

The Role of Monetary Policy in Recession

The following is the text of remarks made by the Governor, Dr Don Brash, while participating in a panel discussion at the annual meetings of the Bank for International Settlements in Basle, Switzerland, in June 1993. Some small editing changes have been made.

. The subject of the discussion session was:

What stance should monetary policy adopt in a recession?

In the invitation to participate in this discussion, the convenor indicated a concern not to have the topic turn into a discussion on the objectives of monetary policy (in terms of medium-term focus versus fine-tuning; and short-term versus long-term effects of monetary policy on output).

However, it is next-to-impossible to avoid starting from the objectives of policy.

At one level, the reason is that it is a truism, I think, that knowing what to do is made greatly easier by knowing why you want to do it. There may be exceptions to this rule, but economic policy surely is not one of them.

At another level, one has to start with the objectives of policy, because the very same monetary policy operations can occur in a given situation even though the objectives of policy are quite different. The circumstances that generate the apparent similarity in behaviour will not last, and the true motivations of the policy maker will be revealed. It is therefore important to be able to disentangle the motivations of the monetary authorities - the reactions of the economy to a given monetary policy stance will differ depending on the public's understanding of the underlying objectives of the policy maker. As we know, if the public guesses wrong, unnecessary economic costs follow.

Let me illustrate this to make it clearer.

Let us imagine that our economies have reached a point of price stability, after a protracted recession. Recovery is now underway, and has been for some time. Looking ahead, one can expect that inflation pressures will start to re-emerge, as suppliers (of goods and labour) find it more profitable to raise their prices than to expand the supply of their product. So, the central bank - with an eye to the lags between policy action and effect - starts to tighten monetary policy.

A central bank that pays a good deal of attention to managing cycles of output would behave this way. A central bank that only pays attention to the preservation of price stability would also behave this way. An observer who did not know the objectives of the central bank might not detect any difference.

Does this mean that the issue posed in this discussion is an empty one?

No. Whether the central bank has only price stability as the objective, or whether it is concerned for both price stability and output, matters a great deal for what might happen in different circumstances, and what might happen at other points in the cycle.

Two ways in which the scenario that I painted might develop should serve to highlight the implications of the different objectives.

Imagine now that data is revised (I suspect that all of our official Statistics Bureaus spring surprises on us), showing that growth has actually been less than we were lead to believe, and that inflation has actually started earlier and more vigorously than we thought. The central bank with the mixed objective set would now slacken policy, if not absolutely, at least relative to the central bank with only price stability as the objective.

Alternatively, imagine now that the application of the monetary policy brakes has slowed economic activity to the point where a recession is likely, but inflation is proving rather stubborn. Again, the two central banks with the different objectives would start behaving quite differently.

The point of all this, of course, is to illustrate that we do need to know the objectives before we can discuss the 'whats' of policy.

In New Zealand, the specification of the objective of monetary policy, in the legislation and reinforced by the required Policy Targets Agreement that I operate under, is crystal clear. Monetary policy is to be directed only at the economic objective of price stability, and nothing else. This, we believe, is the proper specification of the monetary policy objective.

The reason for specifying the monetary policy objective this way is not of course because price stability is inherently more valuable or worthwhile than lower unemployment or higher real incomes. It is not. Rather, the reason for not directing monetary policy at achieving lower unemployment or higher incomes is that monetary policy cannot achieve those objectives in a sustainable way, as I am sure most of you will agree. To attempt to use monetary policy in direct pursuit of output and employment objectives will reduce the chances that the economy will actually deliver the maximum output and employment levels that the economy's underlying structure is capable of.

We take very seriously the macroeconomic theory that describes the problem of time consistency. If there is a real chance that the monetary authorities will use monetary stimulus in an effort to boost growth at one part of the cycle, the expectation of this happening again at other parts of the cycle will quietly but surely raise interest rates by raising the expected rate of inflation. Unless one actually validates those higher inflation expectations, with the resulting damage to the economy, real interest rates will be higher, producing damage in another way.

That is, economic damage will occur once the doubts about the central bank's consistency have become established, almost no matter what the central bank then does, and this damage will persist until credibility is re-established.

It is natural to ask whether a conflict, or tradeoff, between price stability and output objectives is something that will occur with such frequency and power that the 'purist'

(as some have called it) position that we have adopted in New Zealand becomes untenable.

Our belief is that the tradeoff will not be an ever-present or pervasive problem.

I have already alluded to one reason. That is, at important stages of the economic cycle, monetary policy directed solely at the price stability objective will be acting in the same way as monetary policy aimed at smoothing the real activity cycle. As the economy moves towards the point where cyclical stresses emerge, monetary policy will tighten in an attempt to hold back inflation pressures. Equally, as the economy moves towards the point where underutilised resources abound, monetary policy will ease to prevent deflation.

In essence, monetary policy aimed at price stability does take into account the state of the cycle, precisely because of the inflation implications of different stages of the cycle.

Another, and more fundamental, reason why output and price stability conflicts will not be a perpetual problem is that a credible monetary policy directed solely at price stability will change the pricing behaviour of manufacturers, traders, wage earners, and so on. The prospects of inflation staying up while output is contracting are greatly reduced where there is a widespread understanding of what monetary policy is about. Stagflations are in large part products of mistaken expectations. For this reason, not only is the single objective of price stability important, but so also is a very public and open policy process - one which maximises the public understanding of monetary policy - and the adoption of a consistent approach to policy over time.

There is, however, a different type of conflict or tradeoff between output and price stability objectives that poses a rather larger problem for the design of policy. I have been talking, thus far, about monetary policy in connection with business cycles of the demand-induced form. What of circumstances in which there is a major structural shock to the supply side of the economy? For example, what if energy prices were to double or treble again, or if the fiscal authorities raised indirect taxes dramatically?

Here, there is a clear difficulty. Shocks that knock back potential output, or are similar in effect, involve prices and output moving in opposite directions — prices move up, while output contracts. In such circumstances, monetary policy should in principle accommodate at least part of the adjustment. To do otherwise would mean taking all of the adjustment in lost output.

The real problem is to identify when such shocks occur (as they are often not as easy to distinguish from other events as might be imagined), and to set up policy in such a way that monetary accommodation is convincingly constrained to such circumstances. We have attempted to do this in the way that the Policy Targets Agreement is specified (the Policy Targets Agreement or PTA being the agreement between the Minister of Finance and me that sets down the specific 0-2 percent inflation target against which I am held accountable).

For instance, the two kinds of shocks that I mentioned - an energy price shock, and a change in indirect taxes - are, in terms of the PTA, events where inflation outcomes outside the 0-2 percent range could be permitted. I say 'could', because we are required

by the PTA to accommodate significant shocks only (and we have to detail our estimates fully), and then we can only accommodate the direct first round effect of the shock.

There is also provision within our legislation for the statutory objective of monetary policy to be over-ridden by the government. Such an override could be used to alter the way in which monetary policy reacts to shocks that cannot be catered for through invoking the PTA caveats. But, the very public and transparent nature of the override provision is a major check on its casual use, meaning that the mechanism is unlikely to be used except in the most clearcut cases.

Concluding remarks

To summarise, I would like to remind you of the question that was posed: 'What stance should monetary policy adopt in a recession?'

Like most economists and policy makers, my answer is that it all depends!

It depends, in the first instance, on the objective of monetary policy. And in that context, I believe the objective should be price stability, and price stability only.

It also depends on how credible monetary policy is. The greater the credibility, the less the chance that price stability and output objectives will conflict, because of the adjustment of expectations.

And it depends on the source of the shock to the economy that has induced the recession. If the shock is structural in nature, emanating from the supply side, then some monetary accommodation is probably sensible. But to avoid actual or expected misuse of this departure from the price stability focus, such monetary accommodation has to be very carefully circumscribed.

