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MYTHS OF MONETARY POLICY

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I would like to address four interrelated topics, on which the central banking community has been known to pronounce:

- the one instrument, one-target story about money and inflation;
- the no-long-run tradeoff story that morphs into a no short-run tradeoff story;
- the problem of the exchange rate for small, open economies;
- and asset prices, financial stability and macro-prudential supervision.

First, however, I will refer to a subject on which there is a wider consensus among central bankers, that of the "constrained discretion" flexible inflation targeting approach to monetary policy. The flexibility implies that when inflation deviates from the target, the central bank may, indeed should, take account of short-run output effects in deciding how rapidly to try to return inflation to its target level.

But if in the short-run the central bank is targeting both inflation and output (growth), what does inflation targeting buy us? The answer—visible in the stability of inflation expectations for five years and more in most inflation targeting countries—is *stable long-run inflation expectations*, which means confidence in the real value of the currency. That is no small thing; indeed it is essential to the stability of the macro-economy and is the essential achievement of the inflation targeting approach. Thus, for example, since 2004, five-year to ten-year inflation expectations in Israel have nearly always been slightly above the midpoint of the inflation target range.

This stability confers important benefits on the economy. For example, it results in stable long-term real interest, even at times when the short-term interest rate is increasing, providing a certainty that is highly important to the business sector. Likewise, stable expectations affect wage demands and the path of wages.

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ONE INSTRUMENT, ONE TARGET

Not infrequently we hear central bankers say something like: “We have only one instrument, money growth (or the interest rate), and so we can have only one target, inflation.” This view may be based on the targets and instruments approach of Tinbergen, of over fifty years ago, the general result of which was that you need as many instruments as targets. That view is correct if you have to hit the target exactly.

But it is not correct if the problem is set up as is typical in microeconomics, where the goal is to maximize a utility function subject to constraints, in a situation where for whatever reason it is not possible to hit all the targets precisely and all the time. Among the reasons we may not be able to hit our targets precisely and all the time is that there may be more targets than instruments, for instance when the central bank’s maximand is a function of output and growth. In that case we have to find marginal conditions for a maximum, and to talk about tradeoffs in explaining the optimum. So it is *not* generally true that because the central bank has only one instrument, it can take into account only one target—unless the instrument has *no* effect on any variable other than the target.

That brings us to the nature of the impact of monetary policy on the economy.

LONG-RUN AND SHORT-RUN TRADEOFFS

To a first approximation the long-run Phillips curve is vertical, and there is no long-run tradeoff between inflation and output and/or unemployment. More than once this has been used to argue that because there is no long-run tradeoff, monetary policy should not be used to try to affect both output and inflation in the short run.

This argument is invalid unless there is no short-run tradeoff—a position that was argued early in the development of the rational expectations approach to monetary policy, but that is generally not correct, except perhaps in a hyperinflation.

The truth is that the long run is a succession of short runs, and that at every moment the central bank has to take the short-run tradeoff into account.

How to combine the no long-run tradeoff view with the existence of a short-run tradeoff? The best way devised so far is the flexible inflation targeting approach. The Reserve Bank of Australia’s version is that it should aim to attain the inflation target on average over the cycle, which is analytically clear, but may be practically hard to define in a country that has not suffered a recession for almost two decades. An alternative version, adopted by most inflation targeting central banks, is that they should operate in a way that when inflation diverges from target, policy should aim to bring it back to target over the short run, typically defined as one to two years. At present, given the difficulty of forecasting inflation in Israel for periods longer than a year, the Bank of Israel tries to set a policy that will return inflation to the target range within a year.

THE PROBLEM OF THE EXCHANGE RATE FOR SMALL OPEN ECONOMIES

No small open economy, certainly one in which exports account for about 40–45 percent of its GDP, can be indifferent to the behavior of the exchange rate, which vies with the interest rate for being the most important relative price in the economy. (Of course, the word 'real' could be inserted twice in the previous sentence.)

The exchange rate issue comes to the fore when a country experiences an unwanted real appreciation as a result of capital inflows—as is happening at present in several developing and emerging market countries that have emerged from the recession more rapidly than the major industrialized countries and which have had to raise their interest rates to deal with inflation. Provided the resultant appreciation is modest, it may be possible simply to accept it as part of the international adjustment mechanism. But if it becomes too large, as happened in Israel in 2008, the country will want to take action to keep the real appreciation from seriously damaging growth.

The textbooks say that fiscal policy can be tightened to reduce the interest rate and thus reduce the incentive for capital inflows. That is a good story, which is valid in many circumstances. But usually fiscal policy has enough of a problem in managing government spending and its financing without being burdened with having also to take responsibility for the exchange rate—and so the question returns to the central bank and to tools other than fiscal policy.

One strategy is for the central bank to intervene, buying foreign exchange and sterilizing the purchases by offsetting sales of domestic assets. It is frequently said that foreign exchange intervention does not work—that the monetary authority cannot stand against the market forever. That is certainly true when the pressures are in the direction of a depreciation of the currency, for then the central bank has only limited access to the asset the market wants to buy—foreign exchange. It may be able to offset temporary pressures to depreciate, even those resulting from a capital outflow; some of the reserves will be usable for this purpose, and the country may also have access to foreign loans. But the country cannot stand against the market forever in this case.

However, the case of capital inflows, which we are discussing, is different. In that case the central bank has the capacity to supply what the foreign exchange markets want—domestic currency. And provided the central bank is willing and able to sterilize the foreign exchange purchases, there need be no consequences for the inflation rate. The process can continue as long as the country is willing to continue to acquire reserves—and in recent years several countries have been willing to increase reserves by far more than anyone would have expected just a few years ago. As is generally known, the Bank of Israel has also increased its foreign exchange reserves considerably, and via the normal functioning of the laws of supply and demand this had a not insignificant effect on the exchange rate of the shekel.

Full consideration of the decision whether to intervene by increasing reserves in the face of an undesired capital inflow would involve calculating the costs of the appreciation and the consequences of the intervention for current and future exchange rates, along with the costs and benefits of holding additional reserves.

What if the country decides not to continue intervening? It is then driven to consider controls on capital inflows, a topic on which the IMF has recently pronounced more favorably than in the past. Controls are typically awkward, inefficient, inconsistent with a general pro-market approach, may discriminate against small and medium sized enterprises, and are frequently associated with corruption. In short, capital controls have very little to recommend them other than that they may be better than the alternatives. Policymakers should make every effort to avoid using them—but central bankers should never say never.

ASSET PRICES, FINANCIAL STABILITY AND MACRO-PRUDENTIAL SUPERVISION

In the 1990s there was a thorough discussion of the question 'Should the central bank try to prick bubbles?' The Fed reached the conclusion that it should not, and it was prepared to face the consequences, i.e., the need to correct the situation when the bubble burst. To some extent this attitude was affected by the experience of the then Chairman of the Fed, Alan Greenspan, who tried, unsuccessfully, to sound a warning about an impending bubble in the stock market in 1996, and in retrospect it appeared that there had not been a bubble at that time. This approach apparently proved itself in the US when the high-tech bubble burst, the Fed mopped up by sharply reducing interest rates, and the resultant recovery reinforced believers' confidence in the "mopping up" approach.

The question as stated above, whether to try to burst bubbles, presents the issue in rather extreme terms. The question should rather be whether the central bank should take asset prices and the state of asset markets into account in setting monetary policy. The answer to this question is yes.

In the run-up to the current financial crisis, in the United States, the United Kingdom, Spain and other countries, the bubble and its consequences were concentrated in the housing market and its financing, direct and indirect. In many countries housing prices enter the price index in one way or another, so an inflation targeting country would have reason to react to rapidly rising prices of housing.

More generally, the central bank might want to react to rising asset prices to an extent which is different than that implied by their direct current contribution to the consumer price index. We are dealing here with the issue of *macro-prudential supervision*, and the question arises of what instruments the central bank can use to that end.

The obvious answer is to use regulatory instruments, such as mortgage terms, and possibly countercyclical capital and maybe liquidity ratios. This can be done, and will have to be done if we are to avoid another crisis like that of 2007–10. Thus, the Bank of Israel, for example, decided at the end of May to deal specifically with a bubble that could possibly develop in the housing market, even though in our opinion it did not yet exist at that stage. The step taken was a directive issued by the Supervisor of Banks instructing banks to make a special provision for housing loans with a loan-to-value ratio of more than 60 percent.

However the official community is still far from having an agreed approach to the issue, including that of where the responsibility should be located. The tendency is to place the responsibility with the central bank, and some central banks have a financial stability committee as well as a monetary committee. but until the issue of the tools it has to deal with the problem is clarified, it will not be clear whether the responsibility can be efficiently exercised. This issue is under active consideration in the BIS, in other forums, and in individual countries, and we need to make progress on it soon.

FINAL COMMENT

I would like to mention two lessons I have learned from this crisis. The first is that a very expansionary monetary policy can be pursued even when the interest rate is almost zero. I have no doubt that asset purchases by central banks can have a much stronger impact on the market than that implied by the literature, even with the interest rate at almost zero levels.

The second lesson relates to the role of the central bank as the market maker of last resort. The central bank plays an important role as the lender of last resort, and this was seen very clearly in the US and Europe in the latest crisis. But the crisis taught us that in addition to this role, the central bank can also act as the market maker of last resort. The Fed, for example, instead of injecting liquidity into the financial system across the board, focused its activity, and managed to revitalize important financial markets that had failed during the crisis by means of its asset purchases in those specific markets. This is a new approach, different from the generalized supply of liquidity described in the literature as the monetary policy implemented in previous crises. This, too, is an extremely important lesson to be learned from the present crisis.