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## The role of monetary policy

Recent weeks have seen considerable criticism of the Central Bank of Iceland's monetary policy. Some of the comments seem dramatically at odds with the views that have prevailed among economists and central bankers around the world over the past three decades. It is therefore appropriate to take another glance at the basic ideas that "are now accepted by monetary authorities and governments in almost all countries of the world" as being the key to a successful monetary policy strategy, as Frederic Mishkin, a governor of the Federal Reserve Bank of the United States, argues in a recent paper (Mishkin, 2006, pg. 1).

### The costs of inflation

The economic and social costs of high inflation are now almost universally accepted. The runaway inflation that plagued many parts of Europe during the 1920s, the persistent inflation problems experienced by a number of South American countries in the late 20th century and, most recently, the soaring inflation in Zimbabwe – with inflation reaching several thousand percent – have all highlighted the detrimental effects of hyperinflation. In fact, there is no need to look at such extreme episodes to understand the high costs of inflation: the double-digit inflation in the industrial world in the 1970s and 80s, with inflation around 10%, made the costs very apparent.<sup>2</sup>

The detrimental effects of inflation are wide-ranging. The inevitable fluctuations in inflation make it difficult for households and firms to discern between changes in relative prices and general inflation. The sense of relative price that is the foundation for effective competition becomes dulled. The future price level becomes less predictable, leading to inefficient investment decisions and allocation of funds. This uncertainty reduces the informational content of price changes and hampers the market economy's ability to allocate limited resources efficiently. The interaction of inflation and the tax system exacerbates the situation. The tax system, for example, has a tendency to give preference to current consumption over future consumption (i.e. savings), and to favour investment in residential housing over other types of investment. These effects of the tax system increase with rising inflation. High inflation also exaggerates social inequality and erodes social solidarity. Income is transferred from small savers to professional investors, who are more able to protect themselves against inflation; from low-income groups to high-income groups; and from renters to

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2. The findings of Khan and Senhadji (2000) indicate, for example, that persistent inflation over 1-3% in industrial countries and over 7-11% in developing countries is detrimental to long-term economic growth.

homeowners, to give just a few examples. This transfer of income generates social tension and conflict among various income groups.

High and volatile inflation therefore has detrimental economic and social effects, which intensify as inflation rises and becomes more entrenched. Historical experience also shows that the cost of disinflation can be substantial in terms of lost output and income. This temporary cost is small, however, in comparison with the permanent cost of chronic inflation. For these reasons, low and stable inflation has become the overriding goal of monetary policy.

## What can monetary policy attain?

Until the mid-1970s, the general consensus was that there existed a long-term trade-off between inflation and employment. An expansionary monetary policy could attain a low rate of unemployment at the long-term cost of modest inflation, while tighter monetary policy would suppress inflation but allow unemployment to rise. Economic research and the bitter experience from that era have led to an almost complete rejection of this notion.<sup>3</sup> On the contrary, the economy tends to move towards its natural level of output growth and unemployment, irrespective of the level of inflation. Monetary policy that attempts to hold unemployment systematically below its natural rate or to maintain output growth in excess of the growth in potential output ultimately leads only to escalating inflation without generating more jobs or increasing output growth. In fact, the above arguments concerning the high costs of inflation suggest that a more likely result would be fewer jobs and less output growth in the long run. Furthermore, research has shown that the harder monetary policy tries to maintain employment and output growth above their natural values, the less the short-term benefits become – and ultimately, they disappear entirely. The reason is that private agents gradually adjust to the behaviour of the central bank, and inflation expectations adapt ever more readily to higher inflation.

Because prices and wages tend to be sticky, the role of monetary policy basically centres on maintaining a low and stable rate of inflation and to reducing temporary deviations of employment and output from their natural levels, provided that inflation expectations have been successfully anchored. In periods of overheating, all the above targets become consistent with one another: output exceeds capacity, unemployment falls below its natural rate, and inflation is high. The role of monetary policy in such circumstances is to suppress economic activity temporarily by raising the policy interest rate, thus reducing inflationary pressures and bringing the economy back to a sustainable level. However, this process can take time and lead to temporary economic hardship for companies and households. It is therefore essential not to lose sight of the long-term benefits of getting inflation under control.

The more credible monetary policy is, the less costly the disinflation process will be. Greater credibility makes it easier for the central bank to affect market expectations, thereby reducing fluctuations in inflation and output. A successful monetary policy that provides a

3. See, for example, the Nobel Prize Committee's discussion of the research of last year's prize-winner, Edmund S. Phelps (translation forthcoming in *Financial Bulletin* 2006(2)).

credible nominal anchor for the economy is therefore critical for successfully stabilising fluctuations in employment and output growth.

## Price stability as the overriding goal of monetary policy

The general consensus today is that the most effective way to ensure the credibility of monetary policy is to give the central bank a clear mandate with price stability as the overriding goal. This does not imply, however, that other goals, such as high employment, strong output growth, and economic equality are of lesser importance. What this simply reflects is the importance of containing inflation and the fact that monetary policy can only affect long-term inflation, not employment or output growth.

Recent research clearly shows that the credibility of monetary policy is best guaranteed if the central bank follows a systematic and predictable pattern of behaviour. This reduces the temptation for policymakers to exploit the short-term trade-off between inflation and employment at the cost of higher inflation later on.<sup>4</sup> An effective way to reduce this so-called time-inconsistency problem is to give central banks the primary goal of maintaining price stability and ensuring the independence of the central bank to achieve the target without government interference. Such an institutional commitment to price stability can therefore enhance the credibility of monetary policy and improve its performance.<sup>5</sup>

It is therefore no coincidence that the trend for the last few decades has been in this direction. A study by Fry et al. (2000) shows that 78 of 94 central banks surveyed defined price stability as the primary goal of monetary policy. Where other goals were stated, they were almost always hierarchical, with price stability having priority. The Central Bank of Iceland Act is therefore more or less identical to the mandate of the Bank of England, the European Central Bank, Norges Bank, the Swiss National Bank, and Sweden's Rikisbank, to name only a few.<sup>6</sup> The legislation of the US Federal Reserve is older, however, and stipulates that it should achieve price stability and maximum employment. Yet over the past two decades, the statements and the actions of the Federal Reserve have indicated clearly that price stability takes precedence in the event of a conflict between the two (see, for example, Mishkin, 2006). In the study by Fry et al., 66 of the 94 central banks surveyed had full statutory independence (see also Thórarinn G. Pétursson, 2000). Since that survey was conducted, the number of countries that define price stability as the primary objective of their monetary policy has increased still further, as has the number of countries that have granted their central banks full statutory independence.

4. See, for example, the Nobel Prize Committee's discussion of the research of the 2004 prize-winners, Finn Kydland and Edward Prescott (translation in *Financial Bulletin* 2005(1), pp. 40-64).

5. See, for example, the findings of Alesina and Summers (1993), which show that independent central banks have been more successful in maintaining low inflation than less independent central banks.

6. It therefore meets the so-called Maastricht requirements for a hierarchical mandate for monetary policy and the statutory independence of central banks in countries seeking to join the European Union.

Price stability is not a clearly defined concept, however, and therefore needs to be defined more explicitly. An increasing number of countries have introduced a numerical inflation target for their central banks. This ensures that everyone interprets price stability in the same way and reduces the scope for the central bank or the government to avoid making difficult decisions when trying to attain price stability. A formal numerical target provides a clear nominal anchor for the economy and increases the transparency and credibility of the monetary policy framework. The experience of inflation targeting has generally been good, although disinflation has not been without costs and it has usually taken a fair amount of time to achieve visible success.<sup>7</sup>

## One instrument – one goal

The Central Bank of Iceland has been criticised for, among other things, not attempting to stabilise the exchange rate of the króna. However, it should be kept in mind that monetary policy has only one instrument at its disposal, i.e. the policy rate. The economic effects of other measures, such as foreign exchange interventions and changes in reserve requirements, are more or less identical to the effects of using the policy rate. These measures do not therefore represent independent policy instruments. For example, an increase in reserve requirements would reduce liquidity in the market and push up market interest rates roughly in the same way as a policy rate hike would. The reason that central banks prefer to use the interest rate instrument rather than foreign exchange interventions and reserve requirements is that, in modern financial markets, the policy rate offers a more transparent and effective means of influencing market interest rates, although financial market globalisation has somewhat reduced its effectiveness and complicated its deployment.<sup>8</sup>

In view of the fact that central banks only have one instrument, they can only work toward one long-term goal. The discussion above should make it clear why that goal should be price stability. Any attempt to achieve other targets will inevitably come at the expense of this overriding goal. Fluctuations in the real exchange rate, for example, play an important stabilising role over the business cycle, in addition to being an important transmission channel for monetary policy. The real exchange rate has a tendency to appreciate during expansionary periods, which, all other things being equal, weakens the competitive position of tradable goods sector and thereby reduces domestic income and employment. This in turn reduces the output gap and ultimately eases inflationary pressures. If monetary policy is used to counteract this real appreciation, it will ultimately lead only to increased volatility of other economic variables such as interest rates, employment, output growth, and inflation.<sup>9</sup>

7. See, for example, the summary of the implementation and results of this policy in Þórarinn G. Pétursson (2005).

8. Further discussion of the impact of globalisation on monetary policy can be found in Box III-1 in this issue of *Monetary Bulletin*.

9. West (2003), for example, finds that reducing real exchange rate volatility in New Zealand by 25 per cent could increase output volatility by about 10-15 per cent, inflation volatility by about 0-15 per cent, and interest rate volatility by about 15-40 per cent.

## Conclusion

The predominant goal of monetary policy – and in fact, its principal contribution to economic welfare – is the promotion of price stability. Clear institutional support for this goal will increase the credibility of the policy framework, thus improving the effectiveness of monetary policy and reduce the costs of bringing inflation back to target when it has drifted away from it. Credibility is therefore the key for successfully anchoring inflation expectations and stabilising the real economy in Iceland. It is also conducive to dampening the undesirable effects of exchange rate fluctuations on the domestic economy. All ideas aiming to blur the mandate of the Central Bank or limit its monetary policy independence are likely to undermine this credibility and damage both monetary policy and the Icelandic economy.

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