2017 Asia Economic Policy Conference:
Monetary Policy Challenges in a Changing Global Environment
Conference Summary

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The Center for Pacific Basin Studies (CPBS) of the Federal Reserve Bank of San Francisco held its fifth biennial Asia Economic Policy Conference (AEPC) series on November 16 and 17, 2017. The theme of the conference was "Monetary Policy Challenges in a Changing Global Enrivonment." This special issue of the *Journal of International Money and Finance (JIMF)* is devoted to publishing the proceedings of the conference. Production of the papers were greatly assisted by the editorial assistance of Joshua Aizenman. This is the first time that the CPBS collaborates with the *JIMF* to publish the AEPC proceedings. We hope for a long and fruitful partnership between the San Francisco Fed and the Journal.

The program focused on the challenges faced by policymakers in advanced and emerging economies as the U.S. continues its monetary policy normalization. The topics discussed include international consequences of slower growth, the zero lower bound problem for monetary policy, the implications of U.S. interest rate increases for foreign economies and international bank lending, global capital flows, recent default patterns in emerging market economies, and the history of China's shadow banking. In this summary, we provide a brief overview of the material included in this conference volume. Some discussants chose not to publish their formal comments because the authors have fully incorporated their comments in subsequent revisions of the papers.

President John Williams of the Federal Reserve Bank of San Francisco delivered the opening keynote speech "When the United States Sneezes…" He argues that history teaches us that a recession will come at some point, so prudence demands that we use this time with economic calm to examine our monetary policy framework and consider how to make our economy more resilient to the adverse effects of a recession when it arrives.

The first paper, written by Michael B. Devereux and Changhua Yu, "Evaluating the Role of Capital Controls and Monetary Policy in Emerging Market Crises," examines the roles of commitment and macro-prudential policies in the design of optimal monetary and capital account policies during "sudden stops" to capital inflows. The authors demonstrate that policy commitment is far more important under floating rates than under a fixed exchange rate regime. In contrast, however, the pursuit of macro-prudential policies is more important under fixed exchange rate regimes. They also demonstrate that the direction of optimal capital controls policy at the onset of a crisis is dependent on the exchange rate regime, with optimal policy calling for a tax on inflows under floating regimes and subsidies on inflows under a peg.

In their paper “Home-Country Interest Rates and International Investment in Safe and Risky U.S. Bonds,” John Ammer, Stijn Claessens, Alexandra Tabova, and Caleb Wroblewski examine a large data set of U.S. bond holdings by foreign investors from 31 countries to evaluate how interest rate levels influence international investment patterns. They find that lower home country interest rates do induce inflows into the United States, but primarily in the form of corporate bond purchases, rather than purchases of government treasuries. They interpret this change in composition as reflecting a “search for yield” response to lower average returns. The results are robust to controlling for domestic macroeconomic and financial conditions.

The first day’s proceedings concluded with Narayana Kocherlakota’s keynote address on “The Future of the Zero Bound Problem.” Kocherlakota notes that the zero bound problem has -- and will continue to – pose substantive challenges for monetary policymakers. In recent years, a number of advanced economies had their policy rates at or near the zero lower bound, along with what he describes as “horrific” macroeconomic outcomes, including high unemployment and excessively low rates of inflation. Moreover, lower estimates of long run levels of the natural rate of interest suggest that the zero bound will be hit more frequently going forward than it was in the past. He then discusses constraints on using forward guidance as a mechanism to stimulate the economy at the zero bound, arguing that such policy is unlikely to be credible. He is similarly pessimistic about the scope for successful asset purchase programs or lifting the inflation target. Instead, he concludes that allowing modest movements below the zero bound might be the promising policy response. More aggressive movements of policy rates below the zero bound might be achieved if physical currency could be eliminated.

The second day of the conference began with the paper “Foreign Effects of Higher U.S. Interest Rates” by Matteo Iacoviello and Gaston Navarro. The authors construct a measure of exogenous shocks to U.S. interest rates and examine the channels through which a surprise increase in U.S. interest rates can spillover to other countries. Based on a panel of quarterly data from 50 advanced and emerging market economies, spanning the period from 1965 to 2016, the authors find that the spillovers to foreign economies of surprise movements in U.S. interest rates are large, and on average as large as the effects on the U.S. itself. They also find that the transmission channels of the spillover effects vary substantially across economies. For advanced economies, surprise changes in U.S. interest rates are transmitted through the exchange rate and trade channels. If a country trades more with the U.S., or its currency is (de facto) pegged to the dollar, then the spillover effects are typically larger. For emerging market economies, the exchange rate and trade channels are much less important. Instead, a country's financial fragility measured by a vulnerability index explains most of the spillover effects.

In the paper "U.S. Monetary Policy and Fluctuations of International Bank Lending," Stefan Avdjiev and Galina Hale examine empirical evidence on how changes in U.S. monetary policy affect cross-border bank lending. They find that the correlation between the federal funds and international bank lending fluctuates over time, and it can be either positive or negative. They study the driving factors of this time-varying correlation using a Markov-switching regression and the BIS data on cross-border bank lending flows, with a quarterly sample ranging from 1978 to 2015. They identify two regimes. A boom regime with high growth of lending from advanced to emerging economies and a stagnation regime with low or negative growth of lending from advanced to emerging economies. They find that the impact of U.S. federal funds rate on cross-border bank lending flows depends on the prevailing capital flow regime, and also on what drives changes in the federal funds rate (macro fundamentals or monetary policy stance). During periods with the boom regime, the federal funds rate is positively correlated with cross-border bank lending, and the correlation is driven mainly by the macro fundamental component of the federal funds rate implied by the Taylor rule. The authors argue that the positive correlation in the boom regime is consistent with a search-for-yield behavior. During periods with the stagnation regime, the correlation turns negative for bank lending to emerging economies, and it is driven primarily by the monetary policy stance component of the federal funds rate. This negative correlation is consistent with a flight-to-quality behavior by internationally active banks. These results help reconcile the seemingly contradicting findings in the literature about the correlation (or the lack thereof) between U.S. monetary policy changes and international bank lending flows.

The formal portion of the conference was closed with brief remarks by Barry Eichengree. In his concluding remarks, Eichengreen identified the Asian financial crisis as a unifying theme of the conference. He summarized the methodologies and policy implications of each paper presented at the conference. He highlighted how the research focus has shifted and the methods used by economic researchers have evolved since the Asian financial crisis 20 years ago. He concluded that significant progress has been made in both policy and economic research in the past 20 years.

The conference proceedings concluded with a dinner keynote speech by Carmen Reinhart. In her speech "The Curious Case of the Missing Defaults," Reinhart discussed the seemingly puzzling observation that, during the period from 2012 to 2016, global capital flows dried up and commodity prices fell sharply, but sovereign defaults in emerging market economies did not spike higher as predicted by the historical experience in the past two hundred years. She offered two clues to the puzzle. One factor is better management of capital inflow boom and improved fiscal and monetary policy in emerging market economies. The other factor is the rising prominence of China in the global economy as a stabilizer of global trade and China also provided large official capital flows to support development projects in other emerging market economies.