The Role of Monetary Policy: Where Does Unemployment Fit In?

Donald ***T. Brash***

I have been asked to focus on the pressures and constraints on monetary officials resulting from chronically high unemployment.

We all know that unemployment is one of the biggest problems facing most Organization for Economic Cooperation and Development (OECD) countries. We also know that there are strong demands on policymakers to provide solutions.

But responsible policymakers must recognize the limits of the policies they have at their command. Even with the best of intentions, some policy approacheshave the potential to end up doing more harm than good. To apply such policies just to be seen to be doing something would be very irresponsible indeed.

Most economists now accept that there are clear limits to what monetary policy can do to help lower unemployment. Monetary policy does have a clear part to play, and an important one. But it is not a tool we should use directly to stimulate growth or employment. Experience has taught us that such an approach will not work. On the contrary, it can be very damaging.

The best contribution monetary policy can make to growth and employment is to maintain stability in the general level of prices.

However, the wishful thinking that often underlies attempts to use monetary policy to stimulate activity and employment has not disappeared. Within public and political circles alike there is still a belief that monetary policy could do more to reduce unemployment than simply dealing with inflation. To those holding that view, focusing monetary policy upon price stability can appear a very callous approach.

As you may know, the Reserve Bank of New Zealand now has a clear and very distinctive mandate to maintain price stability. You will not be surprised to learn that people often criticize our monetary policy framework for not paying adequate attention to unemployment.

Today I would like to give you some insights into the way this issue has developed in New Zealand and how the Reserve Bank has responded. I would also like to explain why the monetary policy framework in New Zealand plays an important role in reducing pressures on the central bank to influence employment in ways that will ultimately prove unsuccessful.

Monetary policy: What did the past teach us?

To begin, I think it is useful to review the main lessons we have learned about the role of monetary policy over the past two decades. Unless we keep those lessons firmly in mind, we run the risk of repeating the mistakes most countries made over that period.

At one time or another, governments around the world have tried to use monetary policy to achieve almost every conceivable economic objective, and some social objectives as well. Economic growth and employment have often been high on the list of objectives for monetary policy.

New Zealand's experience over the 1970s and early 1980s provides as good an example as any of this shotgun approach to monetary policy. The former Reserve Bank legislation, in place until 1989, required that monetary policy be directed toward enhancing economic and social welfare. In doing so, attention was to be given to promoting the highest level of production, trade, and full employment, and to maintaining a stable price level.

The act did not define these objectives. Moreover, the Reserve Bank was given little operational independence to achieve them. Legally, the responsibility for monetary policy rested almost entirely upon the minister of finance.

Given the multiple goals, and the lack of any real accountability framework, ministers of finance faced little discipline in the conduct of monetary policy. As the theory of political economy might predict, there was an overriding tendency to use monetary policy to stimulate the economy. The fiscal stance over this period was also expansionary, with large and persistent fiscal deficits.

Despite the expansionary macroeconomic policy, New Zealand's growth performance over the period fell well below the OECD average. The unemployment rate, which is estimated to have been as low as 1 percent in the early 1970s, trended upward to just over 5 percent by the early 1980s. That upward trend was temporarily broken in 1984, due to a significant further stimulus, and a reduction in real wages arising from a wage and price freeze.

The expansionary nature of macroeconomic policy resulted in high and variable inflation. The Consumer Price Index (CPI) increased fivefold in New Zealand between 1970 and 1984. Among the OECD group of countries, prices over the same period increased "only" threefold.

New Zealand's experience over this period helped to teach us many lessons about the conduct of monetary policy that other countries have also learned.

The unemployment-inflation tradeoff

It is clear that we were asking monetary policy to do things it could not. Stimulating activity worked for short periods in the sense of increasing both output and employment. Ultimately, however, the only enduring result was high inflation. Monetary stimulation was no safeguard against unemployment. In economic parlance, there was no stable, long-run Phillips curve that we could exploit to help improve economic growth or employment prospects.

It is worth recalling that Bill Phillips, a fellow New Zealander, never claimed that there was an exploitable policy tradeoff when he originally uncovered the unemployment-wage relationship.

It would be misleading to assert that our poor growth record and the emergence of unemployment over this period were simply the result of following inflationary policies. Clearly, other factors were also at work. Our highly regulated economy was unable to adjust efficiently to changes in the global economy.

But inflation made matters worse. By impeding the efficient operation of markets over a long period, inflation appears to have worsened both growth and employment prospects. Our lackluster growth performance would certainly suggest that.

Internationally, of course, there is a growing body of evidence suggesting that inflation hinders growth. By implication, it also hinders employment prospects.

Our experience strongly supports this international evidence that monetary policy is best directed toward a single goal—the maintenance of stability in the general price level. That objective is the best contribution monetary policy can make to growth and employment prospects.

Central bank structure

New Zealand's experience can also teach us much about the appropriate structure of a central bank.

A central bank must be given a clear mandate to maintain price stability. But it also needs the operational independence to pursue that goal. Without it, political incentives are likely to pressure governments to direct monetary policy toward real sector objectives that it cannot sustainably meet.

But even operational independence is not enough. In order to ensure the central bank delivers on the price stability goal, it must also be made fully accountable for its performance.

Putting the lessons into practice: the New Zealand monetary policy framework

We have attempted to apply these lessons to the monetary policy framework in New Zealand. Starting from late 1984, the incoming government directed the central bank to begin reducing inflation. The government passed a new Reserve Bank Act in 1989 to formalize that objective. The act came into force in early 1990. The act makes the achievement and maintenance of stability in the general level of prices the only focus of monetary policy.

The act itself does not define "stability in the general level of prices," but requires the minister of finance and me to negotiate a Policy Targets Agreement, or PTA. This defines price stability quantitatively. Thus it becomes a clear target to which we can be held accountable. The current target is for the maintenance of twelve-monthly consumer price inflation between 0 and 2 percent. The PTA is renegotiated whenever a governor is appointed or reappointed. Both the minister of finance and the governor must be satisfied that the specific target is consistent with the act before signing the agreement.

Price stability, as defined, was first achieved in 1991, around seven years after we were first directed to pursue low inflation. We have maintained inflation within that 0 to 2 percent range ever since.

Many people, in New Zealand and abroad, were surprised at the passage of the Reserve Bank Act. They were also intrigued that the act received unanimous support from both major political parties.

Politicians' support for the Reserve Bank Act reflects very considerable political courage on their part. Implicitly, they have recognized that the long-term benefits of pursuing price stability outweigh whatever political benefits there are from using monetary policy to meet short-term objectives. Given the continued pressures politicians find themselves under to do more about unemployment, and the widespread belief in an inflation/employment tradeoff, the broad political support for the act is remarkable indeed.

Pressures on the monetary authorities

Recent trends in *unemployment*

Over most of the period during which we were reducing inflation, the New Zealand economy experienced a recession in activity. That reflected not only the influence of disinflation, but also the adjustment pressures caused by microeconomic reform on a scale probably unprecedented in the OECD in the last four decades.

At about the time we achieved price stability in 1991, the economy entered a recovery phase and has continued to strengthen since. Over the year to March 1994, the economy grew by 5.3 percent.

The unemployment rate, which continued to rise during the disinflation period, has fallen from a seasonally adjusted peak of 10.9 percent in September 1991 to 8.4 percent in June 1994. Total employment has grown by nearly 4 percent over the past year.

Most forecasters expect the unemployment rate to fall further over the next few years as economic growth continues. Increases in the labor force, and a rise in the labor force participation rate associated with growth in job opportunities, are expected to partly offset the decline in the unemployment rate, but despite this, we, ourselves, are expecting the unemployment rate to be around 8 percent by early next year.

But even 8 percent unemployment is still uncomfortably high and most New Zealanders, and indeed most New Zealand policymakers, want to see it further reduced.

The role of the policy framework

Does the New Zealand monetary policy framework shield the bank from pressures from politicians and others to "do something" about unemployment? I would like to give an unequivocal "yes" to that question, but I can't. You probably wouldn't believe me if I did. But the framework undoubtedly helps to reduce those pressures.

Our framework is certainly very effective in discouraging us from diverting from the price stability objective when implementing monetary policy. The PTA establishes a clear target against which I am accountable. If the bank were to succumb to pressures that jeopardized that target, we would soon be required to explain why.

As governor, I am personally accountable for our monetary policy performance. If we fail to meet our inflation obligations under the PTA, the act makes it possible for the minister of finance to dismiss me. That threat places an important discipline on me not to target anything other than price stability.

The process of accountability is carefully formalized under the legislation. We are required to produce monetary policy statements at least once every six months, explaining our policy actions. These policy statements mean that our actions are subject to close scrutiny not only by the government, but also by the financial markets and other interested bodies.

Each monetary policy statement is followed shortly after by a hearing conducted by the Finance and Expenditure Committee, a parliamentary committee consisting of both government and opposition members—rather like the congressional committee before which Mr. Greenspan regularly appears. The committee can ask the bank for further information about our performance.

Inevitably, the financial markets are an important arbiter of our performance. If our words or actions suggested we had been pressured, or were going soft on the inflation target, interest rates could be expected to rise quickly. That in itself could be harmful to employment.

Since the passage of the Reserve Bank Act in 1989, indeed since late 1984, there has been no attempt by any government to influence the implementation of monetary policy. On occasion, temptation must have been strong. In late 1990, for example, just before a general election, the bank felt it necessary to firm monetary conditions to ensure continued progress toward the price stability goal in the face of an expansionary fiscal stance. I'm sure that no government wants that just before an election.

Under a clause in the act, the government has the power to direct the bank to focus monetary policy on some objective other than price stability. However, that instruction has to be in public (by means of an Order-in-Council), and in most circumstances, that makes it politically unattractive.

The public communications function

In the long run, the monetary policy framework can only survive if people widely support it. Within the business sector, especially among farmers and manufacturers, there is growing recognition of the benefits of price stability.

Among the general public, support is also growing. People are beginning to see that it is possible for stable prices, economic growth, and job creation to go hand-in-hand, and for more than just a fleeting period.

However, the policy framework has always had, and still has, its critics. They have attacked the framework for its exclusive focus on price stability and argued for a wider mandate that pays more attention to unemployment.

Among those to have criticized the framework have been a former prime minister, and leaders of several of the smaller opposition parties. The Council of Trade Unions, unemployed workers groups, church leaders, many academics, and some media and talk-back hosts have also questioned the framework.

The critics are keen to see the inflation target diluted, with the bank pursuing some kind of employment target as well. Implicit in that call is the notion of a long-run, exploitable, Phillips-type relationship.

Many of the public share that view. In March 1994, the *National Business Review* (the most widely read business weekly in the country) published a poll on the Reserve Bank Act. The poll, known as "The NBR-Consultus Poll," asked people if they would support a change to the act to include the reduction of unemployment as one of the bank's objectives.

Sixty-two percent of those polled said they *would* support such a change. The remainder was about equally divided between opposing the change and being unsure about it. In the same poll, however, 80 percent of those polled admitted to knowing "hardly anything" or "not that much" about the existing act.

One of the bank's most important functions has therefore been to try and build a wider constituency for the price stability objective. Most people can accept that inflation imposes significant costs on the economy and society. But people also need to be convinced that attempting to trade off just a little more inflation for a little less unemployment, however tempting, just isn't a workable proposition.

Since the late 1980s, the bank has operated a very active public communications program. We undertake a substantial program of speeches and presentations for a wide variety of public groups. The bank also briefs politicians and members of the media on the policy framework.

When presented with the facts, most people are prepared to at least consider the merits of our monetary policy approach. And there are many compelling facts that we can point out to people in those presentations.

The first is that unemployment in New Zealand had become a deep-seated problem long before we embarked on the price stability goal, despite a sustained period of monetary stimulation. Clearly, structural factors outside the ambit of monetary policy were at work.

We can also highlight the international experience pointing to the absence of an inflation-employment tradeoff or a long-run Phillips curve. And we can cite the growing body of empirical evidence that suggests inflation is actually harmful to growth. The high degree of international agreement on these issues is strong support for our monetary policy approach.

Building support for the policy framework has been no easy task. Nor can we claim to have finished that task.

Our public communications role needed to begin while inflation was being brought down. Throughout that period, unemployment was rising steadily, partly reflecting the disinflationary pressure needed to lower inflation.

In those circumstances, the message that price stability would be beneficial to growth and employment was bound to meet with resistance. The public made its own assessment of the costs of disinflation. Having made that assessment, people could easily believe that price stability, once achieved, would also be costly.

The bank has always acknowledged openly that disinflation involved employment costs. We also note that it is difficult to quantify those costs given all the other influences on unemployment at that time. A key message in our speeches during disinflation was that the employment consequences would be reduced, the sooner wage and price setters realized that we were absolutely committed to lowering inflation.

Among the economics profession and elsewhere, there is still considerable debate on the costs of disinflation and whether the costs of "going the whole hog" are worth incurring. For New Zealand, those costs, whatever they were, have now been incurred.

The bank, therefore, stresses to people that forsaking price stability now would at some point require those costs to be paid again, unless we were prepared to tolerate high inflation indefinitely. Clearly, the higher one assesses the costs of disinflation, the less attractive a return to high inflation becomes.

Public support for price stability has not been helped by the silence, and sometimes the outright criticism, of some of the major beneficiaries of price stability. Their criticisms, while often unrelated to unemployment, have reinforced the idea among some people that price stability has very few benefits.

To illustrate: During the high inflation era of the 1970s and 1980s, real, post-tax interest rates on savings were typically negative. As in most other countries, savers in New Zealand pay tax on their entire nominal interest earnings, not just the real component.

As inflation has fallen, real, after-tax returns have improved. But people have suffered from money illusion. As nominal interest rates have fallen, savers have commonly perceived themselves to be worse off than under high inflation. Many of those on interest incomes, such as the retired, have been vocal critics of price stability. Their confusion has certainly not helped public support for price stability.

Unemployment and monetary policy: Some common issues

Apart from those critics who still hold to a rather simplistic Phillips-curve view of the world, there are three other strands of criticism surrounding the monetary policy framework in New Zealand.

First, some critics argue that the bank achieved price stability too early, and as a result, incurred unnecessary costs in terms of output and unemployment. The original PTA required us to achieve price stability by 1992. At the end of 1990, this deadline was changed to 1993. In fact, we achieved a 1 percent rate of headline inflation (and a 1.7 percent rate of underlying inflation) in 1991.

The bank has openly acknowledged that we did get to our target earlier than intended and that that ***may*** have resulted in additional costs. But that conclusion is by no means clear. Recent work by writers such as Laurence Ball and others suggests that the optimal speed of disinflation may actually have been faster than the seven years we took. A case can therefore be made that by getting there a little early, we avoided some of the employment costs which would have been involved by a still more prolonged disinflation. The jury is still out on this issue.

Second, some critics hold that employment prospects could be improved if only the Reserve Bank were prepared to tolerate a lower New Zealand dollar. Since **a** lower exchange rate would, it is argued, enhance the competitiveness of exporters and import substituting industries, activity and employment would be enhanced also. This is, of course, an open economy variation on the familiar argument that monetary policy is capable of a sustained stimulative effect on employment and growth.

Given New Zealand's relatively open economy, the nominal exchange rate is clearly an important influence on the inflation outlook. The bank has been quite open in stating that it must hold a view on the exchange rate that is consistent with price stability. That view is made with reference to the many other factors feeding into the inflation process. While, in practice, we can often tolerate quite wide fluctuations in the exchange rate, we cannot be indifferent to its moving beyond those limits.

Our ability to influence the nominal exchange rate means that we can certainly affect the real exchange rate in the short term. But economic theory and our own experience tell us that attempts to drive the real exchange rate down will be successful for only as long as it takes people to realize the inflationary consequences of a lower nominal exchange rate. In other words, our capacity to beneficially influence the real exchange rate is limited to our capacity to fool people, or for however long it takes for sticky prices to change.

Historically, depreciations in the New Zealand dollar have simply reflected relative price changes between New Zealand and its trading partners due to inflation. A depreciating dollar has not been associated with sustained improvements in our real exchange rate. For example, over the twenty years from 1970 to 1990, the Zealand dollar depreciated (on a trade-weighted basis) by just over 50 percent. Over this period, prices in New Zealand rose by just over twice as much as those in our major trading partners.

A third concern of critics relates to the definition of the price stability target itself. Price stability is defined in the PTA as consistent with year-on-year increases in the CPI of 0-2 percent. It is sometimes held that the 0-2 percent definition is either "too low," "too narrow," or both. Maintaining the target is said to be unnecessarily costly in terms of output and employment.

Is the inflation target centered around "too low" a midpoint? We don't believe so. Over the three-and-a-half-year period during which inflation has been maintained within the target, the economy has entered a sustained growth phase. This is hardly convincing evidence that we have impeded growth or employment.

As best we can tell, the center of the target—1 percent—appears to correspond to genuine price stability once the various sources of bias in the CPI are allowed for. In the bank's view, there should be no ongoing employment costs of maintaining that target, provided wage and price setters are confident that we will, on average, deliver that outcome and adapt their behavior to that reality.

It is sometimes posited, by Lawrence Summers for example, that some low, positive target rate of inflation is more appropriate than price stability so that real wages are able to fall over the economic cycle if required. Downward nominal wage rigidity is seen to limit real wage adjustment when inflation is zero.

As I have argued elsewhere, with price stability, nominal wages are likely to grow at the trend rate of productivity growth over the business cycle so that real wage movements are able to fall below trend without nominal wage cuts. It simply requires forgoing some of the nominal wage increase that would otherwise occur due to productivity increases.

Moreover, nominal wage stickiness, where it exists, is surely a feature of an individual's employment contract. It is much less likely to apply in an average sense. Most firms are able to reduce the ***average*** nominal wage without having to cut the wage of any incumbent employee. The replacement of highly paid retirees and resignees with lower-paid recruits, and a reduction in the remuneration steps that accompany promotions, are all ways of capping or reducing the nominal wage bill without resorting to outright pay cuts.

Those supporting a ***wider*** target band often point to a potential instrument instability problem under the current target. Because of the imprecise nature of the monetary policy tools at our disposal, they say policy adjustments may become erratic as we attempt to keep from over- or undershooting the target. Accordingly, monetary policy may cause unnecessary gyrations in economic activity, perhaps to the detriment of employment.

Moreover, it is argued that, under a narrow target, the Reserve Bank may often be forced to act before it has sufficient information on the outlook for inflation. Thus inappropriate policy actions may be taken because inflationary movements will often be misread.

Is the current price stability target too narrow? On the evidence to date, I would have to say no. The bank has successfully maintained inflation within the 0-2 percent range since 1991. During that time we have not been led to make frequent or erratic adjustments to policy settings. I readily concede, however, that the framework is still young. It is yet to be tested over a full economic cycle.

It appears to me that widening the target so that we wait longer before adjusting policy is an argument that can easily be overdone. There is a long international history of having waited too long before acting when inflation emerges. As a result, the costs of correction have often been accentuated. A target that limits the scope for policy adjustments to be deferred can thus actually minimize the resulting costs of correction.

I should also mention that a clause within the PTA recognizes explicitly that it may not be appropriate to contain the' CPI inflation rate within the 0-2 percent target at all times. That clause recognizes that when certain shocks beyond the direct control of policy occur, it may not be worth incurring the output and employment costs of trying to offset them.

These shocks include large terms of trade movements, and changes in indirect taxes and government charges. In addition, interest rates are measured directly in New Zealand's CPI. A significant movement in interest rates may thus provide grounds for allowing the inflation rate to move outside the 0-2 percent range. (To do otherwise would, of course, create an absurdity: a tightening in policy that led to an increase in interest rates would increase measured inflation and provoke a further tightening in policy, and so on.)

We are, of course, expected to account for and explain cases where headline inflation does temporarily leave the range. The presumption is that we will meet the target most of the time.

Inflation expectations and policy credibility could both be seriously damaged from the move to a wider target or if the target was shifted upward. Those in the financial markets could conclude that the real aiming point for inflation had become the upper portion of the new target. That perception could complicate the maintenance of price stability. And interest rates would almost certainly rise in response to higher expected inflation. That would do nothing to help employment.

From my comments, it should be clear that I am not by any means persuaded of the merits of a change to the target: at a technical level, the issue is relatively minor, but the likely change in perceptions caused by a widening of the target range could well damage growth and employment rather than the reverse.

Concluding comments

Little did Bill Phillips know, when he uncovered his unemployment-wage relationship, of the unfortunate effect his discovery would have on the conduct of monetary policy for decades afterward. It is rather ironic, given Phillips' own view that the relationship was of little policy relevance. With many having been brought up on the Phillips curve, there are always likely to be pressures on monetary authorities to tolerate just a little more inflation to help unemployment. New Zealand's monetary policy framework plays an important role in shielding us from that temptation.

Reducing unemployment is now the most important economic and social objective in many OECD economies. People understandably ask what the monetary authority can do to help. By aiming monetary policy squarely at maintaining price stability, there is much we can do.

By aiming monetary policy elsewhere, we would not only damage the economy and its capacity to generate sustainable employment, we would also distract attention away from where the real solutions to unemployment lie—in labor market reform, in training and retraining, and in the reform of the relationship between wages and benefits.