Commentary: What Operating Procedures Should Be Adopted to Maintain Price Stability?—Practical Issues

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With his paper, Charles Freedman provides an impressive overview of the most important practical issues relating to the maintenance of price stability in a monetary framework with direct inflation targets. His lucid analysis ranges from the choice of the appropriate price index to the potential benefits of greater transparency about the objectives and actions of monetary policy.

Charles Freedman invites us in his paper to consider whether the maintenance of low rates of inflation requires a different monetary policy strategy from the one needed to combat high or rising rates of inflation. The topicality of this subject derives from the fact that, since the beginning of the 1990s, inflation has declined sharply all over the world. For example, the rate of inflation in the ten major industrial countries averaged 2.2 percent both in 1994 and in 1995. For 1996 and 1997, too, the Organization for Economic Cooperation and Development (OECD) expects moderate, or further diminishing, growth rates of consumer prices in its member countries; the forecasts for the OECD countries, excluding Turkey and Mexico, predict less than 2 percent per year in each case (measured against the rate of change in the GDP deflator).[1] With the exception of 1986, when the sharp decline in oil prices had a restraining effect on the rise in consumer prices all over the world, the rates of inflation are thus at their lowest level for more than thirty years, and in some countries, they have reached a level which is generally equated with price stability.

In the United States, the rate of inflation has fallen from more than 5 percent in 1990 to approximately 3 percent; the same applies to the average price increase in the fifteen member states of the European Union. In Canada, just as in Germany, the rate of inflation is at present below 2 percent, and no new rise seems likely in the foreseeable future. It is true that in some countries a similarly low price increase could be observed for some time, for example, in Germany in 1967-68 and then again in 1986-88. What is new is that the decreasing, or low, rates of inflation have not been limited in the past few years to a few industrial countries, but, instead, it is obviously a global phenomenon. This trend has prompted some commentators to designate inflation as an “extinct volcano” and to announce the beginning of the “zero era.” Some are already talking about the “death of inflation,” and even the danger of a global deflation is being mooted.[2] In Germany, the new school, which asserts that “inflation is dead,” calls up memories of the vision of the former Minister of Economics Karl Schiller, who as early as 1968 announced: “Inflation is dead, as dead as a rusty nail.”

However, experience since then has shown that the combating of inflation can by no means be considered a problem which has been finally solved or may even be relativized again. We should never be too sure that the mistakes of the past will not be repeated; and this applies all the more to a central bank. On the other hand, we can at least hope that the problems which were associated with the high rates of inflation were so dramatic that they will not be easily forgotten.

There are many reasons for the trend toward slower price increases in the past few years, but monetary policy is clearly the most important one; conversely, it must take the blame for mistakes committed in earlier years. In this context, the breakneck speed of inflation rates in many countries in the 1970s was not least attributable to the attempt to use an expansionary monetary policy to overcome the negative effects on employment of the oil price shocks. When, however, inflation in the OECD countries accelerated to more than 12 percent in the mid-1970s and failed to decline perceptibly toward the end of the decade, the perception spread that

high inflation rates were obviously not capable of solving the growing employment problems. Once it was realized that inflation is basically a monetary phenomenon and that the influence of monetary policy on employment lasts only as long as the expected inflation trend differs from the actual rate of inflation, it became imperative to concentrate monetary policy once again on its core task. As a result, a growing willingness to regain price stability could be observed in the 1980s.

Concurrently with the appreciation that monetary policy should concentrate on solving the inflation problem, it became increasingly clear that the success of that policy is greatly dependent on institutional arrangements. Particularly the independence of the central bank—which had not been a major topic of academic discussion for a long time either—has since become the nucleus of a positive and normative theory of inflation. The fact that there is a close connection between the independence of the central bank and success in the field of combating inflation can be justified convincingly not only in theory. Empirical evidence is conclusive, too: numerous studies have shown that, as the degree of autonomy of a central bank increases, the average rate of inflation and its fluctuations decrease, as a rule. At the same time, the fact that high and volatile inflation rates are associated with high costs for the overall economy and that stable prices are conducive to the long-term growth process are, in my opinion, two of the established findings of our discipline.[3] However, far less research has been devoted to the "excess burden" or "sacrifice ratio" in the case of a no-more-than-moderate pace of monetary erosion. Is the result to be expected here really worth the effort?

This question might well be answered in the affirmative, bearing in mind especially the sometimes complex interplay between inflation and the tax and transfer system and the ensuing distortionary effects. If one follows the cost-benefit analysis undertaken by Martin Feldstein for the United States, which is also interesting from a methodological point of view, the potential benefit of the transition from a low rate of inflation to price stability is by no means a *quantité négligeable*.[4] Even if, like Feldstein, one takes due account of the costs of

transition, the positive welfare effect will materialize every year and, on a present value analysis, dominate the temporary output losses.

Experience of inflation in the past has prompted some countries to commit their central banks statutorily to pursuing the objective of price stability, and to grant them a high degree of independence in doing this. Other countries have tried to prove the stability-orientation of their monetary policy by announcing official objectives and by ensuring greater transparency in terms of the decisonmaking criteria they apply. Charles Freedman has just presented the Canadian model to us. The Bank of England, too, has made major efforts in that direction.[5]

The position of the central banks vis-à-vis their respective governments has also been strengthened in the past few years by the fact that, as a result of the increasing liberalization of the capital markets, monetary policy in the major industrial countries has been subjected more and more to the critical observation by the international financial markets. Investors from all over the world are closely watching each national economic policy-related decision. The increasing "expectation bias" of the financial markets has meant that a discretionary departure from a stability-oriented course is penalized more quickly and more sharply by capital outflows and rising interest rates. The mere suspicion that the control of inflation is to be sacrificed in favor of other objectives can lead to a massive loss in confidence. The resulting risk premiums push up interest rates at the long end of the market and thus frustrate the original intention of pursuing an employment-oriented monetary policy.

To put it in a nutshell:

- The financial markets have become an important ally for implementing a stability-oriented monetary policy.
- In cases where convictions as to the central task of monetary policy are still of a faltering nature, the globalized financial markets take over the function of a merciless disciplinarian.

One might even go so far as to say that the high inflation rates of the past destroyed the very basis of the existence of inflation by drawing the attention of the financial markets to the dangers of an easier monetary policy. Inflation committed suicide, as it were. However, the wolf always comes when you stop crying, "Wolf." In fact, things are not going so well in our economies that we do not have be afraid of the temptation to solve problems through inflation becoming irresistible again. The fact that at present there is virtual agreement on the importance of stable money is, therefore, no guarantee for ensuring that the pendulum will not swing the other way again in future. If, for example, public debt, which in many countries threatens to get out of hand, cannot be restrained, the inflation tax could once again be regarded as a simple and politically "cheap" means for solving the debt problem. Keeping watch and warning against the dangers of a new shifting of priorities, therefore, remain a permanent task of the central banks.

Even though the underlying conditions for maintaining the price stability achieved seem to be favorable at present, a stability-oriented policy cannot, therefore, be taken for granted. In this context, I should like to draw your attention to three key questions concerning monetary policy.

- How can confidence be created in the stability orientation of the central bank through the latter's self-commitment?

- What is the appropriate monetary policy strategy—not least in view of the first question?

- How can this strategy be best implemented in practice?

In view of the increased sensitivity of the financial markets, the central bank has to gear its approach toward anchoring market participants' expectations about inflation as far as possible to the low level achieved at present. Fostering the belief that price stability is in the interest of the central bank itself and in the interest of those responsible for its monetary policy (the key words *independence* and

statutory commitment to price stability spring to mind here) and achieving as much transparency as possible in the monetary policy decisionmaking process are important requirements here. Only if the confidence of the markets in the permanence of the price stability achieved can be ensured, can society fully profit from the positive welfare effects of an existing high degree of price stability. Failing this, expectations about inflation, and thus longer-term interest rates, will continue to contain no-confidence premiums, which, in turn, will have a negative effect on investment and real growth, and thus jeopardize the acceptability of a monetary policy geared toward price stability.

But even if the central bank is clearly committed to the final objective of price stability, announcing a correspondingly low inflation target, as an anchor for inflationary expectations, is hardly sufficient. Instead, the central bank has not only to announce the final objective but also has to disclose the policy rules and to convince the public that the decisionmaking criteria used are suitable for maintaining over the long term the degree of price level stability already achieved. In view of the length of time required before monetary policy impulses eventually affect demand and prices, all central banks have to depend in their decisionmaking on indicators or intermediate variables, which signal incipient inflation dangers as early and as reliably as possible.

In this context, a number of central banks have placed increased emphasis on inflation forecasts and their discussion in public. As we have heard from Charles Freedman, such inflation forecasts can be interpreted as an intermediate objective on the road to price stability. Doubtless, an explicit discussion of inflation targets and inflation expectations alone is an important step toward more transparency. This applies particularly to those central banks whose policy—for whatever reasons—was previously geared less clearly to price stability. In addition, the fact that under that approach all relevant information is evaluated by the central bank will be considered attractive. On the other hand, we have to assume, as before, that our knowledge of inflationary processes is very incomplete. It is, therefore, likely that it is not only the results of inflation forecasts which

will remain controversial but also the ideas of what are the appropriate forecasting procedures. Providing for transparency will, therefore, always remain an ambitious task.

A monetary policy which is based on a multitude of more or less equivalent indicators and the resulting inflation assessment is, however, more difficult to fathom for the markets and the other economic agents than a strategy which concentrates on pursuing an intermediate objective. Those central banks which have direct inflation targets are aware of the fact that they have to counteract the impression of arbitrariness inherent in an approach of looking at everything by stepping up their efforts at more transparency. Even if the central bank publishes its assessment of future price perspectives regularly and in detail, however, the transparency of a policy rule which is based on inflation forecasts will probably be lower than in the case of a monetary policy which focuses on an intermediate monetary objective.

I agree, in principle, with Charles Freedman when he says that the differences between monetary targeting and direct inflation targeting will presumably be lower, in practice, than might initially be assumed on the basis of the theoretical discussion. Both approaches are ultimately geared toward the final objective of lower inflation rates and are based, for the assessment of future inflation dangers, on a multitude of financial and real economic indicators. But the most important difference probably consists in the different weights attached to the individual indicators. It is true that in its decision-making the Bundesbank takes into consideration the entire monetary policy environment, but it attaches particular importance to the growth of the money stock, which is reflected in the derivation and the announcement of the monetary targets.

Monetary targets not only increase the transparency of the policy rule; they also promote a clear definition of economic policy responsibilities: by setting the monetary target, the central bank assumes responsibility for the inflation trend, but not for fiscal or wage policy decisions which lead to a one-off shift in the price level or have a short-term impact on the current rate of inflation. By contrast, the

higher priority attached to price forecasts and to the final objective under a direct inflation targeting approach runs the risk that monetary policy will become involved in the general economic policy decisionmaking process, and this might make it more difficult to defend its independence.

In contrast to the Bank of Canada, the Bundesbank has remained faithful for more than two decades to its concept of deriving monetary targets, announcing them, and pursuing them. No one would claim that there have been no difficulties in maintaining this strategy. The annual target has been missed nearly every other year. However, even in those years, the monetary targets have proved to be successful as important points of reference, if only because we have been forced publicly to justify deviations from the target by putting forward convincing arguments. On the other hand, this has protected us from the danger of accepting failures to meet the target too easily. I would even go as far as to say that this is not only attributable to the comparatively good result with respect to the final objective, namely, price stability. It is also the strategy and its implementation which have helped to establish the reputation of the Bundesbank's monetary policy.

In the Bundesbank we have always endeavored to make the monetary targets somewhat less abstract and to demonstrate the link between monetary growth and our price notions to the public. We established this link when we derived our targets. It was simple and at the same time flexible, and helped us to influence expectation formation in the economy in accordance with our objectives.

In the 1970s and in the first half of the 1980s, when the inflation rates were still far above our own targets and when it was imperative to regain price stability step by step, we initially based our monetary targets on the so-called unavoidable price increase rates. With these objectives, we were able to reduce monetary growth rates gradually. When in the second half of the 1980s price stability had been achieved, we chose our monetary targets in a way to ensure that they were compatible with annual price increases of no more than 2 percent.

Even though the Bundesbank has not always stated explicitly which inflation measure it considered the most appropriate one, it has tended to prefer a broad definition of that measure: if there are no major price shocks, the GDP deflator, for example, may well be an acceptable choice. However, periods with high import price rises, such as we experienced in connection with the oil price shocks, require additional considerations in that respect. If inflation rates overshoot this critical ceiling, we have to take the distorting and growth-impeding effects of price rises so seriously that we cannot accept them over the long term. All in all, the changeover from a policy of regaining price stability to a policy of maintaining a high degree of price stability within the framework of our concept has been possible without posing real problems.

The situation became more difficult when, in the wake of German reunification and the strong expansionary impulses associated with this, prices in Germany at the beginning of the 1990s rose more sharply for some time. Although it was foreseeable that this inflationary impulse would not disappear immediately, we did not assume higher price increase rates when we derived our targets. In other words, our monetary targets were very ambitious at that time. One might even say too ambitious. We thus quite intentionally tolerated ex ante overshootings of the target, which actually materialized then. As a result, our record of target achievement has necessarily suffered. On the other hand, through the target and its derivation we could make it clear that we were not prepared to accommodate higher price rises permanently in monetary terms. We thus, in fact, succeeded in keeping expectations about inflation in check. Neither in the foreign exchange markets nor in the capital markets have there been manifestations of no confidence in our policy. This was extremely important at a time when fiscal deficits rose sharply and when we had to regain price stability relatively quickly and without incurring excessive real economic costs.

This success was, of course, also due to the fact that the Bundesbank had previously shown how serious it takes its obligation to ensure stable prices. I can, therefore, only underline the *leitmotif* of Charles Freedman's paper, namely that credibility is of utmost

importance. For us, monetary targets and their derivation were important for making our intentions regarding stability clear to the public. On the other hand, if we had abandoned the strategy of monetary targeting at the very time the situation was extremely difficult, this would presumably have caused devastating psychological damage. Monetary policymakers would then have had to react all the more restrictively in order to make it clear that they would never give monetary stability a lower priority, even if only temporarily.

Finally, with respect to implementation, our current monetary policy is not significantly different from that in periods of higher price rise rates—or, where it does differ, this is not due to the changed price situation. This is another advantage of a monetary targeting strategy. It would presumably be more problematic if, for example, we had adopted a strategy which depends more on finding the correct "real" rate of interest, since uncertainties concerning expectations about inflation would then be of key importance.

Endnotes

[1]See *OECD Economic Outlook*, No. 59 (June 1996), p. 7.

[2]See, for example, R. Bootle, *The Death of Inflation—Surviving and Thriving in the Zero Era*, (London, 1996).

[3]See also the recent study by J. Barro, "Inflation and Economic Growth," *Quarterly Bulletin*, Vol. 35, No. 2 (Bank of England, 1995), pp. 166-75.

[4]See Feldstein, M., "The Costs and Benefits of Going from Low Inflation to Price Stability," (NBER Working Paper 5469, 1996).

[5]See C. B. Briault, A. G. Haldane, and M. A. King, *Independence and Accountability*, (October 1995), mimeo.