The Art of Monetary Policy

Talk by the Governor, B.W. Fraser, to the 23rd Conference of Economists, Surfers Paradise, 26 September 1994.

I am honoured to have the opportunity to address this year's Conference of Economists.

Economists have long had a substantial influence on public debate and public policy. We should not be surprised by that. Keynes observed almost 60 years ago that:

> '... the ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed, the world is ruled by little else. ... I am sure that the power of vested interests is vastly exaggerated compared with the gradual encroachment of ideas.'

Monetary policy is one area where the gradual encroachment of ideas has left its mark. Views about the role of monetary policy have evolved over several decades in response to the arguments of economists and the lessons of experience. They are still evolving and there is no unanimity. My own views, which I offer from the perspective of a policy maker, are in part encapsulated in the topic of my talk, 'The Art of Monetary Policy'. However one sees economics in the round, monetary policy is definitely an art, not a science.

What Can Monetary Policy Do?

I start with the goals of monetary policy. What can monetary policy do?

One thing most economists can agree on is that monetary policy should be concerned primarily with 'price stability'. That term can be defined in different ways, but low inflation is the primary goal of central banks everywhere. Monetary policy is widely seen as the main key to low inflation, although some locks also need other keys. This audience does not have to be reminded that economies work better when prices are relatively stable, and consumers, investors and savers are spared the effort of having to adapt to ever changing price levels.

A second possible role for monetary policy– that of helping to smooth the business cycle – is more controversial. Some economists argue that monetary policy has *no* effect on output. Others, on a different tack, argue that attempts to smooth the cycle with monetary policy will prove counter-productive.

The notion that monetary policy has no effect on output can only be a throwback to textbook constructs of self correcting forces which keep the economy in some kind of equilibrium – including, in their modern guise, perfect foresight and rational expectations. It is clearly wrong over any time horizon relevant to policy makers. Changes in monetary policy might not do much to raise the economy's 'long-term' growth potential, but they certainly affect output and employment over the course of the business cycle.

Some economists concede that monetary policy can influence both prices and output, but worry that one objective will be pursued at the expense of the other. The mechanical formulation of this argument is that one instrument cannot achieve two objectives. But multiple objectives are routinely pursued – and satisfactorily met – in all walks of life. The issue, therefore, should not be settled by any mechanistic dismissal of the possibility. History, on my reading, demonstrates that consistency of goals is attainable, although I recognise that conflicts can occur and that policy must sometimes give priority to one objective.

The validity of this view can be illustrated with the help of the distinction between disturbances (or 'shocks') on the demand side and those on the supply side. In the case of a demand shock, which might cause the economy to run too fast, the appropriate monetary policy response is to raise interest rates to slow activity *and* combat inflation. There is no intrinsic conflict here between the two objectives (although actual policy making still requires some fine judgments and depends on imprecise instruments, leaving ample room for mistakes).

In the case of a supply shock, the monetary authorities have the same fine judgments to make but the situation is quite different. A supply shock, for example a major oil price increase, will reduce both actual and *potential* output, as well as raising prices. If policy were to respond simply by stimulating the economy in an attempt to return to the initial output level, its main effect would be to ratchet up the inflation rate. In this situation, monetary policy should give priority to price stability (and rely on structural policies to restore potential output).

Australia has encountered shocks of both kinds over the post-war period. In the 1950s and 1960s, they were mainly on the demand side and, broadly speaking, keeping inflation low and moderating the business cycle were one and the same task for policy makers. Inflation was seen as a product of excess demand so that smoothing the cycle helped to deliver price stability. The outcomes on both objectives were generally satisfactory, although policy makers were sometimes reluctant to slow down the economy when things were going well. William McChesney Martin's famous dictum that it is the job of central bankers 'to take away the punch bowl just when the party gets going' is an early recognition of the need for monetary policy to be forward looking – and perhaps a reminder that acting in a timely fashion is not always easy.

In the 1970s, the problems were more on the supply side, with the price of oil quadrupling and wages exploding. As noted a moment ago, such shocks *do* bring the two goals into conflict in the short run, because they simultaneously raise prices and lower both actual and potential output. Experience suggests that the authorities, both here and overseas, often have been reluctant to take the tough measures necessary to lower inflation in an economy already weakened by the shock.

During the 1980s, policy in Australia sought to restore the earlier balance and consistency of output and price objectives, with some success. The past decade also has seen more focus on the 'medium' term and on structural change, and less on smoothing the cycle. Over this period, fiscal policy came to be framed increasingly in a medium-term framework, leaving cyclical stabilisation largely to monetary policy.

Today, a significant body of opinion holds that not much can be done about the cycle, and that fiscal policy should aim for structural balance, while monetary policy should address price stability. This kind of instrument assignment commands a wide degree of academic acceptance, as well as a fair amount of rhetorical support among practitioners. My reading of recent macroeconomic policy actions around the world, however, suggests that policy makers have not totally foresaken the cycle when setting monetary or fiscal policies. Nor should they. Policy makers cannot eradicate the business cycle but, notwithstanding their less than complete success in the past, they can help to moderate its amplitude.

Having one, rather than two, specific objectives does not remove the difficult decisions which lie at the heart of good monetary policy. In responding to demand shocks, the authorities will want to take account of the level and path of real income and demand. There is always a question of how rapidly or how gradually policy should be eased or tightened in seeking to return to the desired path. For supply shocks, all monetary authorities are in the same position, with the same invidious decisions to be made about the desirable speed of winding back the offending price increases, and the same constraint of lower potential output.

Indeed, apart from possible 'credibility bonuses' (of which I will say more later), monetary policy everywhere operates to lower inflation essentially by creating slack in the economy. It follows that monetary policy, even when primacy is given to price stability, should keep one eye on the consequences for output and employment. In practice most central bankers are interested in real activity (whatever their charters might say), both for its own sake and as an indicator of future inflation.

The *Reserve Bank Act* prescribes multiple objectives for the Bank. It is required to have regard to activity and employment, as well as to price stability. Personally, I am quite comfortable with those multiple objectives.

That should not be taken to suggest softness or wimpishness about inflation, or to imply a belief in permanent trade-offs between inflation and unemployment. I think it is regrettable that central banks with an attachment to more than one objective are often treated with suspicion so far as their commitment to low inflation is concerned. They are sometimes portrayed as misguided adherents to defunct Phillips curve notions that unemployment can be reduced permanently by tolerating higher and higher rates of inflation.

For the record, the Reserve Bank does not carry around any model of a usable Phillips curve in its kit-bag. We do not believe that more than a quart can be had from a quart pot, or that an economy can run sustainably beyond its resource capacity. We do, however, believe that monetary policy influences the course of the cycle and, handled with skill, that influence is beneficial. We do, then, seek to have regard, in pursuing a low rate of inflation through the cycle, to the consequences of our actions for activity and employment, as well as for inflation.

Some of you might be thinking that this treatment of what is a fairly simple and straightforward point is rather laboured. Perhaps it is, but many commentators – including some practitioners – do forget it, or pretend that it does not exist.

It is apparent from what has been said already that monetary policy makers have many questions to try to resolve. What, for example, is the nature of a particular 'shock'? What is the outlook for inflation? What stage of the cycle is the economy at? What is the 'natural rate' of unemployment? What are safe 'speed limits'? What is the impact of other policy settings?

None of these questions has an easy answer. All involve judgments and we know that judgments are fallible. That fact has led to the search for 'rules', or 'intermediate targets', to guide monetary policy, as an alternative to relying on the judgments of central bankers and Treasurers. In the eyes of some people, governments in particular are seen to be prone to predictable temptations which impart an inflationary bias to policy making. On this view, the best outcome for inflation (and output) is achieved only when the authorities lash themselves – Odysseus-like – to the mast of an inflexible rule. But are rules the answer? Are they likely to deliver more acceptable outcomes for Australia? In my view, the answer to both questions is a clear 'no'.

What Should Guide Policy?

The main rules that have been suggested to guide monetary policy are monetary targets and exchange rates fixed to a low inflation 'anchor' country.

The idea of giving monetary policy the *sole task* of achieving a set rate of growth of a monetary aggregate dates from the old Quantity Theory of Money, which was revived by Milton Friedman in a famous paper in 1948. At some time in their recent history, most industrial countries, including Australia, have taken this idea seriously and have used money supply targets to guide policy. Several European countries, including Germany, still maintain a certain attachment to monetary targets. (The Fed in the United States publishes a monetary target, but this appears to be more an on-going obligation under a law passed in 1978 than an integral part of current policy making.)

For many countries, any relationship between money (however defined) and nominal income which might have existed in earlier times was rendered an increasingly unreliable guide for policy by the financial deregulation of the 1980s. In Australia, the practice of setting a growth rate 'projection' of the monetary aggregate M3 was abandoned in January 1985. Research in the Reserve Bank, both at that time and subsequently, pointed to the fragility and instability of empirical relationships between money and income in Australia.

Some economists who continue to investigate these relationships purport to find, in the haystack of the statistics, the needle of a stable money-income relationship. But *ex post* 'stability' is not good enough. Harvard economist, Benjamin Friedman, made this point well when he said:

> '... the question is not whether a sufficiently clever econometrician, surveying the wreckage after the fact, can devise some new specification, or invent some new variable, capable of restoring order to a collapsed relationship. What matters is whether it is possible to identify before the event a set of regularities of sufficient centrality and robustness to provide the qualitative and quantitative basis for sound policy making.'

As I have said, we have not been able to identify such 'regularities' before the event. The experience of the preceding 30 years proved to be of little value in foreseeing the extent to which financial deregulation would affect linkages between money and income. Unrelenting changes in financial markets and structures seem likely to render any on-going search for useful links unproductive.

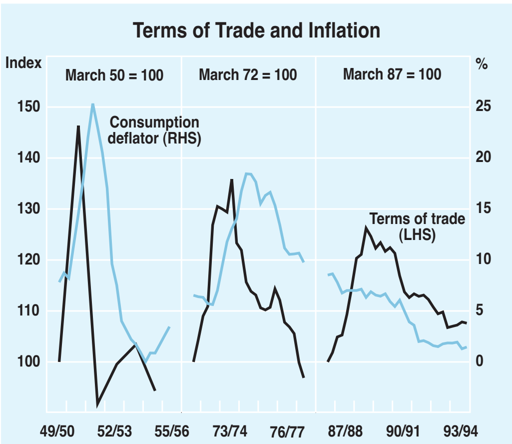
I should be clear about where this conclusion takes us. Monetary and credit aggregates may still contain useful material, including corroborative information about turning points in nominal demand, or about structural developments (such as changes in debt levels in particular sectors). We continue to scrutinise them in that light; we do not believe, however, that they can be elevated to the status of an intermediate target for monetary policy.

The other prominent 'rule' is to peg the exchange rate to the currency of a low inflation anchor country. The European Exchange Rate Mechanism (ERM) is the most notable current model, with Germany playing the anchor role. This arrangement appears to have been helpful to a number of European countries, providing them with the discipline they needed to lower their inflation rates.

In recent years, the ERM has been shaken by the 'shock' of German reunification, and at times overwhelmed by massive speculative flows of capital. Some participating central banks, in attempting to defend fixed parities, have found themselves kicking own goals in expensive games with speculators. These experiences have resulted in the departure from the ERM of some countries which did not want to go on directing their monetary policies largely to managing exchange rates, and in much wider intervention bands within the ERM.

Australia knows something about the problems that can be caused by shocks, having experienced several violent movements in its terms of trade over the decades. Given this, it would be unwise to tie the Australian dollar to the currency of any low inflation country which was not exposed to similar shocks. Graph 1 illustrates why. It shows the inflation outcome in the aftermath of three large rises in the terms of trade since the Second World War. In the first two episodes, in the days when Australia had a fixed exchange rate, rising terms of trade were followed by sharp rises in domestic inflation. In the more recent episode, with a floating exchange rate regime, that outcome was not repeated.

Graph 1



Of course, the exchange rate regime was not the only difference across these episodes. In the late 1980s, for example, the Accord processes also helped to keep inflation in check. But the capacity of the floating exchange rate to respond to terms of trade changes – with the currency tending to appreciate when international commodity prices rise – is an important shock absorber for the Australian economy.

In summary, in my view, neither a monetary target nor an exchange rate target has any appeal as a guide for Australian monetary policy. In these circumstances, a good deal obviously swings on the judgment and competence of the Reserve Bank in seeking to keep inflation under control. This leads me to say a little more about the Bank's approach.

As I mentioned earlier, our aim is to maintain price stability while doing what we can to smooth the business cycle. Alan Greenspan has defined price stability in terms such that 'expected changes in the average price level are small enough and gradual enough so that they do not materially enter business and household financial decisions'. This is a practical definition, although putting numbers to it still requires judgment.

Economists can advance various reasons why policy should aim for a small positive number, rather than a zero rate of inflation. For one thing, should reductions in real wages be necessary, these are more likely to be achievable through modest rises in prices than through falls in money wages. Again, current measures of inflation, because they do not adjust fully for improvements in quality and new products, tend to be biased upwards.

In our judgment, underlying inflation of around 2 to 3 per cent is a reasonable goal for monetary policy. These figures, incidentally, are not intended to define a (narrow) range; rather, they are indicative of where we would like to see the average rate over a run of years. Such a rate would meet Greenspan's test, and minimise the costs of inflation. It is similar to the informal goals of the US Federal Reserve and the Bundesbank, and not dramatically different from the more formal targets in the United Kingdom, Canada and New Zealand.

Our focus is very much on the 'underlying' rate of inflation. This, conceptually, is a measure of the trend in the general price level which reflects the broad balance between aggregate demand and supply in the economy. That trend, rather than the published (or 'headline') rate which can be affected by 'special' factors, is what matters for monetary policy purposes. Unfortunately, there is no single and unambiguous measure of underlying inflation, which is perhaps a drawback in promoting public acceptance of the concept. Our preferred approach is to monitor different measures of underlying inflation and reach an informed judgment on the basis of all those measures. As a minimum, however, the effects of changes in interest rates should be removed when trying to assess underlying inflation for policy purposes.

However it is quantified, the goal itself has to be pursued in a forward looking way. If policy waits until inflation actually rises, it will respond too late. This means relying to some extent on forecasts of inflation. In preparing our forecasts, we study the forces which drive inflation, including the macro demand/supply balance, capacity utilisation and the labour market, financial aggregates, wages, and price expectations. We then come to a judgment about the inflation outlook, and the balance of risks from a policy perspective.

Forecasting, as everyone knows, is a hazardous and imperfect process. But there is no getting away from the need for it. To borrow once more from Benjamin Friedman:

> 'Making decisions and taking action in a setting driven by the unknown and the unknowable are a large part of what the making of monetary policy is all about.'

This apparent lack of rigour will disappoint some people, particularly those looking for a simple rule. But it is no use having a compass if there is no reliable magnetic north. Instead, we have to consider all the evidence and make informed judgments about the likely effects of monetary policy actions on the economy. We obviously hope those judgments are close to the mark, although even good calls will overshoot or undershoot to some extent. As Alan Blinder has said, small errors will, in the eyes of history, be seen as bull's-eyes.

What Framework is Conducive to Good Monetary Policy?

The quality of the Bank's judgments on monetary policy will reflect, in part, the experience and competence of its officers. But it will also reflect the broader framework in which monetary policy operates. It is to that framework that I now turn.

The first observation is that monetary policy does not operate in a vacuum. (The corollary is that monetary policy alone cannot deliver low inflation in an acceptable way.) Its contribution to price stability and smoothing the business cycle will be enhanced if other policies are working towards broadly similar goals.

In many countries, where spending has been unrestrained and deficits have accumulated over many years, fiscal policy has become largely unusable for counter-cyclical purposes. This is not true, however, of Australia where, after four successive budget surpluses in the late 1980s, the Government has been able, responsibly, to run deficits to help the economy out of the recession. The Government is committed to a substantial winding back of the budget deficit over the years ahead.

With growth now firmly established and private investment kicking in strongly, my hope is that the Government will try harder to better its current deficit reduction plans. That will not avoid the need for interest rate adjustments but, to the extent that it helped to manage demand pressures in the economy, it would be relevant to the setting of monetary policy. (Incidentally, while it would be reasonable to presume that firmer fiscal policy would be helpful in this regard, that help is not guaranteed – as we saw in the late 1980s, when reductions in the budget deficit were accompanied by stronger growth in private sector activity, putting additional pressure on monetary policy.)

More critically, better progress in reducing projected budget deficits would boost national savings and help to alleviate the current account constraint. Australia needs, over time, to lessen its dependence on foreign savings and reduce its vulnerability to destabilising changes in market sentiment towards it (which, of course, have implications for monetary policy).

How wage and price setters behave is also very important. Monetary policy would be assisted if these players were convinced that underlying inflation would be held around 2 to 3 per cent, and acted accordingly in coming to their decisions. If that were to occur, and if wage rises were linked to genuine improvements in productivity, price rises would be moderate, as would interest rate rises. That is a very simple and straightforward message which, like all good news messages, cannot be repeated too often.

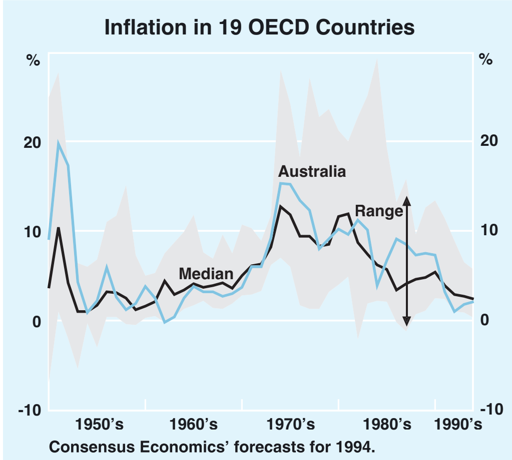
On the other hand, a free-for-all in wage and price setting which threatened a major outbreak of inflation would have to be countered by much larger rises in interest rates, notwithstanding possible consequences for activity and employment. To do otherwise would set up Australia for an early replay of the painful experiences which accompanied the recent reduction in inflation.

This is one aspect of the issue of the *credibility* of monetary policy, which is talked about a good deal these days. Usually the issue arises in the context of the authorities' perceived (lack of) credibility with the financial markets. Having credibility in that quarter is important to all central banks, not least in countries like Australia which have sizeable budget and current account deficits to fund. But that is not the only relevant quarter; as I have just noted, credibility with wage and price setters would help to control inflation. Then there is the issue of the Bank's credibility in terms of its obligation to the broader community to do what it can to sustain economic activity and employment.

In theory, the more credible a central bank's anti-inflation credentials, the less it will have to actually tighten monetary policy and pursue its objective through the creation of wasteful slack in the economy. It has some intuitive appeal, although the theory is not always borne out in practice: everywhere, it seems, actions count for more than words.

What is clear is that credibility cannot be legislated for, nor can it be established quickly. Australia's performance over the past three years is quite impressive, with an average underlying rate of inflation of around 2 per cent (see Graph 2). But we will need to establish a much longer track record of low inflation to exorcise the memories of high inflation in the 1970s and 1980s. In particular, we will need to sustain low rates of inflation through the upswing of the current cycle to build real credibility. That is what we are about.

Graph 2



I want to come now to an aspect of the *institutional* framework in which monetary policy is conducted, namely the issue of central bank independence. It is relevant to the conduct of monetary policy in Australia, if only because some commentators persist in their mistaken beliefs that the Reserve Bank is not independent and that can flow over to broader perceptions of the Bank's anti-inflation credentials and credibility.

'Independence' is not a precise term, and it is helpful to draw a distinction between *goal independence* and *instrument independence*.

No central bank has absolute *goal* independence, that is, the unconstrained ability to choose and change its objectives. Nor should it, in my view. The practical question is how explicit, precise and immutable is the remit given to the central bank by the political process. It can be very specific (as in New Zealand, where the central bank has been given the sole objective to keep inflation within a 0 to 2 per cent band), or quite broad (as in Australia, where 'stability of the currency' and 'the maintenance of full employment' are featured).

As noted earlier, I am quite comfortable with the Reserve Bank's broad, multiple objectives. For me, they encompass the various real life concerns of macroeconomic policy makers, and they have in them a degree of flexibility that befits policy making in an uncertain world. At the same time, however, they do require alertness against possible conflicts and policy prevarication that can lead to, for example, a reluctance to remove the punch bowl.

Instrument independence concerns the extent to which a central bank has the freedom and discretion to implement the goals of monetary policy. A central bank that is required to maintain a fixed exchange rate, or to finance the government's budget deficit, has limited instrument independence.

On this measure, the Reserve Bank has become increasingly independent over the past decade, partly because of major regulatory changes, such as the introduction of a tender system for treasury notes and bonds and the floating of the currency. These changes have enhanced the *capacity* of monetary policy to control inflation independently of the Government's fiscal position, and independently of inflation in the rest of the world. This capacity has been further enhanced by a change in operating procedures, which has seen public announcements of every change in the official cash rate – the key policy interest rate – since January 1990. Adjustments to monetary policy are now transparent and clear, avoiding the scope for confusion which existed in earlier times when changes in rates were not accompanied by official commentary.

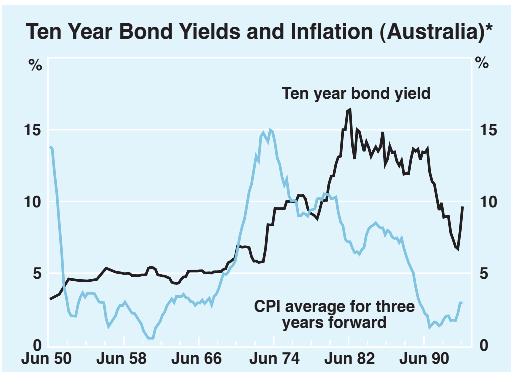
In terms of freedom and discretion to change the cash rate when that is deemed appropriate, the Bank has effective independence. It has not, as some commentators like to imagine, been pressured to adjust (or not adjust) interest rates for political motives. The initiative and basic carriage of changes in the cash rate rest with the Bank. As part of this process, we consult with the Treasurer and his department. That is required by the *Reserve Bank Act* but it also makes good practical sense for the Bank and the Government to sing much the same tune when interest rates are being adjusted.

The basic approach I have described was followed in the lead-up to last month's decision to raise the cash rate by three-quarters of a percentage point. The effects of that increase are now being monitored, as part of our on-going assessment of the various indicators bearing upon the outlook for activity and inflation. Judgments are being made about the appropriateness of current policy settings all the time.

Others in the economy are doing similar things and reaching their own, and sometimes different, judgments. A case in point is the bond market, where yields on Australian bonds have risen sharply over the past six months or so. This has sprung in part from concerns about inflation in the United States, but the amplification of those concerns in their transmission to Australia implies an adverse judgment about the outlook for inflation in our economy which we do not share. While we foresee some upward pressure on inflation as the recovery continues, we expect policy and other developments to prevent a return to the high levels we have experienced in previous upswings.

This is not a matter of 'taking on the market', but of different parties coming to different judgments. No-one is infallible. The natural tendency in some quarters is to assume that the authorities will get things wrong (as they do sometimes), but to forget that markets also can get things wrong; they failed, for example, to pick both the big rise in inflation in the late 1970s, and the big falls in the early 1980s and early 1990s (see Graph 3).

Graph 3



*This gives an indication of how well/poorly bond markets have picked the inflation rate three years ahead (probably about as far ahead as many participants in bond markets attempt to look). The yields on ten year bonds at each point in time are compared with a moving average of the actual increase in the CPI in the three years forward from that point (to the extent practical).

We do look closely at swings in the financial markets and the various explanations that are advanced for them. From what I have said about the Bank's approach, it should be clear that any differences between our judgments and the markets' judgments can occur not only because our inflation forecasts might differ, but also because our basic objectives are much broader than the markets', and our horizons are much longer. At the end of the day, the Bank has to come to its own judgments, and be prepared to back those judgments. That is the art of monetary policy.

Conclusion

The Bank's commitment to low inflation does not stem from a belief that conquering inflation is more important than combating unemployment. Rather, it comes from a belief that combating unemployment by allowing inflation to rise would simply return us to a world we have taken great pains to leave. It would be an admission of failure.

In the final analysis, achieving low inflation while doing what we can to smooth the business cycle provides the best possible environment for investment, growth and employment. It is what the art of monetary policy is all about.