Overview

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Once again, this Jackson Hole conference has provided us with a fascinating set of papers and a rich discussion. I am sure that all of us have learned a lot. In presenting some of my own reflections on what has been said, I will focus on four questions among the many that have arisen.

First, how should central banks formulate their key objective? Second, how should they go about pursuing it? Third, how should they respond to shocks, and, in particular, how should they act in the face of asset price behavior that seems to be creating bubbles? And fourth, the subject of this last session, what kind of exchange rate regime should emerging markets select?

Concerning how central banks should formulate their monetary policy objectives, support has been expressed by conference participants for inflation targets ranging between zero and about 3 percent. Reference has been made to people who are not here who have advocated figures both above and below this range, but I don't think anybody in this room has advocated a figure that is outside the range of zero to 3 percent. This rather narrow range of dispute is, in a way, an eloquent testimony to how successful central banks have been in taming inflation. Still, the choice between zero inflation and some low positive number is an important one that raises both theoretical and practical issues.

There are two reasons for selecting a non-zero figure, in addition to measurement bias. First, it is claimed there are downward rigidities in prices and, more especially, in wages. Second is the fear of a liquidity trap. I will deal briefly with each, although there has been more discussion here of the liquidity trap than of downward wage and price rigidity.

Mervyn King, both in his paper and in his oral remarks, questioned both propositions. I am personally somewhat less persuaded than he is. The fact that most central banks continue to follow an inflation target that is somewhat above the measurement error (the Bank of England is one of them) suggests that there is at least a residual belief that downward price and wage rigidities and the liquidity trap are legitimate sources of concern.

King is probably right that downward rigidity in goods prices is something that will disappear quite quickly with the experience of stable prices. Downward rigidity of wages, however, may be more of a problem. In some countries, for example, it would not be legal for wage rates to be lowered without the prior agreement of employees. I suspect there may be a number of situations in which, either for contractual reasons or for internal management reasons, it is not so easy to lower nominal wage rates. In the end, this is an empirical question, however, and we are all looking forward to the promised update of the Akerlof, Dickens, and Perry study.

There has been more discussion here on the subject of the liquidity trap. King has argued that, at realistic parameter values, it is unlikely to be a serious problem. But how then do we explain away the dilemma that has faced the Japanese authorities? Maybe Japan is not a pure liquidity trap situation. But I do believe that negative inflation complicates policy-making in a recession. And negative inflation is likely to occur in recessions if zero is the objective in normal times.

So, I personally come out in favor of something like the targets that central banks are actually following, namely somewhere in the range of a little above 1 percent to about 2 percent. For the time being, and in the absence of clear information about how economies would function with even lower inflation, this seems appropriately prudent.

A slightly different issue is whether to target the price level or the rate of inflation. This question has surfaced before in Jackson Hole discussions a couple of years ago. I personally find the arguments relatively evenly balanced. There is a case that can be made for targeting the price level (or the trend in the price level) in terms of the added certainty attached to long-term financial contracts. In theory, however, it should not make a great difference in the long run whether the target is inflation or the price level, because if the shocks to which the economy and the price level are subject to are random and uncorrelated, the divergences between an inflation target and a price level target will be limited. For this reason, it is possible that a price level target may turn out to dominate an inflation target. We will doubtless hear more of that in the years to come.

Let me pass to the second question. How should central banks go about pursuing whatever final objective they adopt? My sense is that there has been a very large measure of agreement in this conference around what has been called "constrained discretion." Many have favored the use of inflation targeting as a way of communicating to markets what central banks are trying to do and of building credibility by actually doing it. Transparency is an integral part of constrained discretion and has been applied so far with remarkable success by almost all of the countries that have adopted inflation targeting as a mechanism. There was little support here for more rigid rules simply because rigid rules are unlikely to have credibility over time, given that the precise nature of future disturbances is so hard to predict.

We are now riding the crest of a wave as far as the success of inflation targeting is concerned. But we should realize that the inflation-targeting regime has not yet faced a real test. A real test would come if the world economy, or an individual economy, were subject to a serious stag-flationary shock in which conflicting pressures would arise on central banks. So, we should guard against hubris setting in and reserve judgement on how resilient inflation targeting is until it passes that test. I am certainly not saying that there is an alternative and better way of conducting monetary policy, simply that we should be wary of claiming that we have found out how to tame the business cycle.

We should also realize that inflation targeting works well only when there is enough credibility to coalesce expectations around the target. It is, I suspect, much harder to make such a regime work when that credibility is not present. This may have been one of the reasons why Yutaka Yamaguchi warned in his remarks against the introduction of an inflation target for Japan. I agree with him that it is an open question whether the kind of credibility to make inflation targeting work well exists today in Japan; although I know there are those in the audience who feel that is exactly the way Japan should get out of its present difficulties.

Thirdly, how should central banks respond to disturbances? We have discussed two types of shock: a sudden exogenous disturbance to economic conditions and the price level, and the gradual buildup of asset prices at a speed faster than the general price level. However, it is the response to asset price inflation that has attracted the most interest.

There was a large measure of consensus that policy-makers should be interested in asset prices mainly in so far as they are likely to feed into future inflation. And the inflation targeting approach, it was implied in the paper by Bernanke and Gertler, and endorsed by many speakers, in a sense, contains the impact of asset prices because they are modeled into future inflation forecasts.

It would be hard to dissent from that consensus, and I don't. Nevertheless, I find it hard to avoid a nagging concern about possible consequences of asset price bubbles that are not incorporated in the standard approach. When there is a bubble (and as we were reminded yesterday that can only be known after the event), the way in which it is resolved can be messy. Prices rise gradually but they do not always fall in the same manner or with such predictable consequences for the wealth effect and for spending. Moreover, rising prices rarely generate the problems for individual institutions (and the system at large) that falling prices do.

In my view, there are two or three disequilibria in asset prices and related markets that should give us pause for concern for the future. One is obviously the level, and more particularly the rate of growth of

equity prices in the United States. Whatever we think about the level of Wall Street, we would probably agree that equity prices cannot go on rising at the rate they have and which is now increasingly reflected in private sector saving decisions.

A second disequilibrium is reflected in a very large size of the U.S. current account deficit. That cannot go on forever. And a third is in the very low savings rate, which I also would stipulate cannot go on forever.

Of course, it is not hard to paint a scenario in which these disequilibria are resolved in a relatively benign way with a soft landing for the world economy. But, recalling my earlier point, large disequilibria tend to be resolved in messy ways and with unpredictable consequences. I for one would certainly feel more comfortable if the disequilibria were smaller in the first place so that the risks of an unstable unwinding were lower. But I cannot honestly say that it is easy to design a monetary policy that helps prevent that risk.

Lastly, on the subject of our most recent panel: emerging markets exchange rate policies and the dollarization option. The paper by Eichengreen and Hausmann certainly presents much food for thought, even if their characterization of an inability to borrow long-term in domestic currency as “original sin” was stronger meat than some in the audience could digest.

The real issue, of course, is why countries cannot borrow in their own currency. Of those who participated in the discussion, some felt that it was an unavoidable problem in small open economies that had to be accepted and adapted to. Others saw it as simply the legacy of recent experience that could be changed through determined pursuit of sound policies. I find myself more in the latter camp, for reasons Marty Feldstein articulated very well.

For emerging markets, as for industrial countries, there is a balance of advantage in exchange rate arrangements in favor of what might be called “constrained flexibility.” Dollarization has the well-known drawback that U.S. monetary policy is unlikely to be well suited to countries with very different production structures, fiscal choices,

electoral cycles, and so on. Pure flexibility may condemn a country to undesirable volatility in its exchange rate. But exchange rate flexibility, embedded in arrangements in which there is a credible anchor for domestic monetary policy (for example, an inflation target) can help avoid the dangers of the two extremes.

Can you correct that problem of the incapacity to borrow long-term in domestic currency? I think you can, and I suspect that it can be done more easily than Eichengreen and Hausmann suggested. The development of Chile's long-term debt market owed much to the creation of private pension schemes, which is desirable in its own right. In addition, there is a large appetite among institutional investors in the richer countries for diversified portfolios. And I suspect that countries in Southeast Asia with relatively good histories of inflation control will, once they have corrected some of their fundamental structural problems, be quite an attractive outlet for funds from the industrial countries. We know some of the reasons that have gotten in the way of developing those bond markets. They include legal and institutional structures, as well as shortcomings in corporate governance. Those are on the way to being improved.

A factor that previously has hindered the growth of fixed interest markets has been the absence of a substantial government deficit seeking finance. One of the small silver linings in the recent crisis has been the need to develop domestic bond markets. So, much debt will have to be issued to bail out banking systems that those countries have little choice but to turn to domestic financial markets. The development of domestic financial markets, combined with a flexible exchange rate and a credible domestic anchor for monetary policy is, I believe, a more promising path for overall stability than pegging irrevocably to a currency of a country facing quite different macroeconomic and structural circumstances.