

FRBSF WEEKLY LETTER

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Credibility, Commitment and Inflation Policy

Most economists now accept the notion that the success of a policy designed to maintain low rates of inflation can depend importantly on the public's beliefs about the government's commitment to the policy. This point was made recently by Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve System when, in testimony before Congress he stated "One key element that would minimize the transition (to price stability) would be a conviction of participants in the economy that the anti-inflation policy is credible, that is, likely to be effective and unlikely to be reversed."

Less agreement exists concerning the means by which policy can achieve credibility. Some argue that a reputation for following credible and effective policies must be earned, whereas others argue for institutionalizing policy goals to increase their credibility.

The Federal Reserve's willingness to maintain its anti-inflationary stance in the early 1980s, despite the rise in unemployment from 5.8 percent in 1979 to 9.5 percent in 1982 and 1983, was viewed by many as critical in giving credibility to the Fed's stated goal of reducing the rate of inflation. Some, however, continue to support moves to amend the Fed's Charter to require explicitly that the Fed achieve and maintain price stability. Legislation has been proposed requiring the Federal Reserve to establish zero inflation explicitly as its goal. Such a change, its proponents argue, would increase the credibility of policy by limiting the ability of the Fed to engage in short-run discretionary policy actions that might be inconsistent with longer-term price stability.

Although the future of legislatively established inflation goals is uncertain here, a recent act of New Zealand's Parliament made price stability the primary objective of that country's monetary policy. In fact, the head of its central bank has signed an employment contract that sets out an

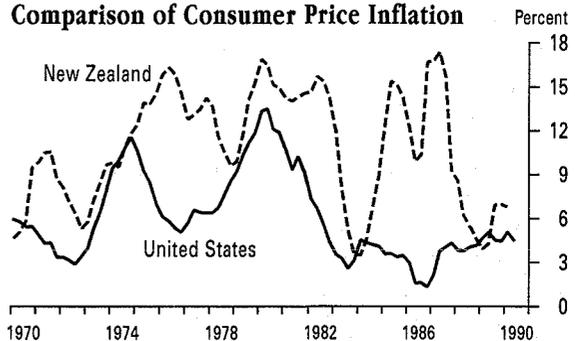
explicit goal of 0 to 2 percent inflation by the end of 1992. Using New Zealand's experience, the arguments for and against the use of more explicit inflation targets are reviewed in this *Letter*.

New Zealand's new policy

On February 1, 1990, The Reserve Bank of New Zealand Act (1989) took effect. Designed to reflect the role of the Reserve Bank in New Zealand's newly deregulated financial sector, the Act also changed the monetary policy objectives of the central bank. According to the Act, "The primary function of the Bank is to formulate and implement monetary policy directed to the economic objective of achieving and maintaining stability in the general level of prices."

A major motivation for this single-minded focus on price stability was New Zealand's poor inflation record. The chart shows the rate of inflation, as measured by the Consumer Price Index, for New Zealand and the U.S. Until early 1989, New Zealand's inflation rate had fallen to the level of the U.S. only during 1983 and 1984. That drop reflected the impact of disinflationary policies in New Zealand's major trading partners, and wage and price controls in New Zealand from 1982 to 1984. As evident in the chart, New Zealand's inflation slowdown based on wage and price controls was only temporary.

Comparison of Consumer Price Inflation



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To ensure that the country's Reserve Bank pursued the legislative goal of price stability, its Governor has signed a formal contract with the Minister of Finance setting out a specific inflation goal and a timetable for its achievement. The Governor can be dismissed for not achieving the target specified in the contract.

The contract states that "... the Reserve Bank should formulate and implement monetary policy with the intention of achieving price stability by the year ending December 1992. An annual inflation rate in the range of 0 to 2 percent will be taken to represent the achievement of price stability." It also specifies a number of conditions under which the policy target may be altered, but "... increases in wages or profit margins that are inconsistent with these targets will not be accommodated by the Bank and will not give grounds for automatic renegotiation of the policy targets."

Arguments for a zero inflation target

Proponents of New Zealand's proposal to adopt price stability as the sole goal of monetary policy cited three issues: achievability, credibility, and accountability.

First, they argued that policy goals needed to be stated in terms of macroeconomic variables that could in fact be affected by monetary policy. Since most economists accept that the long-run effects of monetary policy fall entirely on the price level and not on real variables such as the economy's average unemployment rate or real growth rate, the proponents believed that the goals for monetary policy should reflect what can be achieved by monetary policy.

Second, the proponents argued that a legislated policy would provide the credibility needed to prevent expectations of inflation from developing their own momentum. According to macroeconomic theory, which emphasizes the importance of expectations in the inflationary process, a policy designed to maintain low rates of inflation is likely to be more successful when the public expects the policy to be consistently applied. In contrast, a belief that authorities will abandon an inflation fight would lead to an escalation in wage increases, and force the monetary authority to choose between ratifying wage and price increases, thereby sacrificing its inflation goals,

and generating unemployment in order to keep inflation low.

Third, establishing a specific target for inflation and making the Reserve Bank responsible for its achievement was part of a broader reform of the public sector designed to increase accountability. Proponents of price stability as the sole goal of monetary policy believed that the institution entrusted with the responsibility to conduct monetary policy must be accountable to elected government officials and to the public. They argued that accountability is most easily achieved when the performance of the monetary authority is easily measured. Vague policy objectives involving potentially conflicting goals would make accountability more difficult than a goal expressed simply, in terms of one easily measured outcome.

Criticisms

New Zealand's new framework for monetary policy has not been without its critics. A consideration of the impacts of aggregate demand and supply shocks can help illustrate the potential problems of a monetary policy focused solely on price stability. Aggregate demand is the total spending in an economy, and aggregate supply is the total of that economy's production capacity.

An aggregate demand shock, such as a fall in government expenditures, will act to temporarily lower the level of economic activity. The resulting rise in unemployment will tend to moderate wage increases. Weak sales and moderated wage costs tend to reduce prices relative to their initial path. Under a policy of price stability, the monetary authority would respond with an expansionary policy designed to keep prices from falling. This shift in policy would help maintain the level of economic activity and moderate the rise in unemployment. In this case, there is no conflict between stabilizing employment and stabilizing prices.

However, as national economies discovered in the 1970s, a short-run conflict between inflation and unemployment does arise in the face of aggregate supply shocks. An oil price increase, for example, pushes up prices while tending to depress real economic activity. A monetary authority with both unemployment and inflation goals must then contend with the choice of a

contractionary policy to prevent prices from rising but which will exacerbate the increase in unemployment, or an expansionary policy to moderate the rise in unemployment but at the cost of further increasing the price level.

Monetary policy can temporarily delay the output decline caused by a permanent adverse supply shock, and it is for this reason that central banks have recently focused, at least in principle, on contributing to short-run real economic stability while ensuring that monetary policy remains consistent with longer-run price level or inflation targets. Critics of strict price stability policies argue that a narrow focus on inflation alone will produce costly and unnecessary fluctuations in real economic activity and inflation.

A current test

Iraq's invasion of Kuwait serves as a vivid reminder of the vulnerability of energy-importing countries to oil price shocks. Central banks are again facing the prospect of accepting temporarily higher rates of inflation in order to maintain current levels of economic activity, or accepting an economic slowdown in order to prevent inflation from accelerating.

The agreement between the Governor of New Zealand's Reserve Bank and the government does allow for a renegotiation of inflation targets in response to a significant movement in the country's terms of trade. The terms of trade, the ratio of the price of New Zealand's exports to the price of its imports, will fall as the price of imported oil rises. In addition, New Zealand is already experiencing a recession.

Whether New Zealand's Reserve Bank will raise its inflation targets to accommodate the rise in oil prices remains to be seen. As long as monetary policy stays firm overall, the oil price rise should have only a one-time effect that would dissipate, according to some commentators, by 1991. Thus, the Reserve Bank could still achieve its low inflation target for 1992, although with a higher price level than originally planned.

Zero inflation target in the U.S.

In the United States, Representative Neal (D-NC) has introduced legislation (HJ Res. 409)

that would establish zero inflation as the official goal of the Fed. During hearings on the bill, Alan Greenspan and four of the presidents of regional Federal Reserve Banks, including Robert Parry, President of the Federal Reserve Bank of San Francisco, expressed strong support for this idea. In his testimony, President Parry was quite explicit in arguing that the Fed should conduct policy to maintain a constant price level. Under this approach, if prices were to rise, the Fed would tighten policy to force prices back down to the target level. This approach contrasts with one that would aim just to keep the price level stable at the new higher level.

Although Neal's proposal would make price stability the official goal of monetary policy, unlike the New Zealand Act, his bill has no formal mechanism for enforcement.

Conclusions

Achievability, credibility, and accountability are generally desirable qualities of any proposed policy, but most would agree that they are not sufficient to ensure desirable monetary policy outcomes. In fact, policies that are unduly rigid in the face of rising cyclical unemployment may undermine their own credibility.

New Zealand has gone farther than any other country in designing an institutional framework incorporating the three qualities, but that framework is already facing a test of its flexibility. New Zealand's current recession is leading to pressures on the government to revise the timeframe over which the Reserve Bank should achieve its target rate of zero inflation. On October 26, the National Party, which had promised to push back the achievement of 0-2 percent inflation until 1993, gained a landslide victory over the governing Labor Party. New Zealand's experiment must therefore still prove itself capable of providing the price stability that is widely accepted as the ultimate goal of monetary policy.

Carl E. Walsh
Associate Professor,
University of California, Santa Cruz
Visiting Scholar, FRBSF
and Fulbright Fellow,
New Zealand Institute of Economic Research

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Research Department
Federal Reserve
Bank of
San Francisco

P.O. Box 7702
San Francisco, CA 94120