Discussion on Papers by Warwick McKibbin, John Quiggin and Peter Stemp

1. Glenn Stevens

These are three quite different papers, from very different perspectives. John Quiggin adopts a micro approach; Warwick McKibbin's views are informed by research on optimal policy regimes in large-scale macro models, while Peter Stemp's comments are mainly based on the literature which deals with institutional structure and incentives for monetary policy. I want to respond to a couple of points raised by each author, and then end by suggesting three questions – one from each of the papers – on which discussion might focus. I am going to talk about the three papers in the order in which I read them, which is not the order in which you have heard them today.

John Quiggin's paper has a micro framework. He starts with a representative agent maximising a lifetime utility function subject to the usual constraints. If I understand this analysis correctly, John makes two points:

- People care about volatility in consumption streams. If you give them two streams of income and consumption which have identical discounted present value, but one is much more volatile from period to period than the other, they will prefer the less volatile one, if they are risk averse. This is a standard implication of concave preferences: people prefer a certain amount equal to the expected value of a gamble to the gamble itself.
- Macroeconomic stabilisation policies may diminish welfare at the individual level even if they stabilise aggregates, if there are sectoral or distributional elements to the effects of policy applications (which, of course, there clearly are with monetary policy).

The implications drawn from this are that monetary policy should stabilise real interest rates; output stabilisation should be achieved by a particular kind of fiscal policy, namely lump-sum taxes which are positive under conditions of strong growth and negative under conditions of weak growth or recession. Inflation *per se* should not be a target of monetary policy – or any policy. This seems to be based on the idea that stabilising interest rates will be consistent with stabilising inflation, rather than the idea that inflation is costless, but more fundamentally there is no money or prices in this model, so it cannot really answer questions about inflation.

This view of monetary policy has, in some ways, a parallel to the older monetarist idea that activist monetary policy can be destabilising, but at the same time it turns that idea on its head. The Friedman money *k*-per cent growth rule was designed to avoid instability emanating from long and variable lags. The idea was that interest rates should not be smoothed, but allowed to vary as the market determined to keep demand for money on line with the smoothly growing supply. Central banking practitioners, on the other hand, have always smoothed short-term interest rates. They can justify this by the claim that shocks to money come from the demand side; I suspect they also think that lessening volatility in interest rates is, under most circumstances, probably 'a good thing'. Among

the reasons for this may be perceived costs of reversals, a topic covered in the paper by Philip Lowe and Luci Ellis. To a point, I think central bankers would find some agreement with Quiggin that the idea that a high degree of instability in interest rates is not good.

But only to a point. I think central bankers would have to take issue with a proposal to try to stabilise real interest rates completely. For one thing, they will always worry about the response of price expectations to a price shock. Suppose inflation rises unexpectedly because of a temporary demand disturbance. If inflation expectations do not change, then the actual inflation shock will die out, inflation will go back to where it was; no nominal interest rates need change, and no policy-induced effects on the economy are necessary. Real interest rates in an expected sense do not move (though real *ex post* interest rates temporarily fall). This is well and good; but suppose expectations *do* move when actual inflation rises. Then something has to happen to bring them and actual inflation back down again, unless we accept that higher inflation is costless (an argument Quiggin does not make). In the standard framework that is a rise, temporarily, in real interest rates. This is just an application of the literature covered in detail in Malcolm Edey's paper about needing to tie down the price level by having real interest rates respond to a nominal target. This literature would say that John's real-interest-rate-stability rule would not achieve this. Furthermore, unless markets have some confidence that action would be taken to contain inflation, they are likely to build an inflation risk premium into market rates, which means that real interest rates are higher than they would otherwise be.

An additional point is that the 'equilibrium' real interest rate may itself be subject to shocks. Economists often assume this away, but I do not see why we should. Trying to stabilise the real interest rate on financial assets in the face of such shocks would be inherently inflationary or deflationary – just as Wicksell pointed out. So while John assumes (in the structure of his model) that stability in the intertemporal price of consumption is good, surely relative prices are supposed to change when underlying fundamentals shift. It may be appropriate to assume that the fundamentals determining equilibrium real interest rates do not shift – then again it may not.

One response to these concerns is to look for a more active role for fiscal policy in stabilising output and inflation. John is not the first person to say that we should not eschew the use of taxes for countercyclical stabilisation. (Bernie Fraser, former Governor of this Bank, said so too.) The question is to what extent this is a practical option. It is not necessarily that easy, and one can I think detect in the concluding part of John's paper a recognition that this sort of use of tax policy is not politically straightforward – it will be easier to cut taxes in recessions, for example, than to raise them in booms (a bit like interest rates, actually). Does this lead to arguments for an independent fiscal authority, immune from the political process, setting lump-sum taxes according to its forecast of the state of aggregate demand? The paper does not take this issue up – but it seems a logical implication of the argument.

A more general comment perhaps is that the paper does not consider explicitly the institutional framework. This is in contrast to Peter Stemp's paper, which does draw attention to the institutional framework for monetary policy.

Peter also eschews any active role in output stabilisation for monetary policy, but for

a different reason to John. While John thinks that even if it succeeds in stabilising aggregate output, monetary policy can still be welfare reducing, and it should not worry unduly about responding to inflation *per se*, Peter thinks that policy cannot hope to stabilise output because of lags *etc*. and it should concentrate *only* on prices. Commenting on the evolution of the policy framework over the past decade, Peter says Australia has 'meandered through a range of policy regimes'. Whether that course was a meandering one or a purposeful evolution is discussed in detail in Stephen Grenville's paper. John's concern is that even though we have a reasonably sensible target regime at present, there is 'nothing to stop reversion' to some other less defensible regime. Hence his call for further institutional development.

In reflecting on the lags issue, one is, I think, bound to observe that the lags between monetary-policy changes and inflation are in all probability longer than those from policy to activity. The available empirical evidence in Australia suggests so anyway. The obvious reason is that changing the economy's short-run output trajectory relative to potential – opening or closing output gaps – is an important part of the short-run dynamics of inflation. If long and variable lags are a reason not to try to stabilise output, why do these same arguments not apply to trying to stabilise prices?

The answer is that they do apply, but that despite these difficulties, targeting inflation is still the best policy approach available, unless we have the unfailing intermediate target (a very stable money-demand function or sustainable exchange-rate peg with the perfectly compatible larger neighbour). The way we target inflation is by making the best forecast we can and adjusting the instrument accordingly.

A policy so carried out should, incidentally, do something to help stabilise the business cycle in instances where the cycle is driven by demand-side disturbances: policies to manage the cyclical swings in inflation and policies to dampen cyclical swings in output should be much the same thing. In other words, even if one accepts that inflation should be the sole *long-run* objective of policy, that does not rule out a role for policy in doing what it can to counter cyclical swings in output. In this sense, at least, policy can have dual objectives (Fischer 1996). One can, I hope, say this without it implying one thinks that monetary policy can reduce unemployment below the NAIRU sustainably or things of that nature.

The main idea which supports the focus on institutional structure is the time-inconsistency one: policy-makers are continually tempted to spring some surprise inflation to get some growth beyond potential. But since everyone knows this, and expects the higher inflation, the equilibrium is that we get the higher inflation without the growth; if only policy could credibly pre-commit to price stability, we could get an equilibrium with a lower inflation rate (and still the same growth). The way we achieve this is to appoint a 'conservative central banker', or work hard at designing an optimal contract.

Peter proceeds by examining the evolution of the structure in Australia and elsewhere, developing a ranking of three central banks in terms of independence and accountability on various criteria. He finds Australia has improved absolutely over time, but is last (by a fair distance) in this particular group. The basis for this conclusion is that, in his view at least, the RBA has insufficient operational independence, and there is not enough accountability (i.e. it is not clear enough who, if anyone, loses their job if the target is missed).

I think there is little point in getting into a discussion about rankings. While the three central banks are obviously ones of interest – they are all represented here today – it is a small sample. On the more comprehensive rankings – such as those of Grilli *et al.* (1991) and Cukierman (1992) – the RBA comes out around the middle, which seems about right to us. The RBNZ and the Bank of England will have moved up in these rankings with the reforms of recent years.

On the specific issue of whether the RBA has full operational independence, Peter's comments are, to say the least, puzzling. The Bank has for some time had operational independence for interest-rate moves. The Board decides the changes and makes them. The Statement on the Conduct of Monetary Policy issued by the Treasurer and the Governor in August 1996 makes this even clearer than it was. It says the Bank is independent, and that it will pursue the target.

Evidently this is not clear enough for Peter, who says that because some Board members 'lack technical expertise', because one member is head of the Treasury (an institution not usually known for its preference for higher inflation), and because there are no published minutes of the Board's meetings, 'it is not possible to evaluate the extent of government influence on Board decisions'. This strikes me as trying a little hard to establish lack of independence. Supposed lack of technical expertise would have little bearing on independence; and *if* there were improper political pressure, it does not seem likely to me that minutes – especially published ones – would reveal it. While Peter seems to imply the Bank should be more independent, he is not very specific about exactly what should be done to bring this about.

It is an old record, but it must be put on again: the Bank is, and has been, independent of government and has not tailored interest-rate decisions to political needs. The ultimate test of this is the outcomes: inflation has averaged about $2^1/_2$ per cent since 1991. (Incidentally, when Peter says the target is not quite clear enough for us to be able to evaluate success, the answer is that we have had six years of inflation at an average of $2^1/_2$ per cent. When we say we want to average two-point-something over time, this is exactly what we mean.)

But rather than extend that (rather sterile) debate, what might be more useful is to talk about Stemp's more important recommendations. I think the main one of interest is the idea that there should be a review process in the event of the target being revised.

The Statement on Monetary Policy says the Bank will report to Parliament periodically. This was already provided for in the Act in the form of the Annual Report, but there will now be two Semi-Annual Reports on Monetary Policy each year, with the Governor appearing before the relevant Committee. We had the first one in May this year. If the Bank loses the plot on inflation, or tries to fudge the target, or avoid responsibility for inflation outcomes – things which Peter seems to worry about – then the Parliament can and should call it to account.

True, there is no threat (or power) to dismiss the Governor if he or she misses the target. The formal review processes in the event of the target being missed in some other countries are of interest. But this is an area of inflation targeting where there is little to go on in the way of actual experience. For the most part, reviews have not been triggered in countries which have formal mechanisms – which of course is good insofar as it means inflation is being controlled. So far, we have only one example to my knowledge of the

target technically being missed, and the review processes operating; that was in New Zealand in 1996. Dr Brash was obviously not fired – since he is here today! – we assume because the RBNZ by any standard has done a very good job in controlling inflation.

This episode does remind us, however, that the way in which the reviewing body (surely a parliamentary one) chooses to conduct its review will be important. Personally, I think the idea that pre-determined sanctions for failure to control inflation, meted out by elected representatives, will be an important deterrent on central banks otherwise disposed to spring an inflation surprise is a bit naive. McCallum (1995) has argued that the time-consistency problem is not solved by having Governments review central bank performance, only relocated. (Have we given enough thought to whether the incentives are correctly structured to make sure that, if inflation exceeds a target, parliamentarians demand to know why the Governor did not raise interest rates sooner or by more?)

I think there is ample scope for our system, characterised by very open public and parliamentary debate on monetary policy, to keep people's minds concentrated. There are arguments for some sort of mechanical review process in the event of failure to hit the target, but it could also be argued that the review processes which occur before such an event – and so might head it off – are more important. The parliamentary group has a fairly wide mandate to query the Governor on any issue twice a year. It might be worth seeing how this works for a while before concluding, as Peter does, no effort has been made in the area of improving accountability.

As a modeller from way back – indeed as one who has a model of the whole world – Warwick McKibbin is not as daunted by the problems of model uncertainty as Peter Stemp. Unlike both Peter and John Quiggin, Warwick believes in a certain amount – an optimal amount – of monetary-policy activism, aimed at a degree of stabilisation of output and inflation in the face of various shocks.

Warwick has given us a distillation of a very large program of research aimed at establishing the set of circumstances in which various rules are optimal or close to optimal. This seems to be in the same general line of research as that of, for example, Gordon de Brouwer and James O'Regan at this conference. Noting that a fully optimal rule may well be so complex as to approximate discretion – that is, not really a rule at all in the usual sense of that word – Warwick goes on to talk about various classes of fairly simple, and transparent, rules and their robustness across different circumstances.

One of the basic findings of this research seems to be that rules which respond to both output and inflation deviations – let me call them BHM-HMcK-Taylor rules – are not too bad in a variety of circumstances, and dominate alternatives in many important cases. There will be a detailed discussion of these sorts of rules later in the conference so I will not go into them now.

Warwick characterises the current approach to policy in Australia as close to such a rule, though the weights in our particular rule are unclear to him, and he comments that it may be credibility enhancing if we were to spell them out. Perhaps there is something to be gained by telling people our reaction-function weights – how much we think we have to adjust our instrument in response to deviations of forecast inflation from target. I think, however, that what has been more important for us over the past five or six years is to clarify the weights in our *objective* function. By the setting of our instrument, we

have been proving to people that the weight on inflation in our objective function is high, by being prepared to tighten policy quickly when inflation pressures begin to mount. As it has become clearer that we have succeeded in containing inflation at the rates we said we would, credibility – on several measures – has gradually increased (though there is further work to do here yet).

Warwick's conclusion returns to the idea of robustness, and challenges us to keep probing the limits of our present rule, and contemplating the possibility of a major shock which might require a different reaction function (I do not think he is talking about a different *objective*). It might be worth spending a few minutes in our discussion speculating on what these shocks might be.

One can think of several possibilities. I think one of the hardest ones to face might be asset-price fluctuations – where it may be difficult for policy to respond in a timely enough fashion to prevent instability in the financial system which flows over to the real economy. (Question: Would a BHM-HMcK-Taylor rule have worked well in Japan in recent years? Would it have avoided the bubble economy, and subsequent problems?)

Let me try to finish up my discussion of these three quite different perspectives on Australian monetary policy, by suggesting a few topics around which we might organise discussion:

- First, interest-rate volatility: are there costs in interest-rate fluctuations, even movements which the macro models suggest are optimal from an aggregate point of view, arising at the micro level? If so, how may they be minimised while still achieving a degree of aggregate stabilisation, particularly inflation stabilisation? What role might reasonably be expected of fiscal policy in stabilisation?
- Second, the institutional framework for monetary policy in Australia: what further changes, if any, might be useful? Is there anything we can learn from the experience of other countries about how to structure review mechanisms?
- Third, how do we balance the need for *credibility*, which may require, if not a rule, perhaps fairly predictable responses to observed information – 'rule-like behaviour' – with the need for *adaptability* – the capacity to learn quickly about changes in the economy's structure, and to assess big shocks accurately, and to respond quickly?

References

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2. General Discussion

There was considerable discussion concerning John Quiggin's proposal for greater stability of real interest rates. There was little support for the extreme version of this proposal which sees the central bank keeping the real interest rate constant. It was generally felt that such a policy would fail to tie down the inflation rate, as it would see policy accommodate inflation shocks. Moreover, since the real interest rate is the outcome of preferences and opportunities, a constant real rate would fail to respond to evolving 'fundamentals'. Notwithstanding these comments, some participants argued that real interest rates should be more stable than they have been over recent decades.

Most speakers saw some merit, in principle, of an increased role for fiscal policy in the management of the cycle. But most wondered whether or not this was practical. While changes in monetary policy alter the distribution of income and affect different sectors of the economy in different ways, some participants questioned the proposition that fiscal policy could avoid these distributional effects. Lump-sum taxes might reduce the size of any effects, but would probably not eliminate them and, in any case, such taxes are extremely difficult to implement.

There was also a discussion about the political economy of fiscal policy, with several speakers noting that it was much more difficult to increase taxes than to reduce them. In the end this difficulty served to limit the flexibility of fiscal policy to actively assist in the management of the business cycle. In this regard, some noted the commitment of several European countries to satisfy certain fiscal criteria as a precondition for monetary union as an example of governments being prepared to tie their hands on fiscal policy.

There was also a discussion on whether an inflation-targeting system is more effective if there is a review mechanism (with the possibility of penalties) which is invoked when inflation breaches a certain band. There was no general agreement on this issue. Some argued that if there is to be a review process, the inflation target needs to be specified so that it is clear when the target is being met and when it is not being met; they see the Australian specification of 'two-to-three per cent over the cycle' as not meeting this criterion. The alternative view is that the Reserve Bank of Australia is subject to systematic periodic scrutiny by a parliamentary committee, and that the public is able to assess the Bank's expected path of inflation over the next few years.

Some thought a triggered review mechanism was necessary to focus the minds of central bankers on the need to achieve low inflation. It was also argued that review procedures are an important part of the process of public accountability. Others saw little benefit in triggered review processes, arguing that the process of review should be ongoing. They wondered whether governments would be prepared to penalise central banks for not having had higher interest rates. Also, the possibility of a triggered review with some form of penalty could distort the incentives of the central bank, leading it to induce extra volatility in output to avoid a review. Others noted that when policy is decided by a committee, as opposed to an individual, it is difficult to design appropriate penalties. Despite these potential problems, some participants argued that the New Zealand system had worked well; the review procedures had helped underline the commitment of the central bank and the government to low inflation.

Finally, there was a brief discussion on the appropriate size of reaction coefficients in simple interest-rate rules. (This issue was also discussed following the paper by de Brouwer and O'Regan.) It was noted that that the optimal coefficients depend upon the type of shock. If policy-makers can observe shocks, then optimal monetary policy does not require that interest rates always respond by the same degree to deviations of inflation and output from their targets; that is, there is not one simple rule that policy-makers can use. Despite this, some participants wondered whether a simple rule would perform better than unconstrained discretion, believing that discretion could be abused.