

Commentary: Monetary Policy and the Control of Inflation

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Governor Crow touched on most of the major issues one wants to raise, leaving his discussants with little to question. I can only echo his comments about the goal of price stability and the critical importance of firmly setting monetary policy on a noninflationary path and keeping it there. Like Governor Crow, I do not believe this objective has much chance of being achieved unless there is some formal understanding that frees the central bank from financing government budget deficits. I would go further. Monetary policy cannot deliver stable prices in Eastern Europe unless there are fiscal and other reforms; the commitment to price stability will be meaningless if most prices remain controlled. These fiscal and price reforms are only part of the economic reform necessary to make monetary policy work effectively.

There are two main points on which I must differ with Governor Crow. First, I believe Governor Crow overemphasizes the importance of interest rates, financial instruments, and well-functioning financial markets in the conduct of monetary policy.

Central bankers in many countries have become so accustomed to conducting open market operations in well-developed money markets that they forget that this has not always been their practice. Central banks used discount rate changes to good effect in an earlier era. If there is no market for financial assets a central bank can hold a daily, weekly or monthly auction of the volume of reserves or base

money it wants to issue. To withdraw base money, the central bank could auction eligible paper.

Monetary policy works by changing asset prices relative to output prices and by changing the composition of asset portfolios. A developed market for short-term financial assets is not necessary for the conduct of monetary policy. Monetary policy can be effective in controlling inflation if relative prices are (1) free to change and (2) act as signals for resource allocation, which is to say that allocation decisions are made in markets not by private or public monopolies.

Second, Governor Crow suggests that if one anchor is good, two may be better. He regards Poland's effort to use tax-based incomes policy to control money wages as an interesting, and probably useful, experiment. Possibly he sees incomes policy as a way to improve the chances of reaching and sustaining price stability.

I am skeptical about the usefulness of centralized wage policies for several reasons. Wage standards tend to become uniform standards, or they sanction uniform rates of change. A problem in many economies that is particularly important in Eastern Europe is to bring relative wages into some relation to relative productivities and relative demands. Wage boards and incomes policies discourage these micro adjustments. Further, I don't believe his proposal can work effectively. If Eastern Europe is to become competitive internationally, it must find ways to get costs of production (including wages) into harmony with international competitors. If the exchange rate is fixed and the money wage is encouraged to conform to some national standard, the principal way to reduce real wages and real costs of production is to devalue the currency, sacrificing the other anchor.

Equally important, the countries of Eastern Europe must learn where to concentrate their productive efforts. If subsidies are reduced or, better, removed, some products previously produced will be imported, and others will be exported in greater or lesser degree. To learn where their comparative advantages lie, these countries must allow relative prices and costs to adjust. Wage stabilization hinders adjustment of this kind.

I can summarize much of the rest of my comment in three words—credibility, flexibility, and applicability. After discussing each of these in turn, I will add a few words about the so-called monetary overhang that is often said to be a problem for the Eastern European economies.

Credibility

One of the most urgent tasks in Eastern Europe is to get people accustomed to using price signals—relative prices changes—to guide resource allocation. The monetary system can best contribute to this task by assuring that the price signals are as clear as they can be. Price stability removes the problem of separating general and relative price changes and reduces the problem of separating temporary and permanent changes in the price level. The signals from demand, cost, or productivity changes are then easier to interpret. The quality of the information provided by the price system is greater. This, in turn, increases efficiency.

In principle, there are several ways in which the monetary authority can maintain price stability. The principal alternatives are either fixing the exchange rate or adopting some fixed or adaptive rule for money growth. Either of these rules will work if the role is consistent with price stability, and the public believes that the central bank will follow the rule. Neither role guarantees success. **A** fixed exchange rate rule runs the risk that the exchange rate will not be consistent with price stability or, as Chile learned in the **1980s**, that the real exchange rate is revalued. A monetary role will have difficulty with velocity changes in a rapidly changing economic system.

Establishing credibility—the belief that the central bank will follow the role—is particularly difficult in Eastern Europe. Under the centralized planning system that was common to these countries, the state bank financed not just the excess of spending over receipts in the government budget but in the budgets of all the enterprises. As we know from experience, if the state bank (or the central bank) continues to finance all budgets on demand, inflation will not be

avoided, and credibility will not be established once prices are decontrolled.

Credibility for the new monetary policy can be achieved most effectively if the new system is seen to be a major departure from the old, and the opportunities for discretion are severely restricted. Unlike Governor Crow, I would not equip the central bank with the power to choose the money stock or the interest rate. In fact, I would restrict the government's monetary role by establishing a monetary authority like the Hong Kong or Singapore Monetary Authority. The exchange rate is fixed. The authorities are empowered to issue money only if they receive convertible currency, and they must withdraw money when they lose convertible currency. They collect seigniorage, but they have no discretionary authority to change the quantity of money and no legal means of doing so. Money can only be issued to the extent that the country earns convertible currency.

This system has several additional advantages. Let me spell out a few. First, it focuses attention on the need to compete in world markets. Efficiency in international markets begets domestic efficiency, and increased domestic efficiency encourages exporting. Second, domestic prices would adjust toward world levels. If the exchange rate is fixed to the dollar or the mark, domestic commodity prices will move toward U.S. or German prices for goods of the same quality. Third, interest rates will fall toward the world level. At first there would be a risk premium but the premium would decline as confidence grows that the system will be maintained. Fourth, budget deficits would be limited. All borrowing, whether denominated in domestic or foreign currency, would have to be financed from domestic or foreign saving. The market would limit borrowing by raising the interest rate as borrowing increased.

The monetary authority would be limited to a few monetary functions. A banking authority, or financial market authority, would have the important task of developing and supervising a competitive banking and financial system to increase the efficiency with which savings are allocated and investment financed.

Flexibility

Under the system of material balances and central planning, prices had no allocative role. Resource allocation and pricing were unrelated, and prices changed infrequently. In a market economy, prices change frequently and guide the allocation of resources. Price flexibility permits the market to respond to changes in relative demand or relative scarcity.

Flexible costs and prices can reduce fluctuations in employment and output. Developed markets contribute to price flexibility. In Eastern Europe, where price and wage flexibility has been rare for decades, reliance on flexible prices and wages to signal the appropriate reallocation of resources is likely to develop slowly. People must learn to follow the signal. And they must learn that rising prices for the goods or services that they buy is not necessarily a sign of anti-social behavior by the sellers.

We know from our own experience that this is a difficult lesson to learn. Large increases in the prices of consumer goods in the United States often lead to claims that speculators and profiteers are responsible for the rise and to calls for lower prices, controls, or investigations. Large declines in price lead to demands for protection, subsidies or minimum prices. Government responses to these outcries typically reduce price flexibility, thereby making the economy less efficient and less competitive. The information, provided by the price system, to guide resource allocation is suppressed.

Applicability

Monetary reform is a useless gesture unless it is part of an economic reform that allows prices to adjust. Monetary reform and price flexibility should be parts of a comprehensive reform program that includes the establishment of open, competitive markets in a wide range of goods, services, labor, and assets. For it is competition in a market economy that reduces monopoly power and induces self interested individuals to provide the social benefits that free markets generate. And, it is the right to keep the gains and the responsibility to accept losses that induces people to compete. Hence, estab-

ishment of private property and other institutions that sustained the competitive market system, such as accounting and legal systems, must be part of the reform.

The United States and other private property, free market economies have placed many restrictions on property and markets. Some of these are introduced to equate private and social costs, as in the case of pollution, or to protect minors or others. Some are designed to redistribute income. The type of market system that is most likely to endure is a democratic, capitalist system with its tensions between efficiency, growth, and redistribution. Redistribution requires taxes, and high taxes reduce effort or shift activity away from established markets. Heavy intervention and redistribution reduce the likelihood of a successful transition to democratic capitalism.

Those who question the applicability of the market system to Eastern Europe or the Soviet Union typically do not have these restrictions in mind. Those who raise the issue of applicability question whether private property and competitive markets will produce growth, raise living standards, and increase efficiency in their countries.

The argument often made is that experience and the established culture are so different that individuals will not respond to the type of incentives that have worked elsewhere. We know that this cannot be wholly true. People from all of the cultures and countries of the world have responded to market incentives in the United States and there is now additional experience in a wide variety of cultures. And the prevalence of "black markets" and other private arrangements suggests that entrepreneurs are not unknown in Eastern Europe or the Soviet Union. Increased competition is a way to get these entrepreneurs into more productive activities.

I believe that an important distinction is often neglected in discussions of applicability of the price system. Misleading language contributes. We talk about people "working for money," but, money is only a means of buying goods or assets.

People produce and innovate to acquire goods, services and assets. That is why monetary reform alone is not sufficient. It must be part of a social and economic reform that puts toasters, washing machines, dryers, TVs, cars, houses and the like into stores in every city and village and provides an infrastructure that includes roads and electricity to make these durables useful to a large part of the population. The reform produces incentives by providing opportunities for accumulation and for improved living standards.

Monetary overhang

In many countries, there is said to be a "monetary overhang"^v—forced saving in the form of cash balances that people would spend if more goods and services were available. The concern is that, if prices are decontrolled, prices will rise as people seek to shift from money to goods. The fear that others will behave in this way encourages a flight from money, for the anticipated increase in prices will reduce future purchasing power.

There are two solutions to this problem—increase the supply of goods or reduce the stock of outstanding money. Currently, in most of Eastern Europe, the first requires imports. The second calls on the government to withdraw money from circulation by selling assets, including housing, as Governor Crow suggests, or selling some type of indexed bond that pays a positive real rate of interest. If the country replaces the state bank with a monetary authority, as I have suggested, the bonds should be denominated in the currency to which domestic money is pegged.

I see no reason to choose between these two alternatives. Governments should offer assets, including indexed bonds, to privatize ownership and absorb excess supplies of money. If the monetary authority fixes the exchange rate and maintains convertibility, the public can buy imported goods. Once the public becomes convinced that the exchange rate will remain fixed and prices will remain stable, they will choose to increase cash balances. Thus, credible policies reduce monetary overhang both by withdrawing money and by increasing the demand for money.