

Monetary Policy Coordination: 2022 versus 1982

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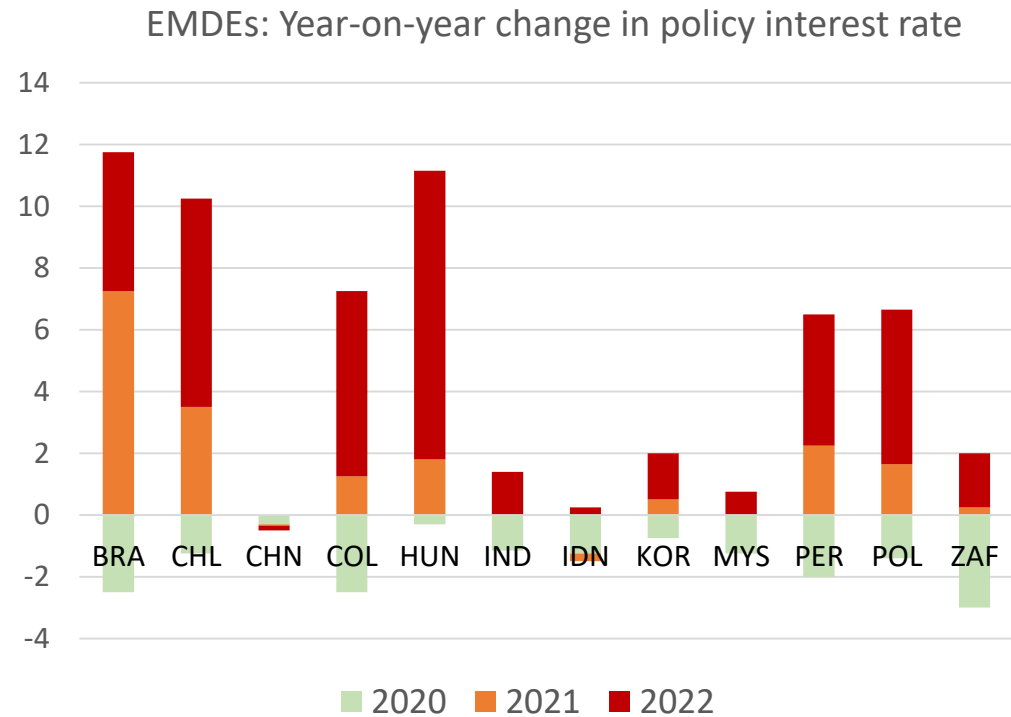
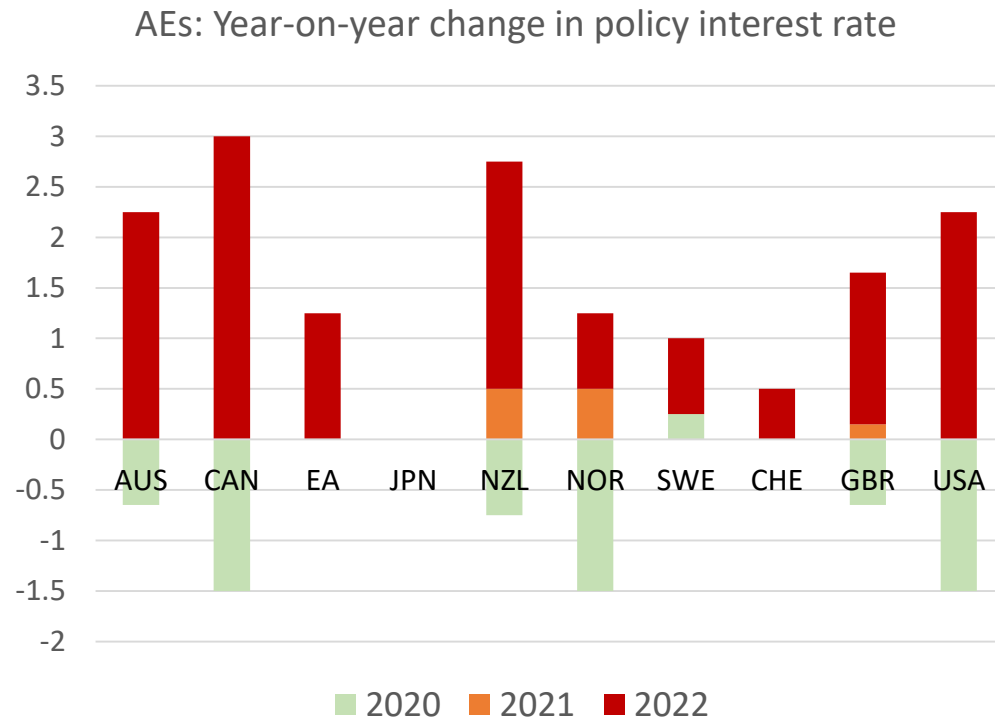
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G20 Global Financial Stability Conference 2022
Seoul, Republic of Korea

Roadmap

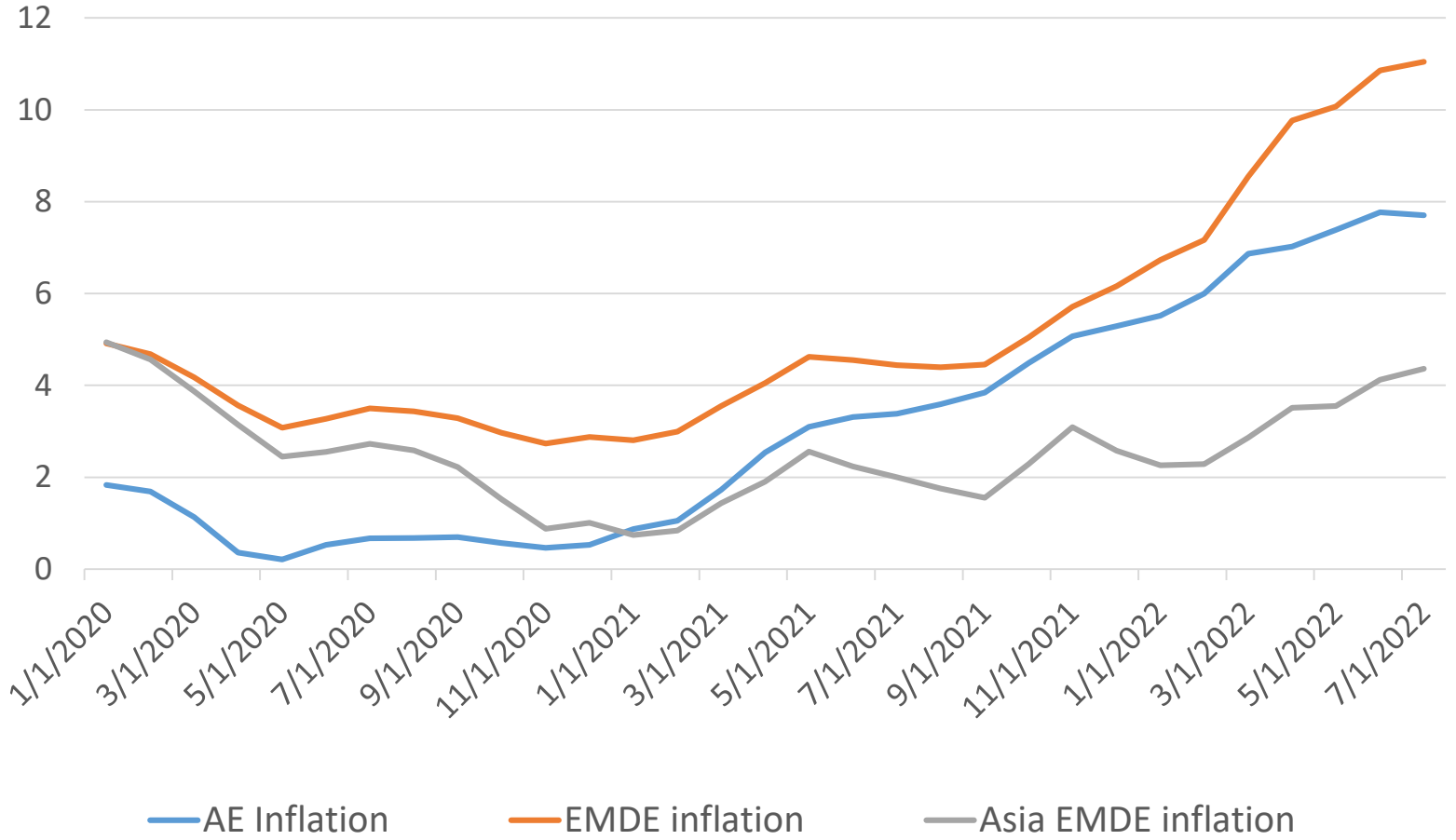
- Central bank tightening
- The inflation problem
- The U.S. is leading, with more to come (starting today)
- The strong dollar and effects abroad
- Global disinflation in the 1980s
- The need for policy coordination
- Why it is likely even more important today

Monetary tightening around the world



Sources: BIS and national central bank websites, updated to 9 September 2022

The global inflation problem



Source: Year-on-year inflation, monthly, from Haver Analytics

Drivers

- Stresses due to reopening (less problematic in Asia in general)
- Labor supply in some countries
- Shipping bottlenecks, higher costs as pandemic continues
- Energy and food prices
- Exacerbated by Ukraine war, though some recent relief due to recession fears, supply-side adjustments, and strong US dollar
- Expectations

Release date: 02/09/2022



Food prices have fallen from their peak six months ago, but they remain very high.

US is dominating the tightening cycle for AEs

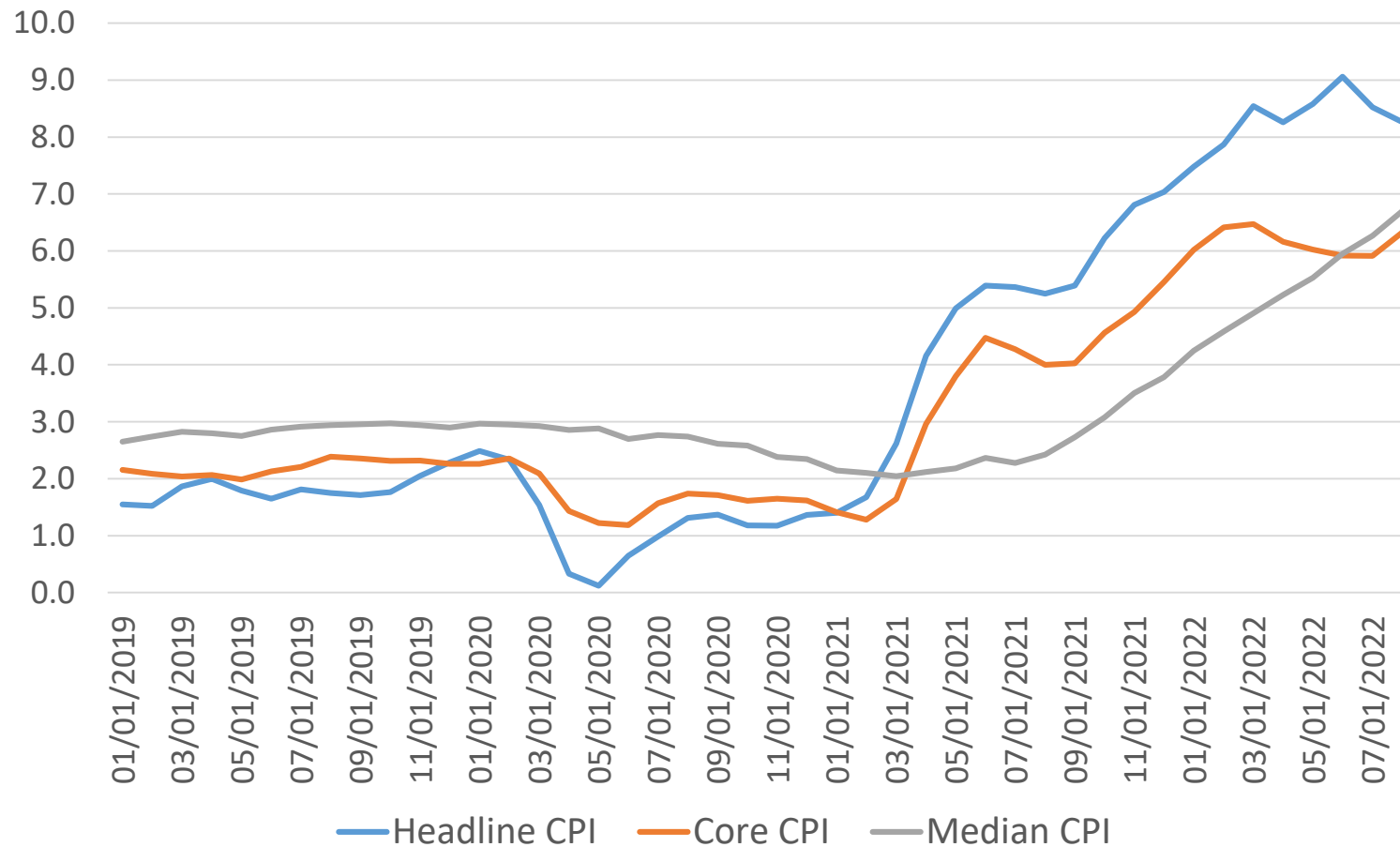
- The US recovered most rapidly from lockdowns and reached the pre-COVID trend line first
- That despite a fall in labor-market participation
- Massive transfer of purchasing power to households and local governments
- Its jobs market has been burning hot (job vacancies/unemployment)
- Consumption still strong
- High-yield spreads have risen, but not to levels consistent with a sharply slowing economy; Gilchrist-Zakrajsek EBP is low; but SLOOS has spiked up
- *The Fed will likely need to hike considerably more to slow inflation – US real rate remains below “neutral” level (one-year Treasury rate at 3.92% on 9/13/22 while one-year expected inflation was 5.75%, per NY Fed survey)*



ICE BofA US High Yield Index Option-Adjusted Spread

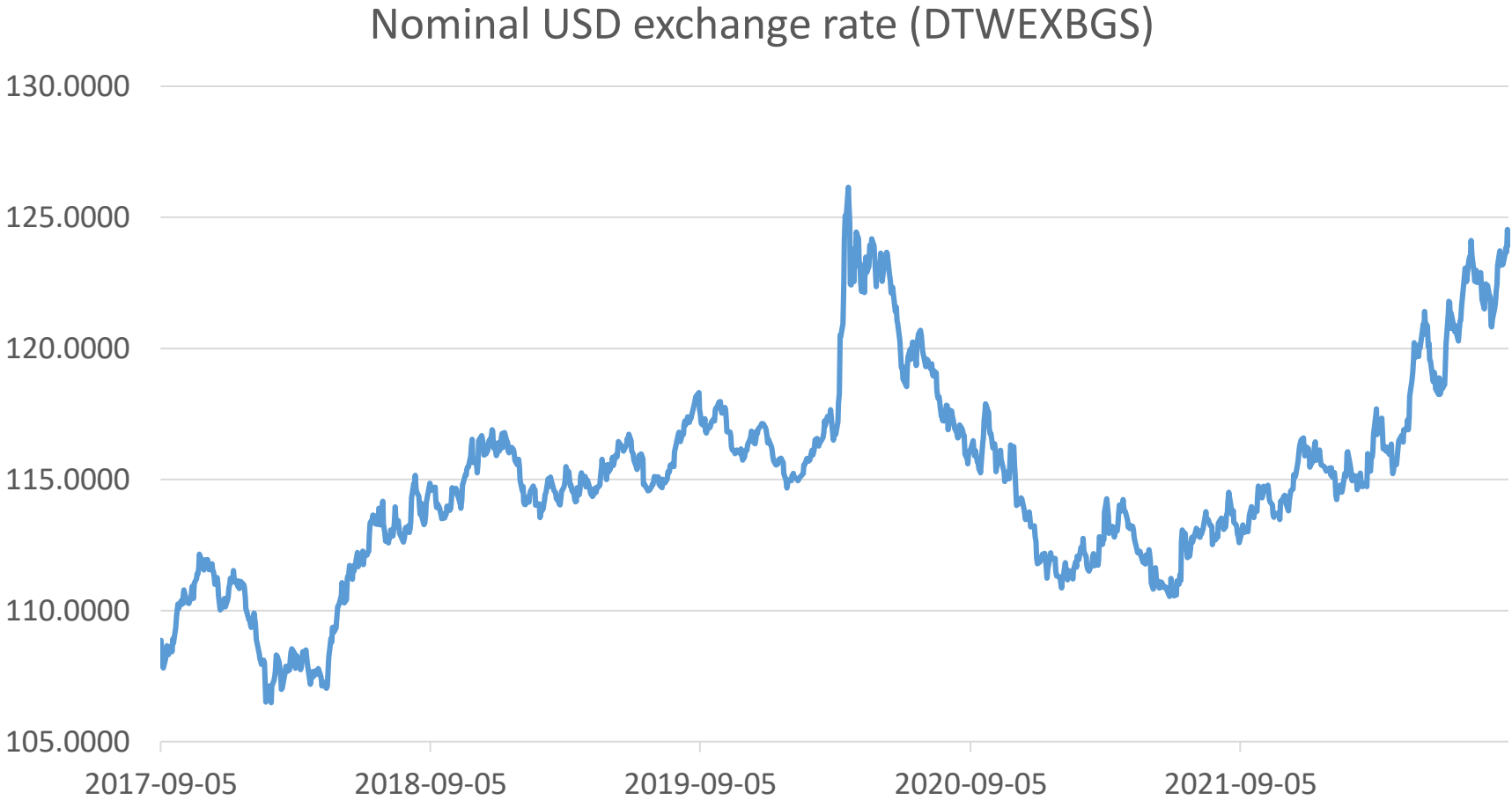


Measures of U.S. inflation remain high and nearly all indicators worsened in August



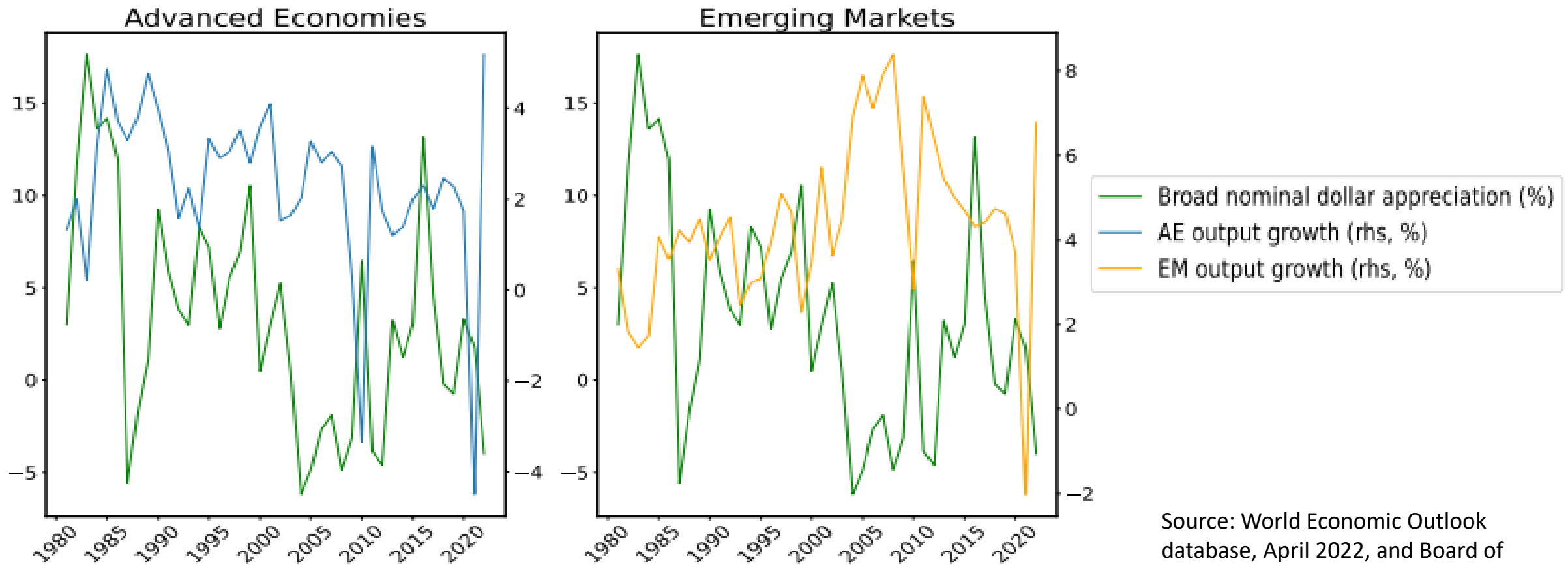
Source: Year-on-year inflation rates from Federal Reserve Bank of Cleveland

The dollar has strengthened broadly



Source: Board of Governors of the Federal Reserve System

Dollar appreciation comes with global financial tightening, especially hurting EMDEs



Source: World Economic Outlook database, April 2022, and Board of Governors of the Federal Reserve System

Some key global correlations with the dollar

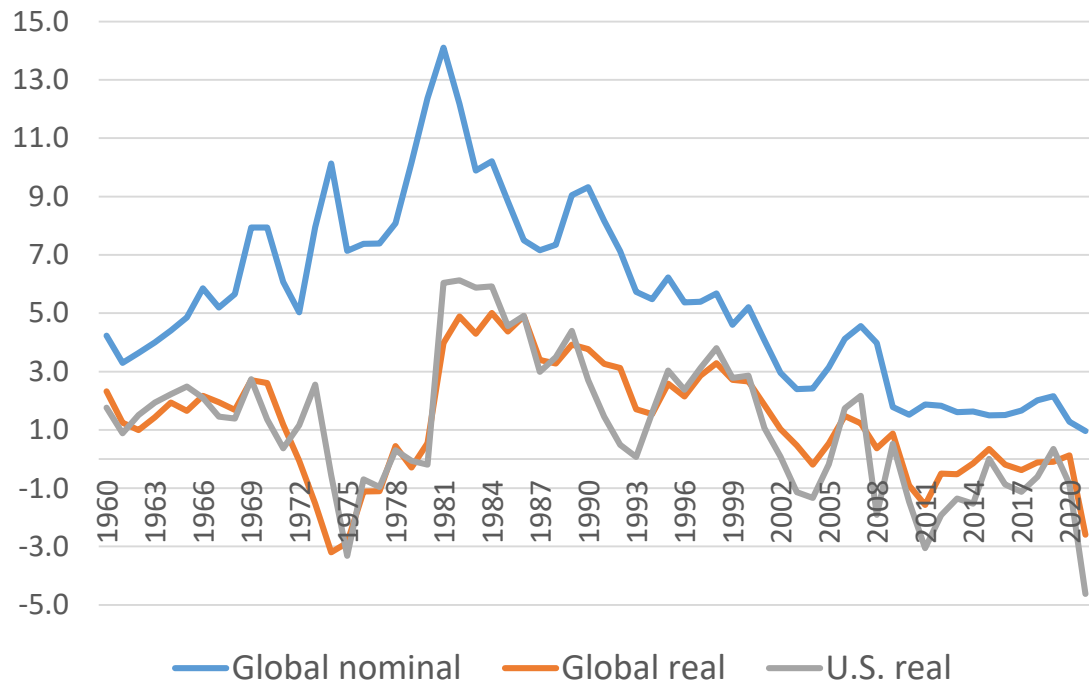
<i>Correlation with...</i>	1980-2021	1980-2000	2001-2021
World trade volume growth	-0.32	-0.39	-0.61
Growth in world investment/GDP share	-0.45	-0.32	-0.58
Advanced economy output growth	-0.05	-0.24	-0.36
EMDE output growth	-0.63	-0.56	-0.59

Table 1: Dollar appreciation and global aggregates

- In general these correlations are higher in this millennium, due to:
 - Growth of world capital markets – and the dollar’s role within them
 - Global value chains
 - Increasingly global nature of inflation (Auer et al. 2018; Ha, Kose, and Ohnsorge 2019) and influence of import prices in Phillips curves (Forbes 2020; Obstfeld 2020)
- In general, we would therefore expect bigger spillovers nowadays from monetary tightening, especially Fed tightening

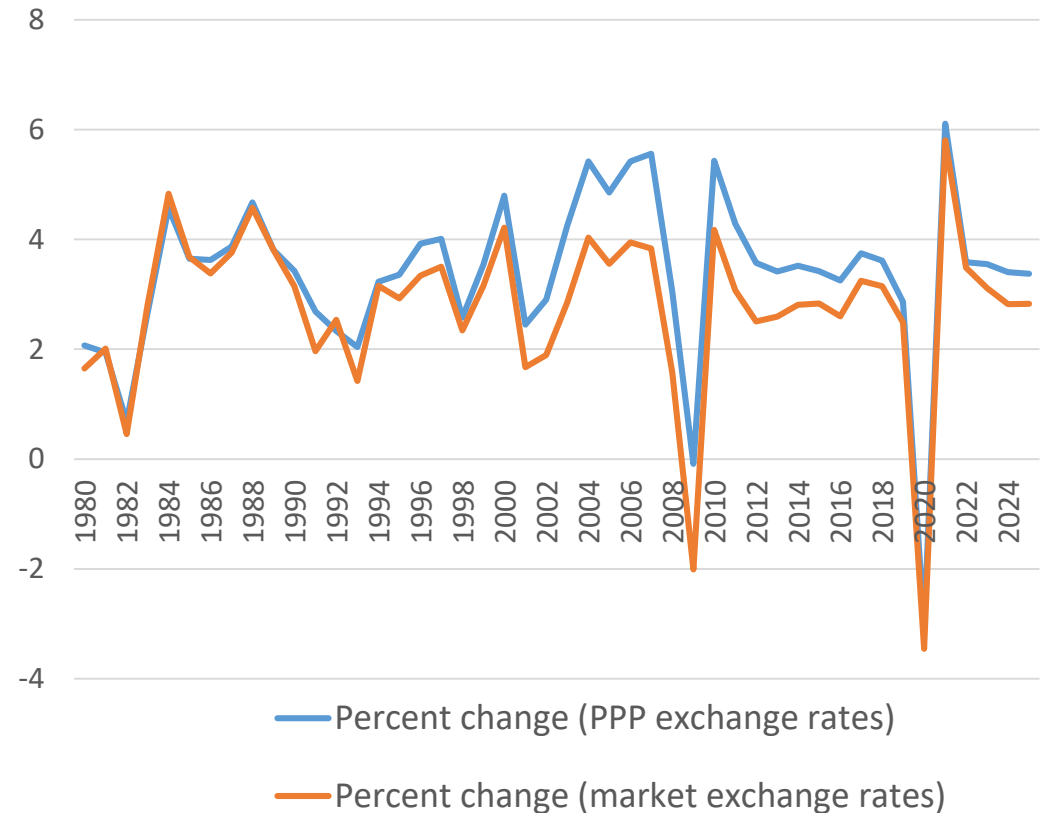
In the early 1980s, synchronized global disinflation caused a deep recession in 1982 and crises

Central Banks Raised Global Interest Rates in 1981



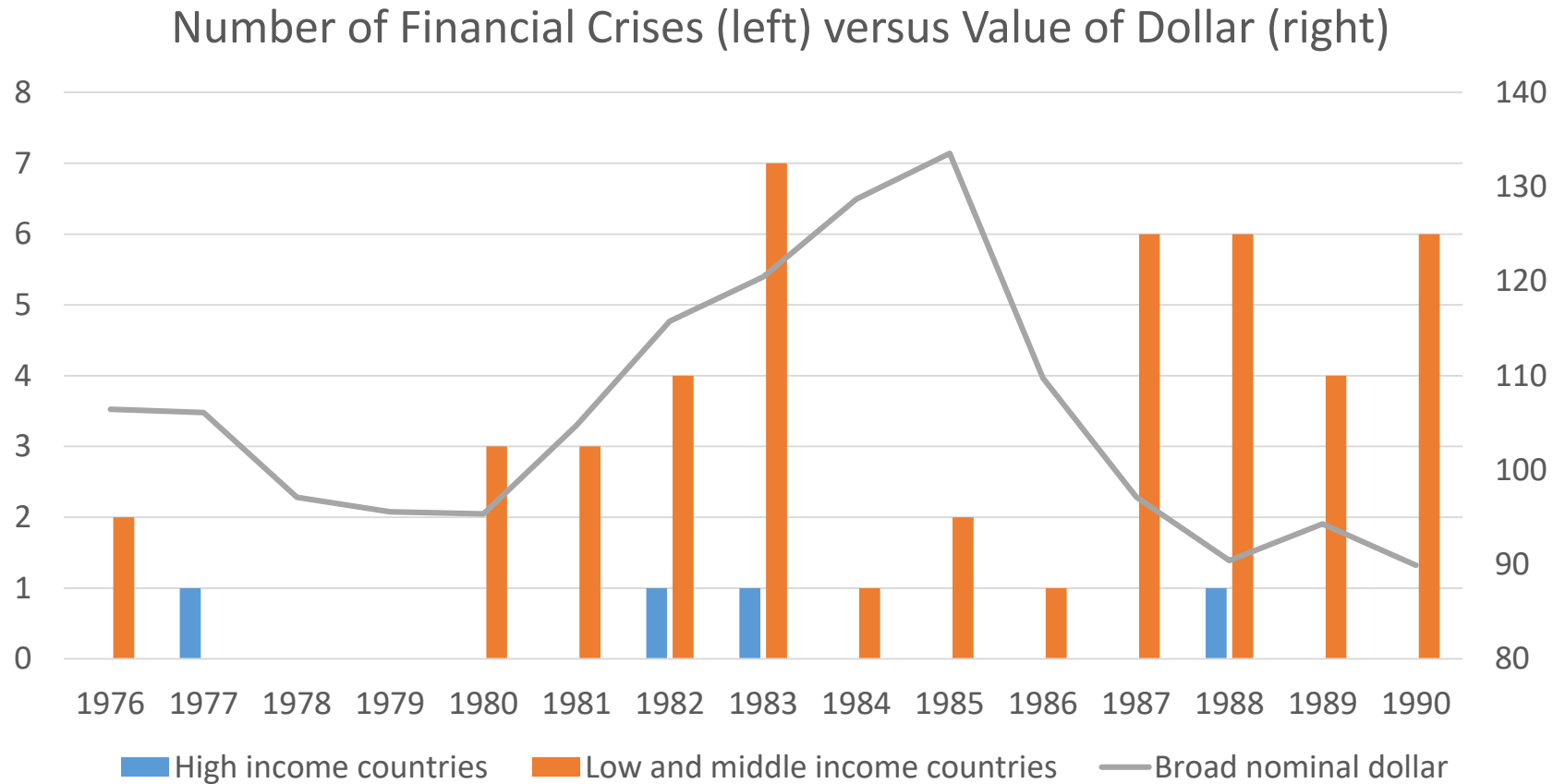
Source: J. Ha, M. A. Kose, and F. Ohnsorge, "Global Stagflation," CEPR D.P. 17381, June 2022

World Economic Growth Plummeted in 1982



Source: World Economic Outlook database, April 2022

EMDEs fell into debt crises as the dollar soared – a “lost decade” for many



Source: Crisis count from Laeven-Valencia dataset; USD exchange rate from FRED (series TWEXMANL)

Anatomy of potential policy mistakes

- When I tighten and appreciate my currency, this may cause your import prices to rise – effectively, I export inflation abroad (beggar-thy-neighbor)
- This is analog of the export of deflation through depreciation at ELB
- Thus, my tightening raises the marginal value of tightening to foreign monetary policymakers
- We see this, e.g., in ECB board members' comments on exchange rates
- A Prisoner's Dilemma may result, with all countries suffering
- More controversially, foreign slack may directly enter my Phillips curve
- If so, I tighten excessively by not taking account of foreign tightening
- This is simply a forecast error risk, not strictly a “coordination failure”
- *More globalized markets likely exacerbate the coordination failure and risk of forecast error compared with four decades ago*

The case for coordination

- Every economy has different needs to reduce inflation going forward, but there is still an opportunity for beneficial monetary policy cooperation
- Each central bank could try to forecast others' actions and carefully compute the predicted effects on home inflation
- This requires guesswork, plus solving a complex fixed-point problem
- Much better for central bankers to communicate their assessments and policy intentions directly, and ask if they are jointly too harsh
- This would also be a chance for central bankers jointly to communicate to markets their collective resolve to quell inflation
- That in itself might decrease sacrifice ratios – which may be big, as stressed in the just-released WB paper by Guénette, Kose, and Sugawara
- Central bankers have coordinated in deflationary crises – why not now?

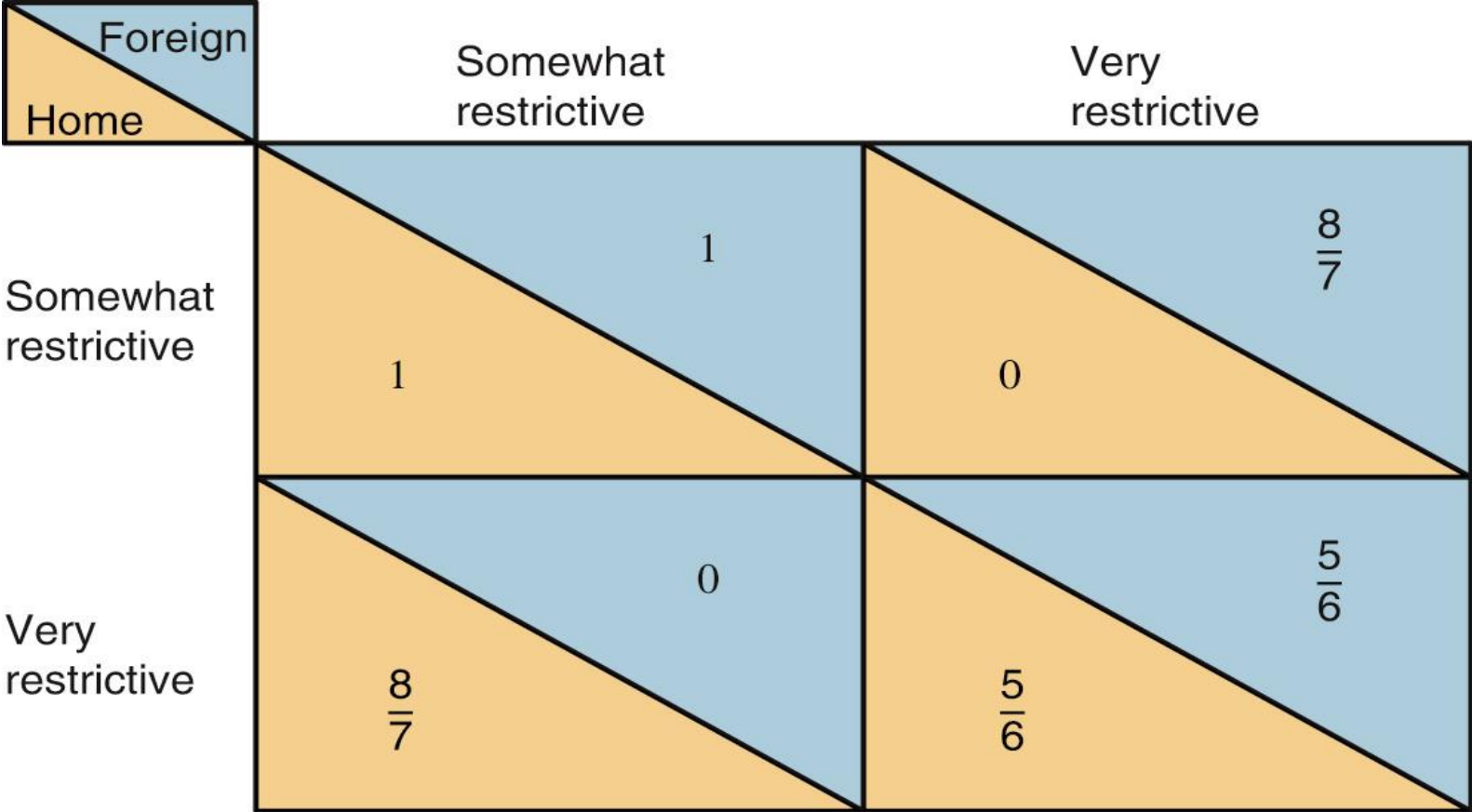
Hypothetical effects of different monetary policy combinations on inflation and unemployment

Monetary policy choices in one country affect the outcomes of monetary policy choices made abroad. (Inflation and unemployment outcomes in the foreign country are denoted by an asterisk.)

		Foreign	
		Somewhat restrictive	Very restrictive
Home	Somewhat restrictive	$\Delta\pi^* = -1\%$ $\Delta U^* = 1\%$	$\Delta\pi^* = -2\%$ $\Delta U^* = 1.75\%$
	Very restrictive	$\Delta\pi^* = 0\%$ $\Delta U^* = 0.5\%$	$\Delta\pi^* = -1.25\%$ $\Delta U^* = 1.5\%$
Somewhat restrictive	Somewhat restrictive	$\Delta\pi = -1\%$ $\Delta U = 1\%$	$\Delta\pi = 0\%$ $\Delta U = 0.5\%$
	Very restrictive	$\Delta\pi = -2\%$ $\Delta U = 1.75\%$	$\Delta\pi = -1.25\%$ $\Delta U = 1.5\%$

Payoff matrix for different monetary policy moves

Each payoff entry equals the reduction in inflation per unit rise in the unemployment rate, calculated as the *inverse sacrifice ratio* $-\Delta\pi/\Delta U$.



If both countries play Nash, they will choose very restrictive policies (lower right corner). Less restrictive policies, if adopted by both countries, lead to a better outcome for both (upper left corner) .