

# Monetary Policy Issues in Open Economies

Introduction to a Special Issue of the  
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Many of the advances in monetary policy analysis over the past two decades have been developed from the perspective of a large open economy. The early theoretical work on the New Keynesian model frequently ignored exchange rates, financial capital flows, and trade flows. This neglect carried over into the first generation of DSGE models that were taken to the data and used for policy experiments. When open-economy versions of New Keynesian models were developed, they generally assumed perfect capital mobility and uncovered interest parity. While these assumptions allowed the models to address some issues relevant for open economies, they were often not well suited for investigating policy issues in small open economies where financial markets were not fully integrated into world capital markets, and where domestic financial markets were underdeveloped. Standard models also restricted attention to interest rates as the sole instrument of monetary policy, ignoring the role that exchange rate controls, monetary aggregates, and required reserve ratios play as policy instruments in many emerging-market economies.

A wide range of issues of importance for open economies, including policy analysis in DSGE models, the effective use of policy instruments, and global spillovers, are addressed in this volume of the *International Journal of Central Banking* (IJCB). The volume includes papers, discussions, and commentaries presented at the third annual IJCB Monetary Policy Conference hosted by the Bank of Canada on September 29–30, 2011. The conference, in addition to the contributions in this volume, also included opening remarks by Bank of Canada Deputy Governor John Murray, a speech by Bank of Canada Senior Deputy Governor Tiff Macklem, and a panel discussion with Jean Boivin (Bank of Canada), Janet Yellen (Board of Governors of the Federal Reserve System), and Christopher Sims (Princeton University) that was moderated by John C. Williams (Federal Reserve Bank of San Francisco).

The first paper in this volume, “Is Exchange Rate Stabilization an Appropriate Cure for the Dutch Disease?” by Ruy Lama and Juan Pablo Medina (both from the International Monetary Fund) employs a calibrated DSGE model to investigate the role of exchange rate policy in a small open economy in which learning-by-doing in the tradable goods sector creates an externality. If monetary policy leans against an exchange rate appreciation, it can reduce the efficiency loss that would otherwise occur when the tradable goods sector shrinks, but it does so at the cost of distorting resource allocations in other sectors of the economy. Lama and Medina find that exchange rate stabilization reduces economic welfare. The paper is discussed by Michael Devereux (University of British Columbia). Jon Faust (Johns Hopkins University) provides a broader commentary on evaluating and using DSGE models for policy analysis.

The next two papers explore the role of reserve requirements and exchange rates as policy tools. In “Reserve Requirements for Price and Financial Stability: When Are They Effective?” Christian Glocker and Pascal Towbin (both from the Banque de France) use a model with sticky prices and a financial accelerator mechanism to study whether the active use of required reserve ratios can help to achieve macroeconomic goals of inflation, output, and financial stabilization. They find that assigning the central bank’s interest rate instrument to achieving standard inflation and output stabilization objectives while using reserve requirements to achieve financial stabilization comes close to the fully optimal policy based on the loss function they use. This paper is discussed by Carl Walsh (University of California, Santa Cruz). In the second paper, “The Federal Reserve as an Informed Foreign Exchange Trader: 1973–1995,” Michael Bordo (Rutgers University), Owen Humpage (Federal Reserve Bank of Cleveland), and Anna Schwartz (National Bureau of Economic Research) conduct a careful study of exchange market interventions by the United States between 1973 and 1995 to assess the effectiveness of such interventions. While they find that 60 percent of the interventions were successful on the criterion they establish, this figure was no better than random. Evidence was found, however, that larger interventions were more likely to be successful. Kathryn Dominguez (University of Michigan) provides a discussion of the paper. Robert G. King (Boston University) offers a commentary that places both the papers from this session,

despite their differences in methodology, within the broader context of recent research investigating monetary policy in open-economy environments.

The final two papers in the volume focus on global spillovers. In “Food Price Pass-Through in the Euro Area: Non-Linearities and the Role of the Common Agricultural Policy,” Gianluigi Ferrucci (European Central Bank), Rebeca Jiménez-Rodríguez (University of Salamanca), and Luca Onorante (European Central Bank) study the food price shocks of 2007–08. By accounting for the effects of the Common Agricultural Policy on food commodity prices in Europe and allowing for non-linearities in pass-through effects, they find that increases in producer and consumer prices in the euro area were primarily caused by the rise in commodity prices. Tsutomu Watanabe (University of Tokyo) discusses the paper. In the final paper, “Tailwinds and Headwinds: How Does Growth in the BRICs Affect Inflation in the G-7?” Anna Lipińska (Federal Reserve Board) and Stephen Millard (Bank of England) construct a three-country DSGE model to represent the G-7, the BRICs, and an oil-exporting country. They employ the model to study how a persistent positive shock to productivity in the BRICs affects inflation in the G-7. In their benchmark calibration, the tailwinds generated by this productivity shock dominate, lowering inflation in the G-7. Paul Beaudry (University of British Columbia) discusses the paper. A commentary on import prices and inflation is offered by James Hamilton (University of California, San Diego), who emphasizes that the answers to questions about pass-through are likely to depend very much on what causes import prices to rise.