

General Discussion: Overview Panel

Chair: Kristin J. Forbes

Mr. Frenkel: My remarks focus on the proposal to raise the inflation target. The logic of the proposal rests on the fact that real interest rates have declined to very low levels and that with the existing levels of inflation targets (typically 2 percent), the resultant levels of nominal rates (the sum of the real rate of interest and expected inflation) are too low. Hence, so the argument goes, a higher level of inflation targets would permit higher nominal rates of interest even though the real rates of interest are at historically low levels. I have several reservations regarding this policy recommendation. First, before considering to raise the inflation target we should have a better understanding as to the reasons for the decline in the real rate of interest. Specifically, among the factors responsible for the low real rates are demographic factors, uncertainty, a lower level of productivity, and the like. By raising the inflation target, we would imply that the exceedingly low level of the real rate of interest is there to stay; the higher inflation target in fact would validate the low real rate. I believe that this verdict is premature. Some sources of the uncertainty are policy induced and should be removed; furthermore, the low level of productivity should also not be taken as a given, and policy efforts should be directed towards raising productivity. These efforts should typically be affected through the implementation of structural policies that remove distortions and

increase the flexibility of the economic system, through improved infrastructure, education, and tax incentives that promote an innovative culture. In addition, one would need to pay serious attention to the Bank for International Settlements' argument according to which the policy-induced low interest rate environment has contributed in part to the decline of productivity, since it has stimulated the interest-sensitive sectors (like housing) that are typically low-productivity sectors.

In addition to these points of principle, there is a practical issue. Most of the major central banks such as the Fed, the European Central Bank, the Bank of Japan, the Bank of England, have been struggling for a while to raise their corresponding inflation rates from a near zero levels towards their inflation targets of about 2 percent per year. What good would it make to raise the inflation target above its current level of 2 percent when the level of actual inflation is stuck below 2 percent?

The remarks by Governor Agustín Carstens have reminded us that there are still many countries, especially in emerging economies which suffer from high inflation. For such countries, the challenge is to lower inflation toward its target. The credibility of the inflation targeting strategy, which is the main strategy adopted by this group of countries, would be seriously eroded by changing the inflation target. If the industrial countries were to raise the inflation target as proposed, it would damage the efforts of the emerging markets who are still struggling to stick by their inflation targeting strategy in an effort to achieve price stability.

My final remark pertains to Governor Haruhiko Kuroda's insightful point that a major challenge faced by policymakers in Japan is the deflationary mindset of economic agents. Specifically, the decline in the price of energy may aggregate the deflationary expectations and thereby make it more difficult to raise the Japanese inflation rate. One needs to find the mechanism that would break the deflationary inertia so that a once and for all decline in the price level would not be transformed into a more permanent deflationary expectation. A potentially useful policy mechanism would influence the public-sector wage negotiations. If the government could induce a higher wage agreement for its own employees in the public sector, the

private sector in its own wage negotiations would use the public-sector example, and thereby the deflationary spiral could be stopped and reversed. This of course is a political issue and its feasibility depends on the ability of the government to raise wages in the public sector.

Mr. Henry: I want to make a point that connects something Governor Carstens said to something that Chair Yellen alluded to yesterday, which connects to Jacob Frenkel's question about why are real interest rates so low? And the issue is structural reform. If you look at the figure Governor Carstens passed out, and look at the period of time when inflation dropped like a stone in emerging markets in 1994, I think of that period as being correlated very highly with broader structural reforms, which really took hold in the emerging world in that period of time—changes in trade, openness to capital flows, privatization, and a whole range of other structural reforms. If you go back to the first figure he showed, you'll actually find if you look at the change in growth from 1980 to 1994, emerging markets grew about 3.5 percent per year. And in the period, even including the crisis, from 1995 through 2015 and 2016, they grew at 5.5 percent per year. And so the issue is when will advanced economies really embrace the structural reforms that they pushed so hard on emerging economies, and there's a well-known list of things that the International Monetary Fund has been talking about: everything from changes in the composition of public spending, to investment in infrastructure, to greater investment in human capital in places like the United States—and labor market reform frankly, immigration to address falling labor force growth and even a contracting labor force in some parts of the world. My question then, given that observation, is to all of the panelists. Is it appropriate for central banks to provide more explicit, as it were, sort of forward guidance about the limitations of monetary policy relative to structural reform to address the challenges of slow growth, and this low natural rate we've been talking about which may be, in fact, quite unnatural because of some of the inefficiencies and distortions that advanced economies face because of the lack of commitment of leadership to actually do something to raise expected future productivity?

Mr. Svensson: I have a question for Governor Kuroda. I admire how Governor Kuroda is consistently trying one measure after the other to try to achieve the inflation target of the Bank of Japan. But there is one measure that Governor Kuroda has not used yet. I'm thinking of helicopter money. Or what Ben Bernanke more appropriately, in his blog, has called a Money-Financed Fiscal Program. That is, a fiscal expansion financed by a permanent increase in reserve requirements that pay a zero interest rate. Maybe that is the dramatic policy measure that could possibly get rid of the Japanese deflationary mindset. What is Governor Kuroda's view on that policy measure?

Mr. Duffie: Governor Kuroda, when I saw your remarks about inflation expectations, I was thinking about the lecture Chris Sims gave at lunchtime yesterday when he described the situation at the zero lower bound, and the desire to create a concern by investors in government bonds that inflation would erode the market value of their bonds. Now, we want to find out, is that the case in Japan? In the United States, we can look at the inflation expectations that Ricardo Reis presented earlier, which come from market prices that include risk premia. Those risk premia can tell us whether investors are worried about inflation rising. In that case, the market implied rates would be above the survey results. Or, in the bad case, we can perhaps see market implied rates below the survey forecasts, which would tell us investors are worried about deflation, not inflation, and they're worried about the failure of monetary policy to work or fiscal policy to work at the lower bound. So, in Japan's case, is there any market-implied information that can tell us whether investors are worried about inflation going up and eroding the value of their bonds? Or, are they more worried about deflation, and macroeconomic performance being very poor?

Ms. Forbes: I'd like to turn back to the panel to see if you could answer some of those questions, and in particular, I'd be interested in your comments on the benefits and costs of nominal GDP targeting or higher inflation targets. Benoît Coeuré touched on these briefly. But these were issues that attracted attention before the conference, and we haven't discussed them yet in any detail. Why don't we start with Benoît.

Mr. Coeuré: I noted with interest that Jacob Frenkel's question on raising the inflation target was not addressed to me, which is fine. That's OK, because we are really focused on what we are implementing; we are really focused on bringing inflation back to 2 percent. The good news is that inflation has doubled last month from 0.1 to 0.2. That's good news, but still some way away from our target. We're really focused on that. And more fundamentally, the way I would see the role of the European Central Bank (ECB) in the whole post-crisis framework in the eurozone, our role is to provide a nominal anchor to other players to implement their strategies, and in many cases that is deleveraging strategies, public and private, and reform strategies. I don't think changing that target would serve any purpose. It would put the others into confusion. If I may add a word on inflation expectations. That's an important discussion, and preventing inflation expectations from becoming entrenched, one way or the other, has been at the heart of the efforts of all of us since the crisis. Of course, monetary policy can, and should contribute to that. We have to be forceful; we have to be clear in what we're going to do, and that's what forward guidance is about. We have to be forceful in what we're doing, and that's what we've done. But other policies can contribute as well. Chris Sims discussed this contribution of fiscal policy yesterday at lunchtime, but structural policy also is going to contribute. What we've seen in Europe since 2007 is a sequence of half-baked and half-hearted structural reforms that does not help supporting inflation expectations. That has contributed to entertaining disinflationary expectations because the expectation that a disinflationary impact of structural reforms would persist has been entertained by a series of half-baked structural reforms. Forceful structural reform also can contribute to make it happen, that the downward adjustment in prices is one-off and is not getting entrenched into disinflationary expectations.

Mr. Carstens: With respect to Jacob Frenkel's question, and I definitely do not really believe in changing the target of inflation, in particular for emerging markets, where many of us are still in the process of having a sustainable convergence to our objective. I think a lot of the success has been to consolidate the credibility on the monetary authorities, and I think that if you change the target, it could undermine that credibility.

In terms of nominal GDP targeting, and sort of addressing also to Peter Blair Henry's question, emerging markets are in a situation where the impact of monetary policy on GDP is far more limited than in some advanced economies. To target GDP it's quite difficult; if you go down that route, with the lack of timely information about GDP evolution, you really don't know exactly what you're targeting. I am completely for and we have done this a lot in Mexico of making clear what the central bank can do to facilitate growth or not to engineer sustainable growth. For that, the bottom line is you need structural reforms, and in a way we have been very supportive of what the federal government in Mexico has done during the last years in terms of those reforms. As a matter of fact, one reason why some of the inflation in many emerging markets still do not fully converge to target even though they have a well-established inflation targeting regime, is because there are still some structural issues to be addressed, like in some markets they are noncompetitive, and also because they haven't really found a solid institutional or framework to guarantee fiscal stability, and fiscal sustainability. I think that is very, very important, and that establishes far more limits in both fiscal and monetary policy as an instrument to promote higher growth in emerging markets.

Mr. Kuroda: A number of questions and comments were raised. I will try to answer if not all, most of them. First, on the idea of raising the inflation target. Actually in Japan, there are a significant number of economists who argue for reducing inflation targets from 2 percent to something like 1 percent. The argument is that, as I said during my initial intervention, at this moment after three years of extremely accommodative expansion in monetary policy, the inflation rate measured by CPI excluding fresh food and energy shows a positive sign, but still it's about 1 percent or slightly below 1 percent. And of course, headline inflation is now negative, reflecting substantially reduced energy prices. So, they argue that a 1 percent inflation target may be more realistic and achievable. But because we reject this kind of idea, at this moment the Bank of Japan is engaged in kind of a comprehensive assessment of the effect of our monetary policies in the last three years in order to come up with necessary measures to achieve the 2 percent inflation target at the earliest possible time. So we don't intend to change the current inflation target.

The second point Jacob Frenkel raised is a very interesting point because in Japan regular workers' pay negotiation is called "spring offensive" starting in March and ending basically in May with large manufacturing companies first, then large nonmanufacturing companies, and then finally small and medium-size companies and business, where trade unions or labor unions negotiate over the pay rise or bonuses in the year. And when they negotiate, their starting point is inflation in the last several months. And this tends to make wage negotiations very much backward-looking rather than forward-looking. But this negotiating process has been well established in the last 60-70 years, and at this moment, neither business nor trade unions are prepared to change despite the government effort in the last three years to convince both sides to change their negotiating process. So far, not much result, not much success. The idea of raising public sector pay in advance of a private sector wage increase is, again, legally impossible. Of course, we can change the law, but unless we change the law, government employees' wages and salaries are decided by following the private sector wage settlement in the past year. Always backward-looking, again. But I think wage increase is absolutely necessary for price increase which should be sustained.

On structural reforms, I agree that monetary policy cannot do all things without the help of fiscal policy and structural policies. Actually I am a member of the Committee on Economic and Fiscal Policy, chaired by the prime minister, and once or twice a month we meet to discuss monetary policy, fiscal policy, structural policies and trade policies. In that sense, the Bank of Japan is provided the opportunity to speak up about structural policies. On helicopter money or monetary financing of fiscal expansion, I am not quite sure what it means because if it is meant to combine fiscal policy and monetary policy into one decision making, again, that is not possible in the Japanese institutional setting. However, as you may know, the Bank of Japan is purchasing Japanese Government Bonds (JGB) annually in the order of 80 trillion yen. The government's new issue of JGBs at this stage is only about 30 trillion yen. Even after the big fiscal stimulus measures announced by the government, 30 trillion yen may be increased to 35 trillion yen. But still, we purchase from the market JGBs in the order of 80 trillion. That means that market holding of JGBs

would continue to shrink quite rapidly so that after the announcement of big fiscal stimulus package by the government, JGB interest rate didn't really increase at all. JGB interest rate continued to be very low and continued to decline in the face of QQE. So in that sense, I don't say so openly, but in that sense, you may say that we are making more than headway on there. Finally, this is a difficult one as you know. The Japanese government has accumulated national debt of more than 200 percent of GDP. And the rating agencies downgraded JGB ratings to A or something. And yet, whenever some market turmoil develops, yen or in practice JGBs tend to be the safe assets. It's difficult to understand.

Mr. Vergara: I am from one of the countries that, according to Kristin Forbes' metric, is meeting its inflation target. I'm very happy for that. But I must admit that if this conference had taken place last month, we wouldn't have been on the list. In my country, Chile, inflation has been above target for the last couple of years, and now it's gradually going down. That has been the case in most, although not all, Latin American economies. Why? Mostly because we've had a significant currency depreciation. And this is associated with both the end of the commodity price supercycle, which translated into a decline in the terms of trade for the region, and to less favorable external financial conditions. The average Latin American economy has seen a depreciation of about 40-50 percent. Some countries had more than that, such as Brazil and Colombia. Some had less, such as Chile and Peru. So, what has been the monetary policy reaction? Basically, at least in our case, to keep monetary policy very accommodative since we thought that this was a one-off, transitory shock and because inflation expectations have remained well anchored around our target. Now, we should also admit that the shock was larger than originally expected, and also more persistent. Lately inflation has been going down in most of the region, basically because the exchange rate has stabilized and also because the economies are growing below potential. In this scenario, Mexico stands out as an exception since inflation during this period actually has been below target. I would like to ask Agustín Carstens if he can elaborate a little more on that. And also given this low inflation and the Mexican

economy growing below potential, why you have embarked in this recent tightening cycle.

Mr. Song: First, I would like to thank all the three governors for their very informative and useful presentations. I would like to ask a few questions to Governor Carstens and Governor Kuroda. First to Governor Carstens. As we understand, with the economic globalization going on over the past few years, the global economies have been closely interconnecting while the developing economies, particularly emerging market economies have been enjoying their great benefits from the globalization. Meanwhile, these emerging market economies have also been suffering various shocks from the outside. For instance, when the developed countries change their monetary policy in raising their interest rate, the emerging market economies would be suffering a heavy capital outflow. And this thereafter makes the emerging economies' exchange rate fluctuate very sharply, which will also make their economic growth slow down dramatically. So, in this case, some of the emerging market economies have taken temporary capital control and other measures. I would like to ask Governor Carstens, do you think this is appropriate for the central banks of the emerging market economies to take these useful and effective measures to reduce such side effects due to the change of the monetary policy from the developed economies? For instance, you can see that from your Chart 3, from 2006 to 2016, the capital flows fluctuated a lot in the emerging market economies. The second question is related to the inflation topic. Do you think it's possible or effective for the emerging market economies to implement the inflation targeting objective? Number three is what's the appropriate level of foreign exchange reserves for the emerging market economies?

Mr. Toth: Inflation is always and everywhere a monetary phenomenon. That was sort of a longstanding consensus that we had, and that's why we didn't really discuss the fiscal policy. We took it as exogenous, whatever fiscal authority is going to do, we're going to offset it with a monetary policy and stabilize the economy. Now I think the Great Recession lessons are such that there can be two issues with that. The first one is fiscal dominance that can prevent us from reaching the inflation target, and the second one is zero lower

bound. If there's a lack of structural policies, the neutral rate can be so low that it can be difficult for us to reach the inflation target. So my question is, shouldn't that longstanding consensus of not commenting on the fiscal policy change? Shouldn't we provide the public and the government with sort of a good fiscal analysis in the areas of debt sustainability, so that's fiscal domains, or in the areas of structural reforms, so that's low neutral real rate. And that would be just purely on the basis that we are responsible for reaching inflation target, and these two issues can directly prevent us from doing that. So my understanding is that recently sort of the ECB, out of those developed market countries, started to comment more on the fiscal policies, but I'm not seeing really other major central banks going in this direction.

Mr. Goldfajn: The comment I want to make or the question is we have quite a bit of depreciation in the region, supercycle is over, in the case of Brazil we had not only because the commodity cycle but domestic issues, economies depreciated by 50-60 percent depending on where you are. And most of the countries basically stick to the inflation targeting framework. They looked at depreciation, saw the impact of depreciation on inflation and took the best decision about that. In the speech by Agustín Carstens, I will basically agree with most of your description. I think inflation targeting has been quite helpful in the past to reach the converges you've shown. And in the case of Brazil, it's healthy right now. Basically, expectations two years ahead are already on target even though we had quite a bit of inflation. So that's happening right now. So I want you to qualify one issue which is an issue that you said in passing, so I want to just make sure I understand. You mentioned that you believed that we should look at exchange considerations, and you look, which I interpreted as putting more weight on the exchange rate issues, over and above what their impact on inflation which is the traditional way we are doing it. So the question is, are you concerned about exchange rate considerations, exchange rate issues, for other reasons? For example, for national fragility? Can we stick to the classic model and leave microprudential measures to deal with the fragility, and leave the inflation targeting, exchange rate considerations the way it used to be?

Mr. Taylor: I wanted to ask a question about the international relationship between the policies. Agustín Carstens has a regression from the Bank of Mexico showing that there's some reaction in the interest rate to U.S. interest rates, and you can see that in many other countries, and in fact, you see some people argue there's connections between the quantitative easing actions from one to the other. In principle, that takes you away from the policy that's ideal for each country because you're doing some extra reaction. So I've been worried about that, and thinking of proposals. But my question generally is, how important is that as a distraction or something that takes you away from what would be good policy? And, if so, what do you do about it?

Mr. Kimball: So, I think there's an explanation for Chart 4 that Governor Kuroda showed about the JGB yield curve coming down, that Massimo Rostagno talked about at the Brookings conference in June. And that's if people think interest rates can only go up from zero, then out in the future, you're going to have the yield curve go up more. And so I think it's hugely valuable when you bring down market expectations about the effective lower bound. And Massimo argued that that was very complementary with a quantitative easing policy.

Mr. De Gregorio: My questions follow from Ilan Goldfajn's. Why should we go beyond what inflation targets suggest and do monetary policy specially regarding the exchange rate? What is special about exchange rates that could lead to further reaction in monetary policy? And a question to Mr. Coeuré. Your presentation was very persuasive showing how successful it has been in raising inflation expectations, core inflation and reducing interest rates. Now my question is, why is Japan still not growing? So, perhaps it is the lack of progress in the other arrows of "Abenomics."

Mr. Carstens: Well, in terms of inflation in Mexico, why it has been below, is that we have done tremendous structural reforms and many of them have been reflected in much lower prices—in telecommunications, in electricity. And we have a little of tightening by us because core inflation, and especially subtracting also some of the, that could be one-offs, put those closer to the upper bound in our bank. That's why we have had good results in inflation, but

precisely given the exchange rate and so on in the past, the exchange rate movement is pushing core inflation closer to our upper bound. Now in terms of why I mentioned that probably we should pay a little bit more attention to the exchange rate, so far, the pass-through has been really low. That probably has to do with a relatively low rate of growth with some competitive changes in our economy. But, at the same time what worries me a little bit is the fact that you can have nonlinear adjustments in the exchange rates, especially the interface, I wouldn't say all of the economies, but there are many emerging market economies that have had received more capital flows than what you can digest adequately. Many of them are managed by asset managers and there is a threat of poor behavior. And what percent, a very small percentage of their portfolio might represent a very large portion of the assets in your own country, and that can generate some, I would say, stepwise or nonlinear impacts. Now, you cannot fully mitigate that with monetary policy, but I think if you present a much stronger macro framework in terms of fiscal, in terms of also monetary policy discipline, I think that you can reduce the probability of that nonlinearity. So that is for me and that's why I put it in sort of a contingent, as a part of a contingent plan. It's not that you have to day to day put that in the reaction function, but you really have to be mindful of that because regrettably we had the good years of much capital coming in, but now we might face the opposite. And we have to be prepared. So it's part of a contingency plan.

Mr. Coeuré: Two points. First, on Ján Tóth's question on commenting on fiscal policies, which also relates to a question asked earlier by Peter Blair Henry. First, there are different traditions. Obviously there is more of a tradition for central banks to provide policy advice in Europe and that predates our monetary union. I think we are legitimate to do so insofar that we have a stake. There is a risk of fiscal dominance. Both ways, by the way: when there is too much fiscal policy, also when fiscal policy is not well designed, is insufficiently growth friendly, or when the fiscal space is not allocated the right way. So, there is also a risk of what I would call structural dominance, that is a lack of structural reform that puts pressure on us. That is why we have a say, and as you said, the ECB has a tradition to comment on the issues. But we have to refrain from digging

too deeply into political issues. We have to be humble enough and not become intrusive. So we should refrain from commenting on issues like the composition of spending and revenues. That's not for us. That's too political. Second, I would argue that fiscal policy fundamentally doesn't impair our ability to achieve our objective, in our case to come back to 2 percent. But it has a strong impact on the way we do it, on the design of our instruments, and that's where I was taking us. I don't think it impairs our ability to come back to 2 percent, because ultimately inflation remains a monetary phenomenon. But it shapes the way we do it, and that's where we have a say. Then very shortly on John Taylor's question on international policy, on international spillovers. That's obviously an issue for large, relatively closed economies. I think first, I have no doubt the spillovers are not negligible, and we are very mindful of the consequences of what we're doing on these neighboring economies, obviously. That has a strong impact on some of them. I see some smiles in the audience. Clearly, that has an impact. That said, the counterfactual of letting the eurozone slide into deflation is not an attractive proposition for them either. So I have no doubt that spillovers are positive in terms of their net impact, because of the output spillovers dominating possible financial instability. That said, we should be mindful of them. They can spill back to us. So if there is generalized financial instability that can spill back to us, then we are legitimate to account for it, even within our domestic mandate. And finally, I guess we also have a duty to be mindful if it's among or between advanced economies. As I said in my earlier remarks, I see a particular risk at the lower bound that nominal exchange rate targeting would be used as some kind of implicit coordination device for large economies to reach a particular lower level. That's not the right coordination device. So we should be very strict in delivering on the G-20 commitments, and that is not targeting the exchange rates for competitive purposes. That's very important that we reaffirm this commitment.

Mr. Kuroda: Regarding the very important question raised by John Taylor, I think Benoît Coeuré has responded beautifully, so I don't intend to touch on this very important issue. Instead, two points. One, you can look at the last chart, JBG yield curve, the highest one is the yield curve just before we introduced QQE. The middle curve

is the yield curve just before we introduced the negative interest rate. So, almost three years of substantial QQE, yes, reduced the nominal interest rate, but to this extent. And actually in this period, more important was real interest rate decline caused by increased inflation expectations. That was the sort of first year and a half or something like that. And then, the lowest yield curve shows the yield curve at this moment. This shows that negative interest rate of minus 0.1 percent on a marginal amount of deposits caused a substantial decline of the yield curve. The short end declined by 20 basis points. We reduced interest rates by 20 basis points at the short end. But the long end, it showed a quite substantial decline of interest rates. So, I agree with you that negative interest rate policy sort of unleashed the impact of our QQE subdued up until January 2016. Second, yes, the economy has been recovering, and I think the Japanese economy is growing about 1 percent with huge quarterly fluctuations. But basically in the last three years, about 1 percent GDP growth. It's not so fantastic, only 1 percent, but we're above Japan's potential growth rate which is currently about 0.5 percent. So, because of that, output gap continues to shrink and an unemployment rate is reduced. But the growth rate is only 1 percent, and the government target is to raise medium-term growth potential to 2 percent. And that is a very challenging task, challenging target, challenging objective, and despite the fact that quite a few structural reforms were made, medium-term potential growth rate has not increased much so far. I think there are two big structural reforms to be made in order to raise potential growth rate. One is substantial labor market reform, including more laborer remuneration and foreign workers participation in the Japanese economy. Second is substantial social security reform. These are two reforms that government intends to do, but so far they have not been successful.