Edward M Gramlich: One-country and multi-country monetary policy issues

Remarks by Mr Edward M Gramlich, Member of the Board of Governors of the US Federal Reserve System, at the International Research Forum on Monetary Policy, European Central Bank, Frankfurt, 5 July 2002.

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Introductory remarks

I am pleased to follow President Duisenberg in introducing the first conference organized by the International Research Forum on Monetary Policy, sponsored jointly by the European Central Bank (ECB), the Federal Reserve System (Fed), the Center for German and European Studies at Georgetown University, and the Center for Financial Studies at the Goethe University in Frankfurt.

For this first conference, the paper-givers are from the United States and seven European Union (EU) countries, and attendees include members from all G-7 and EU countries, most of the G-20 countries, and a few others as well. This is a truly international undertaking and I congratulate all participants. I also join President Duisenberg in specially congratulating the organizers--Ignazio Angeloni, Matt Canzoneri, Dale Henderson and Axel Weber.

Both the Forum and this conference will focus on research. We central bankers have plenty of opportunity to talk policy in our various groups. For research, there are lots of research conferences out there, but there are very few held between our staffs to discuss papers, talk about new policy research, and develop research strategies. There are also few opportunities to discuss the implications of research in a way that does not lead to the question, "Oh, yes, but does that mean they will raise rates at the next meeting?" Because of these conferences, policymakers will not raise or lower rates. But we will listen to your results and hope to learn from them. More significantly, we hope that you will learn from your own papers and those of others.

There are areas of economics where there is alleged to be a wide gap between economic research and real world policy decisions. Whatever the case elsewhere in economics, this is not true of monetary policy, monetary economics, or even macroeconomics. Here there is a relatively short distance--many of the questions that you will be dealing with in the next two days are those that my colleagues in the ECB, the banks of Australia, Canada, England, Japan, and on down the list, and the Fed deal with. Policymakers probably do not deal with these questions in the same way as researchers--I have seen very few propositions proved in my five years of going to Federal Open Market Committee (FOMC) meetings. But we deal with them in our own ways and they are the same questions.

Let me take this opportunity to mention some examples of policy questions that could be illuminated with further research. These are all questions that come up in monetary policy discussions or in policymaker meetings, with many of them coming up in your papers for this conference as well. I probably do not need to indicate that the research questions that you have not touched this time around might be very good candidates for future papers and conferences, in my view.

One-country issues

In this open-economy world, monetary questions can be grouped naturally into those affecting the operation of one central bank, a bank that recognizes that the economy is open, and those involving interactions between many economies and central banks. I will start with the one-country issues.

1. Dynamics of the inflation process.

In the long run, of course, a central bank's most important job is to bring about stable prices, avoiding inflation and deflation. For a good half-century, economists have studied the dynamics of the inflation process, with that work still going on and spawning at least one of the papers this week. This has always been very critical work for central banks, and will continue to be so. Among the issues raised today is whether the inflation process differs from country to country--and I suppose with different market institutions, there is no reason why it would not. I would also like to propose that somebody take a look at whether the inflation process is the same as the deflation process in various countries, or whether some different behaviour takes hold when prices start going down.

2. The impact of the exchange rate on demand in the short run.

Most modern-day open economy macroeconomists have been schooled in the Mundell-Fleming model. In this model, expansionary monetary policy lowers interest rates and the value of a country's currency, and expansionary fiscal policy (budget deficits) raises interest rates and the value of a country's currency. If exchange rates were totally determined by bond markets, these outcomes might make sense. But, with exchange rates being determined by bond and stock markets together, the Mundell-Fleming conclusions are open to challenge, I think. In recent years, Fed monetary policy easings have often been followed by rises, not declines, in the value the dollar--because the profit outlook is improved, according to analysts. And we all know that deficit-induced rises in interest rates may lower, not raise, the value of the domestic currency. Our short run understanding of the economy is heavily impacted by all of this, and I think this whole set of questions needs some new thinking and research.

3. Optimal policy design.

There has been much discussion in recent years about how to conduct monetary policy--simple inflation targeting; forward-looking, flexible inflation targeting; a dual pillar approach; the Taylor Rule; seat of the pants. This discussion should go on and will go on--my money says that the various approaches will converge over time. But while that is happening, there is one unresolved traditional question--should the monetary authority target exchange rates? There are also some new questions--should the monetary authority target stock values, should there be special provisions for the zero-bound problem? These and other new questions will make this a fertile topic for years.

4. Currency regimes.

We still have not solved the currency regime problem. Given the undoubted importance of capital flows, should countries float their currency, float with occasional intervention, float with continual intervention, follow a crawling peg regime, or peg their currency to some other currency? A key question here is the pass-through issue discussed in one of the conference papers. There is some recent empirical evidence that pass-through effects seem to be smaller than believed, but how small is small? Many economists are lately taking the bipolar view--either a pure float or a pure peg, but regimes in the middle break down. And some take an even harder position that in the long run, pegging regimes often break down too, as one recently did.

Multi-country issues

There is no need to tell a European that the issues are just as rich when we get to the interactions. The ECB has successfully brought about what is probably the largest currency union in the history of the world. Those of you from Europe see, and fight about, any unresolved issues daily. But there are some questions that strike this overseas observer as eminently interesting, and eminently researchable.

1. Benefits and costs of a currency union.

The 12 ECB countries that have formed a currency union have seemed to be relatively forward-looking, anticipating new problems and not looking back at old ones. At the same time, other countries are considering currency unions, and it might make sense at some point for the EU to look back. Have the benefits of your currency union been all you imagined--more, less, or different? Have the costs been more, less, or different? What advice would you have for countries in South America, Asia, or Africa that might be considering currency unions? This was a huge undertaking and we ought to study it carefully while the lessons are still fresh.

2. The role of fiscal policy in a currency union.

I read in the newspapers every day that your Stability and Growth Pact is up for discussion, or at least that some people wish it were up for discussion. Most of these people seem to be politicians who, euphemistically, may have goals in mind other than minimizing output fluctuations and maximizing output growth in the long run. But there is still a serious question about fiscal policy in a currency union. Does the union want to force all countries to bring their deficits and/or debt ratios down? Or, given that demand shocks will vary across the union, is there a role for decentralized fiscal policy? Can the two objectives be combined, say by writing deficit limits in a certain way, having transition rules, or encouraging countries to run fiscal rainy day funds that would promote long-run fiscal responsibility and short term flexibility? There are many possibilities, and many nuances.

3. Financial integration in a currency union.

This is close to the topic of the next session, the one I will be chairing. We can say more about the issue at that time, but financial market integration is an inevitable feature of the modern open economy. It can take many forms, all of which have implications for exchange rate policy, for currency stabilization, for currency unions, and for policy coordination. These issues all lie on what might be considered a new frontier for monetary economists--beyond the simple macroeconomics we learned in graduate school, and on to broader issues. I am glad to see that these broader issues are within the domain of the research conference.

4. Policy coordination.

This is another topic that has been the focus of research and debate since the end of World War II. Coordination clearly broke down in the inter-war period, and analysts continue to have ideas for improving it. At the same time, global institutions have changed dramatically since the end of World War II, and there may be less need for coordination today. I would first reiterate President Duisenberg's distinction between cooperation and coordination. Beyond that, the widespread introduction of floating exchange rates at least in principle provides a shock absorber that makes policy coordination less important than in a fixed-rate world. Provided that currency swings are modest and do not introduce their own instabilities, we should get specific about the exact gains from coordination in the modern world. Getting specific involves you researchers.

These are some of the questions that might come up in a conference such as this, today and in the future. There might well be more questions, but this is already a very rich agenda.

But you researchers should not limit yourselves to the questions that we policymakers might ask. We will be confronting policy questions and asking for your help. You should also be confronting questions and dealing with them. In the end, we should hope that a common and open research forum like this one will become a significant development in the evolution of monetary policy, on all continents. Here's hoping for a successful enterprise, and here's a challenge for you to make it a successful enterprise.