US Monetary Policy in a Changing World:

Historical Overview and Future Policy Implications

INTRODUCTION

We often hear in the news that, stock market is volatile, consumer confidence is falling rapidly, the housing market remains to be solid, and the unemployment rate is rising and so on. Monetary policy is designed to solve above-mentioned problems by pursuing the right policy objectives, assessing the economic outlook and taking the right policy actions. But it is not always easy to monitor the incoming statistics and remain ready to take appropriate policy actions. It is a fact that, monetary policymakers always face these three challenges. But overcoming these challenges does not guarantee a successful implementation of monetary policy. In this respect, several aspects of global economic integration, which have remarkable effect on the way monetary policy is conducted, should be considered as well.

Globalization - the trend towards greater economic integration around the world - has brought important benefits to world community. It has boosted world trade, opened up access to sources of global finance, and facilitated the diffusion of far-reaching technological advances in transportation, communications, and information processing. Over the past few years an increasing quantity of literature[1] has been written on how globalization has affected the conduct of United States

[1] Donald Brash (2000), Richard N. Cooper and Jane Sneddon Little (2001), J. Alfred Broaddus, Jr.(2000) and Patricia S. Pollard (2001)

(U.S.) monetary policy. Some of these papers have been focused on the openness of the US economy. A very interesting question comes to mind: "How can the implications of increased openness affect the conduct of the monetary policy in the US?" The framework that has guided the literature to date on this issue includes Laurence H. Meyer (1997) who addresses some questions along the way such as "Does an open economy introduce either new objectives or new instruments for monetary policy? How does an open economy affect the monetary policy transmission mechanism? Does the rapid growth in cross-border capital flows limit or even eliminate the ability of domestic monetary policy to affect domestic interest rates? How does U.S. monetary policy affect economic conditions in other countries? How does globalization affect the cyclical properties of the U.S. economy, the inflation process, and longer-term trends in the economy?"

Answering these questions yields to a conclusion that, all above-mentioned factors have significantly affected how the United States monetary policy operates, but have not totally altered it. But it should be considered that, the importance of "international factors" is rapidly increasing as Meyer (1997) noted "…nevertheless, it[2] has importantly affected the monetary policy transmission mechanism and increasingly subjected the domestic economy to the effects of changes in economic conditions abroad" This paper aims to explore the effect of so-called "international factors" on conduct of monetary policy by Federal Reserve System (Fed) and to

[2] Openness

evaluate the influence of “international forces” on the evolution of both U.S. monetary system and the practice of monetary policymaking.

HISTORICAL OVERVIEW

In spite of the fact that U.S. monetary policy has been having a purely domestic mandate, historical evidences show that, U.S. have been significantly affected by the changes in global development. Richard N. Cooper and Jane Sneddon Little (2001) argue that, "…global developments have played a significant role in setting the focus and practice of U.S. monetary policy in the years since Frank Morris became President of the Federal Reserve Bank of Boston" This focus gained more importance when euro was introduced. As we know, in the years when Bretton Woods system was on the brink of collapse, dollar remained the only feasible international transactions currency. A question could be asked as to what is the importance of having an international transactions currency for a country. If we look at the factors, stated by Patricia S. Pollard (2001), that determine the probability that a currency would be used in the international exchange of goods, services, and assets, the answer is obvious. Her paper focuses on five key factors such as size of the economy; importance in international trade; size, depth, liquidity, and openness of domestic financial markets; convertibility of the currency and macroeconomic policies. In the postwar period, the above-mentioned factors have paved the way to the use of the U.S. dollar as the main international currency as there were only a few other alternatives to the dollar in international markets.

But the interpretation of external factors should not be limited with presenting the implication of dollar as an international currency. Cooper et al (2001) noted that,

"…promoting U.S. price stability and maximum sustainable growth has increasingly required taking global developments into account". The impact of these developments should be examined with regard to the regulatory and lender-of-last resort functions and open market, discount, and intervention activity of U.S. monetary policy.

I would like to begin my analysis by exploring the historical performance of the impact of international capital flows on domestic asset prices and on investment and consumption activity. Cooper et al (2001) implied that U.S international trade in securities has been growing faster than trade in goods and services. For example, in 1999 gross U.S. international transactions in securities equaled 200 percent of GDP, while nominal exports plus imports equaled only 23 percent of GDP. Financial liberalization, deregulation, and technology, including the information revolution, have contributed to the globalization of asset markets. A measure of the net result of cross-border capital flows, the combined U.S. holdings of foreign securities and foreign holdings of U.S. securities, has increased more than tenfold just from 1980 to 1996. Foreigners now hold 33% of U.S. government securities, 17% of U.S. corporate bonds, and 7% of U.S. corporate stocks. U.S. holdings of foreign securities have also increased. Foreign stocks now make up about 10% of U.S. residents' equity holdings and foreign bonds make up about 4% of U.S. bond holdings. Analyzing these data yields to a conclusion that, large exchange rate swings in recent years have been driven by private capital flows rather than trade flows. There are some arguments that Free Open Market Committee (FOMC) pays limited attention to the impact of international capital flows on U.S. asset prices. On the other hand, Cooper et al (2001)

noted that, "…over the forty years (1960-2000), FOMC interest has naturally turned from the deficits and gold outflows that drew its attention during the late 1960s to the likely impact of net exports on U.S. demand conditions and of the dollar's exchange rate shifts on price developments in this country".

Empirical evidences shown in Cooper et al (2001) suggest "…international developments have influenced monetary policy more frequently than is generally recognized-even in the period of floating exchange rates…Does the recent experience suggest that the U.S. has learned to live comfortably with a floating dollar?" The answer of this question will help us find out the impact of exchange rate shifts and international financial crises on U.S. monetary policy. As we know, exchange rates move in response to both domestic and international economic developments and sometimes even appear to move for reasons not exactly associated with economic fundamentals. Income and price determination process in open economies include the movements that are tied to changes in domestic economic fundamentals. But movements related to developments caused by international factors or movements not totally tied to economic fundamentals are another source of shock to national economies. Empirical evidences show that linkage between exchange rates and fundamentals are not significantly strong. That's why Fed policymakers have been using increasing number of tools to clearly explain the above-mentioned linkage. These tools include Operation Twist, capital controls, and intervention in the foreign exchange markets.

Oil shocks gain particular importance in analysis of exchange rate pressures. During the 1960s the disruption of oil supplies from the Middle East has increased the oil prices that have had a significant impact on commodity prices. This process is followed by a transitory decline in inflation and easing of monetary policy during the 1980s[3]. In the mid-1980s, oil prices plummeted, contributing to a transitory decline in inflation and easing of monetary conditions. These kinds of changes in oil prices should be considered as an example of supply shock. The rise in oil prices has a strong effect on overall prices in the U.S. The reason is simple: The U.S. is extremely vulnerable to oil price shocks. This vulnerability can be explained by two key reasons. First, U.S. has a high consumption of oil and second, this country imports approximately 50% of crude oil. The rise in oil prices not only has a sharp effect on overall prices in the United States, but, given the relatively inelastic demand for energy, results in an increase in real imports and hence a decline in aggregate demand for domestic output. Even much smaller shocks have had clearly visible effects on the U.S. economy, including the $5 dollar a barrel increase over 1996 and the $5 decline over 1997.

Cooper et al (2001) suggest that, "…while the oil shocks clearly emanated from abroad, their impact became part of domestic outlook. Moreover, the tensions involved reflected the domestic need to choose between offsetting either the demand or the price effects of an oil price shock, not a conflict between domestic and international priorities". In spite of this conclusion, when the foreign exchange value

[3] The fact that oil prices plummeted paved the way to the easing of monetary conditions.

of the dollar witnessed consecutive lows in the late 1970s, oil shocks seemed to be a part of international issue.

Another issue to be discussed in this framework is the intervention policy. Although the legal authority for U.S. intervention policy has never been exactly delineated, Treasury has been leading in foreign exchange intervention policy[4]. Owen F. Humpage (1996) suggests that foreign exchange intervention has no impact on foreign exchange rates. This is explained by Cooper et al (2001) as following: "…U.S. foreign exchange interventions are "routinely sterilized" by offsetting operations in domestic securities ". During 16 years, from 1973 to 1989 heavy intervention seemed to be consistent with periods when international developments were significantly affecting Fed policy. Cooper et al (2001) proves that after 1989 this correspondence has vanished. This was due to the fact that after 1989 some FOMC members chose to oppose U.S. intervention policy. Keeping in mind all above-mentioned facts Cooper et al (2001) proves that "…in periods of steep depreciation, the dollar has continued to exert at least marginal, although perhaps dwindling, influence on U.S. monetary policy-even in the current floating-rate era"

Another matter to be considered on this issue is "international financial crises" factor. As the international financial crises have been occurring from time to time, Fed started to function as a supervisor and international lender of last resort. These financial crises include the financial crises involved major industrialized countries in 1960s, LDC debt crisis of the 1980s, the oil shocks of 1974 and so on. "The shock of

[4] This legislature base dates back to the section 10 of the Gold Reserve Act of 1934

the first LDC debt crisis gave fresh impetus to G-10 efforts to negotiate internationally accepted standards for capital adequacy and other supervisory and regulatory issues"[5]. Both international financial crisis and above-mentioned regulatory issues have increased the Fed's important as international lender of last resort. Although there were arguments suggesting that lender-of-last resort facilities cause moral hazard, Fed still serves as a leading international facilitator in the world.

[5] Cooper et al (2001, p.47)

FUTURE POLICY IMPLICATIONS

Historical overview showed that several aspects of global economic integration had direct affect on the conduct of monetary policy in a particular country. Donald Brash (2000)[6] lists these aspects as following: "First, economies are becoming incresingly integrated through trade, particularly at a regional level; Second, increasing openness of economies is resulting in the world becoming less prone to inflation; Third, we are seeing an accelerating trend toward genuinely global financial institutions; Fourth, in today's globalized markets, capital moves in amounts and at speeds that complicate the management of monetary policy directed to achieving internal macro objectives"

These aspects create challenges for successful monetary policy. Brash (2000) accepts that maintaining all three of an independent monetary policy[7] is almost impossible. It is always rationale to focus on one of these policies and have certain level of control over others. For example, monetary policy independence has had insignificant effect on economic growth in New Zealand since conclusions made by Brash (2000) show that monetary policy independence associated with floating does not keep external or internal "shocks" away. On the other hand choosing one currency arrangements over another one[8] does not make shock go away. In this paper author has mainly focused on the capital moves and the management of policy directed to achieving internal macro objectives.

[6] Although this paper explores the aspect of monetary policy of New Zealand, it has quite direct implications for U.S monetary policy as well.
[7] An inflation target, a fixed exchange rate, and an open capital account
[8] Fixing over floating

Clearly, it is very important that individual central banks do their best to assess the implications of such shocks and that they respond promptly, within their respective monetary policy arrangements, to mitigate the effects on their own economies and on the world economy as a whole. But given the increasing interconnectedness of national economies, a legitimate question is whether there should not be greater policy cooperation, or even concerted action, in response to major common shocks.

In this respect, the cooperation between Fed and Treasury could be viewed as an optimum combination for successful monetary policy, since output, employment, and inflation are influenced not only by monetary policy, but also by such factors as government taxing and spending policies, the price of key natural resources, health of the financial markets, the introduction of new technologies, and economic developments abroad.

In order to have the desired effect on the economy, the Fed must take into account the influences of these and other factors and either offset them or reinforce them as needed. This isn't easy because sometimes these developments occur unexpectedly, and because the size and timing of their effects are difficult to estimate.

As a result, each FOMC policymaker must process all the available information according to his or her own best judgment and with the advice of the best research available. Members then discuss and debate the policy options at FOMC meetings with the objective of reaching a consensus on the best course of action.

The greater attention should be paid for U.S. dollar being used as an international currency. Pollard (2001) concludes that in the postwar period, all factors determining whether a country's currency will likely be used abroad, have favored the extensive use of the U.S. dollar as the main international currency. But empirical researches show that especially in the last decades, the dollar's dominance has been relatively reduced. This was due to the emergence of other major economic powers and increase in the openness level of domestic and regional markets. In no way diminishing the importance of dollar as an international currency, I would like to emphasize the idea stated by Robert Mundell(1998) "The introduction of the euro will represent the most dramatic change in the international monetary system since President Nixon took the dollar off gold in 1971 [and when] the era of flexible exchange rates began…the euro is likely to challenge the position of the dollar [and hence] this may be the most important event in the history of the international monetary system since the dollar took over from the pound the role of dominant currency in World War I". Fred C. Bergsten (2002) on the other hand states that Fed should pay greater attention to dollar's role as an international currency. He proves that, "Econometric evidence verifies the central importance of size for international currency purposes. Some researchers[9] concluded that a rise of 1 percentage point in a key currency country's share of world product (measured at purchasing power parities) is associated with a rise of 1.33 percentage points in that currency's share of central bank reserves".

[9] Eichengreen and Frankel (1996)

Alfred J. Broaddus (2000) recognizes that some of the U.S. economy's key parameters, like the sustainable longer-term GDP growth rate, will be changed because of the unexpected dominance of Euro as an international currency.

CONCLUSIONS

As a conclusion, the trends and developments outlined above can have some extremely important implications for the U.S monetary policy. All of these factors -- the increased global economic integration of financial markets together with so called "dollarization" and the maintained role of the U.S. dollar as an international currency - suggest that changes in Federal Reserve monetary policy may have unexpected effects than revealed in prior experience. U.S. monetary policy will most likely be changed with the increasing level of openness of the economy and the crucial role of the dollar. Forecasters believe that the transmission mechanism of U.S. monetary policy may change as well. In particular, various financial markets (e.g., foreign exchange, bonds, equities) may currently play a more significant role in transmitting changes in monetary policy. Changes in U.S. monetary policy may have more potent impacts on foreign countries than earlier was the case. And the global economy itself may experience different impacts of changes in Federal Reserve policy. For example, changes in U.S. monetary policy can first of all, dominate capital flows in emerging market economies, be associated with financial crises in these countries, and significantly impact interest rates and financial markets in emerging economies under differing exchange rate arrangements. Furthermore, experience shows that the Federal Reserve can still successfully assume international lender-of-last-resort responsibilities and stabilize world financial markets in situations of international liquidity crises in the future.

Finally, in no way diminishing the potential of Fed's future successes, I would like to draw attention to certain weak points and logical groundlessness of the above-mentioned assertion. First of all, Fed's independence shall not be only restricted with political independence as it is now. Second, history shows that serious political setbacks would cause an enormous decrease in economic growth leading to an increase in inflation. In this respect, monetary policymakers should not merely rely on the fact that United States has an independent central bank as a guarantee of ideal inflation rate. Although this idea is political in nature, we have to take into consideration that without political stability attaining economic growth is impossible.

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