

## GENERAL DISCUSSION

# Monetary Policy after the Crisis

Chair: Sarah Bloom Raskin

**Ms. Raskin:** With that, I will open it up to comments and questions from the group. I think Lars may want to take a minute or two to give a quick response.

**Mr. Svensson:** Yes, thanks, Marvin, for thoughtful remarks which I will think thoroughly about. But let me object or take a different stance on one particular thing. I don't understand what you have against overshooting the inflation target in order to bring unemployment closer to a sustainable rate. The inflation targets would be symmetric: being 1 percent below should be as bad as being 1 percent above the inflation target. So, if we can have more expansion in our monetary policy and actually overshoot the target and in this way get unemployment closer to a sustainable level, it seems that this policy is desirable. However, no central bank seems to do this voluntarily—even though I would do it if I were the single decisionmaker at the Riksbank. The Bank of England seems to do it but is a little nervous about it, and I'm not sure it is completely voluntary. But no one else seems to understand this simple logic, except maybe Charlie Evans [President of the Federal Reserve Bank of Chicago], so I guess I'm with Charlie. So, why not treat the inflation objective as symmetric and why be so nervous about overshooting when it would be good on the unemployment side?

**Mr. Goodfriend:** My answer is going to surprise you, I think. It's a question about how you define overshooting. If the Fed or some other central bank chooses a range to target for inflation and stays within that range, there's room for overshooting and undershooting, as long as you're in the middle of the range most of the time. And I'm all in favor of a range. I don't support a point target if the central bank has not committed to an upper bound of that range. I'm nervous about accepting or excusing the variation of inflation around a point target without formal tolerance bounds. So, what I would like is for the Fed to establish a range. I would not mind if that range was 3 percent and 1 percent. I just want a range so that overshooting is well-defined. If you make the range 4 percent to 1 percent, overshooting is well-defined: it's over 4 percent. The confusion arises when the range has not been clarified and we can't really discuss what overshooting means. In the Fed's case, until that range is clarified I'm going to call inflation over 2 percent as above the Fed's tolerance range.

**Mr. Svensson:** I interpret the 2 percent or slightly below 2 percent as a point target, not the ceiling. All the statements I hear lead me to interpret that as a point target that one could overshoot or undershoot but, of course, one can make different interpretations.

**Mr. Goodfriend:** Before I left the Fed, I had thought that 2 percent was an upper bound, but that's the confusion.

**Ms. Raskin:** Okay, Rick, you want to go?

**Mr. Mishkin:** I'm a little puzzled, Marvin, by one of your statements. We had some disagreements many years ago about the issue of what you call "credit policy" versus monetary policy. A lender of last resort policy has a fiscal element to it because the central bank takes on credit risk. So, my question for you is, are you ruling out lender of last resort policy? There are issues that get into the complication of actually engaging in credit policy and, particularly, I have more concerns about quantitative easing in terms of buying private assets. But the real concern is if you do it in a pure discretionary fashion without explicitly talking about your objectives and agreeing how you're going to wind it down at some point in the future. I think the key reason we have less trouble with lender-of-last-resort policies is because they are usually self-liquidating. Monetary policy is too crude a tool to use for a particular market, it just works in general. The reason we are less uncomfortable with its use as a lender of last resort for particular markets is that when the markets recover, those arrangements naturally disappear and that's exactly what happened in this case. So, your pure distinction between monetary and credit policy, I think, is just much too stark.

**Mr. Goodfriend:** Can I respond quickly? In the long version of the paper that I referenced in the slides, I do distinguish this. I completely agree with you. There are conditions when it is OK to do credit policy. For example, temporary loans against good collateral to solvent depository institutions regulated by the central bank are appropriate because the fiscal implications including ex ante distortions and ex post costs are very limited.

**Mr. Prasad:** Since I was one of the people associated with the report that Lars mentioned, I feel obliged to interject myself in what was basically a lovefest between Marvin and Lars in terms of how monetary policy should be run. Actually I agree with them on a variety of issues including the fact that monetary policy and financial stability policy are distinct. But I think that distinction is becoming increasingly untenable. The other point on which I agree and I think frames this discussion is that central banks need independence in order to be

effective, and they need more instruments if they're going to have more mandates thrust upon them. But the reality we are facing is that it's going to be increasingly difficult to separate out monetary policy and financial stability policy. I take Marvin's point that trying to figure out when an asset bubble is taking place is hard, this crisis is teaching us that leverage matters. Once you start thinking about leverage as an important aspect of determining financial stability, monetary policy must also play a role. This distinction is going to be increasingly untenable. In fact, if we persist in maintaining this distinction, it's going to threaten central bank independence if we view central banks as the last line of defense. The second issue is international spillover of policies, and there again, I agree with Lars's approach at one level. I think flexible exchange rates, especially for China, would certainly be a good thing. But consider a thought experiment with two countries—say the U.S. and a small country like Thailand—who are doing exactly the right thing in terms of running a flexible inflation targeting regime with a flexible exchange rate. Thailand would get hammered when you have loose monetary policy in the United States that does not suit it. While Thailand would have capital flowing in, with relatively high inflation to begin with, raising interest rates brings in even more capital and basically slams you against a post. So, in the ideal world, even if you do have flexible exchange rates, one is going to have to be cognizant of these issues with emerging markets. Again, China is an exception here because they have problems with their own currency policy, but for other emerging markets protection from the spillovers of advanced economy policies warrants some sort of coordination.

**Ms. Raskin:** Why don't we get another question or two in.

**Ms. Forbes:** Lars, you mentioned that QE2 probably affected capital flows to emerging markets in different ways, and central banks should incorporate that in their decisionmaking. Have you looked at the magnitude of the effect? There seems to be widespread disagreement. Some people I've spoken to in the United States seem to think that QE2 did have a positive effect on capital flows to emerging markets, but the effect was quite small and overwhelmed by other things going on in the world and other macro variables. Some people in emerging markets, though, argue that the effect was substantial: QE2 was the major reason why capital flows surged to emerging markets, and they have no conventional policies to manage these inflows. I'm sure the truth is somewhere in between.

**Mr. Svensson:** I must admit that I'm not an expert on capital flows to the emerging markets, so I can't say anything about the magnitudes. However, I

know that the Swedish economy is being shocked by disturbances all the time from the rest of the world's interest rates and such. I noticed that the Swiss economy has been suffering from flight to quality and an appreciating currency. I don't quite understand why the situation in emerging markets, once they are reasonably advanced, would be so different from the case of Switzerland or Sweden. And we manage considerable depreciations or appreciations as best we can. I know too little to understand why things are so different in the emerging market countries, why they cannot handle disturbances and spillover in a similar way.

On the issue Eswar brought up, certainly leverage matters. But I think the policy rate is one of the worst tools to affect leverage, as well as maturity and liquidity mismatch. There are much more efficient methods like capital requirements, and we are learning about a number of new tools to utilize when conducting macroprudential policy and financial stability policy. So, I don't see any reason to use the policy rate.

On Marvin's comment about the independence of central banks, I don't think the answer is obvious. I think independence works very well for monetary policy because the target and the objectives are so simple compared to other economic policies. Thus we can hold central banks accountable so that they can be independent, but we can also hold them accountable because the targets are so simple. Financial stability policy is much more complicated, and the goal of financial stability itself is even complicated to define. If we have independent authorities conducting such policies, it's much more difficult to hold them accountable. I'm a little nervous about the democratic deficit if we allow independent agencies that we cannot hold accountable after the fact to handle very complicated financial stability policies. In many countries, macroprudential policies are coordinated or their responsibilities shared and different agencies cooperate. In Sweden, we cooperate and it works quite well, but I don't think we should cooperate between different agencies on monetary policy.

**Ms. Raskin:** I think we have time for one more. Ted?

**Mr. Truman:** Marvin and Lars agreed that there's a long list of causes of the crisis. There's a bit of an identification problem because everybody has their list, and we'll have 100,000 PhD dissertations written over the next 50 years on this question. But Lars did list one of the causes as macroeconomic conditions, and monetary policy presumably has something to do with macroeconomic conditions. You must put some weight on monetary policy as a contributor to macroeconomic conditions. That leads to the fundamental question, which you and Marvin might want to comment on. That is this question of independence of

central banks. Marvin understandably attaches a lot to that, therefore his reason for carefully circumscribing monetary policy is to protect the central bank's independence. But, as you said, that is relatively easy as long as you have a very simple objective that the general public can hold you accountable for.

**Mr. Goodfriend:** I'll go first and you can have the last word, Lars.

I appreciate the question because it's very important to the future of the independent central bank. I think the problems with financial stability, as Lars has alluded to, largely come from the fact that we impose too low capital requirements on our banks around the world. I think the social benefits to significantly higher capital requirements far exceed the social costs. One of the reasons we're having this problem defining central banks' boundaries on financial stability is because we allow banks to run with much lower capital than they should. The banks are happy to do so because they're implicitly getting underpriced backstops from the taxpayers. To fix this other issue, we need to have higher capital requirements. I'm very impressed by Switzerland having moved in that direction, and I think other countries should do so. That's where the problem is, not this issue of the boundary between central banks and the government.

**Mr. Svensson:** On the issue that Ted brought up, the macro condition I had in mind was low real interest rates due to global imbalances. You can say that monetary policy contributed to the Great Moderation because it was too successful, but I don't think that is the reason. The main reason was that risk was underestimated by market participants. Monetary policy cannot, in the long run, affect the real interest rate. What monetary policy can do is move the actual real rate below or above the neutral rate, which is state dependent and depends on a lot of things beyond monetary policy. Some people attribute changes in the real rate all to monetary policy. I think that is wrong. It is only the difference between the actual real rate and the neutral rate that should be affected by monetary policy. When you look at it that way, only a very small part of the low real rate is due to monetary policy.

On the issue of the independence of central banks, people are concerned that Congress or Parliament could intervene in the operations of the central bank, particularly if central banks experience losses on their balance sheets. I think those worries are somewhat exaggerated. Central banks are different from other banks in that they don't need positive capital to operate. The financial independence of central banks comes from having a large positive cash flow. When the cash flow is positive, the seigniorage and other income is larger than the operating costs. And, usually, the seigniorage is many, many times the operating costs of a central bank, so it has a huge positive cash flow. It would take a

very extreme situation for a central bank not to be able to continue operating in the usual way. It will be good to have some agreement that the government, Parliament, or Congress will recapitalize the central bank when needed.

**Ms. Raskin:** Thank you very much.