

KEY THEMES FOR *IT* CENTRAL BANKS

Comments on Leonardo Leiderman

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CONDITIONS HAVE BEEN UNUSUALLY PROPITIOUS FOR LOW AND STABLE INFLATION

- Globalisation has helped to keep prices in check
- Fiscal consolidation has progressed in most emerging market and industrial countries
- Forex reserves have been built up to unprecedented levels in the large Asian and oil-exporting economies
- Central banks have strengthened credibility through greater independence and better policy design, in particular the adoption of *IT*

HOW IMPORTANT IS *IT* – AND COULD THE FRAMEWORK BE REFINED/MODIFIED?

- Most of monetary history is marked by discretionary policies to deal with shorter-term concerns
- The case for discretion was undermined by long and variable lags in the transmission mechanism, Friedman (1958)
- The constant money supply growth rule of Friedman was an overreaction, though also a useful encouragement of humility

”Target-constrained” policies came gradually into central bank favour from 1975, see OECD (1979), and the constraining target since moved from monetary aggregates to inflation

In some cases exchange rate objectives were preferred, leading in Europe to the merger of 13 national currencies into the euro and in some EMs to pegging, currency boards, or ”dollarization”

A fixed exchange rate provides indirect *IT* through the objective of performance of the anchor currency and has considerable virtues of simplicity

IT AND CENTRAL BANK INDEPENDENCE

IT is particularly apt at producing "constrained discretion" (Bernanke and Mishkin, 1997) – the best of both worlds, i.e. longer-term anchoring of inflation **with** some short-term flexibility

IT is also a particularly good mechanism for facilitating central bank **instrument** independence – most govt.s set the inflation objective themselves, but then rather conservatively and without changing it e.g. Sweden and UK

IT is also a framework conducive to transparency and accountability, the two major "plus" words in the perception of monetary policy

IS THE *IT* FRAMEWORK AS CURRENTLY PRACTISED ADEQUATE OR CAN/SHOULD IT BE REFINED?

DOUBTS ABOUT ITS ADEQUACY ARISE FROM

- Asset prices
- Exchange rates
- Financial imbalances
- Excessive belief in one model
- The continuing reluctance of the FED, the ECB and the BOJ move to explicit *IT*

Asset prices have been a concern mainly in industrial countries, so focus on the other four challenges

ON THE EXCHANGE RATE

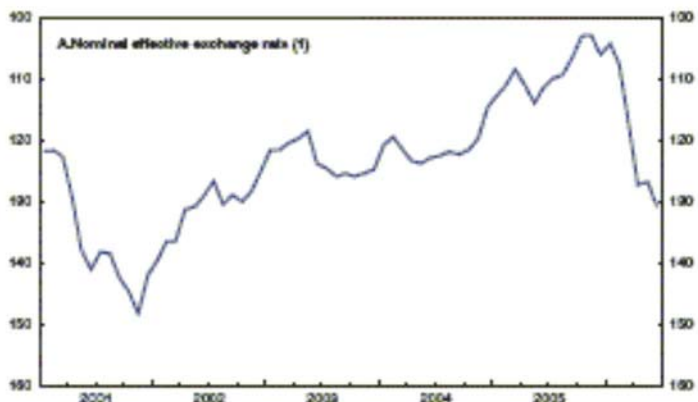
Should the central bank react to movements in the exchange rate beyond their contribution to inflation over the forecast horizon?

Dangerous to borrow low(er) inflation through a strong(er) exchange rate relative to long-run fundamentals – pay-back will threaten monetary control and its timing is highly uncertain also because it is linked to the fate of currencies funding carry trades

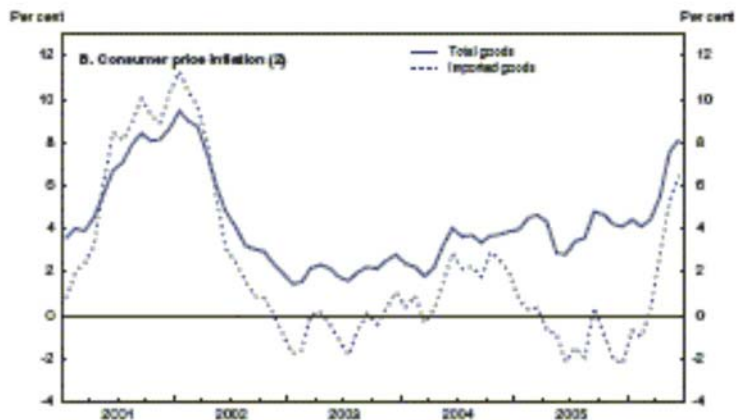
Recent examples (2006/07) from OECD countries
Iceland – Turkey – New Zealand – Slovak Republic
the first three were hit by fading risk appetite in spring of 2006, the fourth has been appreciating fast in run-up to euro

Iceland

The exchange rate and inflation

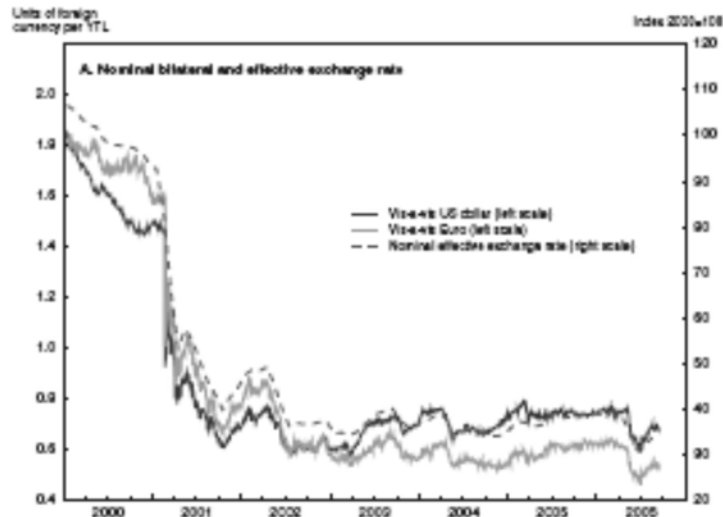


Inflation kept from rising sharply by long period of appreciation (inflation target 2½%)

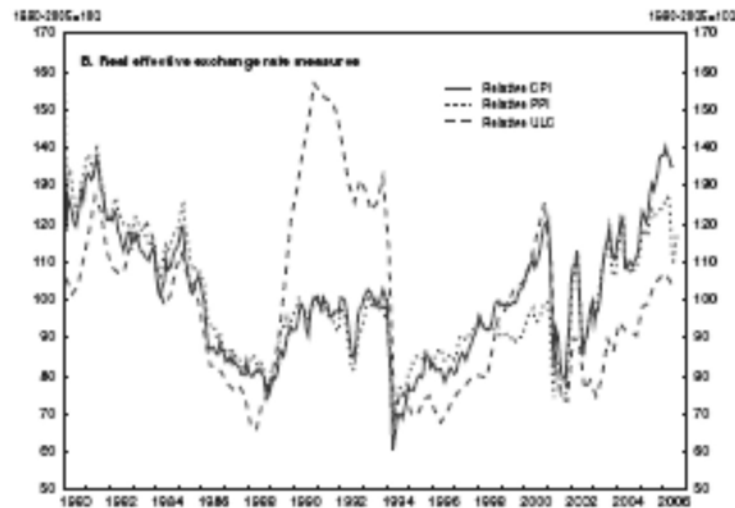


Turkey (1)

Developments in the nominal exchange rate



After massive depreciation in early 2001 a period of relative stability and real appreciation – interrupted in spring 2006



1. All indices of the real effective exchange rate have been rebased to average 100 over the full time period.

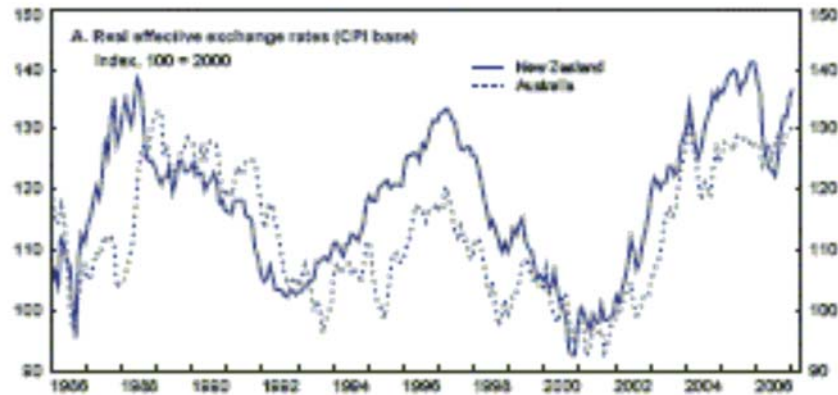
Turkey (2)

The Central Bank now faces a credibility challenge with CPI inflation around 10%



Source: Central Bank of Turkey.

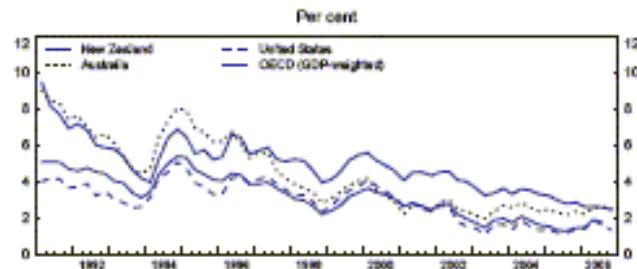
New Zealand (1) Exchange-rates cycles



Major exchange rate cycles

New Zealand (2)

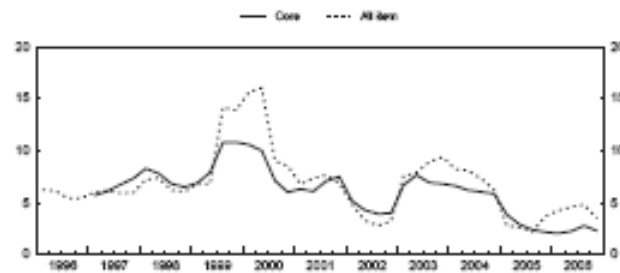
Real long-term interest rates



5. The real long-term rate is the 10-year government bond rate minus CPI inflation smoothed by a Hodrick-Prescott filter. Countries included in the OECD average rate are Australia, Belgium, Canada, Denmark, Finland, France, Germany, Italy, Japan, Netherlands, New Zealand, Norway, Spain, Switzerland, United Kingdom and United States.
Source: OECD Calculations, Economic Outlook 80 database.

Have a cost in terms of a persistent risk premium

Slovak Republic HICP inflation Year-on-Year percentage change

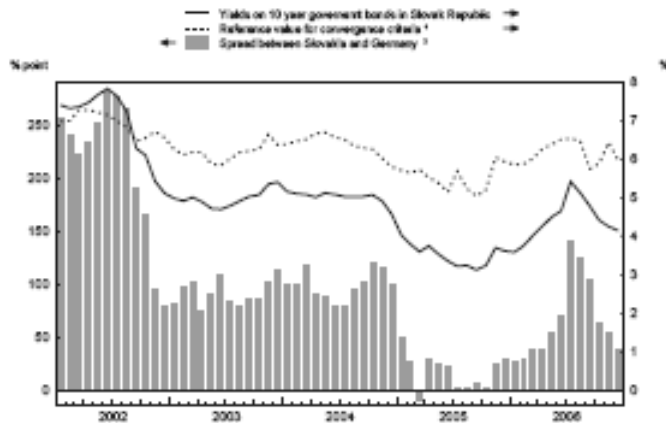


Source: OECD Main Economic Indicators database.

Inflation and interest rates converge to Euro area
with continuing appreciation

Slovak Republic

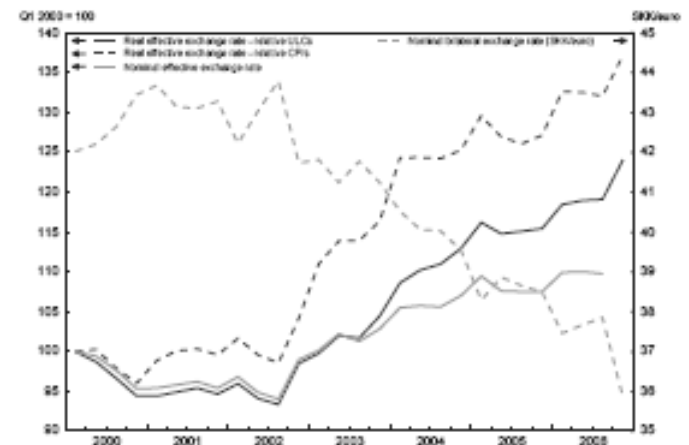
Convergence of long-term interest rates



1. Average of long-term interest rates of the three lowest inflationary countries plus 2 percentage points of interest.
2. Difference in percentage points between Slovak and German yields on 10 year government bonds.

Source: Eurostat and OECD calculations.

Nominal and real exchange rate trends



Source: OECD, Analytical database.

ON FINANCIAL IMBALANCES

Public sector imbalances (may) have become less of a concern, as have external imbalances, but concern over attitudes to the accumulation of gross debt has become serious in several industrial countries

Not reassuring to point out that gross debt is matched by the accumulation of assets (equities and real estate), since asset prices are volatile

The concern is not with inflationary consequences over the forecast horizon, but rather with the pressure on the Central Bank to sustain asset prices and with the ensuring capture of the policy agenda – danger of becoming “a serial bubble blower” (Roach)

ON EXCESSIVE BELIEF IN ONE MODEL

The early credibility literature saw the anchoring of inflation as achievable by firm monetary policy

Commitment to a (simple and not overly ambitious) policy rule was seen as sufficient to combine a chosen inflation rate with output close to capacity

Despite all the refinements in moving from the Barro-Gordon(1983) framework to flexible IT within a New Keynesian model, the latter strategy remains an effort to persuade the public – and financial markets in particular – that the model used for monetary policy decisions is the “true” representation of the economy

Great confidence in “rational expectations” is unwarranted, Frydman and Goldberg (2007), – and especially in emerging markets where uncertainties in macroeconomic relationships are more pervasive

TO QUOTE WOODFORD (2006):

“...there is no reason to regard the procedures currently used by any of the inflation-targeting central banks as the final word on the matter. It makes sense to seek to refine those methods, and to try to find ways to reduce the chances of especially bad outcomes owing to errors in one’s model of the monetary transmission mechanism.”

Can the attitude of the three major central banks in stopping short of embracing *IT* provide guidance?

All three stress that an inflation objective must not be interpreted as a policy reaction function

Some Fed officials, notably the Deputy Chairman, say that explicit IT over a defined horizon may excessively constrains desirable discretion

The ECB has retained monetary analysis as a cross-check on its "economic" analysis of future inflation, allowing the former occasionally to "carry the day" as in late 2005, and it refuses to tie its policy to a single variable (the inflation forecast), Padoa-Schioppa (2004) despite encouragement from many sides – academics and practitioners

The Bank of Japan has felt, during the long period of slightly negative CPI inflation that *IT* was premature – would lack credibility – but some Board members are now advocating explicit *IT*

All three are stepping up communication to convey their strategy more clearly – also because they are under constant pressure to improve transparency

But transparency can be overdone and the most credible central banks fear it could be used to put them in a straitjacket, not just a target-constrained framework

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