The Role of Monetary Policy under Low Inflation

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Comments at the
Closing Panel Discussion
by Allan H. Meltzer

I will use my few minutes to comment on the main issues at this conference. It is an easy conference to summarize because with a few exceptions the papers fall into two broad groups and the issues have been sharply drawn.

I can only echo Don Kohn (and others who expressed the view privately) that the Bank has shown a commendable openness in having this discussion. The Bank was not obliged to hear the views of its critics. It could have chosen a different topic. Nor was it surprised by the views it heard.

I particularly want to express my appreciation to Governor Yamaguchi both for his courtesy and for the attention he gave to these issues. This may come as a greater surprise to many of you then to me. For me, it is one of many examples---albeit an outstanding example---of the openness and willingness to consider other views that I have experienced repeatedly in the nearly 16 years since Mr. Taguchi and several colleagues first met my wife and me on our arrival in December 1984.

I would like, as well, to thank the Bank of Japan and the organizers, Dr. Okina and his staff, for their traditional perfect
hospitality. It would be an error if I said that this is a non-traditional way to increase the monetary base, because outstanding hospitality is a tradition of the Bank. I know I speak for everyone when I express appreciation for your generous, traditional hospitality.

I want to take a few minutes to respond to the principal arguments made by the Bank against what are called untraditional policies. The policies that are called traditional would be better described as "low risk" policies. The history of central banking gives no support to the idea that a central bank buys only very short-term Treasury bills. I cannot speak for all countries, but in the United States short-term Treasury bills became a regular instrument of government finance only in the 1930s.

Open market operations as a means of influencing the money market did not begin until the 1920s. I venture a guess that, during its first 50 years, the Bank of Japan did not operate principally by buying government bills. I know for certain that in the 1950s the issue of whether the Federal Reserve should operate a "bills only" policy---that was what it was called---had not been settled.

What did a traditional central bank buy? It bought bills of exchange, commercial paper, gold and foreign exchange. It helped to finance its government in wartime. The Bank of England was founded for that purpose. The Bank of France made "avances provisoire" to its
government many times and then forgave the obligation when its charter was renewed. And I expect the same was true elsewhere.

The great classic book on central banking by Walter Bagehot discusses what a central bank should buy in a period of distress or crisis. I cannot quote precisely, but Bagehot quotes the Governor of the Bank of England's description of what they bought. After listing Exchequer bills and commercial paper, he adds that they took in securities of types that they had never known heretofore. Clearly, Bagehot believed that the Bank should take risk when required to meet the needs of the country. Bagehot warned against a policy of protecting the reserves of the Bank.

Let me try to connect this bit of history and tradition to a larger issue than the issue of tradition. A central issue that divides many of us at this conference is the type of risk and extent of risk that a central bank should undertake.

This difference comes out most clearly, on one side, in the comments by Governor Yamaguchi, the papers by Okina and Oda, and by Taguchi, Shiratsuka and Mori, but it is present also in the opening comments by Governor Hayami in his references to pre-emptive actions by the Bank of Japan. These papers point to the risks to the central bank from more aggressive actions and use of currently less conventional instruments.
On the other side are papers by Taylor, Goodfriend, Svensson and Cargill that suggest in one way or another that the Bank of Japan should be bolder, either by buying assets other than short-term bills or in announcing targets for the inflation rate or the price level. Even the very abstract Hansen-Sargent paper should be looked at as a formal way of clarifying this issue.

My position on the issue is well-known to the conference participants and to the Bank. I will not repeat it. Instead I would like to spend a few minutes on an issue that has not been discussed.

The reason we have central banks is that a central bank supplies public goods. One of those public goods is managing risks that can be avoided by collective action. The central banker must be willing to lend when the market closes in a liquidity crisis. It should contract, raising interest rates, when the demand for credit threatens to produce excess money growth. These are only two examples of public goods. Providing a secure, stable currency and payments system are others.

Because these are collective problems that profit-maximizing bankers cannot be counted on to resolve properly, central banks are no longer private institutions as many once were. Because there is conflict between political expediency and proper decisions, central banks in many countries are independent of immediate political pressures---so called central bank independence.
This peculiar structure gives central bankers a special responsibility to use an objective function that does not minimize the risk to the bank. Their objective should be to reduce risks to society to the minimum inherent in nature and trading practices.

Let me illustrate that role in a specific context. Everyone here is familiar with the Asian crisis. Although problems remain in several Asian economies, the worst of the crisis is over.

The chart I distributed showing the U.S. current account deficit shows quarterly values of the deficit. Multiply the left scale by 4 to get annual rates. The chart tells a simple story. The Federal Reserve expanded the U.S. economy, and by doing so, the U.S. did two things.

(1) It absorbed additional imports (about $250 billion).
(2) It attracted capital, mainly from private investors.

It did this while allowing exchange rates to appreciate despite several reductions in interest rates.

One can quarrel with the details, with the size of the domestic expansion and with the long delay before the policy began to reverse. Qualitatively, it was the proper response. Imagine how different the outcome would have been if the Federal Reserve had not acted. Their actions in 1998 should be contrasted with the experience in 1929-33 that Tom Cargill discussed yesterday.

The Federal Reserve supplied a public good to the world economy. As the discussion this morning noted, and as Jiff Macklem brought out,
the reason was mainly domestic. There, too, it did not ask: What is the risk to the Federal Reserve? It asked instead: What is the risk to the U.S. financial system and the U.S. economy.

The results of those actions must now be unwound. The U.S. current account deficit at 4% of GDP (and approximately 4% of total world exports) is unsustainable. As my late AEI colleague Herbert Stein often said, "unsustainable events end."

Perhaps the problem will go away. Perhaps the flow of capital to the U.S. will decline at the same rate that the U.S. reduces its (net) imports from the rest of the world. But even in this optimistic case, what replaces exports to the U.S. in the aggregate demand of the Asian countries? What maintains the Asian countries' expansion?

By expanding, Japan would make a contribution to its own economy, to the Asian region, and to the world, as Lars Svensson argued so clearly earlier. But neither he nor I urge that this be done as a public service to Asia. Expansion in Japan would:

1. raise asset prices, including real estate prices;
2. thereby improve the balance sheets of banks, corporations and households;
3. increase domestic demand;
4. end the costly deflation of wages and prices; and
5. reduce the excessive reliance on government spending and debt.
This is an argument for considering the benefits as well as the costs.

Two years ago, and several times before, I tried and failed to convince the Bank that the opposite of currency depreciation is deflation. Depreciation may have a short run cost to your neighbors and trading partners but so does slow growth and deflation in Japan.

Finally, let me turn to the question hinted at in several statements -- that the Bank of Japan will end its zero interest rate policy. Higher interest rates would force more deflation. It is right to think about what comes next; it is costly to act prematurely.

I agree with Governor Yamaguchi when he points out that the Bank of Japan took bold action when it stopped the rush to currency after financial failures in late 1997 and when it took the overnight interest rate to zero. The latter is bold not only because no one has done that since the Federal Reserve in the 1930s but because the effects on the money market and reserve holding were unknown. But deflation has continued, so zero is not low enough. Deflation means that the public wants more real balances than you have supplied. It gains them at heavy cost by forcing deflation. It is in everyone's interest, especially yours, to end the deflation.