CHAPTER 3

Cross-Border Spillovers

In the last chapter we discussed how national monetary policy frameworks should be rethought to better incorporate financial-stability considerations. But there is another equally important reason for rethinking the framework: international spillovers.

If national policies have important cross-border effects, then there is a prima facie case for coordinating them internationally. This observation was of course the main point of the voluminous 1980s literature on spillovers and policy coordination. But it has since been rendered more compelling by changes in the world economy in the last quarter century. The world today is more connected than ever by cross-border financial flows. The policy choices of individual countries, especially those of large, systemically significant countries, can have a substantial impact on their neighbors. When governments and central banks change their macroeconomic policy stance dramatically—as they did in the recent world financial crisis—the spillovers on other nations can be sizeable.

Cross-border spillovers may also have increased as a result of the nature of policy responses to economic shocks and business cycle conditions. A commonly voiced concern is that unconventional monetary policies may have especially large and complex cross-border spillovers. For instance, monetary injections when the nominal interest rate is at its zero bound might result in capital outflows rather than in more domestic activity, if domestic demand is weak and banks are reluctant to lend.[13]

And while concern in the 1980s centered on the interaction of the United States and Europe, two economic blocs with floating exchange rates, spillovers today involve one bloc that floats—the major advanced countries—and one, led by China, with fixed or semi-fixed exchange rates. This asymmetry gives rise to important new issues.

In this chapter we review various channels for international transmission of domestic policies and discuss their implications. We then discuss the tensions that arise in reconciling domestic monetary policies with the larger objective of global macroeconomic and financial stability.

Cracks in the Framework of (Mostly) Flexible Exchange Rates

The international properties of the *de facto* regime of flexible exchange rates were never as desirable as asserted by its champions. To start with, the new regime was not, in fact, universally adopted. It was

[13] This combination of circumstances is not unusual—witness what happened during the recent financial crisis.