Opinion **Central banks**

Central banks can no longer afford to act in isolation

International spillovers from monetary policy have been amplified by increased globalisation

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Federal Reserve chairman Jay Powell with Mark Carney, governor of the Bank of England, at Jackson Hole © Bloomberg

Megan Greene AUGUST 29, 2019

Just as some of the world's political leaders are adopting a go-it-alone attitude, the central bankers who gathered in Jackson Hole, Wyoming, last week are acknowledging the benefits of co-ordination and the downsides of pursuing purely domestic objectives.

Facing trade and currency wars, they are concluding the best approach to monetary policy is to recognise that what they do — particularly at the US Federal Reserve — spills over to the rest of the world.

For decades, monetary policy experts had believed central banks should focus on keeping their own houses in order. Floating exchange rates would absorb global shocks so that domestic employment and growth would not be significantly affected by developments abroad. Exchange rate moves would pass through to import prices, and the central bank could respond with rate moves to keep prices stable and growth near potential.

That theory has gone helter-skelter in a world of growing trade tensions and international financial markets. Fed chairman Jay Powell acknowledged this in his speech in Jackson Hole when he highlighted the global factors affecting the US outlook, from threats of a hard Brexit to rising tensions in Hong Kong.

International spillovers from monetary policy have been amplified by globalisation in recent decades. World trade has doubled as a share of global gross domestic product since 1970. The volume of gross financial flows has also shot up, speeding the transmission of financial shocks across borders.

One of the biggest drivers of spillovers is the dominant role of the US dollar. Roughly half of international trade is invoiced in dollars, five times the US's share in world goods imports and three times its share in world goods exports. This is partly because of the rise of global supply chains and network effects — it is easier to do business with firms using dollars if you use them too. Two-thirds of global securities issuance and official foreign-exchange reserves are denominated in dollars as well, largely driven by demand for safe assets.

The largest effects are on emerging markets. A dominant dollar reserve currency works well in an environment of synchronised growth. But when the US economy outperforms, the Fed's monetary policy stance shifts tighter and the dollar appreciates, hitting emerging markets disproportionately.

A stronger dollar also raises import prices for trade denominated in dollars, pushing up inflation, even if supply and demand between trading partners has not changed. Dollar appreciation makes it more difficult for emerging markets to service their dollar-denominated debt. Fluctuations affect the risk appetite of global investors. Combined with country-specific issues, this drives capital flows in and out of emerging markets, amplifying their imbalances.

But emerging markets are not the only ones hit by such spillovers. Hoarding of safe dollar assets has exacerbated a global savings glut, reducing investment.

These factors have in turn pushed down the global long-run neutral rate — the interest rate that achieves stable inflation around the world. It exerts significant influence on domestic neutral rates and therefore anchors all policy rates, according to a paper presented in Jackson Hole. This makes it more difficult for monetary policy to diverge across countries without affecting exchange rates, current accounts, credit flows and growth. Accordingly, divergence in domestic monetary policy between the US, UK, Germany and Japan is now at its lowest point since 1960.

We witnessed these spillover effects when the Fed raised rates in the most recent cycle. As rate rises kicked in with a lag, the share of the global economy growing below potential rose from about 67 per cent in early 2019 to 80 per cent today. This had a blowback effect on the US, as weaker demand from abroad contributes to softer growth and inflation domestically.

Central bankers are split on what to do about disruptive spillovers. One option is to incorporate them into their planning and pursue a degree of international policy co-ordination, but this is politically tricky. Another option is to reduce the dominance of the dollar. Bank of England Governor Mark Carney suggested a new global electronic currency controlled by central banks. But the technology for this does not yet exist.

Expect the debate to continue. Central bankers have discovered what the politicians deny: globalisation has gone so far it cannot be turned off. With slower global growth and fewer tools to respond to the next recession, they can't avoid being their neighbours' keepers.

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Letters in response to this article:

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