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# Challenges for Policymaking in a Changing Global Economy

Our discussion today about the effectiveness of stabilization policies has been lively and informative. Importantly, the task of judging how effective stabilization policies are likely to be is complicated by the fact that we live in a changing world. Let me focus on one of the underlying forces for change: increased globalization. Thinking about increased globalization, by the way, is a relatively novel situation for the U.S. to find itself in, but is not so novel for the hosts and many others at this conference.

In my opinion, globalization is a net positive for the world economy. Increased flows of goods, services and capital across national borders generally enhance efficiency and should help individual economies become more flexible and resilient. But there are some costs as well; one that pertains to monetary policy is that globalization makes it harder to see what's driving the economic events that we have to deal with. Let me give you two recent examples from the U.S. to illustrate what I mean.

Long-term interest rates in the U.S. have actually fallen, despite the fact that the FOMC has tightened policy eight times over the past year. Several possible explanations of this have focused on global developments, such as increased purchases of government securities by Asian central banks and a worldwide excess supply of savings. But it is difficult to gauge the magnitude of these effects, and, as far as I am concerned, low long-term rates are still a “conundrum,” to borrow a term that Chairman Greenspan has used recently.

The relatively low levels of inflation that prevailed over the past decade provide another example of how increasing globalization may be changing the dynamics of the economy. Some have suggested that the Phillips curve has shifted, perhaps owing to the effects of increased globalization. Following a somewhat different logic, Ken Rogoff[1] suggests a role for increased globalization in the nearly simultaneous decline in inflation across many countries.

I could add more examples from the U.S. (such as puzzles relating to the current account deficit), just as I am sure you could from your own countries. The general point I want to make is that developments like increasing globalization and financial liberalization have changed, and continue to alter macroeconomic linkages, perhaps in fundamental ways. As a result, there is more uncertainty in the economy, and that’s an environment in which it is even harder for policymakers to determine the appropriate responses to economic events.

What does this mean for monetary policy? We have heard Bob Rasche talk about the uncertainty faced by monetary policymakers and express doubts about the effectiveness of stabilization policy. He is not alone in expressing such doubts, of course, but is following a tradition that features Milton Friedman as one of its luminaries. Indeed, some economists take this position to an extreme, believing that uncertainty, both about the current and likely state of the economy and about the effects of monetary policy on the economy, is so overwhelming that policymakers should be humble and focus on

[1] "Monetary Policy and Uncertainty: Adapting to a Changing Economy" Jackson Hole, WY, August 29, 2003.

only one thing: inflation -- which is what the Fed can undeniably control in the long run. This approach is often referred to as "strict inflation targeting."

But I, for one, am not a strict inflation targeter. I do not subscribe to the dismal conclusion of this approach. And—as far as policymakers go—I do not think I'm in the minority. Certainly, the Federal Reserve Act is more optimistic: as you well know, the Federal Reserve is charged with assuring both maximum employment and price stability. I do not mean to deny that there is a debate—both in academic circles and outside them—about how these objectives should be ranked relative to each other and about the ability of monetary policy to achieve them. But I have a hard time believing, for example, that the FOMC's accommodative policy stance following the last recession has not helped support the subsequent recovery. I have discussed some of the issues in this debate in detail elsewhere[2]; for now, let me just say that I think we can and should pay attention to both objectives. Furthermore, I would argue that the Fed has successfully done so over the past two decades. Indeed, these objectives are interconnected in important ways, as I will describe momentarily.

I think the right approach to dealing with uncertainty is for policymakers to increase the clarity with which they convey to the public both monetary policy objectives and strategy. Monetary policy affects the economy not primarily through short rates, but instead through its effects on asset prices, including bond rates and equity prices. If financial markets have a good understanding of the central bank's objectives and strategy, they will react appropriately to policy moves. This allows markets and

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[2] "Stabilization Policy: A Reconsideration," (with George Akerlof), Presidential Address to the Western Economic Association, July 1, 2004, forthcoming in *Economic Inquiry*.
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policymakers to work together rather than at cross purposes—strengthening the transmission mechanism and shortening policy lags.

One important way to contribute to the public's understanding of policy is for a central bank to act in a systematic manner in its response to changing economic conditions. Over time, market participants will observe the central bank's reaction to news and will come to understand the determinants of policy. As a result, they will correctly anticipate policy responses to new information, in a way doing the work for the central bank.

This process can be accelerated through central bank communications that explain policymakers' views on the economy and provide insights into the key determinants of monetary policy, especially during periods when policy may need to deviate from its usual pattern. In this I agree with what Marvin Goodfriend said about the benefits of enhanced transparency and communication in monetary policy.

A look at the recent historical record shows that the FOMC has become more communicative of late. In 1994, it added descriptions of the state of the economy and the rationale for the policy action to the post-meeting press release. In January 2000, the FOMC introduced a statement describing the "balance of risks" to the outlook, and in March 2002, it began releasing the votes of individual Committee members and the preferred policy choices of any dissenters. In August 2003, the Committee added explicit forward-looking language concerning future policy into its statement. More recently, it decided to expedite the release of its minutes so that the minutes of each FOMC meeting are now issued three weeks after the meeting, providing the public with a more nuanced understanding of the various views within the Committee. I strongly believe that all of these measures to increase transparency have improved the effectiveness of policy.

A natural next step for the FOMC is to contemplate providing even clearer guidance to markets by announcing an explicit numerical long-run inflation objective. Unlike many other central banks around the world, the FOMC does not have an explicit numerical inflation objective or range, though we have discussed this issue at FOMC meetings a number of times in the past, most recently in February.

These discussions have highlighted the significant benefits and costs associated with such a move. It would be helpful for the FOMC because it would facilitate both internal discussions and external communication. More importantly, it could help anchor the public's expectations. One recent study has shown that an inflation target coupled with an increase in operational independence for the Bank of England has led to a reduction in the response of long term interest rates to shocks.[3] This evidence implies that inflation expectations are better anchored now. It also makes me somewhat more optimistic about the value of an explicit numerical inflation objective than I would be if I were only to look at the evidence marshaled by Bob Rasche about the similarities of inflation rates across countries that do and do not announce such objectives. Of course, this is an area of active research and I realize that the jury is still out.

One important advantage of well-anchored inflation expectations is that it can give the central bank the freedom to react to other developments (such as an oil price shock, a recession, or financial market turbulence) without raising concerns about its commitment

[3] "The Excess Sensitivity of Long-Term Interest Rates: Evidence and Implications for Macroeconomic Models" by Refet S. Gurkaynak, Brian Sack, and Eric Swanson , FEDS Working paper 2003-50.

to price stability. Indeed, well anchored inflation expectations are likely to give the Fed greater freedom to accomplish the other part of its mandate: maximizing employment.

Recent developments have highlighted another extremely important reason why well-anchored inflation expectations are important --- they may help us avoid deflation. We have long known that inflation can be too high, but the recent experience of Japan has reminded us that inflation can be too low as well. We know from history that such an outcome can be extremely damaging to the economy.[4] Perhaps the most unsettling aspect of the Japanese experience is the evidence on how difficult it can be to get out of a deflationary situation.

This is an important reason why the FOMC became so alarmed about the level and trajectory of U.S. inflation roughly two years ago. In statements issued over the May 2003 to October 2003 period, the FOMC referred to " …an unwelcome fall in inflation…" and worried about "...the risk of inflation becoming undesirably low …" Many people have interpreted these statements as signaling a lower bound for the amount of inflation the FOMC will accept. To the extent that this is true, articulating an explicit numerical long-run inflation objective might not appear to be a very big step.

Of course, there are potential costs to such a move as well. One is the possibility of miscommunication regarding our dual objectives. In particular, one concern, which I share, is that some may misinterpret the enunciation of a long run inflation objective as a down-weighting of the Committee's mandate to foster maximum employment. To reduce the risk of such an outcome, the announcement of any numerical inflation objective should be made in the context of clear and effective communication of the

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[4] Bernanke "Deflation: Making Sure 'It' Doesn't Happen Here." Speech before the National Economists Club, Washington, DC, November 21, 2002.

Fed's multiple goals. Here, I am drawn to some specific language proposed by Governor Bernanke: "the FOMC regards this inflation rate as a long-run objective only and sets no fixed time frame for reaching it. In particular, in deciding how quickly to move toward the long-run inflation objective, the FOMC will always take into account the implications for near-term economic and financial stability."[5]

Another concern is that the announcement of a numerical objective could lead to a change in the way policy is conducted, with excessive weight placed on the measurable goal—which is inflation—relative to the hard-to-measure ones such as full employment, thus leading to *de facto* strict inflation targeting. However, as I noted above, I believe the opposite, namely, that a credible inflation objective would actually allow the FOMC more room to focus on stabilizing output, because it would not have to worry about the adverse effect that its attempts to stabilize output might have on inflation expectations.

Overall, while I am mindful of the potential costs of announcing an inflation objective, I conclude that the benefits outweigh the costs. Such a step could enhance the effectiveness of monetary policy not only for controlling inflation but also for stabilizing the economy.

[5] Ben Bernanke, Remarks at the 28th Annual Policy Conference: Inflation Targeting: Prospects and Problems, Federal Reserve Bank of St. Louis, St. Louis, Missouri, October 17, 2003.