Monetary Policy Challenges in a Global Economy

Introduction to a Special Issue of the International Journal of Central Banking

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Over the past few years, the world economy has been going through a major financial crisis and the most severe recession since the Second World War, putting an abrupt end to what economists have called the "Great Moderation." This global crisis has led to unprecedented fiscal and monetary policy actions by governments and central banks all over the world, raising questions about the modalities, the effectiveness, and the coordination of those policies. This volume of the *International Journal of Central Banking* (IJCB) deals with some of those key questions. It contains the papers, discussions, and commentaries that were presented at the inaugural Monetary Policy Conference organized by the IJCB and hosted by the Banque de France on September 24–25, 2009. The purpose of the IJCB conferences is to stimulate research on issues of topical importance for central banking and provide a forum for interaction between central bank researchers, academics, and policymakers. In addition to the contributions published in this volume, the conference also contained a policy panel, in which Charles Bean (Bank of England), Donald Kohn (Federal Reserve Board), Jean Pierre Landau (Banque de France), and Klaus Schmidt-Hebbel (formerly OECD) debated the implications of the financial crisis for macroeconomic and monetary policy research. Jean Claude Trichet (European Central Bank) gave a lunch speech discussing the need for different types of cooperation amongst central banks in normal and crisis times, and Christian Noyer (Banque de France) delivered the dinner speech.

The first paper—"Cross-Border Spillovers from Fiscal Stimulus" by Giancarlo Corsetti (European University Institute), André Meier (International Monetary Fund), and Gernot Müller (University of Bonn)—examines the role of a number of factors, including trade elasticities, the size and openness of economies, and financial imperfections, for the international effects of fiscal stimulus. Their findings lend support to the notion that coordinated short-term stimulus policies are most effective when coupled with credible medium-term consolidation plans featuring at least some spending restraint. The paper is discussed by Volker Wieland (Goethe University of Frankfurt).

The second paper, “Has Globalization Changed the Phillips Curve? Firm-Level Evidence on the Effect of Activity on Prices” by Eugenio Gaiotti (Banca d’Italia), still refers to the Great Moderation period and examines the hypothesis that the flattening of the Phillips curve observed in the industrial countries over the past two decades is due to globalization. Taking advantage of a unique data set including about 2,000 Italian firms, the paper confirms that the link between capacity utilization and prices has become weaker recently, but it does not support the view that this has been concentrated among firms that are more exposed to foreign competition. The paper is discussed by Hervé Le Bihan (Banque de France). In his commentary, Jordi Galí (CREI, Universitat Pompeu Fabra) argues that it is hard, using modern economic theory, to draw unambiguous implications of globalization for changes in the coefficients of estimated inflation equations and urges for more microeconomic research on price-setting practices of importers and exporters.

The third paper—by Ippei Fujiwara, Nao Sudo, and Yuki Teranishi (all Bank of Japan)—investigates “The Zero Lower Bound and Monetary Policy in a Global Economy.” Using a stylized two-country model, they show that, in the presence of a zero lower bound, optimal monetary policy under commitment features history dependence with international spillover effects. The paper is discussed by Paolo Pesenti.

The fourth paper—by Andrew Levin, David López-Salido, Edward Nelson, and Tack Yun (all Federal Reserve Board)—examines “Limitations on the Effectiveness of Forward Guidance at the Zero Lower Bound.” It argues that for reasonable calibrations of the interest rate elasticity of spending, forward guidance by the central bank on future short-term interest rates may not be sufficient to offset large economic shocks such as the one experienced during the current recession. It therefore makes an indirect case for unconventional monetary policy measures, such as large-scale asset purchases, and fiscal stimulus to complement conventional monetary policy in such a situation. The paper is discussed by Robert King (Boston University). In his commentary, Chris Sims (Princeton University) discusses several aspects of the problems faced by central banks at the zero lower bound, including the difficulty of credibly committing to higher inflation as most New Keynesian models imply, the need for fiscal and monetary policy coordination, and the pitfalls in the taking of quasi-fiscal actions by the central bank.

The final paper—by Charles Freedman (Carleton University), Michael Kumhof, Douglas Laxton, and Dirk Muir (all International Monetary Fund)—deals with "Policies to Rebalance the Global Economy After the Financial Crisis." Against a baseline forecast of October 2009, it describes the policy choices that would help to support global demand on a more sustainable basis and to rebalance its regional elements and therefore current accounts. Using the United States as an example, the paper also provides estimates of the long-term damage from protracted excessive fiscal deficits, and of the benefits from significant fiscal consolidation. The paper is discussed by Raf Wouters (National Bank of Belgium). In his commentary, Carl Walsh (University of California, Santa Cruz) expands on the use of modern macroeconomic (DSGE) models for policy analysis.