

General Discussion: Overview Panel

Chairman: Andrew Crockett

Mr. Crockett: Thank you very much, Jean-Claude. Very interesting observations and comments from both of our presenters. So, I think we should ask the Kansas City Fed if we could trespass just a few minutes into the luncheon in order to have as many reactions as possible. Ric Mishkin.

Mr. Mishkin: I want to make two points. The first one is a point that Marty Feldstein raised, but I want to add to it because it is extremely important. Monetary policy can be effective when interest rates hit at floor zero. There are two reasons why I think this is true. One is that if you look at the literature on the monetary transmission mechanisms, one of the things you realize is that, despite the fact that as central bankers we focus on short-term interbank interest rates as our policy tool, many other asset prices are extremely important in terms of how monetary policy affects the economy. Hence it is very possible to pursue expansionary monetary policy even when the interest rate floor hits zero. I will not go into detail on this point, but I have written a paper for a conference at the Bank of France which goes into this issue. The other thing that should be mentioned is there is a lot of evidence which shows that the recovery from the Great Depression in the United States was one in which expansionary monetary policy was able to stimulate the economy even though short-term interest rates had hit a floor of zero. Therefore, I

think this issue of worrying about hitting a floor of zero is not one that should worry us in terms of pursuing price stability.

The second issue I want to raise is that it is very important to recognize that a good inflation target is two-sided. Many people think that inflation targets are only to prevent high inflation. However, just as importantly, and maybe even more importantly, good inflation targeting prevents deflation. Indeed, preventing deflation is something that is extremely important in terms of making sure that we do not have serious economic contractions. I think the example of Japan recently illustrates that inflation targeting would have been helpful for them. They actually ended up with deflation. It was very clear that, even though the measured inflation was around zero, or a little bit less, true inflation was, in fact, negative. So, indeed, one of the things you can do to prevent serious contractions or even worse, prevent situations that get you into a financial crisis as a result of a deflationary episode, is to have an inflation target, and make it very clear that not only is it bad to go above the inflation target, but it is also bad, and maybe even worse, to go below the target. Thinking of inflation targets as indicating that monetary authorities are only going to be tough and wring inflation out of the economy is a misperception of inflation targets.

Mr. Crockett: Thank you. In order to let the maximum number of people make a point, I ask that you not only be brief but also make only one point rather than multiple points, so that you can focus on the main one. Jacob.

Mr. Frenkel: I would like to add a footnote to Marty's very interesting calculations and the comparison between the permanent gain from lower inflation compared with a transitory course of the disinflation. I think this presumes that you can actually stay permanently at medium or low inflation. If one presumes that even that hypothesis is questionable, and if you assume to aim at 3 to 4 percent inflation, you are bound to raise it down the road; then I would say that the appropriate calculations should include the cost of disinflation itself—for the same reason that the calculations of enjoying drinking should include the cost of the hangover.

Mr. Crockett: Yes.

Mr. Stiglitz: Since there weren't that many hands up, let me make a couple of brief points. One issue that has not been talked about very much during this conference is that it is natural for central bankers to focus on aggregate variables like output and inflation. But the people who bear the cost of disinflation, the people who bear unemployment, are often different from the people who are the bond holders and may bear the benefits from a lowering rate of inflation. There are distribution consequences of a number of the policies that are implicit in the discussion here that ought to be borne in mind, particularly by central bankers. The second point is that Marty's calculation of the distortion associated with taxes—the tax system, as we all know, is very complicated and we do not want to go into the whole detail—but one point is that on other aspects of our depreciation policies, we do not have true economic depreciation, we have accelerated depreciation relative to true economic depreciation. Under quite plausible assumptions, the distortion caused by our accelerated depreciation system relative to true economic depreciation increases as we get the inflation rate down from 2 percent to 1 percent to zero percent. A third point I would like to make quickly is that in terms of the overall strategies of policies, the framework that Svensson put forward is the appropriate way of thinking about this. One of the key issues on this focuses on the uncertainty of policymakers—they simply do not know what the NAIRU is or what the response times are. The key empirical issue, given this uncertainty, has to do with the cost of the errors and the cost of correcting the errors. Most of the models that people have been using have basically used linear assumptions, where the cost of disinflation is the same as the cost of inflation. There is some recent empirical work that suggests that the cost of disinflation may be substantially less than the cost of inflation. So that if you make an error, and allow the economy for a short period of time to have a slightly higher rate of inflation because you have misestimated the NAIRU, the cost of correcting that error may be very low. So taking that nominal error into account is very important in designing optimal policy. Finally, let me just comment on Ric's comment about the importance of avoiding deflation. In an economy in which there are nonindexed

contracts, many of the costs that he describes are also costs that are associated with rapid disinflation, that is to say, bringing down inflation below the rates that were expected at the time the contracts were made. And that argues for a gradualist policy of adjustment.

Mr. Crockett: Scott Pardee.

Mr. Pardee: There has been no discussion whatsoever of the international dimension of monetary policy from the U.S. point of view. It is puzzling, because we have had whole sessions on exchange rate issues in the past. I guess the only answer to that is that perhaps we have had great success, both in the monetary policy of the United States in recent years in stabilizing the dollar as well as the current policy of the U.S. Treasury—that a strong dollar is in the national interest.

Mr. Crockett: Thank you. Elena.

Ms. Kohutikova: I would like to make two points. I'll try to be very brief. I am from the National Bank of Slovakia, and I would like to mention some remarks regarding the credibility of the central bank. I would like to say that the credibility of the central bank is crucial for the countries which have started the transformation process. I think the credibility and independence of the central bank was the main reason for the successful inflation rate development in Slovakia. As a lot of you already know, we started from a high inflation rate and a large devaluation expectation, but we were successful in bringing down year-on-year inflation from 25.1 percent at the end of 1993 to 5.5 percent at the end of July this year. And I think it was because of two reasons. First, the central bank started to build credibility as its first goal, and persuaded the public, firms, and also foreign investors that the bank would be able to keep inflation under control. Second, it was done in a stable exchange rate environment, which means a stable exchange rate policy during the time. Now there is the question of the forecasting. If we would like to continue to maintain our credibility, we have to influence expectations over the future. And we would like to start to do medium-term forecasting as was mentioned here—that means two years' forecasting—to

provide our credibility. Now, should we be satisfied with an inflation rate between 5 to 6 percent for the next year and allow the economy to follow the restructuring process and for privatization to take place? Or should we be more ambitious and continue to reduce the inflation rate? Various economists have said that an inflation rate between 5 to 6 percent in transformation countries is very low. And, some economists think we should increase the inflation rate to 8 or 9 percent to help the economy grow. Another group of economists say we should keep inflation at our current level for the next three to five years to finish the transformation process. The central bank would like to continue reducing inflation until it reaches levels of developed countries by the end of the century. I do not want an answer to this problem. I would like only to say that whatever the inflation rate you chose for medium-term forecasting for monetary targets, forecasting could present a very big risk for the short-term credibility of the central bank, because of the lag of information and long-term statistical data. On the other hand, in my opinion, it is necessary to do it and to influence the expectations in a positive way.

Mr. Crockett: Thank you. I think you can probably say that most of those in this room agree with the group of economists that you cite at the central bank. Could we make our comments very brief now, because we are running over. I would like to give Marty and Jean-Claude an opportunity to comment at the end.

Mr. Barnes: There has not been much discussion about the role of asset prices in this process of moving to price stability. Clearly, inflation was very destructive for financial markets in the 1970s, and the move to disinflation was very positive for financial markets. We have seen that the bullish disinflation process can create speculative bubbles from time to time in asset prices. I was just wondering—is asset price inflation a side show for central bankers in the move to price stability? Or is the potential instability caused by these speculative bubbles something that we should be thinking about in this process?

Mr. Crockett: Thank you. John Berry.

Mr. Berry: I have a question for Marty. Would you achieve potentially the same results without the 5 percent loss of GDP simply by changing the tax laws directly, perhaps by eliminating the mortgage interest deduction that homeowners have or at least limiting that very severely, or perhaps by indexing the basis in capital gains or making some other type of change in the tax law?

Mr. Crockett: Let us draw it to a close now. We have had a number of questions. Can I ask Marty to give a brief response?

Mr. Feldstein: I will try to be brief. With respect to the issue Joe Stiglitz raised about the distortions on the corporate side, the work that I reported on is going to be extended. We will look in that research at the corporate side and also at the impact of inflation on international capital flows, and we will see whether that increases or decreases the dead-weight loss. With respect to John Berry's question, if you scrap the tax system, as we know it, completely and replace it with some kind of a consumption tax, in principle you could get rid of these problems. But if you work within the corporate income tax and personal income tax system, if you try to get around it by indexing, then I think the short answer is you cannot. As I said in my prepared remarks, I used to be a strong believer in indexing the tax laws. And, in a world in which there are stocks and bonds and that is about all, it is not hard to think about how to do that. Once you begin to think about the products that some of the smart people in this room and elsewhere create, then it becomes very hard to think about how you would index. Think about a convertible bond. Do you treat it like an equity or do you treat it like a bond, with respect to indexing? Doesn't that depend on whether it is in the money, or out of the money? It just becomes a very difficult problem. In the paper that made these other calculations, I devote some considerable space to explaining why I think you cannot get around this by indexing.

Mr. Crockett: Thank you. Jean-Claude.

Mr. Trichet: Two remarks. The first one concerns the question of whether or not targeting should be taking into account the two reverse aspects, or whether inflation is too high or too low. In

reflecting on that, I would say that dilemma is an additional argument in favor of a monetary targeting strategy. And the question stands even more in the absence of precise knowledge of what inflation really is. If you do not know exactly what inflation really is, you do not know either what GDP growth in volume terms really is, even if you have an accurate perception of nominal GDP. It seems to me that this makes an additional element again to try to monitor monetary aggregates, in a way where you have some kind of automatic compensation between the possibility of making mistakes on inflation or making mistakes in the other areas. Furthermore, when inflation is obviously low and GDP is obviously low, then you have very low nominal evolutions; in such circumstances, the growth of monetary aggregates and of GDP in volume terms is low. So you are, I would say, on the safe side. And it seems to me that it might be again an additional argument in favor of this monetary strategy. As we get speculative bubbles, it seems to me—and I am speaking under the control of all central bankers present—that it is precisely part of central banking tasks to avoid bubbles in general, which does not necessarily please markets, but is undoubtedly part of the responsibility of the central bankers. Bearing in mind medium- and long-term interests have to be compared to short-term interests, that is a permanent arbitrage that the central banks have to make even if it is quite difficult to weigh the arguments.

Mr. Crockett: Thank you very much, Jean-Claude. Well, that now brings to an end the formal part of the conference.

I know Tom Hoenig wants to say something to us. But before he does, and recognizing, of course, that we still have lunch, dinner, and the afternoon ahead of us, I would like, on behalf of all of us here, to say a few words of thanks to our hosts—the Kansas City Fed. Over the past twenty years or so that it has existed, the Jackson Hole Conference has become, I think, the premier bonding experience for central bankers during the course of the year. And it is that because of an extraordinary combination of factors. First and foremost, I think, is the foresight with which the Kansas City Fed has selected fascinating subjects to discuss and the wide range of experience that it has brought together in the participants in the confer-

ence. Of course, I would not want to diminish the importance of the surroundings in which we undertake these discussions. I know all of us who come on a regular or occasional basis look forward enormously to meeting old friends, to discussing stimulating subjects, to enjoying the wonderful environment of the Grand Tetons and the Jackson Lake Lodge. I would like lastly to say a special word of thanks not just to the two Toms—Tom Hoenig and Tom Davis, who do a remarkable job of putting on this conference—but, of course, to all of their staff, because we all know that a conference like this does not get organized without an enormous amount of staff work. We see the tip of the iceberg, I suspect. A lot more goes into it. And I think we should remember those too. Lastly, and especially, we know that this is the last occasion that Tom Davis will be here in his present capacity. I am sure it will not be the last occasion that we have the opportunity to see him among us. And I would like particularly to say “thank you” to Tom Davis for everything he has done over the years for this conference, but more generally, a very warm “thank you” to all of our hosts, Tom Hoenig and all his colleagues at the Kansas City Fed. Thank you very much.