2. Controlling inflation in a less benign environment

For the second time in three years, rising commodity prices are fuelling global inflation. This inflationary pressure is superimposed on the background of still-large output gaps and high unemployment in virtually all advanced countries. This combination is problematic for an inflation-targeting strategy in which central banks focus on the components of inflation that are under their direct control. Indeed, for central banks in commodity-importing countries, a rise in oil or commodity prices is an exogenous supply shock, and the standard model says that the central bank should only respond to the extent that the shock has second-round effects and increases expected future inflation.

Targeting domestically-generated inflation was an appropriate strategy and did not raise concerns about collective action problems in the 1990s and the early 2000s, when an ample supply of commodities and the entry of China and other developing countries into the global labor force helped subdue global inflation. Against the background of a steep global commodity supply curve, however, expansionary monetary policies by major economies—advanced and emerging alike—may create negative externalities that are not adequately internalized in the standard framework.

This shortcoming is especially evident in the strict inflation-targeting framework in which the central bank commits to keeping the forecast rate of inflation (conditional on market expectations for the policy rate) on target. In this setting, the global environment is taken as given and is not affected by domestic monetary policy responses. As a consequence, the global monetary policy stance is likely to be suboptimal.

In small open economies, monetary policy is reasonably geared to domestic objectives. The same, however, does not apply to the large-economy central banks, such as the Fed, the ECB, and the PBOC. These economies are large enough for their policy choices to involve significant externalities. It would therefore be desirable that these central banks, and perhaps a handful of others, include in their policy objective a measure of these effects. Clearly, however, such a move would involve a collective-action dimension, which calls for an explicit dialogue among these central banks about the amendment of their policy frameworks. We return to this later.

3. Financial channels of transmission

In the idealized world in which all central banks pursue IT and allow their exchange rates to float, an individual central bank's monetary policy actions—say, a cut in the interest rate—are transmitted to the rest of the world mainly through two channels:

- The cut in local interest rates stimulates domestic demand, some of which spills over to additional imports. The magnitude of this effect on the rest of the world depends on the country's share of world GDP.

- The country's nominal and real exchange rates depreciate, shifting demand away from the rest of the world. Again, the size of this cross-border effect depends on the size of the country in question.

In this stylized model, capital flows only have an indirect role, with the potential for outflows from the country undertaking an expansionary monetary policy causing movements in the value of its currency. Prices bear the burden of adjustment.

In contrast, recent experience points to the existence of additional channels whose role and impact may well be large and potentially destabilizing. While the fact that the impact of capital movements can dwarf that of the more traditional trade effects has long been understood, the new and novel observation concerns the size of the cross-border capital movements triggered by the supply