

For release on delivery
1:15 p.m. EDT (5:15 p.m. GMT)
March 25, 2013

Monetary Policy and the Global Economy

Remarks by

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at

Department of Economics and STICERD
(Suntory and Toyota International Centres for Economics and Related Disciplines)
Public Discussion in Association with the Bank of England

London School of Economics
London, England

March 25, 2013

I'm very pleased to participate in this conference honoring my good friend Mervyn King. As Mervyn noted in a recent speech in New York, we had adjoining offices at MIT as young academics and never imagined that 30 years later we still would be colleagues--as central bankers.¹ Now, as then, I value his advice and insight.

The topic of this session is lessons learned from the financial crisis. For me, perhaps the central insight is that the recent crisis, despite its many exotic features, was in fact a classic financial panic--a systemwide run of "hot money" away from assets whose values suddenly became uncertain. In that respect, the crisis was akin to many other financial crises faced by governments and central banks--including that most venerable of central banks, the Bank of England--over the centuries. The response to the crisis likewise followed the classic prescriptions of liquidity provision, liability guarantees, asset evaluation and disposition, and recapitalization where necessary. Although the crisis had classic features, to a significant extent it took place in a novel institutional context, making diagnosis and response more challenging: For example, in the United States, collateralized wholesale funding rather than conventional bank deposits constituted the hot money, and run pressure was experienced not only by banks but by diverse other institutions, such as structured investment vehicles. In addition, the scale and complexity of globalized financial institutions and markets made it difficult to predict how the crisis might spread or to coordinate the response. One of the few positive aspects of this episode was the extraordinary degree of international cooperation achieved among policymakers, including the Bank of England and the Federal Reserve, in responding to the crisis.

¹ See Mervyn A. King (2012), "Talk to the Economic Club of New York," speech delivered at the Economic Club of New York, December 10, http://econclubny.com/events/Transcript_MervynKing2012.pdf.

Because I have developed these themes in some detail elsewhere, I thought today I would tackle a different and more recent issue that has arisen in the aftermath of the crisis--the issue of whether, in the widespread easing of monetary policies, we are seeing a competitive depreciation of exchange rates.² Like other aspects of the crisis, the notion of competitive depreciation has strong classical antecedents, particularly in relation to the global Great Depression of the 1930s. So let me start by briefly revisiting the older discussion and its evolution.

As my audience knows, on the eve of the Great Depression the exchange rates of most industrial countries were determined by the rules of the international gold standard--or, more technically, by the gold-exchange standard, as foreign exchange (primarily dollars and pounds sterling) was used along with gold as a form of international reserves. The gold standard, which had been suspended during World War I, was painstakingly rebuilt in the 1920s. Unfortunately, the reconstructed gold standard had a number of serious problems. For one, the exchange rates implied by the gold valuations that countries chose for their currencies following World War I were in some cases far from the levels consistent with balanced flows in trade and payments. Notably, as John Maynard Keynes pointed out in his famous pamphlet, *The Economic Consequences of Mr. Churchill*, the British pound was overvalued under the new gold standard, which disadvantaged British exports and contributed to weak economic conditions in the United

² See, for example, Ben S. Bernanke (2009), "Reflections on a Year of Crisis," speech delivered at "Financial Stability and Macroeconomic Policy," a symposium sponsored by the Federal Reserve Bank of Kansas City, held in Jackson Hole, Wyo., August 20-22, www.federalreserve.gov/newsevents/speech/bernanke20090821a.htm; and Ben S. Bernanke (2012), "Some Reflections on the Crisis and the Policy Response," speech delivered at "Rethinking Finance: Perspectives on the Crisis," a conference sponsored by the Russell Sage Foundation and The Century Foundation, New York, April 13, www.federalreserve.gov/newsevents/speech/bernanke20120413a.htm. See also Ben S. Bernanke (2010), "Causes of the Recent Financial and Economic Crisis," statement before the Financial Crisis Inquiry Commission, September 2, www.federalreserve.gov/newsevents/testimony/bernanke20100902a.htm.

Kingdom in the late 1920s.³ One of Mervyn King's predecessors as governor of the Bank of England, Montagu Norman, who presided over both Britain's return to the gold standard and its subsequent exit, said of the ill-fated choice of parity for the pound: "Only God could tell whether it [the value in gold chosen for the pound sterling] was or was not the correct figure"; another commentator added, "But of course the Deity may not be an Economist."⁴

Another problem, which became clear as the global economy weakened and financial conditions deteriorated, was that fixed exchange rates under the gold standard were vulnerable to speculative runs. Although runs, or in some cases policy decisions, effectively took a number of countries off the gold standard in the early 1930s, the financial world was shaken to its foundation when the United Kingdom, the unofficial center of the global gold standard, was forced by a speculative attack to leave gold in September 1931. Over the next five years, essentially all of the world's industrial nations left the gold standard, either de facto or de jure. Declines in the value of the departing nation's currency, sometimes very sharp ones, typically followed.

The uncoordinated abandonment of the gold standard in the early 1930s gave rise to the idea of "beggar-thy-neighbor" policies. According to this analysis, as put forth by important contemporary economists like Joan Robinson, exchange rate depreciations helped the economy whose currency had weakened by making the country more competitive internationally.⁵ Indeed, the decline in the value of the pound after 1931 was

³ See John Maynard Keynes (1925), *The Economic Consequences of Mr. Churchill* (London: Hogarth Press).

⁴ As quoted in C.A.E. Goodhart (1972), review of *British Monetary Policy 1924-1931: The Norman Conquest of \$4.86*, by D.E. Moggridge, *Economica*, vol. 39 (November), pp. 450.

⁵ See Joan Robinson (1947), "Beggars-My-Neighbour Remedies for Unemployment," in *Essays in the Theory of Employment*, 2nd ed. (Oxford, U.K.: Basil Blackwell), pp. 156-70.

associated with a relatively early recovery from the Depression by the United Kingdom, in part because of some rebound in exports. However, according to this view, the gains to the depreciating country were equaled or exceeded by the losses to its trading partners, which became less internationally competitive--hence, "beggar thy neighbor." Over time, so-called competitive depreciations became associated in the minds of historians with the tariff wars that followed the passage of the Smoot-Hawley tariff in the United States. Both types of policies were decried--and in some textbooks, still are--as having prolonged the Depression by disrupting trade patterns while leading to an ultimately fruitless and destructive battle over shrinking international markets.

Economists still agree that Smoot-Hawley and the ensuing tariff wars were highly counterproductive and contributed to the depth and length of the global Depression. However, modern research on the Depression, beginning with the seminal 1985 paper by Barry Eichengreen and Jeffrey Sachs, has changed our view of the effects of the abandonment of the gold standard.⁶ Although it is true that leaving the gold standard and the resulting currency depreciation conferred a temporary competitive advantage in some cases, modern research shows that the primary benefit of leaving gold was that it freed countries to use appropriately expansionary monetary policies. By 1935 or 1936, when essentially all major countries had left the gold standard and exchange rates were market-determined, the net trade effects of the changes in currency values were certainly small. Yet the global economy as a whole was much stronger than it had been in 1931. The reason was that, in shedding the strait jacket of the gold standard, each country became free to use monetary policy in a way that was more commensurate with achieving full

⁶ See Barry Eichengreen and Jeffrey Sachs (1985), "Exchange Rates and Economic Recovery in the 1930s," *Journal of Economic History*, vol. 45 (December), pp. 925-46.

employment at home. Moreover, and critically, countries also benefited from stronger growth in trading partners that purchased their exports. In sharp contrast to the tariff wars, monetary reflation in the 1930s was a positive-sum exercise, whose benefits came mainly from higher domestic demand in all countries, not from trade diversion arising from changes in exchange rates.

The lessons for the present are clear. Today most advanced industrial economies remain, to varying extents, in the grip of slow recoveries from the Great Recession. With inflation generally contained, central banks in these countries are providing accommodative monetary policies to support growth. Do these policies constitute competitive devaluations? To the contrary, because monetary policy is accommodative in the great majority of advanced industrial economies, one would not expect large and persistent changes in the configuration of exchange rates among these countries. The benefits of monetary accommodation in the advanced economies are not created in any significant way by changes in exchange rates; they come instead from the support for domestic aggregate demand in each country or region. Moreover, because stronger growth in each economy confers beneficial spillovers to trading partners, these policies are not “beggar-thy-neighbor” but rather are positive-sum, “enrich-thy-neighbor” actions.

Again, the distinction between monetary policies aimed at domestic objectives and trade-diverting exchange rate devaluations or other protectionist measures is critical. The former can be mutually beneficial, the latter are not. Indeed, it was this view that prompted the Group of Seven central bankers and finance ministers to issue a statement in February agreeing to refrain from actions focused on achieving competitive advantage

by weakening their currencies and reaffirming that fiscal and monetary policies would remain oriented toward meeting domestic objectives using domestic instruments.⁷

Among the advanced economies, the mutual benefits of monetary easing are clear. The case of emerging market economies is more complicated. To a first approximation, industrial countries are most concerned that domestic aggregate demand be set at the level that best fosters price stability and a return to full employment at home. In contrast, many emerging market economies may be concerned not only with the level of domestic demand (as needed to achieve objectives for employment and inflation) but with other considerations as well. First, because in recent decades many of these countries have pursued an export-led strategy for industrialization, they may be leery of expansionary policies in the advanced economies that, all else being equal, tend to cause the currencies of emerging market economies to appreciate, restraining their exports. Second, because many emerging market economies have financial sectors that are small or less developed by global standards but open to foreign investors, they may perceive themselves to be vulnerable to asset bubbles and financial imbalances caused by heavy and volatile capital inflows, including those arising from low interest rates in the advanced economies.

I agree these challenges are significant. However, a few points should be made. Regarding the effects of monetary easing on exchange rates and exports, I would note that trade-weighted real exchange rates of emerging market economies, with some exceptions, have not changed much from their values shortly before the intensification of the financial crisis in late 2008. Moreover, even if the expansionary policies of the

⁷ For the full text of the Group of Seven statement, see Bank of England (2013), "G7 Statement," press release, February 12, www.forexmg-pt.com/2013/02/12/bank-of-england-publications-news-releases-news-release-g7-statement.

advanced economies were to lead to significant currency appreciation in emerging markets, the resulting drag on their competitiveness would have to be balanced against the positive effects of stronger advanced-economy demand. Which of these two effects would be greater is an empirical matter. Simulations of the Federal Reserve Board's econometric models of the global economy suggest that the effects are roughly offsetting, so that accommodative monetary policies in the advanced economies do not appear, on net, to have adverse consequences for output and exports in the emerging market economies.⁸ A return to solid growth among the advanced economies is ultimately in the interest of advanced and emerging market economies alike.

Regarding capital flows: It is true that interest rate differentials associated with differences in national monetary policies can promote cross-border capital flows as investors seek higher returns. But my reading of recent research makes me skeptical that these policy differences are the dominant force behind capital flows to emerging market economies; differences in growth prospects across countries and swings in investor risk sentiment seem to have played a larger role.⁹ Moreover, the fact that some emerging market economies have policies that depress the values of their currencies may create an expectation of future appreciation that in and of itself induces speculative inflows.

⁸ Other work also supports the finding of no adverse spillovers. For example, one that finds strong positive spillovers is Bennett T. McCallum (2003), "Japanese Monetary Policy, 1991-2001," Federal Reserve Bank of Richmond, *Economic Quarterly*, vol. 89 (Winter), pp. 1-31, www.richmondfed.org/publications/research/economic_quarterly/2003/winter/pdf/mccallum.pdf.

⁹ For example, Fratzscher, Lo Duca, and Straub find that factors other than U.S. monetary policy have been substantially more important as drivers of capital flows to emerging market economies; see Marcel Fratzscher, Marco Lo Duca, and Roland Straub (2012), "A Global Monetary Tsunami? On the Spillovers of US Quantitative Easing," Centre for Economic Policy and Research, Discussion Paper Number 9195 (London: CEPR, October), www.cepr.org/pubs/dps/DP9195.asp. See also Atish R. Ghosh, Jun Kim, Mahvash S. Qureshi, and Juan Zaldendo (2012), "Surges," IMF Working Paper WP/12/22 (Washington: International Monetary Fund, January), www.imf.org/external/pubs/ft/wp/2012/wp1222.pdf; and International Monetary Fund; Strategy, Policy, and Review Department (2011), "Recent Experiences in Managing Capital Inflow--Cross-Cutting Themes and Possible Policy Framework," paper (Washington: IMF, February), www.imf.org/external/np/pp/eng/2011/021411a.pdf.

Of course, heavy capital inflows and their volatility pose challenges to emerging market policymakers, whatever their source. Policymakers do have some tools to address these concerns. In recent years, emerging market nations have implemented macroprudential measures aimed at strengthening their financial systems and reducing overheating in specific sectors, such as property markets. Policymakers have also experimented with various forms of capital controls. Such controls raise concerns about effectiveness, cost of implementation, and possible microeconomic distortions. Nevertheless, the International Monetary Fund has suggested that, in carefully circumscribed circumstances, capital controls may be a useful tool.¹⁰

In sum, the advanced industrial economies are currently pursuing appropriately expansionary policies to help support recovery and price stability in their own countries. As the modern literature on the Great Depression demonstrates, these policies confer net benefits on the world economy as a whole and should not be confused with zero- or negative-sum policies of trade diversion. In fact, the simultaneous use by several countries of accommodative policy can be mutually reinforcing to the benefit of all.

Let me end these remarks as I began, by paying tribute to Mervyn King. He has been a leader in the central banking community during an extraordinarily difficult period. I wish him the very best in the next stage of his career.

¹⁰ Importantly, such circumstances exclude the use of capital controls to avoid other necessary macroeconomic policy adjustments, such as greater exchange rate flexibility. See, for example, International Monetary Fund (2012), “The Liberalization and Management of Capital Flows: An Institutional View,” (Washington: International Monetary Fund).