

Panel on
Policymaking in a Global Context

Remarks by
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Thanks, Tony. It's a pleasure to join you and my distinguished colleagues for this discussion on policymaking in a global environment.

I was thinking about the best way I could contribute, and I decided to give you the view from my office—that is, a U.S. monetary policymaker's view. I must say, that, literally speaking, I have a *great* view from my office—right out on to the San Francisco Bay. That means I'm actually facing east, with a good look also to the north and south—toward the U.S.

mainland. And, figuratively speaking, that's about how I see my role as a U.S. monetary policymaker— although I'm sitting on the West Coast—at the “gateway to Asia”—my primary focus has to be on the economy here in the U.S.

Of course, being on the West Coast makes the San Francisco Fed the appropriate Reserve Bank to specialize in expertise in Pacific Basin economic issues. We do, in fact, have a research center devoted to those studies. And I do travel to Asia periodically. In fact, I've just returned from a series of meetings with officials in Beijing, Shanghai, Hong Kong, and Taiwan. While I was there, a lot of people asked me what the Fed thought about the deflation that's rampant in Japan, China, and elsewhere in that region. Were we concerned? Would it affect our policy stance? My answer was that, while we monitor conditions worldwide, our primary concern is the U.S. economy. So, like my colleagues around the country, no matter where we sit, our primary focus is on the U.S. economy and on our goals of maximum sustainable output and employment and price stability.

Of course, I'm not suggesting that the increasing integration of goods and financial markets has had *no* effect on our conduct of monetary policy. As we at the Fed often say, “we look at *everything*.” And the effects of globalization certainly have made conditions in other countries more prominent in our deliberations. But, for the most part, the effects on policymaking are “at the margin.”

In my remarks today, I'd like to explain briefly why globalization has not changed the goals or conduct of U.S. monetary policy to any great extent. Then I'll talk about the few instances where policy *has* responded to foreign developments. I'll conclude with a few thoughts on policy coordination.

Let me start by saying that globalization has affected U.S. monetary policymaking only at the margin largely because foreign events rarely *have* a big impact on our economy. Why? First, because the U.S. is the world's largest economy, in terms of both output and financial activity. It accounts for roughly twenty to twenty-five percent of total world output. So foreign shocks matter less for us than they do for smaller countries. Second is the composition of our demand and supply of goods, services, and assets. Certainly, globalization does mean that changes in foreign demand conditions matter more for U.S. aggregate demand. And global financial markets and cross-border capital flows quickly transmit pressures abroad to U.S. markets. But neither has had much effect on our ability to control domestic monetary policy. The reason is that there's still a substantial "home bias" in our demand for goods, services, and assets—that is, the bulk of the goods and services we consume and the assets we hold are produced or issued in the U.S. Third is our having a flexible exchange rate regime, which means we can still use interest rates to conduct monetary policy. That is, so long as we don't target the dollar and so long as the exchange rate can adjust to foreign disturbances—like shifts in preferences between U.S. and foreign assets—there's less pressure on U.S. interest rates to adjust.

Of course, theoretically, a flexible exchange rate regime also provides another channel for monetary policy to influence the economy— that is, for example, when policy eases, theory suggests that the dollar can be expected to fall, all else equal, and that should boost demand for our exports. However, it's often the case that all else is *not* equal. For example, if you look at the dollar on a broad trade-weighted basis, it's stronger today than when we began cutting rates at the beginning of 2001. So the markets appear to be telling us that the prospects still look

better for the U.S. economy than they do for most of the rest of the world.

Let me wrap up this part of my remarks with a general word about the Fed's ability to conduct policy in a global environment. We still have the tools to control domestic monetary policy. When the economy needs to slow down, the Fed can still step on the brakes. And when the economy needs to speed up, it can still push on the accelerator. To the extent that globalization increases "model uncertainty," we may not know exactly how much to speed up or slow down. But certainly globalization hasn't severed the connections to those brake and gas pedals.

Now let me turn to an instance when foreign developments *did* influence Fed policy decisions—the global financial crises of the late 1990s. The currency crises in East Asia that began in 1997 had pretty small negative effects on our economy because those countries were fairly small trading partners of ours. In fact, there even were some *positive* effects. As global investors searched for a safe haven for their money, the U.S. saw strong capital inflows. And that meant that U.S. interest rates fell and monetary policy could be easier than otherwise.

But then came the fall of 1998. The Russian debt default and Malaysia's imposition of capital controls had nearly catastrophic consequences for the worldwide payments system. The increase in perceived risk led to a mass flight to quality, which, in turn, tightened credit conditions severely. That left firms that were highly leveraged in those markets in danger of insolvency and the settlements system in danger of freezing up. As the turmoil worsened and the outlook for foreign growth grew more dim, business and investor confidence in the U.S. plummeted. Faced with these serious downside threats to the economy, the Fed responded with three interest rate cuts in under two months' time. It's worth noting, however, that even here the

policy change—3/4 percent—was not all that large.

Of course, we haven't seen an end of crises abroad. We're all aware of the current problems in Argentina and Brazil, and we'll continue to monitor events there. But, so far, they haven't been a factor in the stance of U.S. monetary policy. Argentina and Brazil are not big trading partners with the U.S. And we don't see evidence of contagion in world financial markets outside of Latin America. Of course, in all of these episodes we do focus on the balance sheet exposure of U.S. financial institutions. The increased severity and scope of these crises has added to the Fed's regulatory concerns about systemic risk to the financial sector and posed new challenges for the Fed in its role as supervisor. For example, in the aftermath of the financial markets problems of 1998, particularly the meltdown of LTCM, we started requiring more information from the banks we supervise about their liabilities to hedge funds.

Let me close with a few words on global policy cooperation and coordination. Given the growing interdependence of national economies and macroeconomic policies, it has become increasingly important to pay attention to the actions of foreign policymakers. Federal Reserve Board officials, senior staff, and Federal Reserve Bank presidents typically meet formally and informally with their counterparts in other countries with some frequency.

These meetings have some important benefits. First, they give us a better understanding of the economic situation and policies in other countries. As a result, our forecasts of global economic conditions—which affect the U.S. economy—are better. And that improves our ability to formulate our national policies. Second, these meetings help us and our foreign counterparts get to know and to trust us each other. So, when an event comes up that genuinely requires international cooperation, we know each other's phone numbers and can work together

quickly. For example, within hours of the tragic and disruptive events of September 11, the Federal Reserve was able to arrange special swap lines with our counterparts in Canada, the U.K., and the euro area, which helped facilitate the continued operation of the international payments system.

What does *not* typically occur at these meetings, however, are agreements to coordinate our policy actions. In theory, everyone may be better off when large countries take into account the effects of their own policies on other countries—that is, take account of policy externalities. But in practice, there's a good reason why the U.S. and other major industrial economies have tended not to do this. We can never be quite sure of the magnitude and timing of any spillover effects from national policies on foreign economies. This is in large part because many of the spillover effects work through the exchange rates, and, as I said before, exchange rates these days haven't reacted in predictable ways to changes in national monetary policies. So, the spillover effects of monetary policies on other countries have not been clear. Consequently, we and our foreign counterparts generally choose not to tie our hands through formal monetary policy coordination.

We take a different tack when it comes to *regulatory* policy in financial markets. In that arena, there's a great deal of coordination. Regulators work together to set global standards for risk management in financial institutions and to cooperate in sharing information about the performance and risk activities of private sector financial institutions operating across national borders. The reason for coordinated policymaking in this area is that problems in one country's financial sector can be quickly transmitted to other countries' financial systems through debt defaults or contagion.

I'll conclude by saying that I'm looking forward to hearing how my colleagues on the panel view globalization and policymaking. As I've said, making monetary policy in a global environment has not deflected the Fed from our main goals—sustainable growth and low inflation for the U.S. economy. Given the significance of the U.S. economy in the global marketplace, it's also what the Fed *should* do, because it's the best way we can contribute to economic prospects in the rest of the world.

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