Whither monetary policy?
Monetary policy challenges in the decade ahead

Opening remarks

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This conference is occurring at a propitious time, as any reader of the daily newspapers is well aware. For over a year now, headlines in the *Financial Times* have almost daily recorded a new source of trouble or unease in both the global financial and economic systems. Yet, when we began to plan this conference over a year ago, the "Great Moderation" was still on. Thus our interest in the topic of "Whither monetary policy?" had far less dramatic origins than the need to respond to unexpected setbacks.

One motivation was almost philosophical. In particular, some of us at the Bank for International Settlements, and that certainly includes me, are firmly of the view that economists actually know far less about how the economy works than they would like others to believe. The implication of such a view is that it is particularly when things are going well that we should be asking ourselves "why", and assuring ourselves that it has been good judgment and not just good luck. That form of questioning is consistent with an old line of Mark Twain's:

> "It ain't the things you don't know what gets you, it's the things you know for sure that ain't so".

Or the similar thought expressed more recently by Donald Rumsfeld (and quite sensibly too):

> "There are known knowns…There are known unknowns… But there are also unknown unknowns. There are things we don't know we don't know".

The fact that conventional views about how the economy works have changed so much in the past also supports the view that our beliefs might yet change again. To refer to an old joke, "Even an economist, when he sees something happen, will admit it is possible". Consider that, at one time, people believed in a Phillips curve that allowed long-run trade-offs between inflation and unemployment. There was also a school of thought that inflation was cost-driven, as opposed to demand-determined. In the 1970s, the dominant view was that inflationary expectations were sticky and the short-run Phillips curve was flat, leading to the important conclusion that it would be too costly to try to reduce inflation through monetary restraint. The one thing all these beliefs had in common was that they were wrong. And we must also add another observation, that the world in recent decades has changed immensely and continues to do so – in the real, financial and monetary spheres. In the light of all this change, the argument that we need to rethink old beliefs about how best to conduct monetary policy becomes even stronger.

As Otmar Issing will shortly remind us, monetary regimes have changed repeatedly over the years. Current disagreements among major central banks on important policy issues are perhaps an early sign that further changes are yet to come. Perhaps the most important of these contentious issues has to do with the role of money and credit. At the Federal Reserve, the use of such indicators to guide the setting of the policy rate is minimal. Indeed, a few years ago the Fed even stopped publishing data for their broadest monetary aggregate. In contrast, you are all aware of the importance attributed to the monetary "second pillar" by the European Central Bank. Its origins lay in the long-held belief of the Bundesbank, dating back to the hyperinflation of the 1920s, that monetary indicators had a low-frequency association with future inflation. Whether that is still its principal source of usefulness is perhaps more open to debate. The Bank of Japan approaches monetary policy decisions using “two perspectives”, with the second perspective relying in part on longer-term trends in credit (rather than monetary) growth. While carefully nuanced, the second perspective seems to be a vow never to repeat the boom-bust cycle that so scarred Japan in the 1990s; in effect, the issue is deflation as much as inflation. As with the Federal Reserves’s experience of the Great Depression, the ECB and the Bank of Japan continue to be influenced by their different but defining historical events.

Nor is this the only area where there have been are significant differences of view as to how monetary policy should be conducted. The Federal Reserve has argued vigorously that credit bubbles affecting asset prices are difficult to moderate using monetary tightening, and that the remedy might be more costly than the disease. Rather, monetary easing can be effective in cleaning up the damage afterwards and restoring economic growth. Others in the central banking community have expressed different views, suggesting not only that monetary policy might have a role to play in the upside, but also that monetary easing in the bust phase of a credit cycle might not prove very effective, or that its effectiveness might come at the cost of further economic and financial imbalances. And to add to the list of issues where different views are held, which measure of inflation should be the focus of the central bank’s attention, headline or core? And what is the best policy instrument for a central bank to target, the overnight rate or three-month Libor, as practiced by the Swiss National Bank? Evidently, there was plenty to discuss even before the summer of 2007.

But the shocking developments since the letters of invitation were sent out have given the debate about monetary policy a new urgency. Far from being completely tamed, inflation is now back with vigour at the global level. Virtually every country in both the advanced market and emerging market economies now has a level of inflation that significantly exceeds explicit or implicit targets, and there is growing concern that inflation expectations and wages could also spiral upwards. At the same time, housing markets in a number of countries are spiralling downwards, with growing concerns that this will have a significant effect on consumption and GDP growth for perhaps many years in the future. Finally, beginning in the US market for subprime mortgages, but spreading out in waves to touch virtually all markets and all types of financial institutions, the global financial system is in disarray. In a number of important countries, efforts to raise capital are faltering and credit conditions are tightening to the detriment of borrowers and spending. Where this will all end is effectively impossible to predict.

How could circumstances have changed from so good to so bad so fast? Answering this question points us in the direction of new paradigms, in effect resolving the differences of view just referred to, and new policy frameworks to avoid repeating the same errors in the future.

Most fundamentally, it could be that central banks have put too much emphasis on achieving near term price stability. Or to put it another way, they have allowed the achievement of price stability over a long period to blind them to two possibilities. First, that a long period of extremely rapid monetary and credit expansion might, in the end, still have inflationary consequences. One need not be a “monetarist” to agree that “inflation is always and everywhere a monetary phenomenon”. And second, that the same monetary cause was leading to the buildup of other significant problems in both the real economy and the financial system.

Some commentators have been suggesting for some time that inflation globally might have been temporarily suppressed through the influence of rising supply potential due to a whole host of factors, not least globalisation. The associated danger noted was that demand growth, encouraged by very easy monetary policies, would eventually prove excessive as “slack” was progressively used up. At the same time, there has been growing concern about rising “imbalances”, which we at the BIS define as marked and sustained deviations from historical norms. In the economic sphere, I would mention very low household saving rates in many countries, with associated high internal and external debt levels. In the financial sphere, unusually high asset prices (houses, equities, high-risk bonds, etc) were also thought worrisome, as was the clear deterioration in credit standards over many years for both corporations (cov-lite) and households (subprime). The associated danger noted was that these imbalances might mean revert, causing a significant decline in economic growth potentially accentuated by financial instability. In the event, all of these dangers now seem to be materialising simultaneously. This is not a good place to be.

Against the backdrop of economic history and the history of economic thought, two controversial ideas are suggested by these latest developments. The first is that monetary and financial stability are not separate objectives, but intimately related. The second is that the horizon over which one pursues price stability can have a big effect on the outcome. Even with actual and near term inflation projections under control, the unwinding of imbalances of the sort just noted could culminate in outright deflation over a longer term horizon. Policy should be conducted so as to recognize this rather different threat to price stability.

There is no doubt that developments in the financial sector can lead directly to problems in the financial sector. In this regard, some might think not only of outright fraud but also of new developments such as subprime mortgages, structured products, SIVs, etc, with a clear capacity to cause financial difficulties. But even here, we must recognise links to the credit cycle and the monetary conditions underlying it. Both Irving Fisher and Hyman Minsky referred to fraud and Ponzi finance as late cycle phenomena. And it could be plausibly argued that it was monetary conditions which created the underlying demand for houses and these new mortgage-related instruments in the first place. More specifically, with the stance of monetary policy very accommodating and interest rates low, the search for yield led many in the financial sector to engage in the kind of reckless behaviour than now threatens financial stability. And to look at this in a more dynamic way, Raghu Rajan has suggested that these same circumstances also gave strong encouragement to the development of new instruments (like structured products) whose express purpose was to push the risks so far out into the tails that investors might think they could be effectively ignored. We now see that this misperception has also contributed to the current lack of financial stability.

As to whether low inflation guarantees continuing good economic performance, economic historians would remind us of the global depressions that began in 1874 and 1929. They would remind us too of the severe troubles faced by the Nordics and the Japanese in the early 1990s and by other countries in Asia after 1997. In none of these cases was the turmoil preceded by any significant degree of inflation. However, in each case the rate of credit expansion (again, often associated with the development of new financial instruments or financial deregulation) had been very rapid. As for the history of economic thought, many prewar business cycle theorists noted that, in economies benefiting from increases in productivity, prices should naturally be falling. They feared that monetary efforts to prevent this from happening would lead to “excessive” credit creation (that is, more credit than could be financed by voluntary saving at full employment), which would in turn lead to the dangerous imbalances just referred to.

At the least, given current circumstances, these issues deserve to be thought about. Indeed some of us would go further and suggest that we need a “macrofinancial stability framework” for conducting both monetary and regulatory policies, one that would use both instruments to lean in a systematic way against credit excesses in the upswing of the cycle. On the regulatory side, the recently released US Treasury blueprint for regulatory reform seems to go in this direction. On the monetary side, a number of central banks also seem to see some merits in these suggestions. It is of course a fact that such a framework would suggest that, from time to time, it might be necessary to raise interest rates even when near term inflation seemed well under control. But if the price of not doing so was a subsequent “bust” that actually threatened deflation, that would probably be thought a deviation from price stability that was even more dangerous.

The papers prepared for this conference touch upon many of the contentious issues I have just referred to, but also many others pertinent to the effective conduct of monetary policy looking forward.

The issue of how inflation expectations are formed remains debatable, at least in the minds of policymakers. Can we simply assume that an explicit, forward-looking framework for maintaining price stability will condition expectations, even if actual inflation were to rise significantly and for an extended period? Or rather, has the remarkable stability of inflation expectations to date simply been a product of the fact that inflation has been low? We may get an answer to this sooner than we would like. And, in this latter case, are expectations more likely to be driven by measured inflation (biased downward by hedonic pricing and other factors), or perceived inflation (biased upwards by things purchased daily, like food and petrol)?

Change in the transmission mechanism of monetary policy is another topic that will be discussed. A principal concern must be whether lower policy rates in industrial countries, particularly the English-speaking countries, will stimulate demand, as has traditionally been the case. One complication is that higher debt service levels, or lower asset prices, might get in the way. Another complication, assuming that long-term rates are increasingly set in international markets, is that long rates might fail to decline with short rates. Indeed, lower policy rates (particularly in the United States) might even cause risk premia to rise, pushing the dollar down and long rates up. These are important complications evoking the notion of "pushing on a string". And to all of these complications must be added the possibility of significantly tighter credit conditions arising from weakened banking systems.

The external dimension of the search for domestic price stability also deserves attention. In small open economies with floating exchange rates, monetary tightening can lead to very substantial exchange rate increases and capital inflows. Not only can these cause problems on the way up, but they can reverse sharply and disruptively as well. In larger economies with exchange rates more or less fixed against the dollar, the danger is that monetary conditions suitable for the US are transmitted to countries for which they are quite unsuitable. A further by product, as appreciating countries lean against this trend through intervention and monetary easing, could be a global trend to excess liquidity. And this in turn raises the question of whether there is any role for the international coordination of monetary policies and, if so, how this might be done. At the very least, it might be suggested that domestic polices err when they are based on the belief that increases in food and energy prices can be ignored in the first instance because they are "external" shocks. For the world as a whole, they are clearly internal, and being largely demand driven they likely warrant a more immediate response from monetary policy.

These issues and a number of others will certainly keep us occupied and, I hope, interested over the next two days. Before closing, may I thank all of the participants for your willingness to join us at this Seventh BIS Annual Conference, with a particular thanks to the authors of papers and their discussants. The high professional standing of the people attending attests to how successful this Annual Conference has become. Clearly, both academics and central bankers do realise that they have something to learn from each other.

In that regard, I want to thank Janet Plancherel for overseeing the logistics, this year as well as in many previous years, and Bill Nelson, Kostas Tsatsaronis, Andy Filardo and Christian Upper for their help as well. But above all, my thanks, and I hope the thanks of all of us, to Claudio Borio, whose intellectual leadership and organisational skills have been crucial to this endeavour right from the start. Thanks to him. Thanks to you all. Now let the debates begin.