

# Discussion

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## 1. Josh Felman

It is always a pleasure to read papers by Rick Mishkin, since they are invariably clearly written, well-focused, and compellingly argued. As I have discovered, however, these same pleasures make life difficult for those who are asked to comment on his papers. Even after several readings, I still find it difficult to find any argument with which I would really disagree. Nonetheless, allow me to raise three quibbles, which of course represent my own views and not those of the IMF. First, I would like to qualify Mishkin's conclusions on exchange-rate pegging. Second, I would like to query his definition of inflation targeting. And third, I would like to raise an important inflation-targeting issue, which he has not mentioned.

On exchange-rate pegging, the paper concludes that the September 1992 ERM crisis demonstrates that not all countries that fix their rate have a strong underlying commitment to this rule. *Prima facie*, this statement would necessarily seem to be true: after all, how else can one explain why France remained in the ERM, while Britain dropped out, except by the latter's weaker commitment to the peg? Like many other 'truths', however, this statement does not convey the whole story.

In this case, what is missing is a recognition that the costs of sustaining the ERM peg varied from country to country, and were particularly high in Britain. One reason is that in Britain, unlike in continental countries, interest-rate increases have a prompt and sizeable effect on housing payments, since most mortgages are variable-rate loans. In 1992, moreover, the economy had turned down and housing prices had slumped, leaving many people with negative equity in their homes. In these circumstances, the country would have had to pay a very high social price for sustaining the peg, since a prolonged period of high interest rates would have forced many home-owners into bankruptcy.

Even clearer is the more recent case of Thailand. There, the initial commitment was extremely strong, as the country had maintained a stable rate for 13 years. Yet, when export growth began to slow and asset prices began to fall, financial markets began to test this commitment, forcing the authorities to maintain high interest rates. As these rates began to undermine the financial system, commitment began to wane, and – after fighting for one year – the country eventually decided to abandon the peg.

From these examples, then, I would draw a somewhat different set of conclusions from Mishkin. To begin with, I would claim that commitment is an endogenous variable, which depends on a cost/benefit calculation. This calculation can be altered by speculative attacks, which can impose very high costs on countries which try to defend a fixed rate. Speculators, knowing this, will therefore attack currencies whenever they expect that these costs would be high, even if reserves are large and the authorities' initial commitment is strong.

Now, on to the issue of inflation targeting. Mishkin defines inflation targeting as the announcement of a numerical target for inflation, coupled with a commitment by the monetary authorities to achieve this target. Once again, while I do not disagree, I do not

think this tells the whole story. In my view, inflation targeting is better defined as the attempt to institutionalise a commitment to low inflation. In a way, Mishkin himself recognises this, when he argues that the chief drawback of the ‘just do it’ approach is that it relies on individuals – and then recommends inflation targeting as a way of ensuring that the commitment will be sustained once the current individuals are gone.

Of course, no other inflation-targeting country has gone as far as New Zealand, which has entrenched its commitment to price stability in law. But every country has gone some way down this road. One practice, which has been adopted here in Australia, is to have the government and the monetary authority issue a joint statement endorsing the inflation target and specifying that monetary policy will be directed toward that end. Another critical step has been to strengthen the fiscal position, in order to minimise the Sargent-and-Wallace-type risk that high levels of government indebtedness will eventually force monetary policy to abandon its inflation objective, and monetise the debt.

In addition, I would stress the importance of two other measures to enhance the commitment to price stability. One is establishing a sound regulatory framework for the financial system, to limit the risk that monetary policy will need to be redirected toward resolving banking problems. The other is promoting labour-market flexibility, to ensure that policy tightenings needed to preserve price stability do not have unduly large effects on employment and output.

Now, I would like to turn to my third quibble. The paper makes no mention of an issue which I believe to be central to inflation targeting, namely the question of the policy horizon. As Svensson has stressed, the main task of central banks under inflation targeting is to set their policy instruments so that their inflation forecast equals their inflation target over some defined policy horizon. But how is this horizon to be chosen? Haldane, in his paper for the conference notes that the horizon will depend on technology, in the form of the monetary transmission lag, and on preferences, with respect to the output-inflation trade-off.

Let us examine how these two factors might play out in practice. To fix ideas, consider the case of a central bank which has made a forecasting error, so that inflation is likely to exceed the target by a significant margin, starting in the next period – say, one year hence. In these circumstances, the bank must decide how quickly it should try to bring inflation back to target.

Under inflation targeting, the institutional framework provides a strong incentive (a preference, in Haldane’s terminology) for the central bank to try to limit the deviation from target. Moreover, such a policy may actually be technologically feasible in a small open economy, where the exchange rate has a powerful and prompt direct effect on prices. In this case, the central bank could keep inflation on track by tightening policy sufficiently to generate a large exchange-rate appreciation. Subsequently, of course, the tight stance will also begin to affect prices via the interest-rate channel, causing inflation to threaten to undershoot the target. At this point, policy can be relaxed.

Such a policy approach, however, could have considerable cost. During the periods of sharp tightening, there could be a large loss of output, especially in the traded sector. More generally, over the policy cycle, there could be large swings in the exchange rate and interest rates, which would increase uncertainty and reduce output, again especially in the traded sector.

At the same time, a strategy of bringing inflation back to target gradually has its own problems. It runs the risk of undermining the central bank's objective of improving its inflation-fighting credibility, as well as the target's role as an anchor for expectations. Indeed, under this approach financial markets may be left without any short-term anchor, unless the central bank explicitly publishes its inflation projections, showing the path that it is aiming to achieve.

Allow me to conclude without a conclusion. I do not pretend to have a definitive answer to the policy-horizon issue, nor does, I presume, anyone else. One possibility may be to shift the incentive structure for central banks, by defining the inflation target in terms of domestic underlying inflation, rather than inflation including import prices. But I'm sure this approach, too, has drawbacks, and that other possibilities exist. For precisely this reason, it would have been nice if this thorny – and central – inflation-targeting issue had been discussed. Perhaps we can start now.

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## **2. General Discussion**

See the general discussion following the paper by Malcolm Edey (p. 72).