can and should target price stability alone, while other economic objectives are best addressed with other instruments and by other agencies. But in a second-best world, where other instruments are ineffective or constrained and where uncertainty prevails, this neat separation breaks down. Under these circumstances, central bankers need to ask whether, inter alia, undertaking bond purchases, while creating moral hazard for their governments, interfering with the conduct of conventional monetary policy, and sending mixed messages, is better or worse than standing by idly and potentially forcing the debt to be restructured, already weak banks to take a haircut, and—in the worst case should be joined—financial market meltdown to occur.

This debate has taken on a particularly sharp edge in the context of the unfolding European sovereign debt crisis. As the public discussions among different official players in that context vividly illustrate, the right answers are far from obvious and outcomes are intimately tied to political rather than just economic considerations. It is also unlikely that the same answer to these questions will be correct under all circumstances.

Central bankers face a difficult dilemma. The more they take these competing objectives on board, the more they depart from the intellectual framework that guides their action, and the more complicated their task becomes. But when they overlook such spillovers in the name of monetary purity, they begin to be viewed as part of the problem and they risk undermining the political consensus that underpins their independence.

Dealing with Currency Misalignments and Overvaluation

Another area where this dilemma is experienced is in the relationship between monetary policy and trade competitiveness. Central banks frequently come under pressure from exporters, industrialists, and agricultural interests who complain that the central bank's focus on domestic price stability and neglect of the exchange rate comes at the expense of the profitability of key sectors. In emerging markets, the typical pattern is for an upswing in expectations to cause capital inflows that in turn strengthen the exchange rate, squeezing tradable economic activities. In advanced countries, similar problems can arise as a result of safe-haven flows and economic problems abroad (see the recent cases of Switzerland and Japan).

Central banks have traditionally responded to capital inflows with sterilized intervention and various forms of capital-account regulation. But sterilized intervention that results in the build-up of reserves is costly and ultimately self-defeating when financial markets are open. Unsterilized intervention (a form of quantitative easing) may help where there is no existing problem of inflation (Switzerland, Japan), but it is problematic in the booming emerging-market setting, where inflation and overheating risk already exist (see, however, Turkey for an experiment along these lines). There has been an increased tendency therefore in emerging markets to resort to controls of various types. Now that such measures are no longer under attack by the IMF, more countries have become willing to discuss and institute them: Brazil, Thailand, and Korea being cases in point.

It is easy to dismiss pressure from exporters as self-interested lobbying. However, there may also be some broader validity to their claims. The share of employment in manufactures tends to shrink as a country moves through middle- and high-income status. But very sharp appreciation of the exchange rate can accelerate that process, with disruptive effects. Workers with industry-specific skills and training may find it hard to redeploy them elsewhere. A long-standing comparative advantage can be undermined. Recall, for example, discussions of how the high dollar in the mid-1980s was creating a Rust Belt in the Midwest and of how a strong franc currently threatens to hollow out Swiss industry.