Commentary: Monetary Policy and the Control of Inflation

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Regrettably, Mike Boskin was not able to join us. He is in Washington puzzling and working through some of the difficult fiscal issues that Marty Feldstein referred to in a more international context. These are, of course, my own views and not Mike Boskin's views.

The first point I want to make is with respect to the discussion on Eastern and Central Europe. I want to try to do this more from a business standpoint. My firm has been active in some of the early business and financial discussions in Central Europe, and I can tell you that we have had a very difficult time of it. So I listened with great interest to some of the remarks of the Central European central bankers.

I would say the most difficult issue we have had to confront in doing business and generating investment interest is the question of currency value, currency reform, and—bringing it all down to the bottom line—currency risk. Currency risk is probably the single largest complaint that I hear in all manner of discussions. Currency reform, including currency convertibility, may not be so easy because the Western currencies themselves have fluctuated in substantial magnitudes in the last five years, or the last 10 years, and, arguably, in the last 20 years, since the breakdown in the early 1970s of the Bretton Woods arrangements. Therefore, I agree that what Paul Volcker called the Bundesbank group, or the EMS group, might be a useful currency anchor with respect to convertibility—or perhaps the U.S. dollar. But the fact remains that no Western investor or businessman can be entirely assured of currency convertibility unless there is going to be a fixed rate someplace along the line. And since the outlook for fixed rates is not particularly positive at the moment, the question of whether currencies are convertible on the open market remains, so that hedging devices can be brought into play if in fact Central and Eastern European currencies are permitted to fluctuate on a variety of spot and futures exchanges.

Now this may be a more expensive or costly way of dealing with currency risk. But it may also be the only way this can be done. So my principal point is: with respect to a variety of economic and monetary reforms, it would be wise to consider using your currencies—and permitting your currencies to be used—on these various international exchanges so the risk factor can be reduced and various sophisticated, high-tech modem hedging devices can be used.

The second point, though, which we have also found in our experiences, is that currency risk is not the only issue. I give you a specific example: A large investment bank (it was my own investment bank) set up a fund for investing in Hungary. I think we were able to raise on the open market some $80 million. We were able to enter into an arrangement with the Bank of Hungary, which in effect took much of the currency risk out of the investment. We were able to agree on a fixed exchange rate over a period of five to 10 years with various technical provisions—but I am not going to get into that. But the basic issue was, to a substantial degree, that most of the currency risk was removed.

That fund, which was put together with the International Finance Corporation as well as some private investors, today—some eight or nine months later—remains essentially uninvested. It is not, I can assure you, for a lack of trying. It is not for a lack of shoe leather or time spent in various hotels or government halls. It is because so many other issues besides currency risk are still prevalent. I will not say all Western investors, although my sense is that the same themes would crop up whether it be Japan or England or Western Europe for that matter.

If I have one urgent request to my East European colleagues, it involves the degree of state regulation and intervention, which remains a painful barrier and impediment to the basic formation of what we call "deals"—investments, structuring new companies, privatization, strategic acquisition and so forth. In particular, the rules of privatization and other legal uncertainties are a problem. What is meant by privatization? Selling shares to local investors? Employees? Western partners? Basically, what are the rules of the road? Also, the constant need to negotiate all manner of corporate business arrangements—the structuring of boards of directors, the structuring of shareholder rights, the structuring of senior management and middle management, a general lack of sophistication—all these issues create difficult barriers. The time and the cost involved really take their toll. Therefore, although I recognize you cannot reverse 40 or 50 years of history overnight, and I appreciate the length and duration that these reforms will take, it remains true that not much U.S. private investment is likely to come into Eastern and Central Europe until these state interferences are substantially curtailed. And I am not really even speaking of macroeconomic policy—issues of tax incentives or free trade or deregulation of prices and all the rest. 1 am merely saying that there are great markets in Eastern and Central Europe, and do not underestimate the creativity and ingenuity of American businesspeople. Also, do not underestimate the willingness of U.S. businesses and investors to come into your countries. Given half a chance, we can probably create all manner of clever approaches to do business, but we have to be given half a chance. So that is my second principal point.

My third point is as much a domestic U.S. issue, coming back to central banks and their control over inflation. There is a little cottage industry that has grown up in New York, Boston, and Washington in the last year called "giving advice to the East European countries." Giving advice are economists, businesspeople, academicians, and all the rest. Maybe it is not such a small industry anymore! I want to discuss this part of my talk with the greatest degree of humility, because as I listened to some of the discussions this morning, Paul Volcker talked about how central banks are themselves engines of inflation. Mr. Crow talked in broad terms about some of the difficult options and issues of controlling inflation.

I think as we enter the 1990s, there are a number of substantive issues which Western central bankers have not yet resolved. And, therefore, with respect to inflation control, it is awfully hard to give advice in clear, ringing terms and tones to our new colleagues from Eastern and Central Europe.

I certainly agree with the goal of price stability. I like the rhetoric; I like the language; I like the fact that a lot of important central bankers use it as often as possible. But I am not sure, speaking as someone who operates in private markets, that I know exactly what we mean by the term "price stability." For example, what is the benchmark—what is the regulator? Are we talking about producer price indexes? Are we talking about consumer price indexes? Are we talking about other government national income and product indexes? Are we talking about a standard of value, such as real goods produced in the economy? A broad commodity index? A return to some kind of gold exchange such as we had during the Bretton Woods period? Are we talking about currency reforms, exchange rate stability? None of these issues has really been resolved, even though the notion of price stability and the use of that phrase is very widespread.

On the issue of implementing price stability (supposing we knew what we agree upon as the end result), are we talking about a monetarist rule—fixing the quantity of money over the long term or fixing the quantity of bank reserves? Are we talking about interest rate targeting in the United States through the federal funds rate or call money rates in other foreign countries? Are we talking about a price rule where central bankers would use commodities or gold or bonds as a target, as a signal, with respect to managing the money supply? And so forth and so on.

We really have not agreed on any of these issues as we enter the 1990s. Therefore, I believe, looking at it as a market participant, there remains great uncertainty and great unpredictability with respect to monetary policy and the issue of inflation control. And I recognize, as I think you will, that we are still plagued by large swings in the money supply, interest rates, and exchange rates and that this uncertainty and unpredictability have taken their toll on businesspeople, financial investors, consumers, and families.

One question I would ask, maybe referring back to Paul Volcker's opening remarks: Are we asking central banks to do too much? Can they, in fact, exercise the degree of economic control that we think they can? And, even in the current setting in the United States (and I suspect this is going to be a model worldwide), what is the proper monetary response to budget deficits and different kinds of so-called deals or compromises? Is it a high-tax, high-spend response or a low-tax, low-spend response? Should the Fed ease or tighten, depending on the nature of the so-called fiscal and monetary mix? There is no consensus about this at the present time, and I do not see how we can give advice overseas if we ourselves are still unsure.

In the end is my final thought. I have always believed, both in government and out of government, that markets know more than even the brightest, best-informed, most technically-competent central bankers or government people. I am a strong believer that market mechanisms should play the guiding role in central banking policy and the ultimate goal of inflation control and price stability. Market price targets serve a very, very useful purpose. And I think with respect to the newly developed, newly democratized, newly opened, and newly modernized Eastern and Central European economies and their central banks, casting a sharp eye on the message of markets will do you much good and help you avoid many of the mistakes we have made down through the years. In the end, that is probably the only advice I can give you. And all I can say is: Welcome to the real world. You will have to puzzle it out and fight it out with the rest of us.