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Commentary

LEE HOSKINS HAS WRITTEN a fine paper on monetary policy. I share most of his views on the role and duties of central banks. Hoskins discusses why the conduct of monetary policy has been entrusted to central banks. He also examines the conditions that must be satisfied for central banks to play an effective policy role.

Hoskins' principal thesis is that central banks are needed to manage a standard based on fiat money. But a fiat standard imposes few constraints on central banks. If central banks are permitted to issue fiat money, there is always the risk that they will abuse their powers. Consequently, under a fiat standard it is necessary to ensure that central banks act in the public interest.

Why do central banks frequently harm the public interest by debasing the currency? Hoskins discusses several possible reasons. He dismisses the answers offered by public-choice economists and also rejects the notion that unsatisfactory performance of central banks is due to the pursuit of inappropriate targets or operating procedures. Instead, he maintains that "central bankers are suffering from a Keynesian hangover." Frequently they do not direct monetary policy solely at price stability but attempt to pursue

multiple objectives that often conflict. Many central bankers attempt to achieve at least two goals—to keep prices stable and to smooth cyclical fluctuations in output and employment. Too often, Hoskins maintains, central bankers also try to manipulate the exchange rate with a view to strengthening the competitive position of domestic industry. Of course they do not pursue multiple objectives because of a character defect. They merely reflect prevailing opinions held by politicians, bankers, economists and other members of the general public.

In Hoskins' view, the performance of central banks could be much improved if they were granted independence from governments and given a single objective—price stability. The central banks—though independent—would not be allowed to choose policy objectives but would be given a clear legislative mandate to achieve and maintain price stability. Moreover, they would be accountable to the public for their policy actions.

I am largely sympathetic to Hoskins' suggestions. An independent central bank with a clear mandate to pursue price stability is likely to perform better than an institution attempting to

respond to diverse and conflicting political pressures. I also agree with Hoskins that the social value of a credible price-stability objective is often underestimated, whereas the costs of eradicating inflation are overstated.

Thus I support Hoskins' call for committing central banks to a price-stability objective. In my view, however, the story does not end here. A clear price-stability mandate by itself is not enough to improve the performance of central banks. Even if we agree that the objective of monetary policy should be price stability, we still have to address a second question: *How* should central banks achieve and maintain a stable price level?

Hoskins plays down the problems of designing operational policy rules consistent with the price-stability mandate. Yet as practitioners of monetary policy know, the translation of such a mandate into specific policy rules is far from trivial. Switzerland offers a good case in point. I argue that the Swiss National Bank (SNB) possesses a clear mandate to achieve and maintain price stability even though Swiss law does not precisely define the objectives of monetary policy. This mandate, albeit informal, rests on a remarkable consensus among the Swiss public about the objectives of monetary policy.

The SNB's informal mandate explains why the inflation rate in Switzerland has tended to be low by international standards. Since the beginning of 1975—when Switzerland shifted to money stock targeting—inflation in Switzerland has averaged 3.5%. This average, however, still far exceeds the SNB's stated inflation target of 0 percent to 1 percent. Consequently, the SNB has failed to achieve price stability despite the informal mandate. The SNB's failure to meet its stated target results largely from two short episodes of accelerating inflation. From 1979 to 1981 and from 1989 to 1991, Swiss inflation temporarily rose to more than 7 percent and 6 percent, respectively.

NEED FOR OPERATIONAL RULES

The SNB's failure to achieve price stability did not reflect a Keynesian hangover. Rather, the SNB encountered various problems when it attempted to translate its price-stability mandate into suitable operational policy rules. The need for operational rules arises because monetary policy affects the inflation rate with a long and

frequently variable lag. In Switzerland the time lag may be as much as three years. Therefore monetary policy decisions do not affect the inflation rate until long after they are implemented. Because of the lag, such decisions invariably entail a great deal of uncertainty. Central banks may err even if they try to adhere closely to their mandate. Once they recognize their mistakes, it is usually too late to take corrective action.

To lower the danger of policy blunders, central banks require reliable early warning signals or leading indicators of inflation. Operational rules centered on these leading indicators give central banks a good chance of accomplishing a goal of achieving and maintaining price stability.

Do central banks possess reliable leading indicators of inflation? This question cannot be answered straightforwardly. Monetarists tend to emphasize the close relationship between money growth and the inflation rate. They maintain that the money stock serves as a good leading indicator of price movements. Therefore central banks are likely to meet the price-stability objective if they adopt an operational rule providing for steady growth in the money supply.

Most central banks today share the monetarist view that inflation is due largely to excessive money growth. Nonetheless, they hesitate to opt for strategies of steady money growth. The SNB is no exception. In Switzerland the growth in both the monetary base and the money stock M1 tend to lead inflation. Therefore the SNB focuses attention on these two aggregates and sets an intermediate target for the Swiss monetary base. It strives to increase the monetary base at a rate of 1 percent per year. The SNB views this target as consistent with price stability in the medium and long runs.

Although the SNB follows a money-growth rule, it need not augment the monetary base by 1 percent year after year. Depending on the circumstances, it may temporarily undershoot or overshoot the 1 percent target. For this reason, the SNB frames its money-growth rule in terms of a medium-range target, to be met on the average of a five-year period. Temporary deviations from the 1 percent growth path may be required if serious unexpected shocks hit the Swiss economy. Two kinds of shocks may prompt the SNB to deviate: unexpected shifts in money demand and other unexpected shocks such as excessive movements in the exchange rate.

SHIFTS IN MONEY DEMAND

A strategy of steady money growth is effective only if money demand is stable. In contrast to many other countries, Switzerland has been blessed with reasonably stable money-demand patterns. But this does not imply that instabilities have not occurred. Serious instabilities arose in the late 1980s as a result of two financial innovations. A new electronic interbank payments system and a major overhaul of liquidity requirements, or minimum reserve requirements, imposed on banks caused a huge permanent drop in the demand for base money. Much of that decline occurred in the first half of 1988, but stability was not restored until about 1990 or 1991.

It is clear that central banks must adjust the money supply to permanent demand shifts or long-lasting temporary demand shifts if they are to keep the price level stable. It is not always advisable to react quickly to demand shifts, however. Money demand is subject to frequent transitory movements that do not call for a central-bank response. Moreover, demand shifts are hard to detect. They often become fully apparent only after considerable time has elapsed. For these reasons, Meltzer (1987) and McCallum (1989, Ch. 16) recommend a slow reaction pattern. They propose mechanical rules that would prompt central banks to adjust the money supply gradually to demand shifts. I support Meltzer and McCallum's call for a gradual response, but I doubt that central banks should be committed to a mechanical reaction pattern. The speed of the response is likely to depend on the nature of these shifts. For example, if central banks know in advance that a major shift will occur, they should adjust the money supply quickly.

Confronted with the demand shift of the late 1980s, the SNB opted for caution. SNB officials knew that a shift would occur but did not know how big the shift would be or how fast base-money demand would fall. As a result of the SNB's cautious response, short-term domestic interest rates fell sharply at the beginning of 1988 but rose again as the SNB gradually lowered the supply of base money. By summer 1988, short-term domestic interest rates returned to their pre-shift levels. Long-term rates, however, did not budge. Thus market participants correctly regarded the fall in short-term interest rates as transitory.

With hindsight, various students of Swiss monetary policy attribute the most recent surge in the Swiss inflation rate to the SNB's cautious reaction to the demand shift. The SNB, they assert, should have acted more aggressively. The SNB's cautious response no doubt was equivalent to a temporary easing of monetary policy. Nonetheless, it cannot be regarded as the main cause of the rise in inflation. I am not aware of any economic theory able to explain how six months of easy money, which the market correctly regarded as transitory, could have generated three years of high inflation. For this reason, I still maintain that central banks should react cautiously to shifts in money demand.

OTHER UNEXPECTED SHOCKS

Similar problems arise from other unexpected shocks that may impinge on the central banks' anti-inflationary monetary policies. In small countries like Switzerland, central banks are frequently compelled to take the real exchange rate into account when setting monetary policy. Real exchange rate movements often fail to reflect economic fundamentals. As I pointed out before, Swiss inflation picked up temporarily in the early 1980s and early 1990s. Although the SNB attempted to keep the monetary base on a growth path consistent with medium-run price stability, the Swiss franc weakened sharply in real terms during both periods of high inflation; that is, the depreciation was much larger than would have been expected on the basis of inflation differentials between Switzerland and other countries. Therefore the exchange-rate depreciation reinforced the inflationary pressures in Switzerland. The SNB reacted to this situation by tightening monetary policy. As a result, the monetary base fell below the medium-run growth path. The tightening of the monetary reins eventually caused the Swiss franc to appreciate again. In this way, the SNB counteracted the inflationary pressures emanating from the exchange rate.

Lee Hoskins takes a dim view of central-bank attempts to manipulate the exchange rate. However, he considers only central-bank efforts to stimulate domestic employment by means of an exchange-rate depreciation. Such policies, I agree, may be inconsistent with the mandate to achieve and maintain price stability. But we should not overlook the situations in which exchange-rate movements undermine central banks' anti-inflationary policy stances.

Nevertheless, Hoskins' objections to exchange-rate policy are often valid. Exchange-rate policy may or may not be consistent with price stability. Swiss experience offers examples of both types of exchange-rate policy. The SNB did more than try to counteract excessive real depreciations of the Swiss franc. In 1978 and 1987 it reacted to an excessive real appreciation by relaxing monetary policy.

Although the real appreciation supported the fight against inflation, the SNB tried to halt or even reverse the upward movement in the exchange rate. The SNB thought that its efforts to curb the appreciation of the Swiss franc were consistent with its mandate to stabilize the price level. In 1978 and 1987 inflation was low and declining. In principle it followed an operational strategy of gradually lowering the inflation rate. In its view a gradual approach would minimize the real costs of achieving and maintaining price stability. Considering its preference for gradualism, the SNB did not welcome the real appreciation of the Swiss franc because it affected the domestic economy in the same way an unnecessary tightening of monetary policy would. Therefore the SNB allowed money growth to rise temporarily above the level consistent with medium-run price stability.

Unfortunately, the SNB's strategy of adjusting money growth to the real appreciation of the Swiss franc turned out to conflict with the price-stability objective. In both periods inflation rose again in due course. The two short episodes of rising inflation are largely explained by the SNB's efforts to counteract an excessive real appreciation of the Swiss franc.

Thus Swiss experience lends at least partial support to Hoskins' objections to exchange-rate policy. However, strict compliance with a price-stability mandate need not imply that central banks should abstain totally from manipulating the exchange rate. Even if the SNB tried to rule out any risks of erring on the side of inflation, it could not afford to ignore real exchange rate movements entirely. Instead it had to react asymmetrically. With an excessive real appreciation of the Swiss franc, the SNB would keep the monetary base on the medium-run growth path.

Faced with an excessive real depreciation, on the other hand, it would push the monetary base below that path. The resulting policy might be closer to shock therapy than to gradualism. The real costs of the shock therapy would constitute the price the SNB would have to pay for playing it safe.

In practice, I doubt that central banks are able to disregard entirely the real costs of eliminating inflation. The SNB has repeatedly emphasized that it cannot stabilize the price level without accepting a temporary increase in unemployment. But the Swiss public also expects the SNB to keep the real costs of its anti-inflationary monetary policy as low as possible. Therefore the SNB, in principle, must follow a gradualist approach. We could probably improve our performance if in the future we display greater reluctance to react to excessive real appreciations of the Swiss franc than we have in the past.

CONCLUSIONS

Let me conclude by emphasizing again that I agree with the thrust of Hoskins' reasoning. Monetary policy should be entrusted to independent central banks with a clear legislative mandate to achieve and maintain price stability. But in my view, independence and a clear mandate are not sufficient to guarantee a good monetary policy performance. It is also important that central banks adopt operational policy rules consistent with their mandate. Although central banks should be free to choose appropriate operational rules, they should be committed to spell out explicitly *how* they intend to fulfill their mandates. In particular, they should state how they intend to respond to shifts in money demand and other unexpected disturbances.

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