of monetary policies, while in fact spillovers are frequently of first-order importance. They can complicate monetary policy management, accentuate the volatility of real activity and increase financial-sector risk.

- The incompatibility of national monetary policies in the face of spillovers is heightened when countries follow different de facto monetary policy regimes (e.g., inflation targeting and exchange rate targeting).[4]

- Spillovers may be further accentuated when central banks pursue unconventional monetary interventions (e.g., when interest rates are at their floor and constrained by the zero bound). Because of weak domestic demand, as well as distressed banks that are unwilling to lend, the portfolio adjustments prompted by unconventional policies may largely serve to increase capital flows to countries with stronger growth prospects rather than boosting domestic credit as intended.

- High levels of government debt in advanced countries and the slowing growth of traditional export markets for developing countries create new sources of political pressure that central banks will find difficult to ignore.

In this report, we start by considering the validity of these criticisms. We then go on to ask how central banking theory and practice need to be updated in light of this shift in thinking. The report consists of four chapters (after this one) followed by our recommendations.

In Chapter 2, we describe how the global financial crisis has recast the debate over central banking. We focus on the relationship between the traditional emphasis on price stability and the broader goals of macroeconomic and financial stability. We discuss why the traditional separation, in which monetary policy targets price stability and regulatory policies target financial stability, and the two sets of policies operate largely independently of each other, is no longer tenable.

If central banks do in fact embrace the goal of financial stability in addition to price stability, monetary policy-making and policy communication will become more challenging. We therefore consider the practical issues that arise when the central bank is forced to juggle multiple mandates.

We then turn in Chapter 3 to a criticism of the conventional policy framework: it assumes not just that central banks practice flexible inflation targeting but also that they allow the exchange rate to float freely. Under these assumptions, each central bank has the independence necessary to target price stability and full employment.

The problem is that policy independence in theory may exceed policy independence in practice. In other words, the conventional framework fails to take into account that national policies can have powerful cross-border repercussions that the affected partner may not be able to adequately offset with exchange rate movements. In part this is because the existing system is not, in fact, one of fully flexible exchange rates. In practice, some countries effectively target exchange rates (China's tight management of its currency's value relative to the US dollar being a prominent case in point). In part it is because international transmission occurs even under flexible exchange rates, through both trade channels and capital flows. The consequences include the prospective re-emergence of global imbalances as well as the proliferation of trade and capital controls when countries seek further insulation from cross-border spillovers.

[4] Though the choice of regime itself may partly be a reaction to spillovers.