The SEACEN Centre

Comments on Trilemma, not Dilemma: Financial Globalization and Monetary Policy Effectiveness

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Outline

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2) Research Question and Methodology
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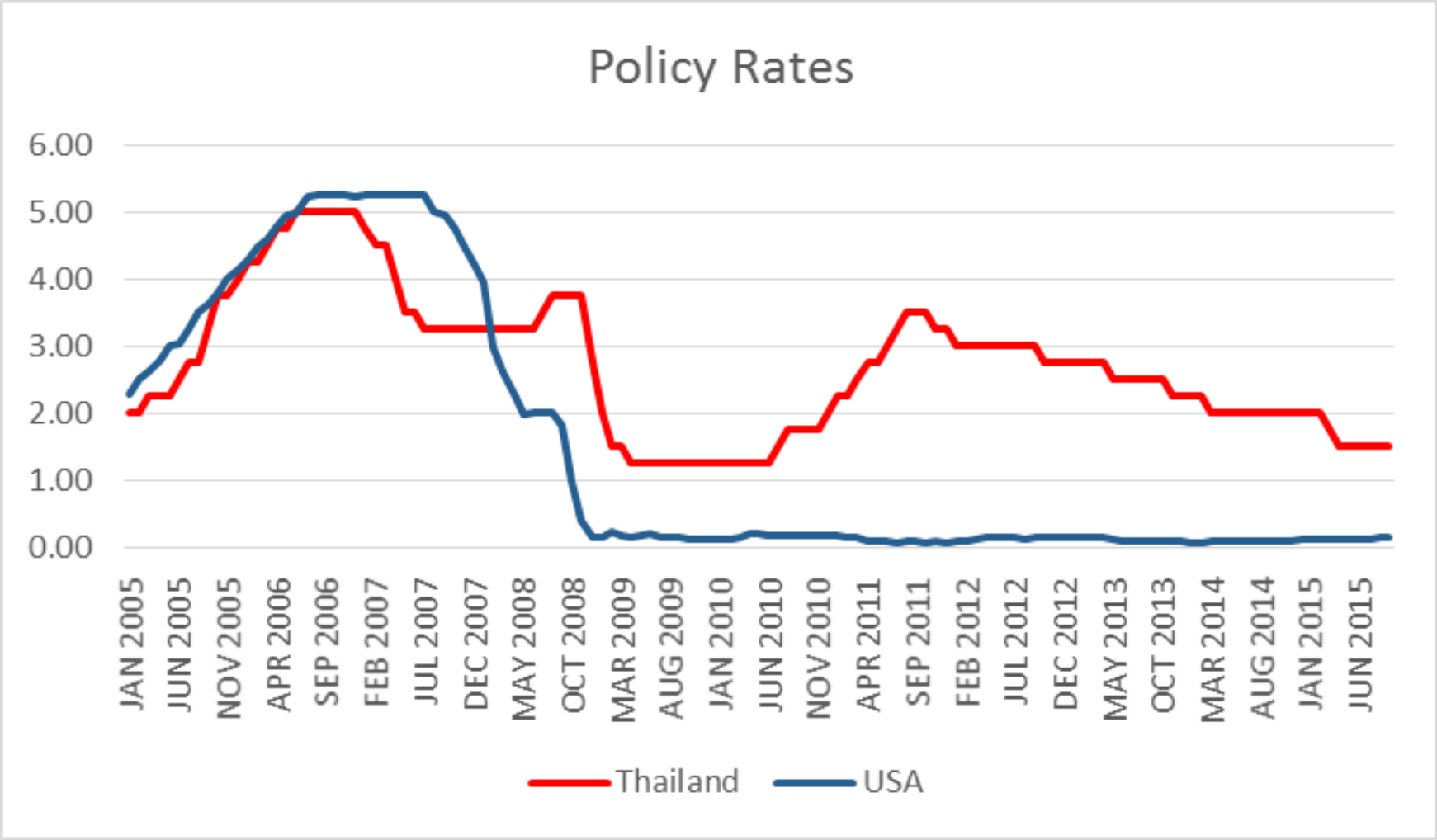
Background and Motivation

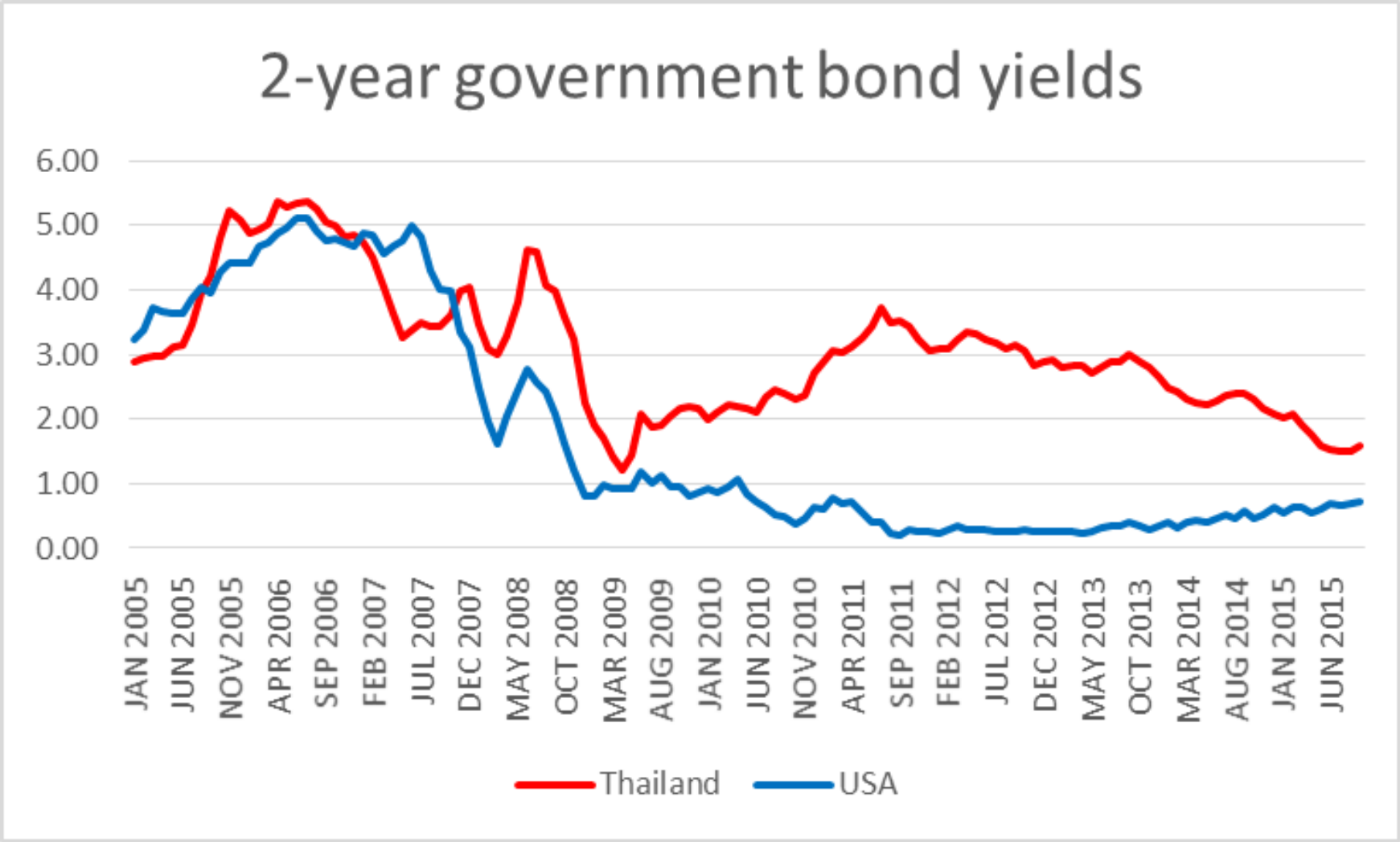
- ‘There is a **loss of independence** irrespective of the country’s choice of exchange rate regime.’ (Turner, 2014)

- ‘The global financial cycle transforms the trilemma into a “dilemma” or and “**irreconcilable duo**”: independent monetary policies are possible if and only if the capital account is managed.’ (Rey, 2013)

Exhibit 1: The BoT seems to be able to set its policy rate independently of the FED, without imposing capital controls, …



… and this appears to have an independent effect on both 2-year rates



and 10-year rates in Thailand

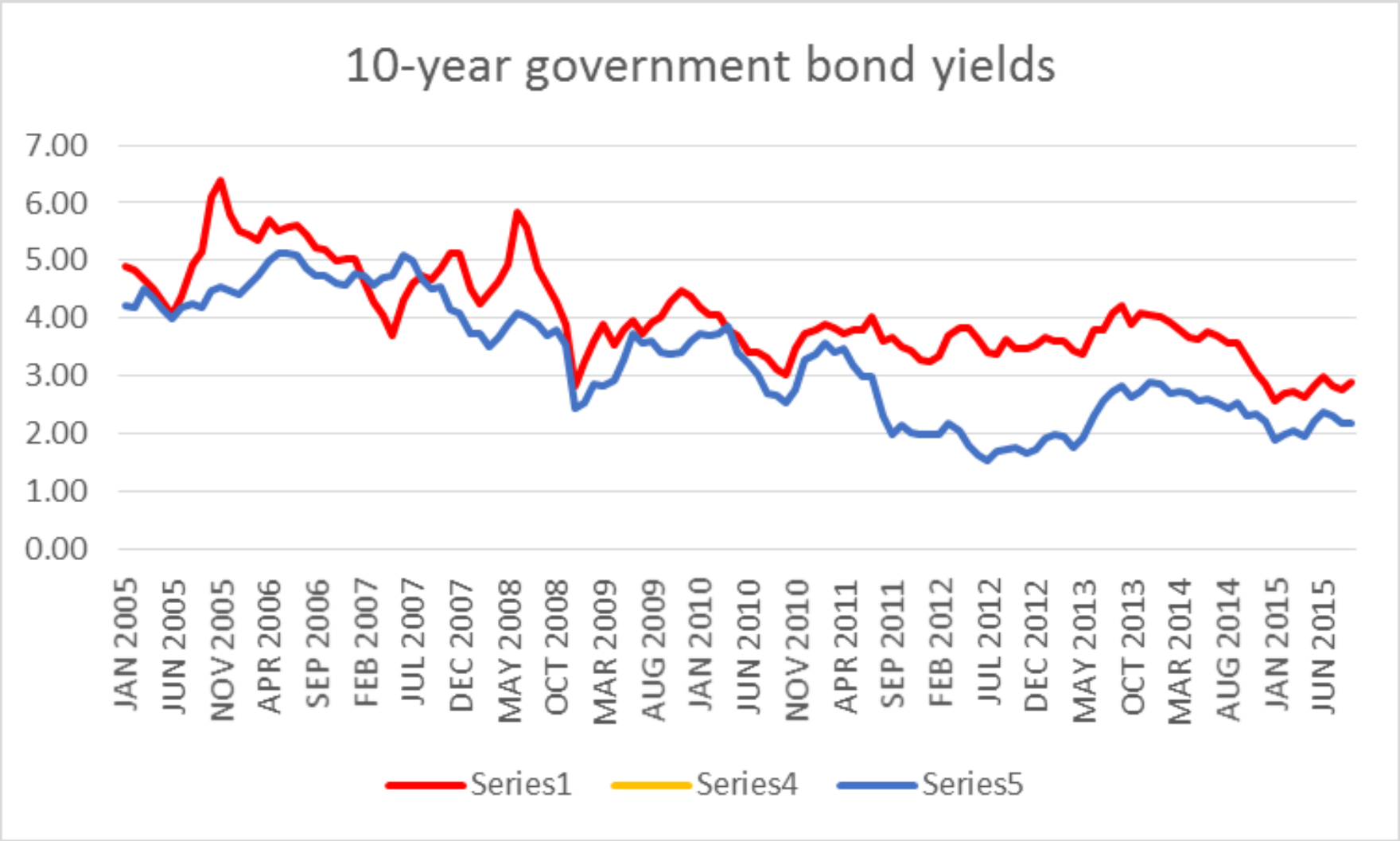
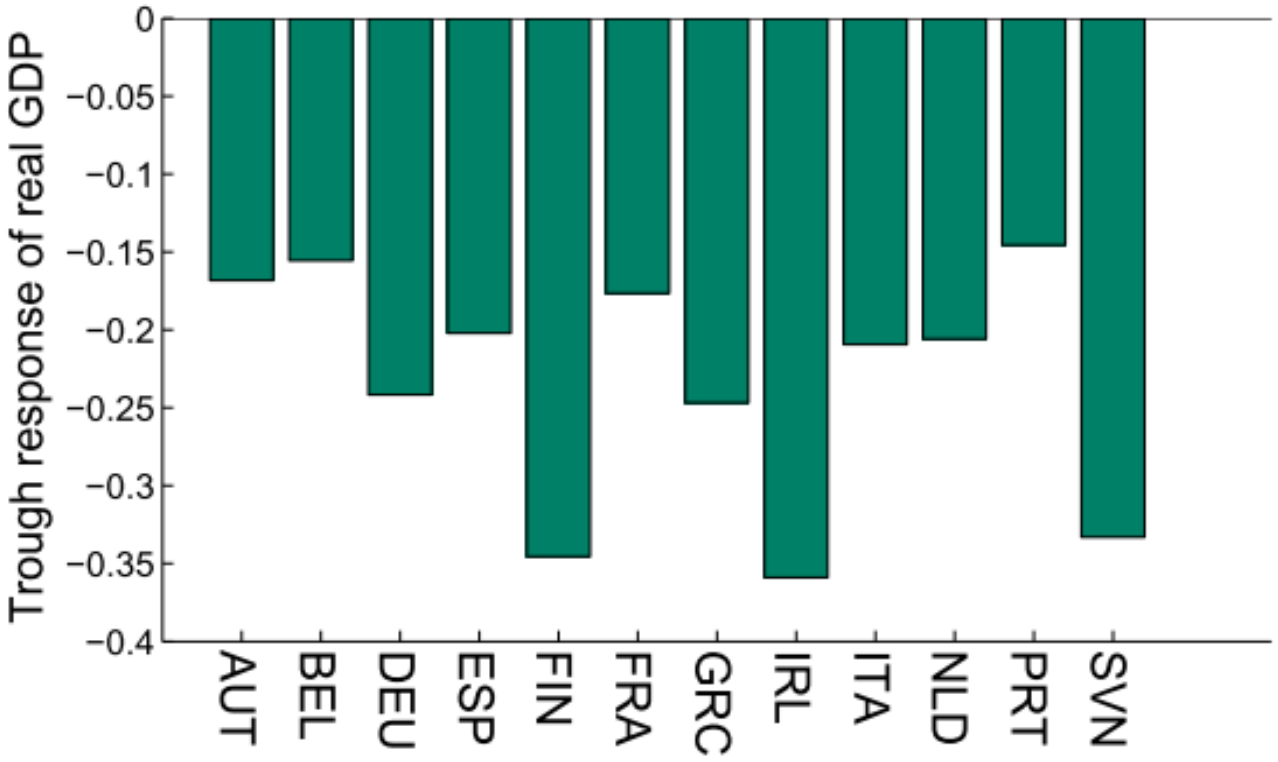


Exhibit 2, Monetary policy in individual Euro area economies effects output and there are no controls on capital movements

Figure 2: Euro Area Monetary Policy Shock: Trough Response of Real GDP



Note: The figure displays the trough responses of real GDP to a 100 basis points contractionary monetary policy shock in the euro area. The vertical axis depicts deviations from the baseline in percent.

Has financial globalization reduced the effectiveness of monetary policy?

- What might ‘reduced the effectiveness’ refer to?
  i. For given nature and size of shocks, monetary policy faces a worse trade off between stabilizing output and inflation variances
  ii. To achieve a certain outcome with respect to output and inflation variability, a heavier dose of monetary policy intervention is needed
  iii. Relative to fiscal policy , monetary policy has become less effective
  iv. Relative to foreign influences, monetary policy has become less important for the evolution of the economy
  v. Because central banks care about exchange rate fluctuations they do not pursue objectives such as output stabilization as vigorously

Research question and methodology

- Question:
  - For a surprise monetary policy intervention of a given size, has the effect on output become smaller?
- Methodology
  1. Estimate a VAR for a sample of countries
  2. Calculate the maximum effect of a monetary policy shock in each country. The size will in general differ between countries
  3. Explain the cross-country variation by variables related to financial integration of the respective countries (as well as controls)
  4. According to the cross-section results, will greater financial integration lead to larger or smaller effects of a monetary policy shock of a given size?

Hypotheses

- There are two different effects of financial integration
  - Interest-rate channel is weakened by financial integration
    - Monetary policy has a smaller impact on domestic interest rates because these are influenced to a greater extent than before by foreign interest rates
  - The exchange rate channel may be increased or decreased depending on the foreign exchange exposure of the economy
    - Net long in foreign currency → The exchange rate channel is stronger
    - NOTE1: THIS REFERS TO CURRENCY EXPOSURE AND NOT TO THE IIP
    - NOTE2: THIS EXCHANGE RATE CHANNEL RELIES ON A WEALTH EFFECT

Results

- Already shown the differences in the responses to domestic monetary policy shocks.
- Cross-country estimates of

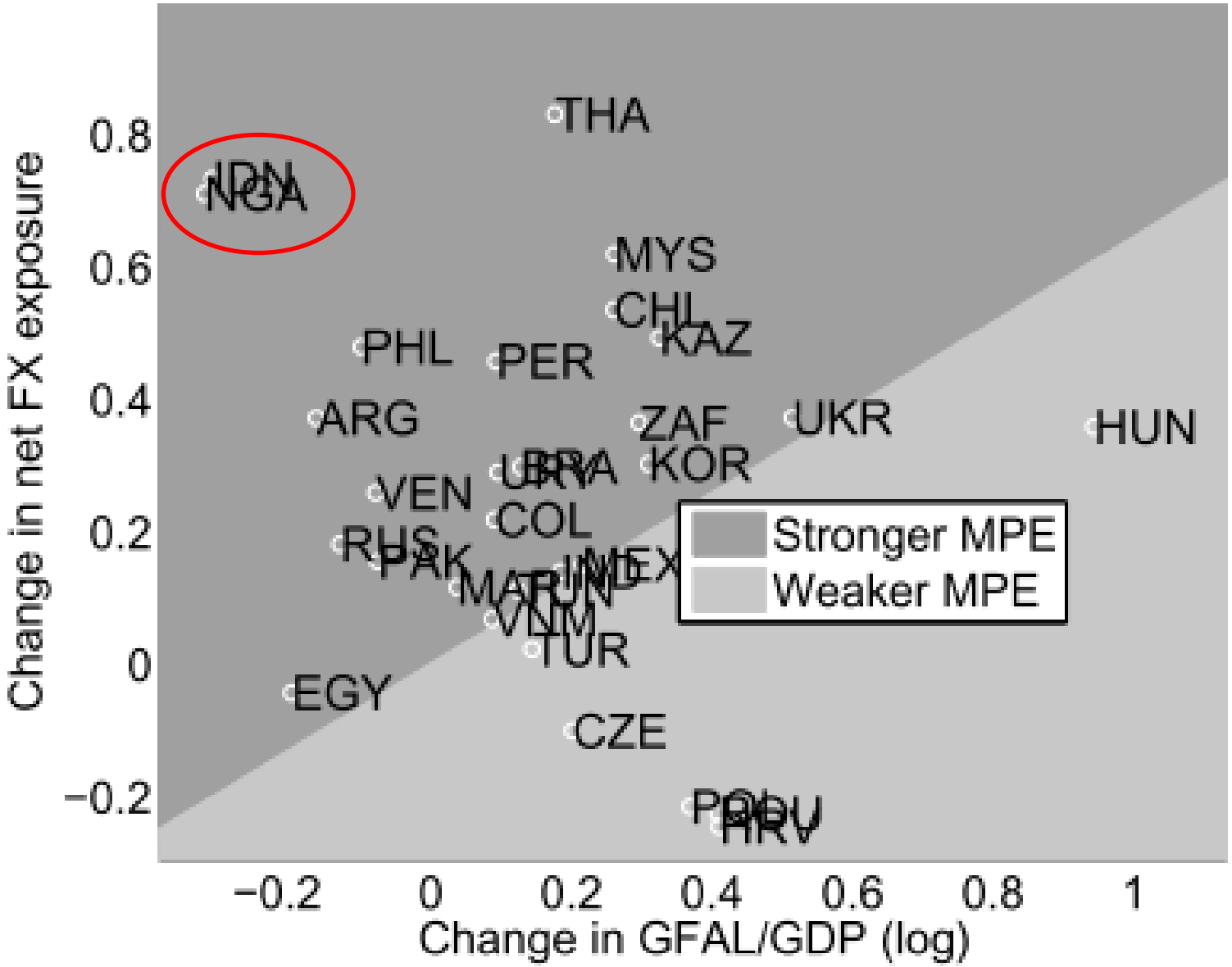
$$s_i = \alpha + \boldsymbol{\gamma} \cdot \boldsymbol{w}_i + \beta^{gfal} \cdot gfal_i + \beta^{nfx} \cdot nfx_i + u_i, \tag{7}$$

- Cumulative effect of financial globalization

$$\Delta s_{it}^{gfal} \equiv \sum_{j=1}^{t} \widehat{\beta}^{gfal} \cdot \Delta gfal_{ij}, \tag{8}$$

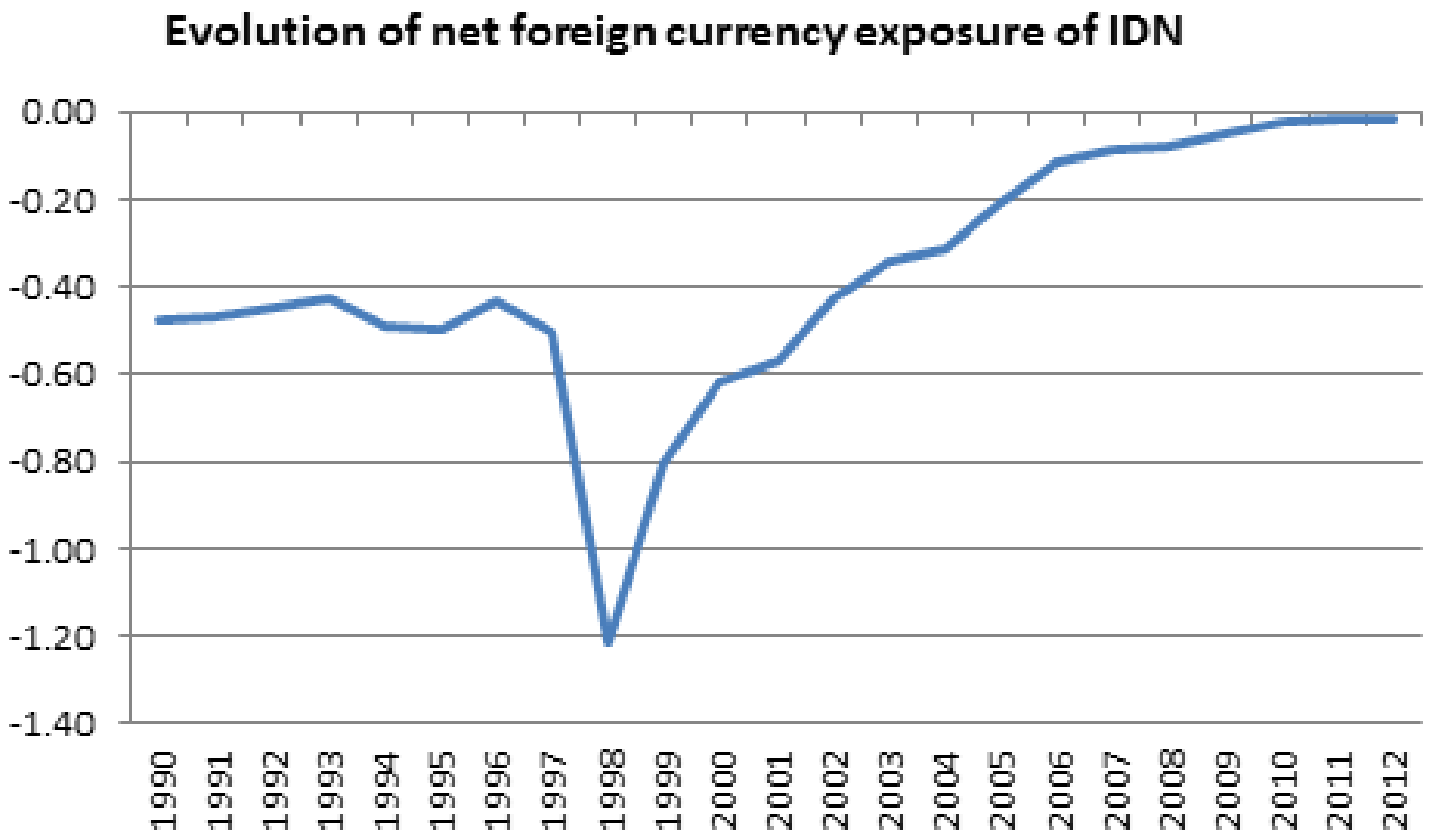
$$\Delta s_{it}^{nfx} \equiv \sum_{j=1}^{t} \widehat{\beta}^{nfx} \cdot \Delta nfx_{ij}. \tag{9}$$

Change in domestic monetary policy effectiveness due to financial globalization and net forex exposure effects



A caution regarding interpretation

- How can monetary policy in Indonesia have become more effective since they have a short foreign currency exposure?



The answer is that that the net foreign currency exposure is becoming less negative over time. This means that the exchange rate channel operating through the wealth effect of this exposure is creating less of a drag than before.

Discussion

- What is the link between financial globalization and net foreign exchange exposure? Where does foreign exchange exposure come from, and does it matter?
  - Reserve accumulation?
  - Issuing domestic currency denominated debt by corporates or the sovereign in international markets (redemption)
  - FDI inflows (foreigners buying domestic real assets priced in domestic currency)
- Related. Does it matter whether the net foreign currency exposure relates to the balance sheet of
  - The private or the public sector?
  - The household versus the corporate sector?
  - The financial sector versus the non-financial sector?

Conclusion 1

- ‘There is a **loss of independence** irrespective of the country’s choice of exchange rate regime.’ (Turner, 2014)

- ‘The global financial cycle transforms the trilemma into a “dilemma” or and “**irreconcilable duo**”: independent monetary policies are possible if and only if the capital account is managed.’ (Rey, 2013)

- ‘Overall we find that the net effect of **financial globalization** since the 1990s has been to **amplify monetary policy effectiveness** in the typical advanced and emerging market economy.’ (Georgiadis and Mehl, 2015)

Conclusion 2

- So there appears not to be an ‘irreconcilable duo’ after all

- But there may still be a ‘dilemma’ as in ‘predicament’ for emerging market policy makers. If central banks have to rely more on the exchange rate channel to give monetary policy some traction, they will have to rid themselves of any ‘fear of floating’ they might have.

THANK YOU