

General Discussion: Global Policy Perspectives

Chair: Stanley Fischer

Mr. Carstens: I have two questions. One for Alan and one for Stan. This is a question about the credibility and independence of central banks. I think it's important to realize that central banks are part of the state in a global sense. I mean, as much as we want to believe that we are very specific, probably unique entities, that we're not part of the government, at the end of the day we are. And I think you, in a very eloquent way, presented different states of the world in which central banks, given that they're part of the state, have to improvise and have to basically react to reality. And, of course, there is a lot of resistance in many central banks, or hesitation, because of the credibility issue. Now, I think if we go back 10 to 20 years ago or more, there was a very strong literature, and action by many central banks, to narrow and make more precise their mandate, to underline their independence and also to have better means to establish their credibility. Now, with what has happened now, and given the fact that some central banks have needed to improvise, do you think that the mandates of central banks should be broader or more flexible?

And then, going to Stan, I fully agree with what you said that there has been progress in Europe, and the fact that now countries are talking about the problems, and actually establishing the pillars needed for long-term sustainability of the regime, which remains to be seen.

But don't you think that it would also be desirable for them to discuss the path toward these long-term objectives? I think the path and the establishment of short-term objectives are essential to anchor expectations and credibility. I think there are two very specific items that I think would send a very strong signal: to make the commitment to do what it takes for the sovereign debt market to work appropriately, and for the interbank market to work appropriately. I think if they manage to get those two markets to work in a solid way, I think that would be a good signal toward progress. But it is not enough to make nice pronouncements about an ideal world in the future. I think they have to sort of delineate the trajectory.

Mr. Kohn: I'd like to go back to a question Adam Posen posed early in his remarks, which was: What's holding the economy back? Why is it that we've had such incredibly accommodative monetary policy for so long and we've had so little growth. And I'm not going to give the answer unfortunately, but perhaps a suggestion for a paper at next year's conference. I think it remains a puzzle. We keep citing shifting headwinds. Ben gave three in his paper, which were very good ones. We talk about the problems in Europe as a headwind. I think the paper this morning on tightness in credit, household deleveraging, covered part of it. None of this to me is entirely satisfying or can explain why growth has been so weak for so long. There could be something deeper going on—in these very low rates for a long time—affecting the behavior of savers, pension funds cutting back, or businesses having to fund pension funds, or it could be something in the distribution of income, this huge shift from compensation to profits. The fact that we keep trying to bring spending from the future to the present, with lower and lower interest rates could be less and less effective over time. Are there really diminishing returns? I think there is a lot we don't understand about what's going on now and it's very hard to make policy if you don't understand what's going on.

A second point, however, is that, just because monetary policy isn't the cause of the problem, that doesn't mean that monetary policy necessarily can't help. Through easier conditions, monetary policy often leans against exogenous events coming from other sources. So,

people say, well it's not monetary policy's fault, therefore monetary policy can't help. I don't think that argument follows. Finally, I think we can be convinced that monetary policy actions have been effective at easing financial conditions. We saw that in Mike Woodford's paper certainly. And it probably could be effective doing more in easing financial conditions. I think what we don't understand very well, and this goes back to my first point, is how those financial conditions—easier financial conditions—feed through to the economy. My instinct is that if you ease financial conditions further, you're going to get at least a little boost in GDP, but without understanding what's holding things back, it's very hard to be confident in that.

Mr. Geanakoplos: Everybody knows—especially every parent—that sometimes in extreme cases, a lender can get more money back by forgiving part of the debt. And yet, the official sector never seems to be able to acknowledge that, so we missed a chance in 2008 to 2009 to write down some of the mortgage debts, even though it would have been better for lenders. And now I see the same thing in the euro: everybody knows Greece is not going to be able to pay the whole debt, but officially speaking, all the officials say it's all going to be paid back and the result is that the debt gets bigger and bigger, because when it isn't paid back, more lending takes place. So I'm asking, why can't we fearlessly face up to what everybody knows is going to happen, and talk about how part of the debt could be forgiven, maybe in exchange for reforms? What prevents us from doing it, when it seems—to me anyway—to be the logical solution that would make everybody better off. It can't be better to have Greece default completely against all the lenders now.

Mr. Taylor: Two quick points, both related to Alan Blinder's remarks. So, I was at the 1982 conference too and what I recall about that was that there was kind of an academic urging for Fed policy to ease, and that was part of a cooperation idea: fiscal policy could be tighter if the Fed could be easier. Volcker resisted that tremendously, and I think that's perhaps what Allan Meltzer was talking about. I'm glad he resisted it because it paved the way for a great disinflation and at least a couple decades of strong growth.

And then the second thing, in terms of current activities now, there are other things to mention. The Consumer Financial Protection Bureau is under the Fed, out of the appropriation process of the Congress. It seems that we've raised these questions about continued independence. Last fiscal year, the Fed bought three-fourths of the new debt issued by the government, this year probably about the same fraction of longer-term debt. And the people who have been concerned about this are not just concerned about inflation. The concern has always been about the two-sided risk. It has to do with these kinds of policies being unpredictable, they raise questions about what the Fed will do, how the exit will actually take place, whether that could be disruptive itself. And so, there's a concern that the policies are actually a drag on the economy. And in some sense we have seen a very slow economy. So I think that those people who have raised doubts or questions about nontraditional, unorthodox policy, are not solely concerned inflation, but also about the other kinds of things that could happen to the economy.

Mr. Liikanen: Stanley gave an interesting analysis of the European situation. I will focus on that even though I must say that Alan and Zeti made a wonderful presentation. But I would like to make three comments based on Stan's really quite fair and balanced analysis. First, on the mistakes of the market: I share the view that the markets did not follow the real differences between euro area member states, and I don't believe they will repeat that mistake. But I think part of the problem lay with us. Our framework was not sufficient: it was strong on the fiscal side with the Stability and Growth Pact—although, in order to implement it, we still need to make it even stronger now—but we didn't focus enough on the differences or macroeconomic performance among the member states. No policy framework was there. So, if you have more than the markets on the one hand, and a better policy framework on the other hand, it is really a big change.

On the deeper integration, I think the big issue of the moment is the banking union. The reason why Mario is not here is not only next week's meeting. It's also his work on the banking union. I'm personally convinced that this autumn we will see consistent progress

toward a banking union, which will mean, in Europe, a possible step in delinking of the sovereign and the banks. It's a major change in our structures. Details will be known later. The European Commission and the European Central Bank (ECB) have been working well together there. The support of the member states is strong.

My third comment is on the coordination and the division of labor. I always get worried when people talk about coordination, because they normally mean that they want to concentrate on the work of others and not on their own. That's why it is more important to talk about the division of labor. What is better now than before is that the division of labor between the member states, the European Union and ECB is clear. That was stated in our statement in August. Member states are responsible for their own public finance and primary surplus, and they cannot run away from this problem. And only a government that truly leads can convince its people. It is not easy, but it must be done. When the governments get into deeper difficulties in financing and they need support from EU-governments and possibly from IMF, there needs to be a program with strong conditions. When all these conditions are fulfilled, then the ECB can act, within its mandate, independently in the secondary market. So it is a real progress that the division of labor is clear. But all in all, I must say that Stan's presentation was quite fair with regard to the European situation.

Mr. Redrado: In the interest of time, I'd like to focus on the excellent presentation of Dr. Zeti, and complement her presentation, on the role that domestic debt markets have played in terms of buffering the volatility that we suffer in international capital flows. In particular, the countries that have developed a strong local currency market for their governments have been more isolated from the current crisis, or more resilient to recent crises. I guess the case of Mexico is probably the most staggering, where 80 percent of public sector debt is denominated in local currency. When you look at the duration of that debt, which is seven years, the duration is higher than the average of OECD countries.

A second point is that it seems to me, when you look at integration in Asia, the pooling of resources among central banks has played a role like the Chiang Mai Initiatives. Do you see a role for multilateral agencies, or multilateral institutions, doing some sort of pooling of reserves along the lines of playing a role in smoothing volatility in our markets?

Ms. Forbes: I've heard increased discussion recently about the possibility of countries putting controls on capital outflows, if the situation in Europe deteriorates, in an effort to avoid contagion. To be clear, this discussion is not about taxes on capital inflows, which have gained some support recently from the IMF and been used by Brazil. Instead, this discussion is about temporary limits on the ability of investors to take money out of a country. Of course, a prominent example of a country using this type of capital control is Malaysia in 1998, in response to the Asian financial crisis. Governor Zeti, I was hoping you could comment on whether you thought this sort of policy was effective in 1998 in reducing contagion to Malaysia? The academic literature is inconclusive. Also, could you comment on whether you think this policy might be effective today—whether for Malaysia or for other countries—especially given increased interdependence and increased financial linkages around the world? Do you think these types of temporary controls on capital outflows could work?

And then Governor Fischer, I would also appreciate hearing your views on this subject. I realize that you probably can't answer whether Israel would ever use these types of controls on capital outflows. But could you put back on your "Draghi hat" and speculate whether you thought these might make sense for euro area countries? If there is deterioration in Europe, do you think other euro area countries might consider this type of temporary control on outflows to mitigate contagion?

Mr. Frenkel: My comments focus on the eurozone crisis. To begin with I note that the debate involving policymakers has been extremely emotional—a state of mind that is typically not conducive to good decision making. Of course, a lot is at stake but one cannot

resist the impression that in addition to the professional economic considerations, a large role is also being played by politics, egos and personal prestige. It is noteworthy, that typically individuals and policymakers from the eurozone countries are more optimistic about the medium-term outcome of the crisis than individuals and policymakers from other parts of the world. One fundamental fact highlighted by Stan Fischer is the very large diversity of key economic characteristics among eurozone countries. The eurozone was launched a bit more than a decade ago when its members converged to become very similar in key economic factors and when they have conformed with the main principles of the Maastricht Treaty (involving size of budget deficits, public debt, etc.). In the subsequent decade, that convergence got transformed into significant divergence. Today, the rates of unemployment across the zone are very different from each other (less than 7 percent in Germany and more than 25 percent in Spain and Greece). Rates of productivity are very different across the zone (exhibiting a very large gap between Germany and Italy), current account positions are very different (Germany has a large surplus while periphery countries have a large deficit), and fiscal positions are also very different across the zone. These differences warrant the fundamental question: "Do these countries belong in the same bed?" The fact that the eurozone crisis has been the subject of ongoing public debate for more than three years, should also tell us something about the severity of the challenge. Against this background, it is hard to disagree with the verdict that under current circumstances the introduction of a Pan-European bond would not be appropriate. In fact, by squeezing superficially the spreads among government borrowing rates, such a bond would not be consistent with the market realities and as such, it may serve as an "enabler" of inappropriate government policies that delay the necessary adjustment.

The long run equilibrium of the euro system may differ from its current configuration. Economic history has many examples of regime changes. We have seen the collapse of the Bretton Woods system, we have seen the evolution of the flexible exchange rate system, and we now witness the extraordinary tension within the euro system. I venture to suggest that if those who created the current

euro system have the privilege and opportunity to start all over again, then, in view of the recent experience, it is likely that the composition and the structure of the euro system would not have been as it is now. It is more likely that a “two-speed Europe” would have been created in which the core countries would constitute the (narrow) euro system, whereas the outsiders would attempt to mimic the policies of the inner core but if they fail, they would not endanger the euro system itself. While the path between the current situation and the long term is unclear, there is a lot to argue in favor of a long-term equilibrium, which is less prone to crises. By definition, a crisis is an aberration. The ongoing crisis of the past three years is clearly too long and it warns the question that was raised earlier: “Do they belong in the same bed?”

Mr. Ryding: Just a quick comment and then a specific observation on Professor Blinder’s advertisement. Quick comment: “The Changing Policy Landscape.” One thing I’ve been struck by here is that I found more people in agreement or sympathetic to the kind of views I hold on the limitations on where we are right now in monetary policy, whether it’s John Taylor, the comments made by Don Kohn, the impact of low long-term rates on the behaviors of pension funds and savers and retirees. And it does seem to me that there is a shift from where people may have been a couple of years ago.

But then on the specific advertisement for potentially negative interest rate on excess reserves that Professor Blinder brought up, we have to remember banks can’t choose how many reserves to hold. The Federal Reserve creates the reserves, and any one bank individually can shed themselves of reserves, but they flow back into the banking system, unless there’s a big increase in the public demand to hold dollar bills or whatever currency. And so it just becomes a tax on the banks and it becomes, once again—to try to tie it back to the session on independence—the Federal Reserve almost becomes a fiscal authority, taxing the banking system. And in part, that’s happening because the Federal Deposit Insurance Corp.’s deposit insurance system has already shifted its tax base from insured deposits to the assets of the bank, less their capital. And so, in already creating these

excess reserves, that imposes a tax on the banks through the deposit insurance system. And if we shifted to a negative interest rate on excess reserves, and then created more reserves through a quantitative easing, that would become a bigger tax. I reckon about 25 basis points right now, that's about a \$4 billion tax on the banking system.

Mr. Levy: Alan, you spoke of three different periods. One, an acute crisis; the second, a post-crisis transition; and the third is normal. So I have two questions. In March 2008, when the Federal Reserve bailed out, or got involved with, Bear Stearns, what period did that fall in?

My second question is, in the context of what Chairman Bernanke said yesterday referring to the high unemployment rate as a grave condition: Is the current situation normal? Are we currently in that period, the third period you emphasized? And I'd like to put that in the context of what Stanley Fischer discussed as the need to impose market discipline. So, here we have the Federal Reserve that basically owns the long-term bond market and is the largest holder of it, and I'd like you to answer whether you think we're in that normal period now, in light of our talking about strong borders between monetary and fiscal policy.

Mr. Shirakawa: My comment and question are on monetary policy coordination. Staff at the Bank of Japan estimated the global Taylor rule, explaining the weighted average of the policy rate. In the estimation, the explanatory variables were the weighted average of the headline inflation rate and the weighted average of the output gap. The estimated coefficient on the headline inflation rate was below 1 percent, in other words, the result showed that the Taylor principle is not satisfied. And the reasons why the Taylor principle is not satisfied here at the global level are several.

One hypothesis relates to a focus on core inflation rather than on headline inflation in the context of globalization. Food prices and energy prices are determined globally. From each central bank's perspective, core inflation might be relevant. However, after all, energy prices and food prices are joint products of global monetary conditions. Or at least partly, they are joint products.

A second channel explaining the violation of the Taylor principle is the efforts by central banks to stem the appreciation of their own currencies. This applies not only to emerging market economies, but also to other countries as well. If the central banks of major countries adopt very accommodative monetary policies, it can have impact on exchange rates in other parts of the world. Those countries in turn, to avoid the deflationary impact, have to adopt more expansionary policies as well. So taken together, this picture can reveal why the Taylor principle is not satisfied globally.

If this kind of analysis is correct, then the thinking on monetary policy coordination might need to change.

For 20 years I have been very much against the concept of international monetary policy coordination. Very often, the term “monetary policy coordination” is used when one country tries to impose a particular policy on another country; that is why I am very much against that kind of concept. Today, I still hold the same view. But to frame the problem that I have described, the term “monetary policy coordination” is not appropriate. Rather, the “internationalization of monetary policy decision-making” might be relevant. This is my observation on the so-called monetary policy coordination, and I would like to hear your views.

Ms. Aziz: I just want to touch on three points. One is on the issue of controls. Yes, Malaysia did impose them in 1998, but they were temporary, they were highly effective and they were withdrawn soon after. But the main point that I want to highlight here is that the kind of flows that we are seeing now are much larger, several times larger than what we saw during that period. And they are even more volatile. But we have been able to intermediate better: to intermediate those flows without having to impose the kind of policies you mention. And one of the key factors is having a local-currency, domestic-debt market that is very developed and disperses the effects of such flows. So we are moving in the opposite direction: toward actually liberalizing, toward greater liberalization, instead of imposing restrictions.

The second point relates to monetary policy and what is really holding back economic recovery. The easy monetary policy of low interest rates and providing liquidity is really a temporary relief. It can only be seen as a temporary relief. In order for the economy to recover, it needs to be reinforced by other policies. When we lived through the crisis—and I think one of the issues that was brought up by one of the speakers, is on the borrowers—we not only looked at financial sector resolution, but also at managing the resolution of the debts of households, small- and medium-sized enterprises, and the corporate sector. The fiscal cost of doing this is so much lower than that of managing the repair of financial institutions. And, therefore, these are the kinds of fiscal policies and income policies that actually can do very much more to support an economic recovery.

And then the final point is on Alan's presentation. I believe that even during crisis times, we must guard the precious independence of central banks. Because it would set a precedent—and this is the most difficult thing to manage, even in the aftermath of a crisis—if we had given way on that.

Mr. Blinder: Let me start, and, depending on whether Stan gives me another 45 seconds, maybe just finish with the questions directed to me. If I have another 45 seconds, I'll say something else. Governor Carstens asked a very *a propos* question about the mandate, and I think the answer is yes. I think central banks all tacitly—and I think it would be a good thing if they were explicit—have a mandate for preserving financial stability. If I were to have had a say in the matter, that would have been included in the Wall Street Reform and Consumer Protection Act—the Dodd-Frank Act. I would have included a little rewrite of the Federal Reserve Act, to put that third mandate in explicitly. Dodd-Frank did give the Fed a lot more powers and responsibility over financial stability. As a number of people in this audience know, one of my longstanding pet peeves is that the Federal Reserve Bank of Kansas City, and Boston, and Chicago, and so on, are all “dot.orgs.” They should be “dot.govs.”

John Taylor correctly points out that the criticisms of the emergency operations are not just about inflation worries. That's correct. A number of them, including from John, have been about unpredictability, as he just said. My answer to that, basically is that, in the abstract, unpredictability is not a good thing. But we live in an unpredictable world, and sometimes extremely unpredictable things happen, things that were thought impossible. In those cases, I think that the actions of policymakers need to be *ex-ante* unpredictable, but *ex-post* sensible. Another way to put this point is that the focus should be not so much on the instruments and the decisions, but on the goals. The goals should be—I don't want to say ineluctable, because goals may sometimes change as well—rarely changed. Yet the instruments may have to change.

The great analogy to that, which John knows very well, is inflation targeting, which focuses on what you're trying to do, rather than, for example, money supply targeting, which is all about the instrument. We had a long debate over that. It lasted 25 years. And at the end, I think the consensus was that inflation targeting made a lot more sense because it focused on the goal.

One minor item on history. John's family and my family were both at the first Jackson Hole symposium. It was in August 1982, we both had little children then, and Paul Volcker was the chairman of the Fed. But by August 1982, or maybe shortly after, Volcker was easing up, having looked at how severe the recession was and having decided that it was time.

John Ryding points out correctly that total reserves are fixed by the central bank. But the demand curve for reserves is not decided by the central bank. In my vision of a policy of paying negative interest on reserves, one thing that is happening at the same time is that total reserves are actually shrinking because banks don't want them anymore. Ben Bernanke has written many times, including mentioning it yesterday, that part of the exit strategy is to pay more on reserves in order to get banks to hold onto more of them. I see it as symmetric: When the Fed pays less, banks will want to hold less.

Mickey Levy asked in what category did March 2008 fall? That's a pretty hard question. Anytime you try to trichotomize something, there's always going to be some borderline cases. March 2008 was clearly such a borderline case. Significantly, however, in terms of monetary policy independence, we were not at the zero lower bound at that point and the Fed still did have conventional monetary policy to use. And regarding Mickey's question about the situation now, I take "now" to be part of my phase two. We're not back to normal yet.

Let me take a shot at answering the question Don Kohn posed: Why haven't we done better? I think that, as Don said, probably nobody has a full answer to that question. But if you look just at the arithmetic of the GDP, it's clear what the horrible sectors are. They're government purchases of goods and services—and we know what happened there, and we could have done better—and housing—and we know we could have done vastly better there. It's a national shame that we haven't done better on foreclosures and housing. I'm not talking about the Federal Reserve failing. I'm talking about some of the things that John Geanakoplos was talking about earlier. That's a piece of the answer.

Another piece of the answer is: we actually had a Reinhart-Rogoff recession. I'll confess that when their book came out, I was a little skeptical about whether this was going to happen in the United States right at that time. But they were right and I was wrong. We did have a Reinhart-Rogoff recession, and these are tougher. Sadly, we haven't deviated that much from the pattern of Reinhart-Rogoff recessions.

And the third thing I would say is that when the problems arose, the Fed only had 525 basis points to spend. If you look historically, a garden-variety Federal Reserve response to a modest recession is around 300 basis points down on Fed funds. But this was far from a modest recession, and 525 basis points just was not enough. After that, we get into the weak stuff.

Mr. Fischer: I'll just give some attempts at answers to a couple of questions. First, the question of whether it would be desirable for the Europeans to set out a path by which they're going to get to where they have now decided they want to get: Yes, it would be very useful.

Whether they would take more time arguing about that, than they would if they just got on with the first steps, I'm not certain.

With regard to Don's question on what's holding the economy back: clearly real estate has been a big part of that.

John, I think a regime in which you write down debt very easily just behaves differently. You need to do it, but you need not to make it too easy, because there's another side to every debt contract. And their willingness to enter it would be different if there was an option attached to every one, unless it was written up and described in some way. But that doesn't explain why it's been so difficult in this crisis to do what seemed to make sense.

Kristin, will other countries use capital controls if something happens in Europe? I think the best analogy we've got right now is what Iceland did when it got into trouble. It used capital controls very extensively to try to contain the problem of what would have been money just flooding out. I don't know whether that's the right analogy or the right precedent but it seems to be one.

Mickey, on the strong borders between monetary and fiscal: there aren't any. Our profits go to the Treasury and whatever we do has a fiscal implication. I'm aware of that. They seem to be even more aware of that than I am. Nonetheless Alan, we changed our address to "dot.org." It irritated the Treasury, but that was fine. We wanted to make a point and we made it. We see the "org" as important.

On Masaaki's discussion of monetary policy coordination, I would like to see what you have done. I would be grateful if you could kindly send me the paper you described.

Let me conclude by thanking my fellow members of the panel for excellent and provocative presentations.