

Commentary: Monetary Policy and Real Stabilization

Matti Vanhala

Lars Svensson's discussion about the role of monetary policy goes to the heart of the matter. I will comment on the topic generally, but using Lars' paper as a vehicle to some degree. I suspect that he represents a possibly significant body of academic opinion that central banks should broaden their view of their own mandate.

I like Lars Svensson's paper. Let me characterize it: It is elegant and insistent, in that its internal logic is consistent in the extreme. It is imaginative in its assumptions about the environment of monetary policy. It is subversive in its policy prescriptions.

I would like to advise you not to focus on the *specifics* of his argumentation and modelling. Focus instead on the two core elements in his presentation: First, the mandate of monetary policy. Secondly, how a central bank should go about designing, deciding, implementing, and communicating its monetary policy in a way that promotes intellectual discipline, transparency, and accountability. I would especially like to stress the importance of this second element. Central banks must make progress in the area of transparency, and here Lars' paper offers some brave and consistent elements for debate. He deserves credit for sticking his neck out.

The fundamental issue for this session is whether monetary policy should or should not directly contribute more to real growth and employment, instead of focusing predominantly on price stability.

Whenever economies slow down, an increasing interest in this question is to be expected, whatever the monetary policy regime. In countries where central banks have only in the last decade been given independence, along with a legislative mandate centering on price stability, it was equally to be expected that once their economies slow down, the rhetoric would change. It is as if quite a few people would have second thoughts about both mandates and independence now that they see that central banks actually behave independently and pursue price stability as mandated.

All this has been in accordance with the script. Most of the rhetoric is froth, not intended for anything but political consumption. Nevertheless, there is always a danger that central banks themselves are intimidated if there is a constant trickle of hints and doubts from the outside.

Given the limited time available, I will be quite straightforward about my own prejudice in this matter:

(1) For monetary policy, with its one and only instrument, i.e., one interest rate (not the curve nor any spreads), to adopt objectives additional to price stability entails a genuine constraint and compromise on price stability in favor of objectives for which monetary policy is ill-equipped and cannot be expected to perform efficiently. Giving monetary policy a role in which it cannot succeed will weaken its effectiveness and its credibility in the area where it has a reasonable analytical basis and a respectable record.

Of course, there are exceptional circumstances from time to time, forcing other considerations into the forefront. But these situations are not the rule.

In any case, and generally speaking, price stability provides a beneficial environment for the real development of the economy. All this is well-accepted. But there is this seductive distinction between the short-term and the long-term real effects of monetary policy. It always surfaces in these debates. What about it?

We are well aware that monetary policy actions can have impacts on the real economy in the short run. It can also have, and has frequently had, longer-run effects when it contributes to violent swings in the economy that result in the destruction of physical and human capital that would otherwise have contributed to continuing real growth. Worse still, it can contribute to a lack of confidence in the operation of the economic system. During the last decade, a great many developed industrial economies have retreated from monetary policies that managed to make a major negative contribution to the real economy by permitting high and variable inflation.

It seems clear to me that deliberately exploiting any assumed favorable short-term tradeoff between price stability and output stability is an incredibly demanding task for monetary policy. We do not possess the knowledge required. We do not know what precise short-term relationships are likely to prevail in the immediate short-term future. We do not even know the current state of the economy with any confidence—as we have seen everywhere again this year. No one really knows what the output gap is, other than a useful and popular concept with many meanings. For these and other reasons, forecasting is particularly bad at detecting changes in trends and at predicting turning points. Yet, this is precisely what would be needed for meaningful stabilization policies. With a medium- and long-term orientation in a monetary policy aiming for price stability, the situation is quite different.

(2) But even if occasionally we might feel confident about being able to contribute to short-term stabilization of the real economy, should we embark on such a course?

In the case of unfavorable supply shocks, a monetary policy designed to soften the impact will delay a real adjustment that might need to start immediately. This point is quite important in the European context; it is possibly less acute for the United States. In Europe, structural rigidities are generally agreed to be a major cause of the modest assessments of potential growth. Here, an accommodating monetary policy can do little to help; quite the contrary, it may worsen the fundamentals.

Similar concerns may apply to the demand side. An accommodating policy implies discounting a forecast reversal (upturn) in the economy that may turn out to be slow in coming. We have lived through such scenarios also in the past.

(3) Another problem with a politically more “forthcoming” mandate in monetary policy is the likelihood that enlargements of the mandate in the direction of stabilization policy take pressure off other public policies, typically the policies that would be the only efficient ones but which are politically difficult to carry to acceptance and implementation. All structural problems belong in this category. It seems to me that political inconvenience has no legitimacy as an argument. Monetary policy should not be allowed to slip into the role of a bad substitute for efficient measures needed on the part of other policymakers, usually the government.

(4) A similar argument is often valid in the context of so-called “coordination” of monetary and fiscal policies. Coordination sounds attractive and rational, but it ties the central bank into suboptimal constellations and policies in its main area of responsibility.

For all these reasons I believe that it is almost certainly unrealistic and always dangerous to the credibility of monetary policy to get into short-term output stabilization. But, this is not a gloomy view of the role of monetary policy. Acknowledging reality gives a better starting point for pursuing whatever aims you can successfully pursue. This means price stability, or perhaps we should say monetary stability, if we take financial stability seriously, as we should. Whether in some future we might be able to justify ambitions concerning asset markets remains to be seen.

Let me now revert to Lars Svensson’s paper and to what I regard as the two core issues in his essay. I have serious doubts about a dual mandate for monetary policy, as I have explained. What I like, however, is his meticulous effort to spell out a consistent framework of transparency. This is an area where work is needed. Lars deserves recognition for sketching out a consistent set of elements, from design to decision to implementation to communication. The problem with

his specific and very precise version is that we might not be able to make it comprehensive to a broad public, in which case it would all be in vain. A useful test is the following question: Can you explain your policy easily to any parliamentarian in five minutes and be sure that he or she, thereby, is qualified to convey it correctly and convincingly to his or her voters in two minutes? If there is any doubt, all transparency and accountability is gone.

