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THE FOUNDERS AND THE FUTURE

Nice-Squared

Remarks by
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Thanks to Larry Goodman for hosting this timely conference in Bretton Woods, and for giving me a chance to give some remarks. In my view the time is ripe for a new international understanding, and perhaps even agreement. It is good, for example, that IMF is revising its exceptional access framework in light of the unpleasant experiences of the recent European sovereign debt crisis.

But I want to focus today on the international aspects of monetary policy. Soon after the end of the Bretton Woods system in the 1970s, monetary economists—myself included—started to use their brand new Keynesian models with rational expectations and price rigidities to examine how monetary policy should be conducted in a world of flexible exchange rates. They found two surprising things.

First, they found that simple steady-as-you-go, rule-like monetary policies would lead to a NICE outcome—that is a <u>non-inflationary consistently expansionary,</u> N-I-C-E, or NICE_outcome to use the term coined by Mervyn King.

Second, on the international side and even more surprising, they found that those same steady-as-you-go, rule-like monetary policies would also achieve most of the potential gains from international cooperation of monetary policy. And this would occur even if each central bank focused on its own country's economic performance. In other words the international monetary system would be NICE: <u>near an internationally cooperative equilibrium, N-I-C-E, or NICE</u>. One could say that the NICE system would help the world economy stay together during the NICE period. Let's just call it NICE-squared.

What is even more surprising is that the actual outcome in the years that followed—the 1980s,1990s and until recently—seemed to bear out these NICE-squared predictions. As central banks moved toward more transparent, rules-based monetary policies—including through inflation-targeting—economic performance improved dramatically, especially compared with the 1970s, and an important step was when the Fed began to announce its federal funds target.

By choosing policies which worked well domestically, central banks contributed—in "invisible hand" like fashion—to better global economic conditions during this NICE-squared period. And toward the later part of this period, central banks in many emerging market countries began to move toward more rule-like policies. As they did so, they began contributing positively to overall global monetary stability.

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But during the past decade—especially since the end of NICE-squared—international spillover effects have again become a major policy issue. Policy makers in emerging market countries from Brazil to India complain about adverse spillover of monetary policy in the US. Policy makers in developed countries including Japan and Europe have pointed to the adverse exchange rate effects of monetary policies in the US and some have raised concerns about currency wars and competitive devaluations. Many central banks—from Singapore to Switzerland—have been forced into near-zero or too-low-for-too-long policy rates have had to take actions, euphemistically called macro-prudential to prevent the booms and busts in housing or consumer durables markets.

What caused the end of the Nice-squared? Some say it was the financial crisis itself. Others say that international capital flows have exogenously become more volatile.

But the more obvious explanation is that monetary policy deviated from steady-as-you-go, rule-like policies of the NICE-squared period. Empirical research shows that such deviations in the United States and some other countries started about a decade ago when interest rates were held very low. Researchers at the OECD and the BIS have detected a similar Global Great Deviation which is continuing to the present—especially when the large-scale unconventional central bank interventions are included.

So the implication is that we should try to go back to the steady-as-you-go, rule-like policies that worked in the NICE-squared period. An international understanding and agreement will help. Such an agreement could instruct the IMF or the BIS, or even ask private non-profit groups, to monitor the extent to which central bank policies are steady and rule-like.

But will it be enough? I think so. The large destabilizing monetary-policy-induced capital flows motivated by search for yields would diminish. Fear of free falling exchange rates would be calmed as reliable central bank actions come to be expected.

A NICE-squared world would reappear. At least that is the hope and purpose of a conference like this. Thank you very much.

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