COMMENT

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Both papers are very interesting, and contain much more than you have heard. I will comment on both papers simultaneously, discussing the main questions that they address. I would like to organise my discussion around two points: crisis prevention, for the most part, and one final comment on crisis management.

On crisis prevention, both papers agree – and so do I – that the most important lesson we have learned is that price and output stability does not imply financial stability. The reason is that in periods of price and output stability there could be an accumulation of financial imbalances that may suddenly unwind. The prices that rise in these periods are those of assets that are used as collateral or that may be related to the expansion of leverage. We now also have a better understanding of how the credit cycle can amplify business fluctuations. Moreover, the high cost of cleaning up is a result of the misallocation of real investment that accompanies these changes in asset prices.

The main questions raised by these lessons are as follows. First of all, should we change the flexible inflation targeting framework in the pursuit of financial stability, and, if so, how? And second, what instrument should be used to achieve financial stability? Should it be the interest rate or regulatory tools? These are very difficult questions, because the science of monetary policy, as Mishkin called it, is still not equipped to address them. In particular, the ninth principle of monetary policy in the paper by Mishkin is not really on a par with the others. Although we have very promising work by Geanakoplos and by Shin and Adrian on the importance of the leverage cycle, the ninth principle has not yet fully developed to the same operational stage as the "neoclassical synthesis".

Nevertheless, with these caveats in mind, I would give the following answers. On inflation targeting, I fully agree with Mishkin. The first eight principles that he mentions are very much valid and they continue to imply that inflation expectations play a central role. They also imply the need to anchor those expectations through appropriate central bank incentives and through an institutional framework. A framework means a structured decision process with clear goals that enables central banks to implement state-contingent policy rules and not just isolated actions; a mechanism for communicating intentions about the long run; a mechanism to hold central banks accountable and to shape their incentives. The crisis has very much enhanced the need for this framework, because it is now clear that we have to use a wider set of policy tools with a lot of judgement. It's also clear that incentives to create unexpected inflation are much stronger, because, if we could do that, it would reduce the debt burden. So we need to anchor expectations even more firmly than before. Flexible inflation targeting is helpful in that regard, because it focuses on the final goal and it is consistent with a very wide range of indicators. Nevertheless there are some possible adjustments that may be usefully added to the inflation targeting framework. Some of them have not actually been mentioned in either paper.

One possible adjustment is to include measures of housing prices to a relevant degree in the inflation target, because those prices react more quickly than others to the financial imbalances. This is an important issue in Europe, where house prices are not so fully reflected in the harmonised price index. One might also want to incorporate the risk-taking channel of monetary policy by adjusting interest rates for risk so as to assess the stance of monetary policy, as was stressed in the ECB paper. Finally, one may want to condition policy decisions on a broad set of financial indicators, and perhaps be prepared to lean against the wind identified by such indicators.

I would also stress my reservations with regard to the emphasis that Mishkin put on the risk management approach. We understand the need for a pre-emptive policy because of the costs of cleaning up. But in the past the risk management approach could have led to excessive accumulation of financial imbalances. Taylor offered the following assessment of US monetary policy in the period 2002-05: maybe the Federal Reserve was too expansionary precisely because there was a need to buy insurance against the risk of deflation.

But these marginal changes to the inflation targeting framework are not enough, because the problem of how to achieve financial stability remains. Here we need to develop a framework to manage the leverage cycle with policy tools other than the interest rate – regulatory tools in particular. Some of the arguments for relying on other policy tools, rather than interest rates, have been mentioned by Mishkin. In particular, we don't want to destabilise the economy in order to reduce the accumulation of credit imbalances.

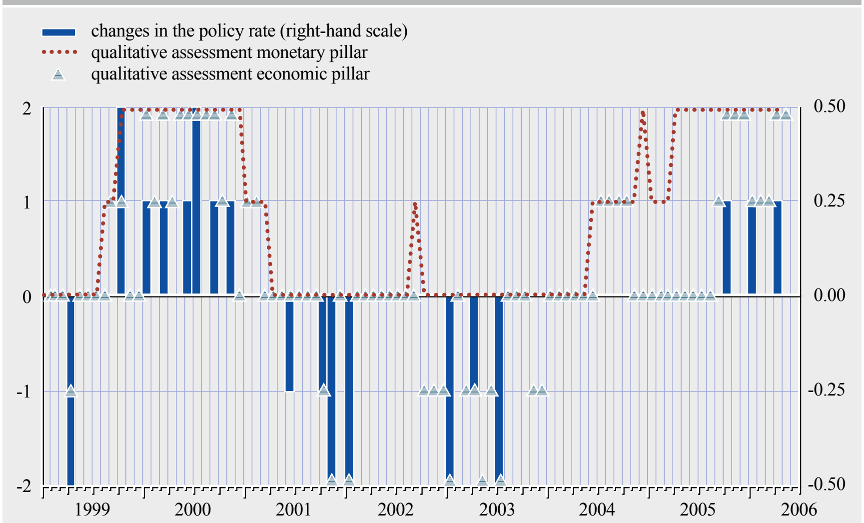
But to be sure of this point, we would need more empirical research. A recent paper by Bean (Bean et al. (2010)) suggests that interest rate changes are not so powerful in influencing credit aggregates and removing the credit imbalances. But he obtained this result using a VAR framework, to which the Lucas critique applies: as you change the policy rule, the parameters also change. Nevertheless, this evidence seems to suggest that interest rates do not have a powerful effect on the credit imbalances.

If you believe that you should rely on other policy tools, there are at least two issues to address. First, do you want to target securities through margin requirements, or do you want to target intermediaries through capital requirements? I think the question here is which approach is more likely to win a race against financial innovation. Perhaps you want to rely on both. The second issue is that you really need to develop a framework, as with inflation targeting, with which to manage expectations in a practical way. We don't just want a predetermined set of rules: we need to manage the leverage cycles with administrative rules, and that requires creating a framework as defined above.

I think there is a strong argument for putting the central bank in charge of both policy tools – interest rates and administrative tools. One rationale in support of this was emphasised in the paper by Mishkin, namely the need to coordinate policies because of the complementarities between them. I think there is a second argument, and it concerns the skills that are needed. We are talking about macro issues, not micro issues, and those skills you find in central banks. It is true that there is the political economy concern, but I would regard that as a concern which is particularly powerful only because we don't have a framework at present. If we had a more transparent and complete framework, then perhaps those political influences would be easier to resist. To put it more bluntly, the institutional framework that we have now reflects the intellectual dichotomy between monetary policy and financial stability policy. If this dichotomy is false, then the institutional framework and architecture should be reconsidered much more deeply. This is also because of the incentive issues, not just because of the required skills.

I will now turn to the ECB paper and the ECB approach. The question that I would like to address is whether the monetary pillar is really an alternative framework for the pursuit of financial stability. By that I mean whether it did indeed prevent an accumulation of leverage, a fall in risk and a surge in asset prices, and, if so, how. My answer is no, it is not really an alternative framework. The ECB paper argues that the monetary pillar improves stability of prices and output in the long run, but that is different from financial stability. In fact, the monetary pillar was not conceived to promote financial stability. It was conceived to improve inflation forecasts in the long run. Indeed, if the goal was financial stability, it is not clear why one would want to condition on money; in fact, the ECB paper considers credit, not money. Besides credit, one may want to condition on measures of the price of risk, such as interest rate spreads and margin requirements, which of course is not what the monetary pillar did.

How important the M pillar in practice



Source: Fischer et al. 2008.

Note: The qualitative coding goes from -2 (clear downward risks to price stability) to +2 (clear upward risks to price stability).

Finally, there is also evidence that the monetary pillar on its own was not so influential in driving interest rate decisions. Here I would like to show a chart from another ECB paper by another group of ECB economists (Fischer, Lenza, Pill and Reichlin) that supports this conclusion. In their research they look at the narrative of the ECB statements to quantify the monetary and economic pillar. Perhaps this is a better way to assess the evidence, because it is so difficult to estimate money demand shocks. The solid line in the graph represents the risks to price stability suggested by the monetary analysis, as reflected in the language used by the ECB President after each Council meeting. The triangles are the same indicators obtained from the economic analysis, also from the ECB statement, and the histograms are the changes in interest rates.

As you can see, typically monetary and economic indicators move in the same direction. When they don't, the economic analysis seems to be more important. This is certainly true for the period 2001-03, when the monetary analysis suggested no risk to price stability. Based on this graph it seems that maybe only in late 2005 was there an instance in which the monetary pillar induced an earlier increase in interest rates than would otherwise have occurred. But overall, I would say that the monetary pillar was not something that significantly altered the framework relative to what I would describe as a form of flexible inflation targeting.

And now one last point on the management of the crisis. Here I agree with both papers, which provided a very rich discussion that I will not repeat. There is, however, a very important lesson to be drawn from the crisis that is not mentioned in either paper. It is the need to manage expectations. In situations of extreme uncertainty, such uncertainty may precipitate contagion, and lead to what Ricardo Caballero has called a sudden financial arrest. This is not surprising, because a crisis can be thought of as a situation of multiple equilibria. The good equilibrium is typically supported by the implicit expectation that there is a lender of last resort that can provide insurance against sudden financial arrest. Disappointing the expectation is very, very dangerous. I think that was a mistake that was probably made in the early phase of the crisis in the United Kingdom and the United States. Perhaps it is a mistake that is going to be made now in Europe. This mistake reflects a genuine dilemma among policy-makers regarding whether to bail out institutions to prevent contagion, or avoid creating incentives for moral hazard in the future. But I think this is to some extent a false dilemma, because moral hazard should be addressed by regulation, not by the threat of withholding insurance. If you withhold insurance you really risk precipitating the crisis.

This is an important lesson for Europe, because there is a fundamental fragility in the euro area that comes from the separation of monetary and fiscal policy. This separation implies that central banks cannot easily act as lenders of last resort to stop a sudden financial arrest in the worst case scenario, and of course this raises the risk of a sovereign debt crisis. It is a relevant lesson to bear in mind, because the main threat will not come from the housing market now; it will come from sovereign debt. It may still be that we have other lessons to learn before the crisis is over.

To summarise, the main points I want to stress are first, that we should preserve the inflation targeting framework, although with some adaptations. Second, we should work hard on developing a framework in which financial stability can be managed with policy tools other than the interest rate. Third, I don't think that the ECB monetary pillar was really an alternative framework. And finally, central banks should be able to provide insurance against a sudden financial arrest.

REFERENCES

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