# Overview

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We have had an interesting and excellent set of papers to discuss on topics of real importance. It is striking that the academics are now talking to the policy-makers in an almost common language. The academic papers are more central "bankerly" than they would have been ten years ago, and that's mainly because academics are becoming more involved in the policy dialogue.

My list of topics is exactly the same as Andrew Crockett's: inflation targeting, how to react to asset prices, the liquidity trap, and exchange rate systems.

Let me start, though, with the question of original sin. Thirty years ago, there was an NBER conference on secular inflation at the University of Chicago, at which Robert Mundell presented a paper. He said that to think of secular inflation as relating to the last two centuries is all very well, but that this is a much longer-term problem. And he described the 600-year cycle in inflation rates, of which the inflation following the Black Death was one episode. But, he said, it really goes back much further than that, because the question is what is the original sin? Well, everybody has his or her own view of what it is that Adam and Eve did in the Garden of Eden. Mundell's version is that the original sin was that Eve told Adam about central banking, about the notion that you can create value with a stroke of the pen. We must give credit for the original sin where it is due.

I will talk about inflation targeting from the perspective of an academic. It is interesting that, except in one or two of the papers, we did not really get to first principles and discuss what the loss function should be. For instance, on the question raised in several papers as to whether to target the price level or the inflation rate, it would be worth trying to address the problem from first principles, with the aid of an analytic model. One argument is that price level stability encourages long-term nominal contracting. A few years ago it was put as "If we had price level stability, as in the 19th century, companies would issue 100-year bonds." The year after that, Mobil issued a 100-year bond. I am not sure just how much welfare gain that provided—the question is hard to answer without the help of a model. If we were to go the analytic route, we would probably also find that the optimal inflation rate varies over time with the state of the economy.

It is notable that the papers here, for instance Lars Svensson's and the comments by Mike Woodford, argued for the benefits of flexibility and for discretion, albeit constrained discretion, views that would not have been offered by academics fifteen years ago. That is partly because of the understanding that inflation targeting is a regime that combines rules about the goals of policy with discretion about how to attain those goals. It is interesting that the bottom line comes down to issues of process more than anything else. There seems to be full agreement on the desirability of transparency, accountability, and consistency. But there is less than unanimity on precisely what the central banker should target.

There are two key short-run trade-offs that an inflation targeting approach has to contend with. One is the Phillips curve, the output-inflation trade-off. The other is the exchange rate-inflation trade-off—the concern that policy-makers, particularly those in small open economies, have for the behavior of the current account. If the real exchange rate appreciates as a result of monetary tightening, then very likely the current account deficit will worsen later, and in any case exporters will be concerned. The pressure is then on to ease monetary policy to allow the exchange rate to depreciate.

Even for firm believers in inflation targeting, such as me, the time has come to confront these trade-offs more explicitly. Most of the papers presented here seem to accept a view close to that embodied in the targets assigned to the Bundesbank and later to the ECB: namely, to target price stability over the medium term, but to seek to achieve also the other goals of the government's economic policy to the extent that is consistent with the price stability goal. The Bank of England attempts to deal with these trade-offs by targeting inflation about two years out, a period long enough for the short-run trade-offs to work themselves out. That seems to be a good solution, but it leaves it to the discretion of the central bank to deal with the short-run trade-offs, while taking into account the critical insight that, in the long run, the central bank controls only inflation. Perhaps that is also what is meant by the authors who say they support flexible inflation targeting.

I doubt whether that is precise enough to guide future thinking in this area. The problem becomes clear when we consider that we have output in the loss function. But, for strategic reasons, we do not propose to judge the performance of the central banker according to the results achieved on both inflation and output. Inflation targeting has been a success so far, particularly in helping countries escape the tyranny of short-termism in central banking. But we need to be more explicit now on how to deal with the inflation-output trade-off.

A very similar issue arises for small open economies in thinking of how monetary policy should deal with the exchange rate issue or the current account issue. The convenient argument, and it is one that I tend to make most of the time, is we should worry about the exchange rate to the extent that it affects inflation. The position taken in the Bernanke and Gertler paper about asset prices is similar. That is a good argument, but it becomes less convincing when the current account deficits start getting up in the range above Marty Feldstein's approved 4 percent of GDP, and toward 6 and 7 percent, because tight monetary policy is producing an appreciated exchange rate. We can all say, and we do, "Well, that is a problem for fiscal policy." But the fact is that, in the short period, the real exchange rate can be affected by monetary policy—incidentally a trade-off about which we know too little.

Andrew Crockett asked what would be on the agenda if we revisit monetary policy issues a decade from now. These trade-off problems certainly need further discussion and could be on the agenda then or earlier. Incidentally, Andrew mentioned that inflation targeting had not yet been through a real test. That was true four or five years ago, but not now. A few years ago, we were told that the early successes in New Zealand, Australia, Britain, and Canada didn't count because inflation targeting was introduced as inflation began to decline. Now, we have had another stage of the cycle in each country, a phase during which inflation rates would normally have risen, probably by more than they have in the most recent upswing. So, I think inflation targeting has been through more of a test than implied by Andrew. But, no doubt, a more severe test will be presented at some time.

For the final remark on inflation targeting: the Bernanke-Gertler paper suggested that the Fed should adopt an inflation-targeting framework. The IMF has generally taken the view that if a country is managing monetary policy well, there is no point in changing it—that is, "if it ain't broke, don't fix it." This is a very good argument, except—and here I speak for myself—that it means the only time you will fix it is when it breaks. And if you think it might break, then you might want to fix it in advance. The real test of a system is not how well it operates when the people who are running it are outstanding, but rather how well it works for the average policy-maker. That is the case for developing a more formal framework for U.S. monetary policy.

A brief comment on asset prices: the Bernanke-Gertler paper takes the view that monetary policy should not react to asset prices unless their behavior threatens to affect inflation. That is a reasonable viewpoint. They also suggested that Japan should have raised interest rates on those grounds in the late 1980s. But I was very struck by Mr. Yamaguchi's question yesterday of whether the authors thought that the Bank of Japan could—from a political viewpoint—have raised interest rates at a time when the inflation rate was zero. It would not have been easy.

In thinking about this problem, we should recall the advice "if you do not have enough policy instruments, find another instrument." When central banks deal with exuberant property markets and housing prices, they do not hesitate to send a message to banks. And if they can regulate some of the terms of mortgages, they do not hesitate to do that either. It is not clear why other asset prices are treated differently.

On the liquidity trap, the basic question for the Bank of Japan is whether it can get expansionary effects from purchases of a wide range of assets, including foreign exchange, long-term bonds, and private sector paper. Of course, this is a slippery slope, as Jacob Frenkel argued. But Japan has had a seven- or eight-year recession, and there must be some trade-off between worrying about the long run and what you can do in the short run. A year ago, when the yen was at 145 and the Asian recovery looked very fragile, the thought that the Bank of Japan would try to weaken the yen by injecting a lot of liquidity seemed like a terrible idea. But we are not in that situation now and the creation of a lot more liquidity in the economy would not do any harm. As for the slippery slope argument, it must be within the powers of humankind to devise a set of rules that say and ensure "this is only temporary."

Finally, let me turn to the issue of exchange rate systems and discuss three points before turning to the main issue. First, there is an interesting divergence between the views of Barry Eichengreen and Ricardo Hausmann, and those of Martin Feldstein, on the desirable size of current account deficits. Marty Feldstein said that a country is in trouble if the current account deficit exceeds 4 percent of GDP. Eichengreen-Hausmann were hoping that current account deficits could reach 10 to 15 percent if we had the right currency arrangements. They argued that was feasible under the gold standard, and it would be desirable now to enable developing countries to invest much more than they save. Marty's argument that 80 to 90 percent of investment is domestically financed is a description of the current system, so it does not dispose of the fact that in good Queen Victoria's reign, under the gold standard, the system worked with much larger current account deficits. I suspect Eichengreen-Hausmann are right, that we could see much bigger and sustainable current account deficits if currency risks were removed.

Second, Eichengreen-Hausmann discussed the costs of holding reserves. The point of Milton Friedman's optimum quantity of money article is that it is socially costless to create money but privately costly to hold it. That applies too to the case of reserve holdings. Here, I have to put in a plug for the possibility of issuing special drawing rights. If there was ever a situation in which there was a need to create reserves, that could be done by an issue of special drawing rights. The present mechanism for doing that is not ideal, but the possibility exists, and it could be useful in a future crisis.

Third, we were told that the existence of forward currency markets in countries with fixed exchange rates is evidence that exchange rate hedges would be provided by the markets even in a fixed rate system. It seems more likely that the forward markets exist now because people do not believe the fixed exchange rate. In any case, if the exchange rate was truly fixed, there would be no need to hedge.

Finally, on exchange rates, I would like to turn to the question of fixed versus floating rates, so forcefully and interestingly raised by Barry Eichengreen and Ricardo Hausmann. The background for thinking should be a simple set of exceedingly powerful facts presented by the recent crisis. The following countries, at some point, had fixed exchange rates: Thailand, Korea, Indonesia, Russia, Mexico (1994), Brazil, and China. Six out of seven got into very deep crises. The following countries, all of which have some weaknesses in their economy, South Africa, Mexico (1998), Turkey, Israel, and India, had floating exchange rates—and they avoided crises of that nature.

Eichengreen-Hausmann push very hard in the direction of dollarization. The benefits of dollarization are clear for a country such as Argentina, which is already committed through a currency board to a very hard peg. However, the Eichengreen-Hausmann paper did not mention the main difference between a floating and a fixed rate system—that a flexible exchange rate provides an additional means of adjusting to external shocks. There is no question that extra degree of freedom is useful at times, particularly when there are adverse external shocks. The plain fact is that the policies needed to operate a fixed exchange rate system when capital is mobile are extremely demanding.

That is why we are likely for now to see emerging market countries—those that are integrated into the world capital markets—moving mostly toward floating, except for a few countries that, for good historical reasons, need and are able to sustain a hard peg. But over the longer term, and with the evidence of what is likely to be a successful EMU, I believe it will come to be seen that the benefits of having a floating exchange rate are exaggerated, that wage and price flexibility are endogenous to the exchange regime, and that many of the benefits of dollarization pointed to by Eichengreen and Hausmann are real. Accordingly, larger currency blocs will develop over the longer term, meaning that we will have more fixed—but permanently fixed—exchange rate systems. But there is much work to be done before that happens.