GENERAL DISCUSSION
Macroprudential Policies in Open Emerging Economies

Chair: Sarah Bloom Raskin

Ms. Raskin: Let's have the authors respond to Anil's comments and then we will go to the floor for questions.

Mr. Mishkin: The issues that Anil raised about the European situation illustrate a counter to the view that central banks should not deal with financial stability problems because it can compromise their independence. One of the things that has been very disappointing to me is that the European Central Bank has not been blowing the whistle on problems in the European banking sector. I think that is really the ultimate source of their problems, because it is very difficult for them to deal with sovereign debt haircuts, which are going to have to take place, if it then means losses that the banks are not capable of handling. Central banks actually have an obligation to get involved in this. And indeed, I think that the European Central Bank's independence is at enormous risk right now because, as a result of not dealing with the problems earlier, they're now being forced to bail out the entire euro system. The good outcome would be if they bail it out and the system survives. But even that outcome is still pretty terrible, because they will have severely compromised their independence. So I think the situation in Europe right now, which is extremely scary, illustrates the point Anil raised very clearly.

Mr. Shin: Thank you very much. I agree with most of the comments, and also believe that we need a better understanding of the causes of market failures and financial crises in order to improve financial regulation. I also would like to emphasize that the central bank has an advantage in doing macroprudential regulation. In the past, financial regulators focused on the soundness of individual institutions, but this singular focus ignored the buildup of systemic risk, which they could not deal with. The central bank with its aggregate perspective can deal better with systemic risk. In that sense, macroprudential regulation can be handled by the central bank.

Ms. Raskin: Thank you. Questions from the floor?

Mr. McKinnon: I like Mishkin's distinction between core and noncore liabilities, the cyclical nature of noncore liabilities, and thinking about putting restraints on these liabilities through various forms of taxation. One of the main noncore liabilities of banks is what they borrow in the interbank market from other banks. So, the question is, should there be restraints on this borrowing? In particular, at the present time in the United States trading in the interbank market has shrunk dramatically. I think that's one of the reasons we can't get credit expansion at the moment, because once interest rates go to zero, short-term interbank rates go to zero, and large banks with excess reserves don't want to lend them out to anybody. So there's a contraction in the interbank market. This hurts smaller banks, which might have good retail lending opportunities, but depend on the interbank market as a liquidity backup to whatever retail credit lines they extend. So, in a way, we've got a problem opposite to what Rick said happened in Korea before 2008; we've got tremendous shrinkage in interbank trading. I attribute it to the zero interest rate policy, which I think is a very bad policy.

Mr. Mishkin: I don't know if I'd attribute weak credit expansion to the zero interest rate policy, but you've illustrated one of my key points, that the U.S. is not in the upside of a leverage cycle right now. It's actually on the downside, in a deleveraging cycle, and that's very important in terms of arguing whether there's a problem with zero interest rates.

Mr. Shin: I agree that the shrinkage of interbank loans is the problem now. But the point we are making is that policymakers need to prevent increases of interbank loans before they become too excessive.

Mr. Hatzius: I have a question for Rick, although I could have asked the same question of Lars earlier. I wonder how compatible in practice flexible inflation targeting is with a dual mandate that puts a significant weight on unemployment. There is a fundamental asymmetry between inflation and unemployment. Deviations from the inflation target are plain for the public and everybody around the FOMC table to see. But deviations from full resource utilization are not plain for everybody to see, and there's a lot of debate and disagreement about it. So I wonder whether you can really have flexible inflation targeting that is approximated by the Fed's dual mandate. I have two questions. One, do you agree that fulfilling the dual mandate is a potential problem, especially in the current situation, where inflation is pretty close to most people's perception of the target but there appears to be a large amount of cyclical unemployment? Number two, do you have any thoughts on nominal GDP targeting—could that be a way for the Fed to put a large weight on real output and employment without having to commit themselves to a particular estimate of the natural rate or structural rate of unemployment? I'd be interested in Lars's view, as well.

Ms. Raskin: Lars, do you want to pipe in?

Mr. Svensson: On the last question, I don't think it's very difficult to see that unemployment in the U.S. is above any reasonable sustainable rate. There are other situations when it may be more difficult to assess resource utilization. The Riksbank's *Monetary Policy Report* has several measures of resource utilization, and you can see that there's considerable disagreement among the Board about the relative importance of different measures. Chairman Bernanke has obviously thought about these things, and he thinks that the Fed is actually doing flexible inflation targeting.

But on what Rick and Anil have said about the role of the policy rate in maintaining financial stability, I think one has to acknowledge that things are quite different across countries. In some countries, financial stability policy is a big mess. In other countries, it works reasonably well. Also, the political economy considerations which Rick brought up, can be quite different. When the Bank of Israel introduced a loan-to-value restriction, there was a big uproar and a lot of criticism. When we did the same in Sweden, nothing happened. Also, most financial systems are quite different. Canada and Sweden have financial systems dominated by an oligopoly of old-fashioned commercial banks. That may be good or bad, but it certainly brings a bit of stability and much less aggressive risk-taking. Whether you have a big, difficult-to-regulate federal banking sector or not matters a lot, and the availability of tools in the regulatory system is also quite different.

We now see big problems in Europe. I don't think anyone has accused the ECB of conducting too easy monetary policy and therefore causing the financial crisis in Europe. What has happened, of course, is that a number of countries—Greece, Ireland, Portugal, and Spain—have not had an independent monetary policy. They had the average euro-area policy, which happened to be too expansionary for them. So they got an overheated economy, with all the problems that follow. We don't know what would have happened if those countries had had a good, independent monetary policy that would have prevented inflation and overheating.

Finally, on the issue of the role of financial frictions in everyday monetary policy, if you have a crisis every 20 or 30 years, then things will probably be quite different in each crisis. But during normal times, I believe that the financial frictions and interest rate spreads are reasonably stable and constant. And that means that developing new models for monetary policy where there are lots of financial frictions is not very beneficial because in normal times these frictions are fairly stable and constant, and the usual models and forecasts of inflation and the real economy work reasonably well. I think one has to distinguish between normal policy in normal times and crisis prevention during those times, and crisis management when something really serious happens. These are different regimes, and we will need different policies in each situation.

Mr. Mishkin: I want to agree with Lars on a number of points, but with some nuances. First, I should say that I was hired by the Swedish Parliament to do a report on monetary policy, and I had to talk to a lot of Swedish politicians. There are differences across countries. They're a much better class of people than the people I had to deal with in Washington [laughter], so I think that differences in political economy considerations matter importantly.

Jan, I think the issue you raised is very central right now. What concerned me about some of the recent Federal Reserve policies, which involved credit policies, such as large-scale asset purchases, for example, is that they're not put in the context of an overall, long-run strategy for the Federal Reserve. So I think that the Fed needs to explain its policies in terms of interest rate paths and paths on asset holdings in the context of a long-run strategy. This emphasizes the issue of why you have a particular inflation goal—mandate-consistent inflation rate is the term used by the Federal Reserve—but you also have to worry about the second part of the dual mandate, what's happening with unemployment. You are right that there is a difference between inflation and unemployment goals. An inflation goal is something that, if central banks can actually achieve it, it turns out that simply picking a number gets you the right answer, as long as it's not a wild and crazy number. So as long as you choose a number between 1 and 3 percent, the welfare function is so flat that it's not going to make much difference in the steady state. Just having a number gets all the right dynamics for efficient policy.

An inflation target is different from an objective in terms of output or unemployment. This is very relevant for Charlie Evans's proposal to allow inflation to rise at times above the Fed's long-run target, because I think what he is trying to get at is this dual mandate. I think there are real problems with the way he has communicated it, because I don't think he's saying that we want to have a higher inflation target. The danger of this is that we'll be able to tolerate 3 percent inflation—and that's never the way we should talk about it. Instead, we should have a midpoint for an inflation objective, let's say 2 percent, which is a number I like. Then, if you use expansionary policy to deal with excessive slack in the economy and you happen to overshoot the inflation goal for a short period of time, that's okay. That's exactly the way the Norges Bank and the Riksbank talk about it, and this is where Lars and I are in strong agreement.

Another issue that I think is really critical: if the Fed is going to talk about unemployment, it needs to make it absolutely clear that an unemployment objective is very different from an inflation goal. Why? Because, number one, the Fed can't control it. Number two, we really don't know what the long-run sustainable rate of unemployment is, and in fact, we don't even know theoretically what it should be. For example, my view is that the long-run sustainable rate of unemployment, the natural rate of unemployment, is somewhere between 4½ and 7 percent, but probably somewhere in the middle. But that represents a huge amount of uncertainty. That doesn't mean that you shouldn't worry about unemployment. If you have 9 percent unemployment, as we do now, with no prospect of it lowering very fast, you actually should do something about it. I think that the subtlety is that it's really critical that the Federal Reserve communicate the difference between an inflation goal and an unemployment "goal"—but I don't want to call it that—as well as the information it uses in setting the interest rate path and in justifying any quantitative easing. I had a lot of problems with QE2, not because of the monetary policy aspects, but because it was done under pure discretion without a longer-term framework. I think this is consistent with some of the issues that Marvin was talking about earlier.

Mr. Kashyap: Can I make just two small points? I guess, Lars, that we should have a side bet: Reinhart and Rogoff give us 700 years of financial instability before we hit the Great Moderation. I think the Great Moderation is the outlier. I'm willing to gamble that for the next 40 years there'll be a lot more financial instability and nonconstant financial frictions than we had during the moderation, and I agree with you that the politics and the institutions differ greatly across countries. But one constant was that banks everywhere tried to get around the Basel Accord. Regulatory arbitrage is like a constant force of nature, and it's just a question of whether you can beat it down. I think the shadow banking system will be more endogenous than it was in the past, the farther we make the capital standard from what the market seems willing to finance. So I just hope that places that have been well-regulated in the past can keep out in front of this, because I think those guys are going to show up on your doorstep.

Ms. Raskin: Well, with that, we will take a break before the next session.