

Monetary Policy Independence in Small and Medium-sized Open Economies

Joseph E. Gagnon
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Summary

- Does globalization mean smaller economies cannot have independent monetary policy?
- No.
- Sound monetary policy with a flexible exchange rate delivers greater domestic stabilization.
- Canada is a good case study.
- Exchange rates may be excessively volatile, but ER intervention should be aimed at small and sustainable current account balances.



The Monetary Trilemma

- A country can have only 2 of
 - Independent monetary policy
 - Open financial markets
 - A stable exchange rate
- Some argue that even with flexible exchange rate, countries must choose between first 2
 - These studies confuse financial correlation with lack of independence
 - Independence less useful in the presence of currency mismatches



Cross-Country Evidence

$$Y_{i,2007-12} = \alpha + \beta D_{IT} + \gamma D_{HF} + \delta \log(\text{PPP GDP PC})_{2006} + \theta \log(\text{POP})_{2006} + \lambda \text{FISCAL}_{2006} \\ + \mu \text{CURRACCT}_{2006} + \rho \Delta \text{GDP}_{2001-06} + \sigma \Delta \text{CPI}_{2001-06}$$

Table 1. Monetary Regimes and Performance after the Great Recession in Small and Medium-Sized Economies

	Average growth rate of real GDP	Average CPI inflation rate	Total change in unemployment rate	Standard deviation of real GDP growth rate	Standard deviation of CPI inflation rate	Standard deviation of nominal GDP growth rate	Standard deviation of unemployment rate
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
IT dummy	-0.4	-2.4	-3.1	0.1	-0.9	-1.0	-0.5
HF dummy	-0.9	-0.8	0.4	0.3	0.2	1.3	0.1
pval IT-HF	.27	.02	.00	.27	.01	.00	.08
No. Obs.	160	172	96	172	172	171	97



Case Study of Canada

- Canadian economy dominated by its US neighbor
 - $CA\ GDP = 0.085 * US\ GDP$
 - $Exports\ to\ US = 0.25 * CA\ GDP$
- Open financial markets
 - Claims on US are 56% of CA GDP
 - Liabilities to US are 78% of CA GDP
- CA dollar is not a reserve currency



Table 2. Correlations between Canada and United States
(April 1995 through April 2016)

	Levels	Monthly Changes
Policy Interest Rate	.92	.46
Long-term Bond Yield	.96	.86
Exchange Rate (with euro)	.16	.69
Core Inflation	.20	.05
Unemployment Rate	.19	.24

Source: Haver Analytics. For variable definitions, see figures 1-5.

Table 3. Macroeconomic Outcomes in Canada and United States
(April 1995 through April 2016)

	Average		Standard Deviation	
	Canada	United States	Canada	United States
Core Inflation	1.6	2.1	.56	.50
Unemployment Rate	7.5	6.0	.97	1.68

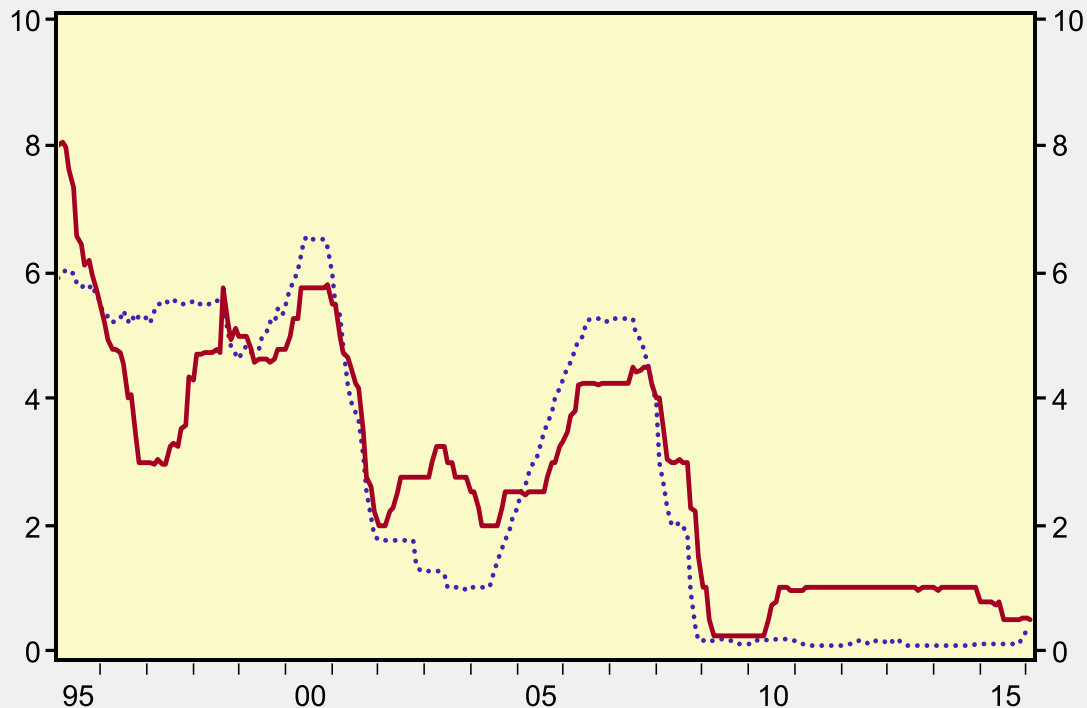
Source: Haver Analytics. For variable definitions, see figures 1-5.



Short-term Interest Rates

Canada: Overnight Money Market Financing Rate [Effective]
%

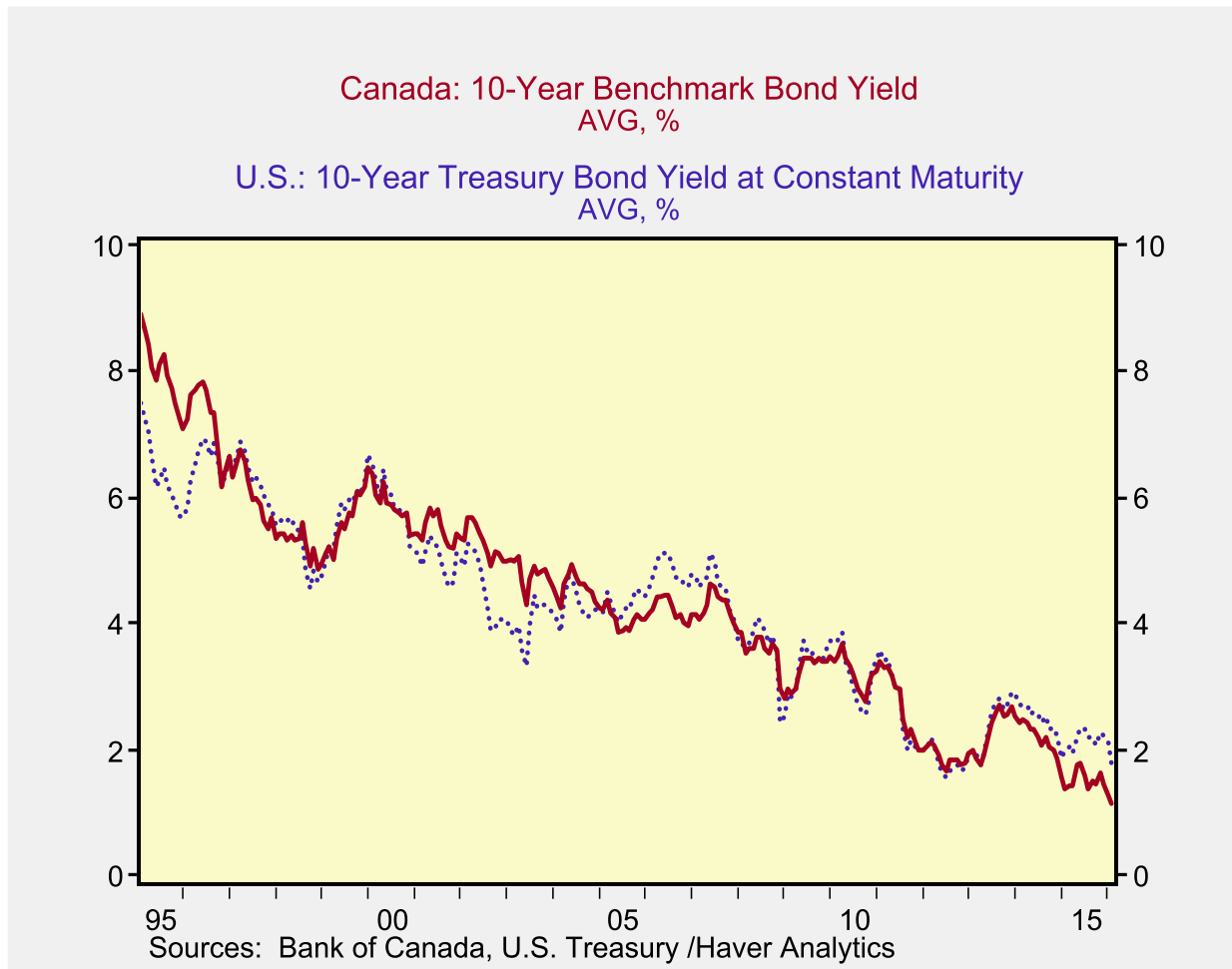
Federal Funds [effective] Rate
% p.a.



Sources: Bank of Canada, Federal Reserve Board /Haver Analytics

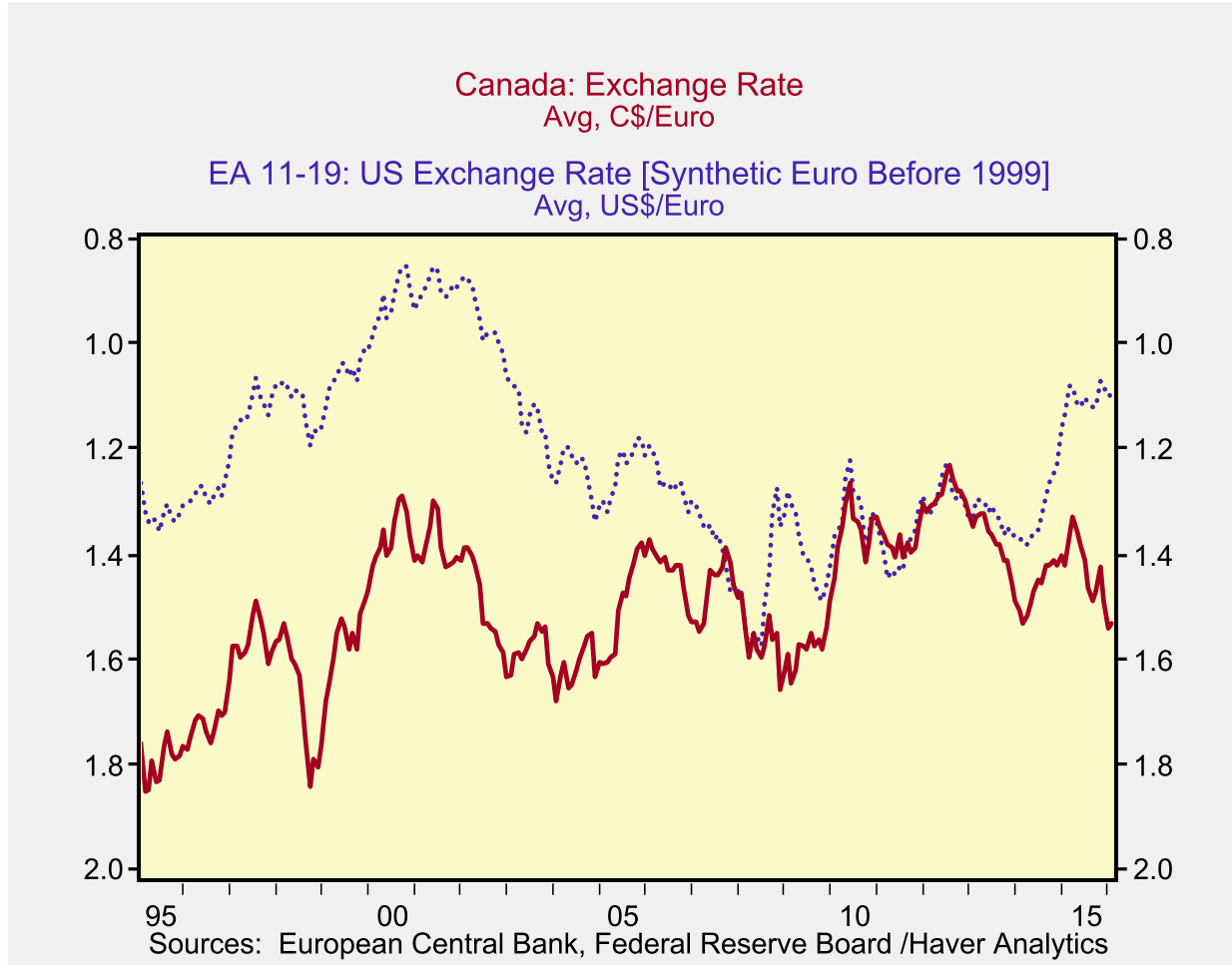


Long-term Interest Rates





Exchange Rates

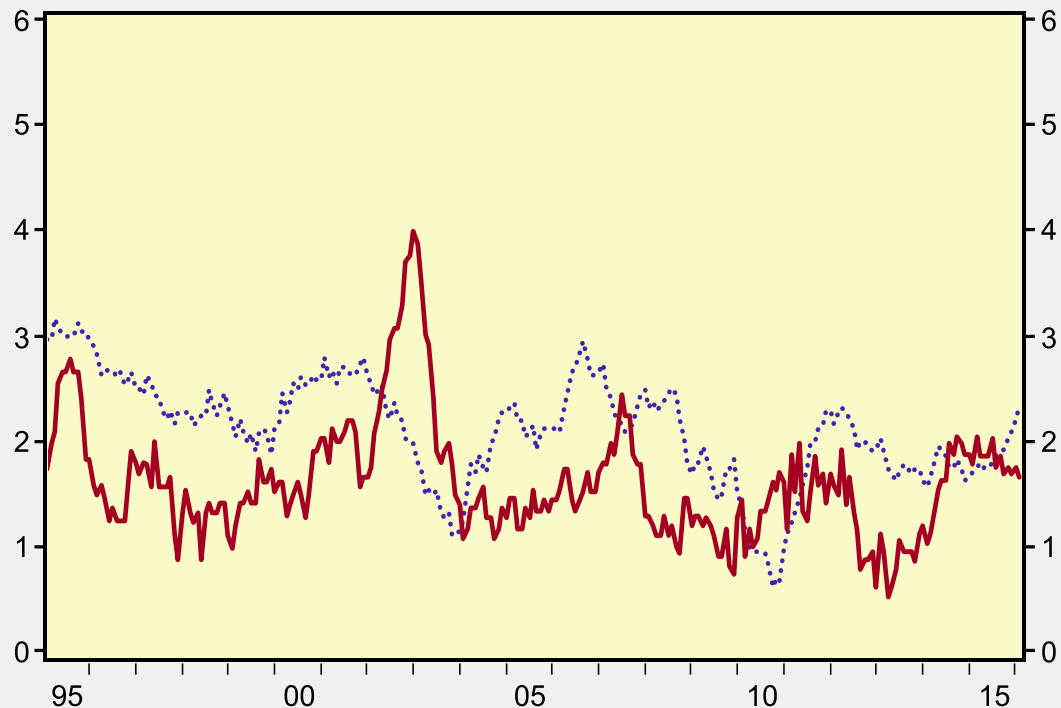




Core Inflation Rates

Canada: CPI: All Items Less Food and Energy
% Change - Year to Year SA, 2002=100

U.S.: CPI-U: All Items Less Food and Energy
% Change - Year to Year SA, 1982-84=100



Sources: Statistics Canada, Bureau of Labor Statistics /Haver Analytics



Unemployment Rates



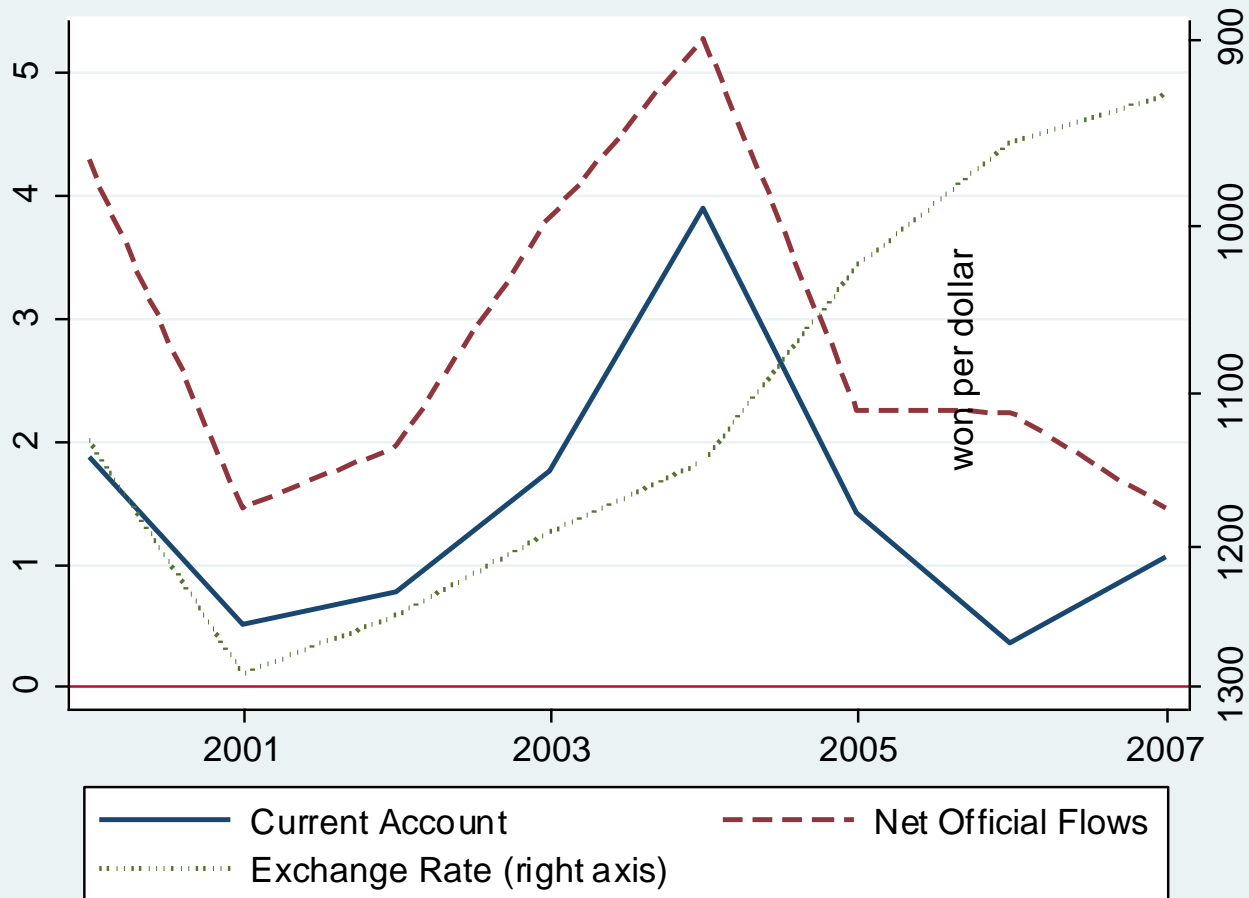


Exchange Rate Volatility

- Monetary independence associated with volatile exchange rates
- ER volatility causes unsustainable current account imbalances
- New research shows that foreign exchange intervention can help to stabilize exchange rates and current account balances



FX Intervention in Korea



Source: IMF Balance of Payments Statistics and International Financial Statistics databases.



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- FX intervention should be aimed at small and sustainable current account balances.