

Monetary Policy in International Relations

This week's readings:

- Mathai, Koshy. "What Is Monetary Policy?"
 - Cohen, Benjamin J. "The Triad and the Unholy Trinity: Problems of International Monetary Cooperation."
 - Frieden, Jeffrey A., and J. Lawrence Broz. "The Political Economy of Exchange Rates."
 - Goodman, Peter S. "The Dollar Is Still King. How Did That Happen?"
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Big questions:

1. What is monetary policy and how do its tools affect domestic and international economies?
2. What is the policy trilemma?
3. Why is international monetary cooperation difficult and what role does the US dollar play?

What is Monetary Policy?

Monetary policy *manipulates the money supply and credit conditions*. This is typically done through **open market operations** and (more recently) **quantitative easing**

Goals of Monetary Policy

- **Price Stability:** Keeping inflation low and stable is a primary goal. Volatile prices create uncertainty, complicate planning, arbitrarily redistribute wealth, and impose practical costs
- **Output/Employment Stabilization:** In the short run, monetary policy can influence aggregate demand, output, and employment because prices and wages adjust slowly. Central banks often use policy counter-cyclically (e.g., easing policy during recessions).

Central Banks

Central banks are financial institutions that are typically the sole issuer of currency and that manage the supply of money. Key responsibilities include:

- **Implementing monetary policy:** Adjusting interest rates and managing the money supply.
- **Regulating commercial banks:** Setting reserve requirements, supervising banks.
- **Lender of last resort:** Providing liquidity to banks during crises.
- **Managing foreign exchange reserves.**

Central Bank Independence (CBI)

Most economists believe monetary policy is best conducted by an independent central bank, insulated from short-term political pressures.

- **No political pressure:** Politicians have incentives to promote inflationary policy to promote short-term growth at the risk of triggering inflation. Independence enhances credibility and anchors low inflation expectations.
- Statistical evidence shows that CBI is associated with lower and more stable inflation.

The International Dimension: Exchange Rates

The exchange rate—the price of one currency in terms of another—is the most important price in an open economy because it affects all other prices.

Exchange Rate Regimes

Governments must choose how to manage their currency's value internationally:

- **Fixed (or Pegged) Regime:** The government commits to maintaining the currency's value at a specific level against another currency (e.g., the USD) or a commodity (e.g., gold).
 - *Advantages:* Reduces exchange rate uncertainty (good for trade/investment)
 - *Disadvantages:* Requires sacrificing monetary policy autonomy (interest rates must defend the peg, not domestic needs)
 - Examples: Gold Standard, Eurozone
- **Floating (or Flexible) Regime:** The currency's value is determined by supply and demand in the foreign exchange market.
 - *Advantages:* Allows policy autonomy to focus on domestic goals (inflation, unemployment).
 - *Disadvantages:* Exchange rate volatility can complicate trade and investment planning.
 - Examples: US Dollar, Euro (vs. non-Euro), Japanese Yen since 1973.
- **Managed Float:** A hybrid where the rate floats but the central bank intervenes to influence its level or volatility. (Arguably: China RMB, Switzerland)

Benefits and costs of high or low exchange rates

- **Appreciation (Stronger Currency):**
 - *Benefits:* Increases domestic purchasing power (imports become cheaper), helps control inflation.
 - *Costs:* Reduces international competitiveness (exports more expensive, imports cheaper), potentially harming export and import-competing industries.
- **Depreciation (Weaker Currency):**
 - *Benefits:* Increases international competitiveness (boosts exports, makes imports more expensive), can stimulate domestic production.
 - *Costs:* Reduces domestic purchasing power (imports more expensive), can fuel inflation.

Domestic Politics of Exchange Rates

Exchange rate policy choices create domestic winners and losers, leading to political contestation:

- **Regime Preferences:**
 - *Fixed rates* often favored by internationally oriented actors (exporters, international investors, banks) who value stability.
 - *Floating rates* often favored by domestically oriented actors (import-competing industries, non-tradable sectors, labor unions) who value policy autonomy for domestic stabilization.
- **Level Preferences:**
 - *Appreciation* favored by consumers and producers of non-tradable goods.
 - *Depreciation* favored by producers of tradable goods (exporters, import-competing firms).
- **Political Factors:** Party ideologies (left vs. right), electoral cycles (tendency to avoid depreciation before elections), political institutions, and central bank independence influence policy outcomes.

Policy trilemma (Impossible Trinity)

A fundamental constraint on international monetary policy is the **policy trilemma**, which states that a country *cannot simultaneously achieve all three* of the following goals:

1. **Fixed Exchange Rate:** Stable currency value.
2. **Free Capital Mobility:** Allowing capital to flow freely in and out of the country.
3. **Independent Monetary Policy:** Ability to set domestic interest rates to meet domestic objectives.

The Tradeoff

Governments must choose which goal to sacrifice:

- **Give up Fixed Rate:** Adopt a **floating exchange rate** to maintain capital mobility and monetary autonomy. (e.g., US, UK, Japan today).
- **Give up Capital Mobility:** Impose **capital controls** to maintain a fixed exchange rate and monetary autonomy. (e.g., China, Bretton Woods system).
- **Give up Monetary Autonomy:** Adopt a **fixed exchange rate** and allow free capital mobility, but monetary policy must be dedicated to maintaining the peg. (e.g., Eurozone members, gold std).

Challenges of International Monetary Cooperation

Given interdependence and policy spillovers, cooperation on monetary and exchange rate issues seems logical to internalize externalities and achieve better outcomes (Cohen). However, sustained cooperation is notoriously difficult.

Why Cooperate?

- **Policy Optimization:** Jointly adjusting policies can lead to better outcomes for all involved than unilateral action.
- **Regime Preservation:** Cooperation can defend existing international monetary arrangements against shocks.

Why is Cooperation Hard?

- **Distributional Conflict:** Who bears the costs of adjustment needed to maintain cooperation or a fixed-rate system? (e.g., deficit vs. surplus countries).
- **Small Gains, High Costs:** Potential gains from coordination may be small, while costs of negotiation, monitoring, and sovereignty loss can be high.
- **Time Inconsistency / Cheating:** States may have incentives to renege on commitments (e.g., competitive devaluation).

Episodic Nature of Cooperation (Cohen)

History shows cycles of monetary cooperation followed by breakdown (Interwar, Bretton Woods, post-Plaza G7 efforts). Cohen argues this is systematic:

- The perceived *marginal benefit* of cooperation (e.g., exchange rate stability) tends to decrease as stability is achieved.
- The perceived *marginal cost* of cooperation (loss of policy autonomy) tends to increase as constraints bind.

- States pursue cooperation when instability is high, but abandon it when the costs to autonomy seem too great.
- “Locking in” cooperation is difficult without deep political integration (like the EU) or mechanisms like supranational authority or hegemony, which are often resisted.

The Dominant Currency: The US Dollar

Despite predictions of its decline, the US dollar remains the world’s dominant currency (Goodman).

- **Roles:** Premier reserve currency held by central banks, main currency for international trade (esp. commodities like oil), primary safe-haven asset in crises.
- **Sources of Dominance:**
 - Deep, liquid, and open US financial markets.
 - Inertia and network effects (everyone uses it because everyone else uses it).
 - Lack of credible alternatives: Euro faces governance challenges (common currency without common fiscal/political union); Chinese Renminbi faces capital controls and political risks.
 - Role of the Federal Reserve as global lender of last resort (demonstrated in 2008).
- **“Exorbitant Privilege” and Power:** The US can borrow more cheaply and faces fewer balance-of-payments constraints. Dollar dominance gives the US “astonishing structural power” (Blyth, cited in Goodman).
- **“Weaponization” of the Dollar:** The US leverages the dollar’s centrality to enforce foreign policy, particularly through financial sanctions (e.g., Iran, Russia, Venezuela). Access to the dollar system is crucial for global banks, making US sanctions highly effective (Goodman).
- **Challenges and Backlash:** The weaponization of the dollar incentivizes others (e.g., Europe, China) to develop alternatives (alternative payment systems, promoting own currencies, building alternative financial institutions) to reduce dependence on the US financial system (Goodman).

Appendix: Tools and Transmission of Monetary Policy

Key Tools

- **Policy Interest Rates:** The central bank sets a target for a key short-term interest rate (often the overnight rate at which banks lend reserves to each other).
- **Open Market Operations:** To achieve the policy rate, CBs buy or sell government securities (like Treasury bills) in the open market.
 - *Buying securities* injects money into the banking system, increasing reserves and lowering interest rates (Expansionary).
 - *Selling securities* withdraws money, decreasing reserves and raising interest rates (Contractionary).
- **Reserve Requirements:** The fraction of deposits banks must hold in reserve, not lend out. Lowering requirements is expansionary; raising them is contractionary. Today, reserve requirements are typically changed not as a tool of monetary policy but for regulatory reasons.
- **Quantitative easing:** The CB buys huge amounts of unconventional assets.

Transmission Mechanisms

How do central bank actions affect the real economy?

	Interest rates	Balance sheet	Bank lending	Forex
How?	Policy rate influences consumer rates, like car and business loan rates and mortgage rates	Higher policy rates lead to asset prices to fall (because its harder borrow money to buy them)	Higher rates lead banks to be more conservative with lending (because its harder to afford repayment)	Higher rates appreciate your currency, making imports less expensive but your exports more expensive
So what?	Higher rates are less affordable, reducing demand	Lower demand leads to lower prices	Less affordability reduces the amount of lending	Fewer exports reduces domestic economic activity

Note: monetary policy is not fiscal policy

Fiscal policy involves government decisions on *taxation and spending*. It also influences aggregate demand but is typically slower to implement and harder to reverse due to political processes.

Monetary policy is often the first line of defense for macroeconomic stabilization (except in fixed exchange rate regimes).