Commentary: Monetary Policy and the Control of Inflation

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Well, I guess as one comes toward the end of a session, people always hope that you will not overrun your time. I will try to keep my comments brief. It was only with great reluctance that I accepted the task of commenting on the control of inflation in emerging, market-oriented economies. The reason is very simple. As economists, we are much better equipped to analyze and forecast the impact of shocks, given the institutional setup. But, we have great difficulties in analyzing the effects of institutional change itself. And this is really the problem we face in Eastern Europe today. In my comments, I would like to focus on the problems that these countries face in the transition period, the period when they shift from a centrally planned to a market-oriented economy. But, as I say, I am not sure just how much Western economists can actually contribute to this topic.

As John Crow rightly points out, the principal task of central banks is to provide a stable monetary anchor. The monetary anchor must ensure that prices remain stable. Price stability is an essential ingredient in a market-oriented economy. In such an economy, resources are not allocated according to a central plan, but by the interaction of individual firms and households who are guided by relative prices in making economic decisions. For this reason, and I think many speakers now have emphasized this point, relative prices play an important allocative role in market-oriented economies. To play this role efficiently, relative prices must emit correct signals,to firms and households. Variable and unpredictable prices are unlikely to prompt firms and households to take correct economic decisions. Since inflation normally implies highly variable and unpredictable movements in prices, it tends to undermine the allocative function of the price system. Thus, price stability is required if relative prices are to play proper allocative roles.

Although the experience of the Western monetary authorities may be useful to the Eastern European countries in search of a monetary anchor, the transition from a centrally planned to a market-oriented economy poses additional problems not normally encountered in the West. The key problem is that in the transition period internal relative prices must be adjusted so that they can start to play an efficient allocative role. Considering the distorted structure of relative prices inherited from the era of central planning, all the Eastern European countries find the required adjustment to be enormous and painful. This leads to a very paradoxical situation. In the transition period, relative prices must be variable if the Eastern European countries are to achieve the reforms that will make the price system work. This may also imply highly unpredictable price movements in the transition period. Yet, price movements in that period should not get completely out of control. The chaos ruling in the transition period should not become a permanent feature of the economy. Rather, out of the chaos in the transition period, monetary stability should emerge and should allow relative prices to play their proper allocative role.

How are the Eastern European countries going to produce this miracle? The answer to this question, I believe, is that the monetary anchor should be chosen at the beginning of the transition period. It should not be chosen at the end. The early choice of an anchor ensures that the price adjustments required during the transition period do not get out of hand. Poland and the German Democratic Republic have clearly perceived the necessity of choosing an anchor early. In Poland, two nominal anchors are currently used—a stable nominal exchange rate and a taxed-based incomes policy. Now, I share some of the ill feelings about the taxed-based incomes policy as Allan Meltzer does. But, as long as this policy is consistent with the nominal exchange rate target, it probably is all right, at least in the transition period. Poland's use of a fixed exchange rate as a monetary anchor makes sense in the transition period because the purpose of the adjustment is to render the Polish economy competitive on international markets. This, in turn, implies that Polish prices should adjust to those in the rest of the world. Clearly, a fixed exchange rate will help in achieving this objective. The German Democratic Republic has taken an even more drastic course of action. Here, the country simply adopts the monetary standard of another country and, therefore, fixes its exchange rate irrevocably.

The early adoption of a monetary standard is important because, as many speakers have mentioned, in the old central planning system the banking system acted as a residual lender to the government and to state-owned firms. This residual lendership may become very dangerous in the transition period when prices are freed because it may become a source of inflation that has to be controlled.

While a stable exchange rate may be useful in the transition period, I am less sure, and here I share some of John Crow's feelings, whether a fixed exchange rate is also a useful strategy in the longer run. Once the transition period is over, it might be better to adopt a monetary standard based on the growth in some money or credit aggregate than to peg the exchange rate. As a central banker from a small country, I know that you may face shocks coming from abroad that harm the domestic economy. In these situations a flexible exchange rate may be advantageous because it may enable the central bank to insulate the domestic economy from undesirable foreign shocks.