inward capital flows. And since local interest rates are likely to be higher to begin with (if the recipient country is an emerging market), this sterilization will be expensive. If sustained over a sufficiently long period, sterilized intervention can weaken fiscal accounts, causing expectations of monetization and higher inflation, which in turn will cause local nominal rates to go up. This, in turn, can call forth yet another round of destabilizing capital inflows.

The conventional view of international spillovers has also relied on the assumption of smoothly-adjusting international capital markets, something that seems less than tenable today. The 2007-09 financial crisis serves as a reminder that financial flows can reverse abruptly, placing intense pressure on the functioning and integrity of markets and market participants. This has been pointed out repeatedly after recent capital-account currency crises—Mexico, Asia, Russia, Brazil, and Argentina. What is new in the 2007-09 crisis was that it happened even in some advanced countries—for example, some European economies, such as Ireland.

A nation previously flooded with capital can thus become the subject of a sharp reversal in flows. Margin and borrowing constraints can suddenly become binding, leading to a painful process of deleveraging. If the need to raise cash causes one round of asset sales, the prices of those assets will fall, reducing the value of collateral and calling forth further asset sales and additional price drops. This can cause massive destruction of value, as firms find themselves liquidity-constrained and abandon unfinished potentially profitable investment projects.

Policy makers in countries on the receiving end of these flows face an unappetizing choice. If they allow the currency to appreciate, they expose themselves to accusations of overvaluation, loss of competitiveness, and de-industrialization. But if they fight the appreciation via intervention, they may find themselves on the receiving end of ever-larger inflows. The central bank may end up allowing some appreciation anyway, but not before accumulating a large stock of expensive domestic liabilities and a large stock of international reserves on which it will take a capital loss (in domestic currency terms) if and when the exchange rate adjustment eventually happens.

While the conventional model of IT-plus-floating acknowledged these complications, it did not place them at the center of the analysis. To the extent countries targeted core inflation, spillovers through global commodity prices were left unattended. This was not a serious concern in the1980s and 1990s, the period of the Great Moderation, but is a more serious one in the presence of large global imbalances and the need to accommodate large stocks of internationally mobile capital "looking for yield."

4. Normal versus crisis times

The conventional wisdom was developed in tranquil times. In crises, in contrast, central banks have resorted to an array of non-conventional monetary policies such as quantitative easing (QE)—the printing of money to buy bonds. What do such policies imply for the question of international spillovers of monetary policy?

One view is that unconventional policies are no different from conventional policies in their cross-border implications. If floating exchange rates can adjust to make international coordination of conventional policies unnecessary, then the same must be true of unconventional policies. This was the view of the United States following the adoption of QE2. In response to complaints from emerging market policy makers who feared the wave of liquidity coming their way, Fed officials essentially argued that, "everything will be okay if you just let your currencies appreciate."[21]

[21] As indicated, for example, by the following excerpt from the speech by Fed chairman Ben Bernanke on November 19, 2010 at the ECB Central Banking Conference: "An important driver of the rapid capital inflows to some emerging markets is incomplete adjustment of exchange rates in those economies, which leads investors to anticipate additional returns arising from expected exchange rate appreciation."