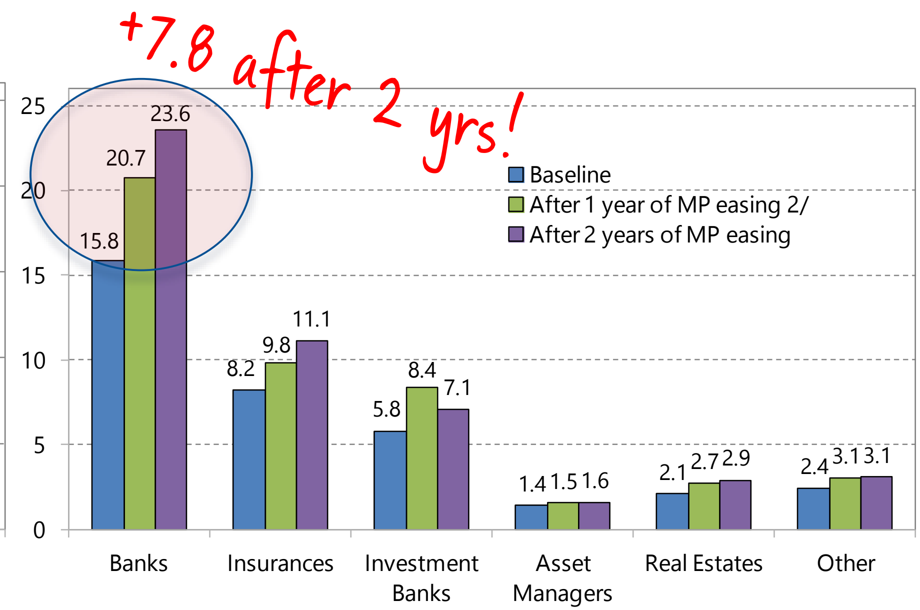
Based on data for a total of 994 publicly listed financial firms 19 advanced economies plus Brazil, Mexico, and South Africa from 1998Q1 to 2014Q4.

Extended policy easing drives leverage up.

Source: Cecchetti, Mancini-Griffoli and Narita (forthcoming).

Impact of U.S. easing on leverage





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.

Conclusions

- 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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