Discussion of Rethinking Macro: International Economy Issues

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The world is messy...

- Pre-crisis consensus – neat separation: targets and instruments
  - Monetary policy
  - Financial stability
- Financial crisis and aftermath suggested
  - The banking sector and the non-banking financial sector are linked.
  - The macro-economy and the financial sector are linked.
  - Countries across the world are also linked
- One source of linkage:
  - liquidity=>leverage=>liquidity
- Subsequent economic analysis indicates there are no clean policies with narrow separate effects, everything is interlinked and there are unintended consequences.
  - Excellent paper recognizes all this and more
  - Does not make policy recommendations.

For example: Monetary policy spillovers in an EM

- Let the exchange rate adjust...
- Problems
  - Positive feedback investment
  - Leveraging and moral hazard
  - Asymmetric fiscal policy
  - Limited monetary policy independence and credibility
- Some exchange adjustment is necessary but it is no panacea: in between trilemma and dilemma

Fear of foreign capital

- Innkeeper and guests
  - They leave en masse when the call comes.
- Build foreign exchange buffers when capital flows in.
  - Cannot make full use of capital flowing downhill.
  - Perforce liquidity provider to foreign capital
  - Impact on monetary policy
- Cannot even draw down buffers fully.
  - Flows and stock both matter
  - Hysteresis

What to do? Rethinking macro

- Recognize that there are spillovers and these could be significant.
- Recognize there are no policy interventions that will lead back to separation easily.
  - Exchange rate flexibility
  - Macro-prudential
  - Capital regulation
- A theory of muddling through!

The monetary policy pass…

- An acute form of belief in separation is to argue that monetary policy had nothing to do with the crisis.
  - It was those bankers…
- A less acute form is to argue that even if it had mild effects, these are unavoidable, use macro-prudential
  - Ignores the effects of easy liquidity on leverage
  - Bias towards overly easy monetary policy – too easy in boom, too easy in bust
  - Gets into all the cracks unlike macro-prudential (Stein).
- Effects are accentuated with minimum inflation mandate
  - Pressure to get increasingly more aggressive
  - Inflation may not budge but leverage will
- What should central bank mandates be if they have better traction against high inflation than low inflation, and monetary policy does influence financial stability?
  - Rules of the game?