Should Central Banks Care About (the rest of) the World?

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- I will focus on the question of whether central banks should tailor their policies to their impact on economic conditions abroad.
- And, if so, how.
- These are large and complex issues. In order to render them practical I will:
  - Focus on the case of the Fed.
  - And utilize historical evidence (look at a particular historical episode).

The international role of the Federal Reserve is of course a much-discussed topic

- The Fed has long been reluctant to acknowledge its international responsibilities.
- But then there was the global financial crisis, the Fed’s dollar swaps with the ECB, BoE and SNB, and its four $30 billion emerging-market currency swap arrangements.
  - At the height of the crisis, the Fed had $583 b. of swaps outstanding, by my count.
- There was the “taper tantrum” in May/June 2013.
- Now there is considerable criticism of the Fed for ignoring the impact on emerging markets of its impending increases in interest rates.

A Yellen speech from the beginning of the year hints that this may now be changing

- To quote: “Because the economy and financial system are becoming increasingly globalized, fulfilling [the Fed’s] objectives requires us to achieve a deep understanding of how evolving developments and financial markets and economies around the world affect the U.S. economy, and also how U.S. policy actions affect economic and financial development overseas…”

- Seems uncontroversial. The question being how this realization should affect central bank policy in general, and Federal Reserve policy in particular.

A historical perspective suggests that this question is not new

- My own work on the two first decades of the U.S. central bank, that is, from 1914 to 1934 (displayed here), points to a number of instances when international considerations featured prominently in the Fed's decision-making.
  - Let me talk a little more about this rich historical period.

Federal Reserve Bank of Dallas
Globalization and Monetary Policy Institute
Working Paper No. 195
http://www.dallasfed.org/assets/documents/institute/wpapers/2014/0195.pdf

Doctrinal Determinants, Domestic and International, of Federal Reserve Policy 1914-1933*

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Abstract

This paper describes the doctrinal foundations of Federal Reserve policy from the establishment of the institution through the early 1930s, focusing on the role of international factors in those doctrines and conceptions. International considerations were at most part of the constellation of factors shaping the Federal Reserve's outlook and policies even in the high gold standard era that ended in 1933. However, neither was the influence of international factors absent, much less negligible. Nor were the Fed's policies without consequences for the rest of the world. Having described the doctrinal foundations of Federal Reserve policy, I analyze how the doctrines in question influenced the central bank's actions and shaped the impact of monetary policy on a number of key occasions, focusing in particular on episodes where the international economy and the rest of the world played an important role.

JEL codes: E4, F5

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Doing so requires making the following distinction

- It requires distinguishing several different senses in which international considerations could have influenced U.S. monetary policy.
  - Four different senses, in point of fact.

- First, the Fed could have organized policy around an international target or external economic indicator. It could have adopted an exchange rate target (as it did by pegging the dollar price of gold and maintaining a minimum statutory ratio of gold reserves to monetary liabilities) and adapted policy accordingly (something that will have to be established – Marvin Goodfriend discussed this in the first session).
- Second, it could have adjusted its policies so as to influence economic and financial conditions in other countries, because developments abroad had a significant impact on the American economy.
- Third, the Fed could have adjusted its policies with problems in other countries in mind because it cared about the problems of those other economies, independently of any immediate impact on the U.S. economy.
- Finally, the Fed could have adjusted its policies with international considerations in mind because it was concerned with stability of the international monetary and financial system as a whole.

- You will note that these four senses in which international factors could matter also figure in current discussions of US policy:
  - Some say that the Fed should pay more attention to how events in the rest of the world are affecting the prospects for the US economy.
    - Janet Yellen flagged this concern in the speech I cited earlier.
  - Others say that the Fed should worry about the impact of its decisions on other countries insofar as those foreign impacts feed back on the US.
    - Again, this concern was flagged in the Yellen speech.
  - Still others say that the Fed should worry about the welfare of other countries for its own sake.
    - A view that is, understandably, more controversial.
  - And still others point to the Fed's responsibility for the stability of the global monetary and financial system.
    - Again, controversial.
    - So what can history (the colorful history of the Fed's first two decades) tell us about these questions?

In my historical period, international considerations mattered importantly on 6 occasions that I will now briefly discuss

- 1919-20 recession
- 1924-5 interest rate cuts.
- 1927 decision to reduce interest rates.
- May-July 1931 emergency loans to European central banks.
- October 1931 interest rate hike.
- August 1932 abandonment of expansionary open market operations.
  - This, you can see, was a period when the Fed paid extensive attention to international considerations.
  - And the results, ultimately, were unhappy. (Fed policy in the 1920s and 1930s is not widely praised.)
  - Therein lies a cautionary tale, as I will emphasize at the end.

Post-WWI Recession

- This was the first Fed-induced recession.
- The decision to tighten in 1919 and early 1920 was motivated by international considerations.
  - US gold ratio were falling, as flight capital was repatriated to Europe, dictating tightening on Gold-Standard Doctrine grounds. Reserve ratios in late 1919 and early 1920 were dangerously close to the 40 per cent statutory minimum.
    - So the Fed tightened starting in November 1919.
  - Preserving the US gold standard also set the stage for restoration of the international gold standard.
    - Which certain influential figures within the System, like Benjamin Strong, viewed as a priority.
- The gold reserve ratio bottomed at 42% in May 1920 and then began to rise.
  - Thus, the sharp but short post-WWI recession was mainly a byproduct of the Fed's pursuit of international targets.

Post-WWI Recession

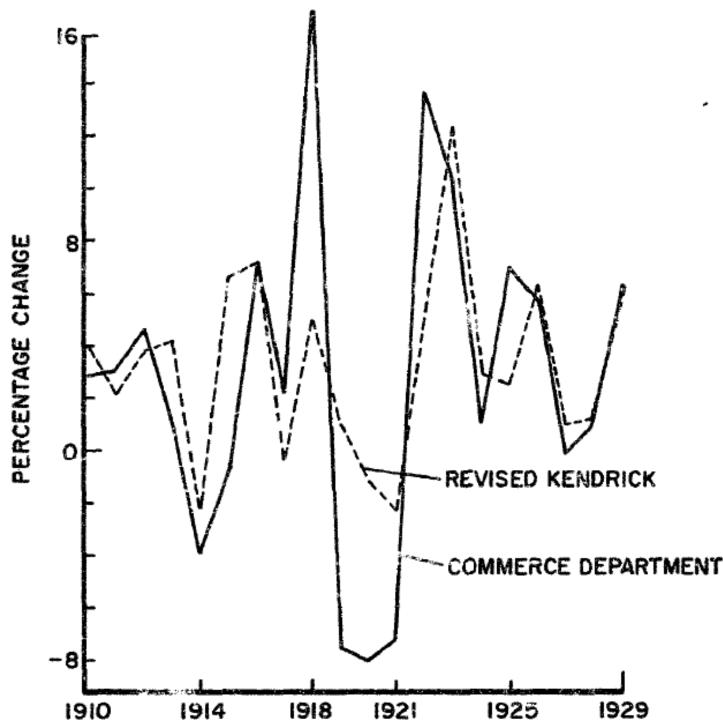


Fig. 1. Percentage change in real GNP, 1910–1929. (*Source*: Table 6.)

- As you can see here, this was a deep recession, one of the three most severe recessions of the 20th century.
- Which, in my view, should have served as a cautionary tale.

Easing in 1924-5 and 1927

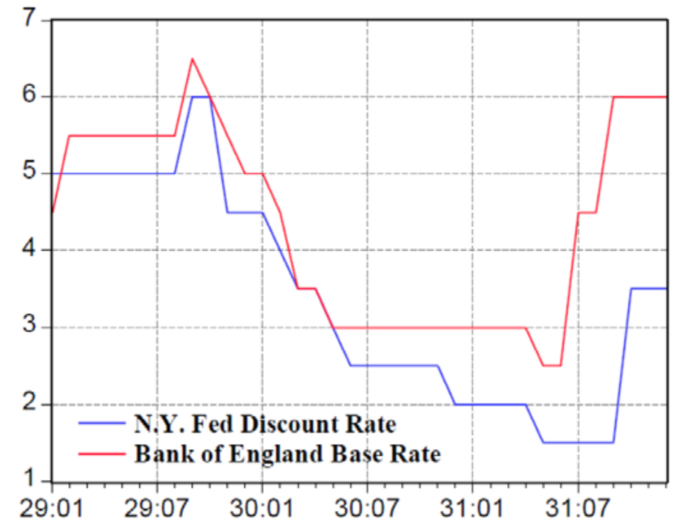
- First initiative designed to help Bank of England back onto the gold standard.
- Second initiative designed to help keep it there.
  - Second episode in particular is criticized for fueling domestic financial excesses.
  - You can guess to what I am referring.

Summer 1931 Emergency Loans

- Response to the spreading Central European banking crisis.
- Included $1 million for Austria on May 30, $2 million for Hungary on June 19 (later increased to $5 million), $25 million for Germany on June 26, and $125 million for Bank of England on August 1st.
  - US nominal GDP is 200 times larger now. By this metric this was a $200 m. loan for Austria, a $5 b. loan for Germany, and a $25 b. “swap line” for England. Total of $30 b. or so at 2015 prices. Small by recent standards.
  - Recall the Fed’s $583 b. outstanding in 2008.
  - Treasury Secretary Mellon (an ex officio member of the Board) and several other board members opposed more extensive support. Half-hearted support was too little, too late. And the consequences spilled over to the United States.

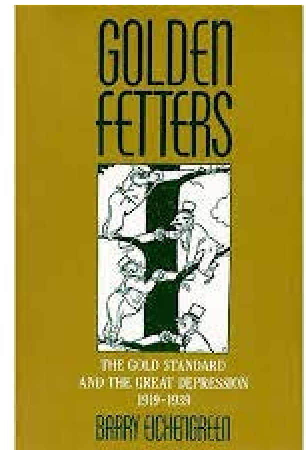
October 1931 Tightening

- No question in this case that international considerations dominated.
  - Occurred after Britain's departure from gold.
  - Tightening was a clear response to gold outflows.
  - Greatly aggravated the severity of the Great Depression.



Open Market Operations of April-August 1932

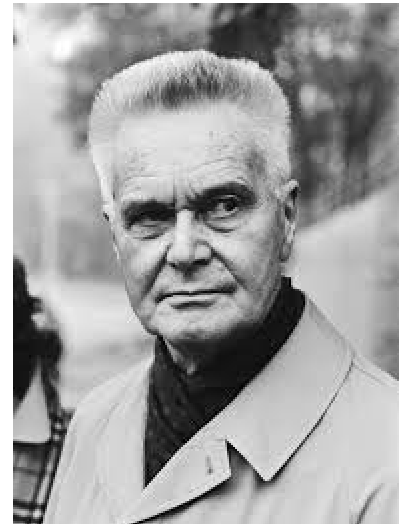
- Gold losses accompanied the expansionary open market operations, and Gold Standard Doctrine dictated tightening in August.
  - So I argued (in this book) long, long ago…
- The skeptics (Hsieh and Romer) argue that new (post-Glass-Steagall) gold cover ratios were never threatened.
- I of course am an impartial arbitrator. But my view, for what it's worth, is that Gold Standard Doctrine was not just a statute but also a mentalité, and worries about the gold cover ratio remained influential.
- My view is that the central bank's prioritizing international over domestic considerations in October 1931 and August 1932, greatly aggravated the Great Depression.
- It was, in large part, what precipitated FDR's transferring control of monetary policy from the Fed to the RFC (and ultimately to his own hands) in 1933.



So how do we evaluate the role of international considerations overall?

- This short review suggests that the Fed was right not to ignore conditions in the rest of the world. What happened in the UK or Germany didn't stay in the UK or Germany, as highlighted by the events of 1931.
- That said, Federal Reserve officials could have dealt more wisely with the international aspects of policy.
- Attempting to reconstruct an international gold standard along prewar lines in social, political and economic circumstances that were now radically changed was not wise, perhaps. (It is tempting to draw a parallel with the euro…)
- Once that decision was taken, however, the Fed either should have either supported that system wholeheartedly or else acknowledged that the experiment was a failure and abandoned it. The half-measures taken in 1931 to support Austria, Germany and the United Kingdom solved nothing. (It is tempting to draw a parallel with the euro…)

- At the same time, if you believe (as I do) that the Fed has to worry about global financial stability as well as domestic price and financial stability, then it needs to develop multiple instruments to target multiple objectives.
  - The Tinbergen Principle applies here, as elsewhere.
- You can only hit two birds with one bullet by dint of (very) good luck.
  - Extending larger loans (swap lines) to the Bank of England and British government would have been a better approach than interest rate cuts in 1924 and 1927, for example.



Implications for Today

- Even a central bank with good reason to worry about economic and financial conditions in the rest of the world will achieve nothing if it fails to attend first to the health and stability of its own economy.
  - This was true of the Fed in the 1920s and 1930s.
  - The same is true today when we hear calls for the Federal Reserve to abandon policies tailored to the needs of domestic stability in order to address problems in the rest of the world.
  - Better is to develop a second set of instruments expressly tailored to this second set of objectives.
    - By analogy with the argument for macroprudential policy as a second set of instruments for pursuing financial stability goals.

- Thank you very much.