

General Discussion: Implications of a Changing Economic Structure for the Implementation of Monetary Policy

Chair: Malcolm D. Knight

Mr. Knight: The themes of these three papers mesh very well: The challenge of establishing the credibility of price stability, the challenge of communicating monetary policy in conditions where markets and market prices reflect private-sector expectations, and the challenge of dealing with certain aspects of financial behavior like the recent developments in household behavior that Glenn Stevens mentioned. We are now going to open up for discussion.

Mr. Meyer: I want to start by thanking Vince Reinhart for taking on a topic, at least from my perspective, that has dominated the discussion in the halls and at meals: the quality of Fed communication and the ability of markets to listen and process that information. It leaves open a lot of questions still about recent communication, but I am going to leave it to others to pursue that. I want to turn my attention to the ECB and ask Vítor Gaspar a question about the May 8 statement of the governing council, which you said was to clarify the price stability objective. It actually confused me even more. I am easily confused, but maybe you could help at least to clarify this. First, you said that the governing council reaffirmed the initial definition below 2 percent. Then, they clarified that by saying that in the near term they intend to stay at 2 percent. That is a little bit confusing. It could be intermediate term versus near term, but let me tell you what I see as the problems.

The first is, if you talk about it being below 2 percent, it is like a zone of indifference between zero and 2 percent. Do you not give any importance to the midpoint of that range? If you don't, is it effective anchoring inflation expectations as much as it otherwise would be? In any case, it seems asymmetric. We know what you are going to do if inflation is above 2 percent. We are not at all sure what you are going to do if inflation is below 2 percent. It seems you turn off the stabilizing properties of price stability-oriented monetary policy when there is an adverse demand shock.

The last thing is, it seems to me what this does is it sets up an asymmetry that is completely different from what other central banks are thinking about today. What you are saying is that you really care if inflation is above 2 percent. We know what you will do, but you might be slow to move if inflation falls below 2 percent. The asymmetry and the lessons of Japan are, if anything, to respond more aggressively when inflation falls below the target than when it rises above the target.

Mr. Freedman: I want to pick up some of the issues that Reinhart raised about communications between central banks and the markets. In particular, an issue that has exercised me over the years is: How do you get the notion across that there is both a base case forecast that was set out and a range of alternative possibilities? We all talk about that, but the emphasis in the market (I may be maligning the market here, but I am interested in their response) seems to be to focus attention largely on the base case.

I'll give you an example from our own experience. In the spring of 1998 in Canada, we made a statement that sounded like this: If the base case forecast that set out in this report turns out to be the case, if there are no major shocks to the economy, then it is likely that interest rates will remain more or less at present levels. If you remember the spring and summer of 1998, there were massive shocks. There was the Russia default and the LTCM crisis, and so on, and, no surprise, interest rates were changed as a consequence of the unforeseen shocks. The market was very, very upset with us, "You promised. You lied." We

responded that our statement had been a conditional statement and that circumstances had changed. I have had an internal debate with my staff as to whether markets don't understand what a conditional statement is or, alternatively, just complain because they lose money, or both. In any case, I know that a number of us at the Bank of England, the Bank of Canada, the Fed, and the Reserve Bank of New Zealand have been struggling with how you get this notion across regarding the probability distribution of outcomes and try to get the market away from focusing on the base case. My own view is that the best way of doing that is not so much by putting out a series of alternatives in a formal way, but by trying to use words to explain it. It is a very difficult task and I don't think any of us have succeeded yet in achieving this kind of interplay with the market in which we get the notion of alternatives and the kinds of shocks that might lead to those alternatives well embedded in the market. Anyway, it is a long way of saying, "What do you think, Vince?"

Ms. Swonk: Vince, thank you for your speech. It should be posted every time, before anybody says anything at the FOMC. Only you have to have an executive summary, which is about two lines, so the market can understand it. On the balance of risks, at the March 18 meeting the Fed said, "Listen, we are about to go to war and we cannot put out a balance of risk statement." To me, that was an enormous opportunity to eliminate the balance of risk statements that you put out following each meeting. There has been a lot of debate about the value of the balance of risk statements in the current environment of uncertainty. It dovetails with what Chuck Freedman has said regarding how you evaluate probability curves with that. My question is, is there a good debate going on within the Federal Reserve System in terms of eliminating the balance of risk? And what would be the pros and cons of doing that in terms of clarifying, maybe with just words, a statement after your meetings, rather than the balance of risk, as they currently stand? You almost have a dual balance of risks

The other comment is in response to household structural balance sheet issues. This is one, of course, as a large consumer bank, we

worry about quite a bit. Our view is that in the United States, we have insulated ourselves somewhat from interest rate movements. As consumers restructure their debt, they lock into low rates of long-term rates. So, they insulated themselves from interest rate movement, restructured their balance sheets in major ways, and paid down credit lines but did not close them. This is the first time we saw this in the industry. Credit lines are now very inexpensive because they are tied to the prime rate—not to market rates. All you have to do is open up your wallet; consumers don't have to apply for a loan. They have the loans already. They have the credit cards in their pockets and they can leverage up very rapidly, which has created a lingering positive effect of monetary policy in the U.S. economy. However, we also know that it is going to leverage up U.S. consumers even more. The problem is, of course, when an adverse negative shock happens maybe several years down the road. Also, the real problems with financial innovation, in terms of consumer balance sheets, are coming now as we have more hostile conditions with rates rising a bit. Financial innovation has allowed consumers to put it back in adjustable-rate mortgages after they move out of them, which means they are going to be in more trouble going forward if rates would rise. Also, we are seeing builders that do funding of interest-only loans and zero down payments, which we know when people don't hold equity in their homes they send back the keys. We don't do that at Bank One. But there are some who do. I just wanted to bring up those issues and wanted your response. In the business of risk management, it is not a today problem, but it is certainly a five- to six-year problem that we are very concerned about.

Mr. Sinai: I have two points. Markets price risk continuously, so they do price alternative scenarios off a baseline. That is a big part of what, in short-run trading, goes on. So, they are well aware of the alternatives. They often have their own view of what those risks are, and those views do not necessarily coincide with the Fed. Then you will get a disconnect.

For Freedman and his seeming frustration at trying to communicate with a difficult crew of people in the trading world, I totally agree with

that. I would urge you to not work so hard to communicate to them in the way that it sounded. It sounds as if you feel badly that you failed to get an A+ in communication. I wouldn't worry about that if I were you. I would say that to any central banker in any country.

The question for Reinhart has to do with communication and transparency. It may sound like the answer is obvious, but I am not sure that it is. It is the question of what is the rationale for taking market expectations and reactions into account on Fed policy actions or expected Fed policy actions. There are a few possibilities. Is it as an information source for what is going on in the data viewed by the markets and the Fed or in true model or true Fed intentions? Is it because market reactions could interfere with Fed goals, what the Fed is trying to accomplish? Or is it, perhaps, because if the Fed wants to be transparent and the market reactions occur that may tell the Fed whether they're really being transparent? In my view, market reactions very often, if not frequently, are transient and may have only temporary significance. This is not very often for Fed policy. The reactions may not be "fundamental"—based on fundamental Fed policy, inflation expectations, deficits, etc., which really determine interest rates. The Fed determines the front end of the yield curve and markets do the rest. Why not make the "best" decision possible? Be as "transparent" as possible. Let markets do what they do. Take, for instance, the market reaction in May and the so-called disconnect communication issue that I think you are referring to that was so prominent. When the 10-year yield went down to a little under 3.1 from near 4 percent and now it is back up to over 4.4 percent, that is not much of a net change at all from the original level. That is not changing interest rates over a two- to three-month period. It is not going to have any effect on the economy. The kinds of things that the Federal Reserve is most concerned about are the goals of maximizing sustainable growth and the price level stability. Why not let the chips fall where they may? Do the best job you can in communication. If it isn't understood, it isn't understood.

Mr. Frenkel: I want to come back to the issue that Reinhart raised: Should you go with larger steps or smaller steps when you don't know where you are? Yesterday afternoon as we were hiking, the rain started coming down. We had a little debate. Should we take small steps to keep from sliding on the wet ground? Or should we take larger steps to ensure that we get back before the rain really starts? This brings to the fore that there cannot be just a general theorem that when you don't know you take small steps and when you do know you take big steps.

Let me try to draw a distinction between two sources of uncertainty. When you don't know the structure of the model and you do type I and type II errors, then it makes sense to start with smaller steps if you assume that the cost of a deviation is more than the linear of the size of the deviation. But if, on the other hand, like in many cases of disinflation processes, you really do not know what would be the nature of the response of the economic agents, consumers or investors, to your own actions, and you know very well their response will depend on their assessment of how determined you are. You need to invest in that issue because you lose credibility to begin with. Otherwise you would not have been engaged in a disinflation process. You have had lousy inflation. Then it may call for more decisive moves and larger steps precisely in order to bring about a response that you want. This brings to the fore the theme we spoke of yesterday about the distinction between two types of countries—those who have not yet reached price stability, without any process of disinflation and those countries that are in the business of maintenance. The two questions are very different in point of clarity. If you have a disinflation process, then the clarity has to do about *what* is the policy measure. If you are in the business of maintenance, the clarity has to be in terms of *how* you are going to maintain it. It is a very different exercise.

Let me make one additional point with the same theme—the exchange rate regime. In many of the countries that have engaged in the disinflation process, the exchange rate regime itself responded along the way, and along this way it also introduced additional structural changes. I am talking about Mexico. I am talking about Israel. I am

talking about Poland, just to mention a few. In these cases, again, in order to get a quicker pass through, in order to get a much easier smoothing, you may need to have a more decisive move. We chose yesterday to take larger steps to avoid the rain.

Mr. Ferguson: Let me pick up a little bit on Jacob Frenkel's point and just add one extra question. This one is addressed to Vítor Gaspar. A few years ago, the Fed was extremely aggressive in our movements with respect to monetary policy. There are many people who think that was the right thing to do. At the same time, the ECB was moving more gradually and more slowly and was being fairly or unfairly criticized in the press and other places. It seems to me that one of the reasons perhaps for our difference in approach was a difference in transmission mechanisms—a bit of what Frenkel may have referred to. I'd be interested in hearing from Gaspar—he has given a brief ad for a book that is upcoming—what the transmission mechanisms are and how they might differ from those that have been in the United States or the United Kingdom and whether or not those differences might explain differences in strategy that we have seen over the last few years.

Mr. Reinhart: I have just a couple of points. First, in response to Freedman's question on how to convey information about the base case versus alternatives: This is a very long-lived question. You can go back to the debate on the immediate publication of the directive. The FOMC had concerns and told the Supreme Court that immediately publishing contingency plans while those contingencies are still real possibilities might add to financial market volatility. The answer in part relates in part to some of the comments that Chairman Greenspan made.

There are two issues. One is, what frequency do you care about things? If your horizon is four to six weeks, then how you convey that message does matter and it is possible, because of things like information cascades and problems in market dynamics and pricing, that expectations or at least what you see in financial markets may get a little away from you. But if what you really care about is how your policy setting this quarter

will, through the lags and the transmission mechanism, affect the economy in a year or a year and a half, a lot of these are transitory.

We don't have the market in the dock to answer this next question: Is there a difference between what we read in newsletters by market economists and what is priced into the market? Economists, newspaper reporters, and everybody who has to write about the economy are more likely to be explaining the modal case: "Here is a story I can tell you about what is going to happen to the economy, and it is probably the most likely." That doesn't mean there isn't a distribution surrounding that mode, which is what will get priced in financial markets. It is not surprising that sometimes we do see a difference between what we tally up in surveys versus financial market prices.

Now, directed to Diane Swonk's comments: There is always a good debate going on in the corridors of the Federal Reserve, as Larry Meyer told us at the beginning. The view in March was that the distinction between risk and uncertainty was apparent and it would be conveying a false impression of precision for the FOMC to have opined on the balance of risk. The May statement, by splitting up the tight linkage between an output gap and inflation, seemed to be an improvement because it spanned more of the space of economic possibilities. What happens after this—the balance of risk, the whole communications policy—is a work in progress. I am not in any position to say anything more about that.

With regard to Jacob Frenkel's comment, as I noted in the beginning, attenuation and gradualism are not universal properties of macro models, particularly in environments where you are really unsure about inflation persistence. Will investors believe you? How long will it take for wages and contracts to reflect the new policy environment? It may be important to be decisive and prompt. That also would lend itself to an asymmetry, particularly in emerging market economies where it is much harder to ease than it is to tighten because you are worried about inflation persistence getting away from you.

Mr. Gaspar: Starting with Larry Meyer's question. The first announcement by the Governing Council of the ECB on October 13, 1998, stated a definition of price stability, as price increases of less than 2 percent according to the harmonized index of consumer prices for the euro area as a whole. This definition of price stability is timeless. It can be monitored on a monthly basis. The governing council went on to say, "We intend to maintain price stability over the medium term." By the use of the word "increases," the governing council meant to be symmetric, excluding, at the same time, significant inflation and deflation. The language used proved challenging, as an interaction between Malcolm Knight, Vince Reinhart, and myself two years ago in Washington made me realize very vividly. So, the Governing Council decided to be more explicit. The definition is still the same—timeless formulation. Then they added, "We aim at being close to 2 percent over the medium term." "Close" is not 0 to 2 percent; it is close to 2 percent. To sum up, the Governing Council aims to keep inflation close to but below 2 percent over the medium term. Now, you could say the Governing Council could have announced an aim of exactly 2 percent. If they wanted to be under 2 percent, they could have said 1.9 percent. Given that we know that the consumer price index measurement bias is time-varying, that would be (If I dare borrow an expression from the Chairman) "spurious precision."

But the markets do understand what "close" means. As I said, according to most indicators, long-term inflation expectations have been in a very narrow range between 1.7 and 1.9 percent. I, for one, am not unhappy with that range.

Now, I'll address the question from Roger Ferguson on the transmission mechanism and the impact of the transmission mechanism with the euro area in the conduct of monetary policy by the ECB. In all fairness, it is not possible for me to summarize the results from the various studies included in the forthcoming volume I have alluded to. However, I believe I can give you a flavor by comparing the transmission mechanism for the euro as a whole, the United States, and the United Kingdom. If one focuses on the overall characterization of the

transmission mechanism in macroeconomic terms, one sees that for the United States, the United Kingdom, and for the euro area, the interest rate channel seems to be dominant. The timing of transmission seems to be very similar in the three economies. If something is different, it is that the transmission of an interest rate impulse into prices seems to take slightly longer for the euro area. The peak effect seems to be at the three-year horizon, while for the United States and the United Kingdom it seems to be around two years.

The evidence on the way the ECB moves is not clear cut. People have tried to look at monetary policy instrument rules, and tried to look at whether, for example, the same rule would lead to significant departures from the policies followed for the euro area and the United States. Some people have found that it would not. That is, the difference in behavior we see when we compare the Fed and ECB has more to do with the objective developments characterizing the economy at the time, rather than differences in the monetary policy reaction function.

Mr. Stevens: All of the questions were directed to the other panelists, which is just fine with me. I will echo that these difficulties of communicating sound very familiar to me. In our own efforts to retrim the ship of expectations, if I could use that analogy, we have often found we are so subtle that no one notices. Then we have to try again. Or we are apparently so unsubtle that everybody rushes immediately to the other side of the ship. So, this is awkward. All we can do is keep trying and keep appealing to market participants to read the words that are on our lines and spend a little less time trying to detect the words they think are between them.

Ms. Rivlin: This question is for Mr. Stevens. The soul searching of central bankers about what to do about asset price bubbles always seems to end with, "It's a very hard problem when the asset price bubble isn't affecting the rest of the economy and we don't really know what to do about it." The thing that occurs to me is that central bankers could move on and say, "Either we need some more specific instruments, because the instrument we have is not good for this purpose, or it is

somebody else's problem. Somebody like the security regulators or the mortgage market regulators ought to be handling this problem, not us." I just wondered what your reaction might be for that.

Mr. Stevens: In policymaking generally, we are usually finding that we like more instruments. That is certainly true. In our own case, the prudential supervisors are certainly stiffening up their examination of the banks' mortgage practices. That is good. The extent to which that really can be used as a countercyclical device is an interesting question. When the bank supervisors used to work for us, which they no longer do, my recollection is great reluctance to tweak a supervisory capital ratio and things like that for macro stabilization purposes. We did actually do that once about 10 years ago, despite the reluctance of the supervision people at the time. Now that they no longer work for us, I suspect the prospect of getting them to tweak their arrangements for macro purposes is probably even less likely. I agree that it would be good to have more instruments. It would be good to pass the problem on to others, but, in practice, it turns out that those instruments are still not that easy to find. Also, I would have to say that in cases where an asset price episode is a leveraged one, they are the ones that matter most. The unleveraged ones do some damage, but the leveraged ones do a lot more damage. The cost of credit, which is facilitating the leverage, is something the central bank is setting. While it remains a hard question, I find it not that easy to say that it is not our business—we are actually setting that price.

Mr. Goldstein: Glenn Stevens, in his remarks, put a lot of emphasis on the structure of financial markets. He mentioned that during the Asian crisis, even though the Australian dollar fell, they were able to avoid an increase in interest rates, attributing that to the fact that they had a low inflation anchor.

I would have thought there was another factor that was important and that distinguished Australia from some others in the region. Australia has relatively little foreign currency debt. When the exchange rate falls, you don't get the decline in net worth and the insolvencies we

saw in many emerging economies in the region. I wonder if you could say a word about that and about what approach the central bank takes toward foreign currency debt.

Mr. Stevens: The point you make, Morris, is correct. One of the advantages we had compared with certainly the countries in Asia was having had a floating rate for a long time when this episode came along. The idea of managing foreign currency exposure was one with which market participants were well familiar. The decline in the exchange rate did not give us a bank solvency problem or a solvency problem for any other lender or borrower. So, we were not faced with the rather awkward choices that many of the Asian countries faced. That is certainly true, and it is a great advantage to be able to borrow offshore or from foreigners in your own currency. Australia actually has a quite high level of foreign debt but a relatively low level of foreign currency debt. In fact, overall our foreign currency position is a net asset position, as it turns out. You are quite correct in saying that was a major advantage in that episode, and it certainly makes policymaking much easier.