

General Discussion:
How Should Central Banks Reduce Inflation?
—Conceptual Issues

Chairman: Gordon Thiessen

Mr. Thiessen: Thank you, Bennett. As a result of the use of discretion on the part of your chairman, we are running a little late here. So, let's start the discussion right away. Questions? Yes, David Hale.

Mr. Hale: Mervyn, you gave a good paper on the transition toward lower inflation among existing central banks. Could you speculate for a minute how you would apply your paper to the new European Central Bank, which begins operations in two years? If we assume monetary union occurs, what can that new central bank learn from the experiences you outlined in your essay?

Mr. Thiessen: Mervyn, why don't you go ahead?

Mr. King: I'd like to respond to Ben (McCallum) too, after I respond to David (Hale). Well, of course, the European Central Bank—if and when it starts—will inherit its position with inflation rates in the member countries close to something that one would call price stability. So I think the fundamental question I was given to answer in this examination paper, which deals with the transition from moderate or high inflation to price stability, is not one that would immediately apply. Now I think the general lesson of the question of learning is one that is very important for the European

Central Bank. There will not be a track record or behavior of that new governing body, or even of the new head of that central bank, to follow. And that will make things rather tricky. And I think the important questions will be how the markets will form expectations about what the European Central Bank will do, and what sort of pressures it will come under, because there is no doubt that one of the criticisms that has been made of the design of the European Central Bank is its lack of accountability. There will, therefore, undoubtedly be a much greater public debate about the role of that central bank and the way in which it reaches decisions than is the case presently, I think, with central banks in the individual member countries, which have reached a stable situation. It will be something new and the question of learning will be very much in the cards. Now I think Ben made a point that unfortunately as economists we understand very little about how learning takes place and about the transition between regimes. One should not criticize economies for that because there are always issues that have to be researched and explored. But it is certainly an unknown factor that concerns many people looking forward to the European Central Bank, which is why I think, if I may roughly paraphrase some views put forward by Otmar Issing: There is a good deal to be said unto the European Central Bank, if and when it starts, for combining both the monetary targets, which have been used successfully by the Bundesbank, with an inflation target, which clearly states the objectives of policy to everyone in Europe, and which will have the other attractions alluded to this morning by Stan Fischer and others. So that may be a useful way forward.

Mr. Thiessen: Okay, there is a question over here.

Mr. Ford: Mr. Dornbusch, you made a very interesting argument that, perhaps in certain situations, entire economies should just switch to the dollar and get on with stabilization through that route. I am curious. Would you cite some examples of where this has been tried in the real world? Also, suppose that some country did try this and got stabilization—how would they then make the transition, if ever, back to their own currency?

Mr. Dornbusch: I must disappoint you, because very few countries have taken the full medicine. Panama has gone very far in that direction. And it served them well except when they quarreled with the United States and suddenly were short of supplies. But, think of Hungary. Hungary is about to embark on a Latin American experiment—exchange rate-based stabilization. In the central bank, there are three groups—one supports fixing the rate to get inflation down. The second group is reading Chilean books to tell the others—that you actually can do well by going down slowly over ten years. The third group is reading books on Mexico, because they are saying what’s happening is already bad. Why don’t they go on the deutsche mark and save themselves ten years of monetary experiment, and focus on what really matters—namely, the whole, real economy? And 15 percent inflation is not the end of the world compared to a terrible economy. So I believe there needs to be far more encouragement to go in that direction in countries where there is just no plausible reason to run their own money and no expectation that in ten years they will do it with any success.

Mr. Thiessen: There is a question back there.

Mr. Daianu: If one relates the focus put on learning to the previous discussion, it seems to me that in a way the whole debate on monetary policy and what the central banks should aim at in the long run was like in a vacuum at the end of the day; one needs to embed monetary policy into the overall policy content. It is not clear to me that learning by doing is enough. It may be that learning is quite impossible because of major impediments to a central bank in pursuing price stability, although the central bank sees that as its long-term fundamental objective. It may be the case that the central bank has to educate. This may sound presumptuous, because the central bank has its own cognitive limits, but, frequently, performing well is not necessarily the only way to muster public support and it may even be unrealistic in this respect when its track record, history, is more than insufficient—like the transforming economies. It may be that there is a rationale for trying to educate, convince people—to tell people, “Look, we need cooperation, we need support”—because without that, one cannot expect the central bank to have the required

strength and the stamina to pursue the long-term goal. And the second comment I want to make is this: I empathize to a large extent with what Professor Dornbusch said. But nations have icons, and icons are important. A national currency may be badly used, may be debauched by policy, but it does not mean that going in the direction suggested is necessarily the best way from a longer perspective—particularly when political sensitivities are extremely high.

Mr. Thiessen: Rudi wants one sentence before we collect a few more comments here.

Mr. Dornbusch: You said “debauched” yourselves, so I don’t have to say it. It is totally, totally an old-fashioned political argument of the Third World to say national money is a great thing, even after hyperinflation when everybody holds dollars. I don’t think it is really heroic to stick to the national currency. Look at Argentina. What they are really proud of is to have moved away from a totally managed domestic money—and the emphasis is on “managed.”

Mr. Brinner: I wanted to get Mervyn’s (King) reaction to the “information content” of inflation-indexed bonds. In the prior panel, we heard Larry Summers say that the markets will be good assimilators of information and particularly good projectors of things like future inflation. I have a different verdict. I think it looks like “amateur hour” out there pretty often. For example, if you look at studies of heating oil futures, you find that the weather in suburban Connecticut (where the traders live) really matters a lot. Or, if you look at the 10-year, I repeat *10-year*, Treasury bond, you see it moves about half as much as the *one-month* industrial production index growth for the United States. Both of these are clearly greatly disproportionate responses. So if we are going to target inflation, I would hate to see us use the changes in the inflation-indexed bonds versus other bonds as reliable indicators of inflation to come. I don’t think there is much information content, and I wonder if Mervyn would disagree with that?

Mr. Thiessen: Let me collect another comment. I’ve got to give the next question to my colleague, Chuck Freedman, because what

is the point of having your own colleague here, if you don't give him a chance to ask questions?

Mr. Freedman: Thank you, Governor. I just want to follow up on the last question. In Chart 2, Mervyn treats the difference between the conventional bond and the real return bond as an estimate of the expected rate of inflation, and uses that as evidence in terms of the relationship between the actual rate of inflation and expected rate of inflation. But, my understanding of the Bank of England's own conclusions on these matters is that the conventional bond and real return bond is not really very meaningful in terms of the level of expected inflation, and one would want to focus only on the change in this measure as an estimate of the change in the expected inflation rate. Yet, what Mervyn seems to be doing is drawing a lot of information from the level. I was just wondering, how much weight can you put on the level in this kind of analysis?

Mr. Thiessen: All right. Let's let our panelists respond to that. Mervyn, let's start with you.

Mr. King: Two or three quick points. Let me pick up first the comments on index-linked bonds. I don't think any wise central banker—Larry Summers has encouraged us to be wise—would ever describe markets as amateurs. So I am not going to do that. And, I think we can learn something about inflation expectations from index-linked bonds. There are obviously difficulties in doing it. We have described this at great length in various working papers, and risk premia and so on make it difficult. But, two observations: When Britain joined the exchange rate mechanism, there was a clear jump in the price of index-linked bonds and the expected rate of inflation fell, as we anticipated. We changed the regime for monetary policy. When we left the exchange rate mechanism, what was very clear within forty-eight hours was that the expected inflation rate five or ten years ahead, not the next year or the year after, but five or ten years ahead, was somewhat higher. That was brought down when a new monetary policy regime was introduced. So there is some evidence there that these things move in ways one can think of as being *a priori* sensible. That is a far cry from saying that you can

get precise calibrations of inflation expectations. But, I look forward to the introduction of U.S. index-linked bonds, which may avoid some of the technicalities of ours, which make expectations more difficult to extract, perhaps, a more liquid market and one in which it will then be possible to examine this whole question further. But I think it will be unnecessarily pessimistic to suppose that one could not embark at least on a serious research program to see what we can learn from the yields on these bonds. And, I would have thought that was one of the great benefits of their introduction. In the text, Chuck, I was much more cautious about what one could say than in the brief comments I made, so I think you will see in the text that you can still learn something from levels; but rates of change were the key element in the comments in the text on the rate at which inflation and the inflation target declined. A comment about learning: I described it in the text as “teaching by doing.” The role of education of central banks is important. And I think for the following reason: There will always be shocks to the economy that affect the inflation rate. And it will always be necessary for central banks, I suppose, to say, “Well, of course, things didn’t work out in quite the way that we might have anticipated.” And the only way to make that a credible statement is *ex ante* to put forward a clear intellectual framework within which decisions are being made that makes it more likely that *ex post* the people will give you credit for the fact that you could not have anticipated an unpredictable shock, rather than simply wrap yourself in sufficient mystery so that no one can tell *ex post* whether it was a shock or whether in fact your understanding of how the economy works was simply faulty. Now, therefore, there is a question of openness. It is not a question of claiming that we know a great deal. And, I think one of the absolutely crucial elements to any policy of openness and transparency is a suitable degree of modesty in what we understand. Without that, the policy will clearly fail. And that is the challenge and it is not easy with a press that typically wants clear and unambiguous statements. Openness does not mean a lack of ambiguity. We do not understand enough about the world, as Ben (McCallum) explained. And, one very final comment on Ben’s point about my comments on the Taylor rule. It is important to distinguish the normative and positive for the following reason: When looking at data on the 1970s, it is possible

to say, of course in retrospect, if the Taylor rule had been followed, we would have done better. My point, however, is that if the British government had been following the Taylor rule, but with a very different inflation target than price stability, then you might well have seen exactly the correlation in the data that in fact we see. And the difficulty in trying to claim that governments have been following the Taylor rule is that once you make adjustments for the fact that it is not plausible to suppose that in the 1970s the British government was following price stability, it was not. And the intellectual revolution that has taken place since then, which has let countries be more committed to price stability, and seeing the advantages of that policy, that revolution has been at least as responsible, I think, for the fall in inflation as has the change in the technical way in which monetary policy has been made. The two things probably go together. If you are not committed to price stability, you will not spend a lot of time thinking about the design of monetary policy rules.

Mr. Thiessen: Rudi.

Mr. Dornbusch: I would just like to supplement my earlier answer to the gentleman from Romania. European Monetary Union (EMU) is happening. People are giving up the national icons, even Italy, which cherishes the lira, is hoping to get into EMU. Isn't now the time to modernize and say we are going to do the same kind of thing? So I think there is today a strong, strong argument for doing so. The second, moderate inflation—15 percent—if you just say no higher but from here on we go down, isn't that the slippery slope and the next thing you are at 16 percent and where is the end? I think that a clear capping and a policy announcement of what you in fact are planning to do will help a lot. Take Mexico—and I finish with that. Everybody is revising up the forecasts: No, the peso will not decline during the rest of the year. They have 17 to 18 percent inflation. Put those two problems together and it's no wonder they aren't investing, because they are waiting for the next problem. So monetary policy is not in a vacuum. Inflation-fighting is not in a vacuum. It must not be overburdened by other problems in the economy. And it must be able to go to second place when a lot of success has been accomplished and the rest is ten years.

Mr. McCallum: Well, I had very little to say in my comments about the real subject, I guess, of this session, which is about moving from a high-inflation regime to a low-inflation regime—except to say that I think we don't know how to really plan that movement accurately. So, how should you do it, then? Well, to me the right strategy to follow is to think quite a bit about where it is that you want to go, to really try to decide upon the regime that you want to get to—what targets and what instruments you are going to use—and then just go there, taking about three years to do it. Along the way, make institutional changes that will make your efforts appear serious and certainly make changes that will give the central bank the ability to get you there. In other words, spend some time looking at the New Zealand experience and see what they did. That is my strategy.

Mr. Thiessen: Thank you very much. Well, we will hear more about the New Zealand strategy, I guess, after the coffee break. Thank you, panelists—Mervyn King, Rudi Dornbusch, and Bennett McCallum. And thank you, all.