

Hélène Rey on Monetary Policy and International Capital Flows

Summary of the 19th Global Economy Lecture

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The 2014 Global Economy Lecture¹ was delivered by *Hélène Rey*, Professor of Economics at the London Business School. In her engaging presentation at the OeNB on December 1, 2014, she stressed how important the credit channel is for the international transmission of monetary policy shocks, underlining, in particular, the international role of the U.S. dollar and the need to incorporate insights from international finance into the analysis of international macroeconomics.

In traditional Mundell-Fleming-type models, the international transmission of monetary and fiscal policy depends on the exchange rate regime. More specifically, floating exchange rates can successfully insulate an open economy from foreign monetary policy shocks. Large cross-border capital flows and deep financial integration – salient features of the modern global economy – substantially alter this result, however.

Modern models of monetary policy transmission that incorporate capital market frictions highlight the effects of what is broadly defined as the “credit channel.” Such models emphasize agency costs as well as risk, and they postulate an effect of monetary policy on an external finance premium. In her research, *Hélène Rey* has added the international dimension to models of monetary policy transmission that incorporate net wealth or balance sheet effects. As she argued convincingly in her lecture, allowing for international spillovers in such models leads to large amplifications of agency costs, procyclicalities and leverage through the credit channel. All this implies gains from international cooperation not present in traditional models.

Looking into a wide range of asset classes (equity, FDI, debt and credit), *Hélène Rey* continued her talk by illustrating the presence of tremendous worldwide comovements, which constitute a global financial cycle. Her research shows that this global financial cycle is essentially driven by just one global factor. In light of the dominance of the U.S. dollar in all asset classes and its disproportionate importance worldwide as a funding and investment currency, *Rey* concluded that U.S. monetary policy is affecting financial conditions even in countries with a flexible exchange rate regime. U.S. monetary policy spillovers occur in this case globally through credit spreads and risk premiums and bilaterally through leverage and credit flows. The international credit channel can operate even if policy rates do not react, which implies that domestic monetary policy becomes ineffective in countering such spillover effects. *Hélène Rey* concluded by emphasizing the need for additional policy tools, in particular macroprudential policies and instruments, which are necessary to restore monetary autonomy in such an environment.

The discussion first revolved around the magnitude of the effects of U.S. monetary policy shocks relative to domestic monetary policy shocks, which *Hélène Rey* assessed as being of equal importance. Prompted on the role of fiscal policy in response to the limitations of monetary policy, she referred to the long time lag in implementing fiscal policy and its limited role as an active cyclical buffer, but she

¹ *The Global Economy Lecture is an annual event jointly organized by the Oesterreichische Nationalbank (OeNB) and The Vienna Institute for International Economic Studies (wiiw).*

agreed that the spillover effects could be cushioned through a timely removal of fiscal distortions. Questioned about the relevance of U.S. monetary policy for the euro area, she referred to a general lack of empirical evidence. Yet her findings suggest ample room for monetary policy transmission from the U.S.A. to the euro area, as many of the globally most important banks are domiciled in the euro area.