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Comments on John Taylor

John Taylor has written an interesting and illuminating paper on international monetary cooperation. He argues persuasively that rules-based monetary policies are highly likely to deliver near optimal cooperation. This happy state of affairs prevailed during the Great Moderation, a period that lasted until the start of recent crises in 2007.

Recently policies have deviated from what the paper smartly calls this NICE situation, many countries may have moved to sub-optimal inflation and unemployment volatility tradeoffs.

As John has pointed out in other papers, deviations from rules-based policies may have contributed to the bubble phase that predated the crisis period that started in 2007, even though inflation has been well behaved, at least until now.

An implicit conclusion he reaches is that perhaps central banks should have kept inflation below their formal or informal targets while credit bubbles were building up. Additionally, it may have been appropriate to introduce prudential measures. This seems to be where the consensus in central banking is going these days.

Here I would like to insert a note of caution: care must be taken not to forget old lessons and ask too much of central banks. It now seems they are being assigned many or all of the following tasks: keeping inflation low, unemployment low and stable, exchange rates not too overvalued and financial markets stable. Unconventional monetary approaches (such as massive asset purchases and foreign reserve accumulation) are now common practice all over the world, and central banks are acting as lender of last resort to their governments, something considered a mortal sin until recently. These may just be pragmatic responses to extreme circumstances by central banks, driven largely because central banks command the only policy tools available at short notice. But it may also have to with central banks overpromising and as a result allowing governments to avoid making the tough long-term more structural adjustments that are often needed.

Countries outside the "bubble core" benefited from high rates of global growth and gains in the terms of trade, but at some point also saw their exchange rates appreciate substantially, a situation dubbed a currency war by minister Mantega from Brazil.

The old literature on policy coordination suggested that currency wars would lead to high inflation, but that has not been the case until now. The explanation is likely to be the massive deleveraging that has been taking place since 2008, very much as Reinhart and Rogoff anticipated in their extraordinary recent book This Time is Different.

John's research suggests that ways must be found to endogenize credit and asset bubbles, no doubt a very demanding agenda. It would also be interesting to study in more depth what would be the best policy responses for countries that never experienced booms and busts, but are exposed to global credit and liquidity cycles. Macro prudential policies should in all likelihood play the key role, but much work remains to be done so the proper timing and magnitude of pre-emptive strikes can be fine-tuned.

One last point on policy coordination: after the acute phase of the recent crisis started in 2008, government officials in most countries were often seen patting themselves in the back regarding their coordinated policy responses. But in reality, expansionary policies were put in place all over the world mostly for domestic reasons, not really as a the result of coordination. Sure the fact that central bankers meet all the time may have helped in the collective understanding of how bad the situation was, so perhaps there was some informal coordination regarding the timing of the responses, but no more than that. For the most part, however, I do not think that at present time much can be achieved in the way of coordination because most countries are not willing to give up on their ability to run their own macroeconomic policies. This may not be so bad in the end; a Hayekian world of competition amongst currencies, if not too unstable, may not be all that bad. Time will tell.

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