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CENTRAL BANK INDEPENDENCE, FISCAL RESPONSIBILITY, AND THE GOALS OF MACROECONOMIC POLICY: AN AMERICAN PERSPECTIVE ON THE NEW ZEALAND EXPERIENCE

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ABSTRACT

CENTRAL BANK INDEPENDENCE, FISCAL RESPONSIBILITY, AND THE GOALS OF MACROECONOMIC POLICY: AN AMERICAN PERSPECTIVE ON THE NEW ZEALAND EXPERIENCE

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In contemporary New Zealand, microeconomics is in the ascendant over macroeconomics, to such an extent that neither the Reserve Bank nor the Cabinet and Treasury appear to give much attention to shorter-run macroeconomic stabilization as a policy goal. This lecture examines why thoughtful New Zealanders are attracted to this atypical aversion, and asks whether that aversion is in New Zealand's best interests.

The lecture concludes that New Zealand's Reserve Bank Act provides admirable institutional arrangements for the political independence of the central bank in New Zealand. Insulation from the political process protects against excessively short-sighted pressures on monetary-policy decisions. Because the Reserve Bank has instrument independence, but not goal independence, monetary policy is appropriately subject to democratic accountability. In principle, the credibility and time consistency of policies can be enhanced by mandating that neither the Reserve Bank nor the Government should engage in macroeconomic stabilization. Yet the economy might incur avoidable costs if policymakers stay completely out of that business. Accordingly, the tradeoff between credibility and time-consistency advantages on the one hand and potential gains from stabilization flexibility on the other deserves more careful attention than it typically receives in New Zealand. The emphasis in New Zealand on getting the long-run aspects of economic policies right is easily explained by recent history. Furthermore, the long-run aspects should continue to have priority. But putting primacy on the long run need not preclude some complementary role for shorter-run macroeconomic stabilization. The credibility advantages of complete abstinence are probably not so overwhelming as to justify keeping macroeconomic stabilization locked up in the closet.

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My visit to New Zealand, under the auspices of the Fellowship in Monetary Economics established at the Victoria University of Wellington with the support of the Reserve Bank of New Zealand, has provided an unparalleled opportunity to learn about your fascinating country. The Reserve Bank, the University, and the Victoria University Foundation have provided highly congenial arrangements for my visit. I am deeply grateful to these institutions -- and to new Kiwi friends too numerous to name -- for their intellectual stimulation and warm hospitality.

Macroeconomic Stabilization in New Zealand

During my visit, I have been struck by several observations. First, thoughtful commentary about New Zealand's economic policies is usually focused on long-run goals and long-run effects. When the shorter run does come into conversation, the point is often made that it is dangerous to focus on the short run. Second, economic policies primarily emphasize microeconomic efficiency. Macroeconomics takes a back seat. Third, insofar as macroeconomics gets discussed, attention tends to be focused on monetary policy and the reforms introduced by the 1989 Reserve Bank Act. The key points of discussion about monetary policy are the need for political independence of the Reserve Bank and the importance of making price stability the exclusive goal of monetary policy. Finally, if discussion of the macroeconomics of fiscal policy comes into the conversation, the emphasis is on the long-run sustainability of government budget trends and on the objective of reducing the stock of debt in relation to the economy.

When I combine these observations, I come up with a striking inference about contemporary New Zealand: Microeconomics is firmly in the ascendant over macroeconomics, to such an extent that neither the Reserve Bank nor the Cabinet and Treasury appear to regard shorter-run macroeconomic stabilization as a policy goal.

New Zealand is remarkably different from other countries in this regard. In the United States, for example, a presumption that macroeconomic stabilization should look after itself instead of being the responsibility of policymakers is held by only a small minority -- with almost none of that minority, by the way, including policymakers within the Federal Reserve or the government. I know of no other nation in which antipathy to macroeconomic stabilization is so widely held as it appears to be in New Zealand.

My two purposes in this lecture are to examine why thoughtful New Zealanders are attracted to this atypical aversion, and to ask whether that aversion is genuinely in New Zealand's best interests. The challenge I have set myself is to explain the ideas in a way that will be intelligible to a wide audience of non-specialists.

At the outset, we need a definition. “Macroeconomic stabilization” as I use the term refers to attempts by policymakers to cushion the consequences of nonpolicy disturbances that buffet an economy, thereby to improve the short- and medium-run performance of the economy relative to what it would otherwise be. Such stabilization efforts, which could use monetary policy, fiscal policy, or both, will be concerned with effects on real-sector variables such as output and employment, not merely with effects on the rate of inflation.

This subject is important and controversial, for any nation, because of a dilemma. If policymakers try to cushion the effects of disturbances that buffet an economy in the shorter run, that effort may adversely affect the credibility of the policymakers' commitment to achieving the long-run goals of economic policy. For example, if monetary policy were to try to offset such disturbances, that effort may introduce a bias toward inflation in the economy. Indeed, as New

Zealanders well know from their economic history prior to 1984, government itself can make serious policy mistakes. Government at its worst can be the primary source of disturbances that destabilize an economy, causing economic performance to be much worse than it otherwise would have been.

But -- here is the other horn of the dilemma -- if policymakers eschew macroeconomic stabilization, the economy may be more vulnerable to shorter-run fluctuations caused by nonpolicy disturbances. Such swings in the economy might be significantly larger than those that would occur if macroeconomic stabilization could be conducted successfully. Abstinence from stabilization means forswearing policy flexibility, which might expose the economy to avoidable costs and risks.

Most interesting questions in economics, if not life itself, involve complex "tradeoffs." This dilemma is a classic example. How far should a nation go in sacrificing short-run policy flexibility to ensure the achievement of long-run credibility? Or, to put the tradeoff the other way round, how much of a risk with long-run credibility is it sensible for a nation to run so as to leave some room for flexible macroeconomic stabilization in the shorter run?

By temperament, I am a cowardly eclectic. I prefer the middle of the road to the ditch on either side. Knowing that about me, you can now guess my own views about this tradeoff, and hence the principal conclusion of my analysis. I am going to try to persuade you that a little more middle-of-the-road balance may now be helpful in framing the goals of New Zealand's economic policies. I emphasize the word “now” in that last sentence. My analysis acknowledges the significance of the pre-1984 experience in which the New Zealand government badly abused macroeconomic stabilization. But I also look to the future, recognizing the sea-change in New

Zealand's policies since 1984.

Two more preliminaries. First, when I said that neither the Reserve Bank nor the Government appear to regard macroeconomic stabilization as a policy goal, I was oversimplifying to get your attention. My inference does capture the tenor of much public discussion. But as will become clear later, I shall also argue that more attention is paid to macroeconomic stabilization than the conventional wisdom asserts.

Second, we ought to acknowledge together the obvious fact that I am an outsider, still very much learning about New Zealand. It is presumptuous of me to offer strong opinions on this subject. My presumption is all the greater because the topic is so difficult and controversial. I justify venturing out onto this thin ice because the topic is so important. I would rather be faulted for falling short when tackling a worthy challenge than for addressing a safe subject, saying things of minor interest.

Some of you are bound to disagree with parts of my analysis. I nonetheless hope that you will recognize the constructive spirit in which I am trying to raise the issues.

Our first step in exploring this difficult topic is to focus on monetary policy. It will clarify our discussion to make a sharp distinction between mandating price stability as the exclusive goal of monetary policy and mandating political independence for the central bank. These two things are not the same, even though conversations often conflate them. The scope for conflation in New Zealand is considerable, since the Reserve Bank Act legislates both mandates.

Political Independence of the Central Bank

Why might a nation wish to establish a politically independent central bank? Two related arguments stand out from all the rest. First, it may be helpful to insulate monetary policy from the political process, especially in democratic societies. Elected officials have incentives to exploit monetary-policy decisions for short-run gains -- such as winning the next election. Politicians may even be tempted to pursue personal goals that do not coincide with the genuine purposes of the electorate at large.

Second, it may be helpful for society to guard against its own tendencies to put too much emphasis on short-run considerations, thereby wrongly neglecting long-run goals. It is not just politicians, in other words, who can temporarily confuse priorities, sacrificing more fundamental long-run interests for short-run gratification. Maintenance of a low inflation rate is a classic example of a long-run goal that societies have lost sight of in shorter runs. If the members of a society tie their own hands by creating a politically independent central bank, such institutional arrangements may be able to offset the bias toward inflation that would otherwise exist.

Consider the analogy of a man with an alcoholic habit. The man knows in his better moments he must reduce his excessive drinking. But he can be weak-willed, losing sight of his true goal. Worse, his good-natured friends at times encourage him to enjoy a drink, with the result that moderation is occasionally abandoned. One method of handling the situation is for the man to give his wife the keys to the liquor cabinet and wine cellar, asking her to be his monitor, to protect him against his shortsightedness.

The rationales for central-bank independence I have emphasized presume that the institutional arrangements created do serve to foster the true goals of the society. To make this important point clear, we need to draw a distinction between instrument independence and goal independence. As the alcoholic's monitor, the wife has instrument independence; she has the keys to the wine cellar and controls day to day access. But the husband and wife share the goal of reforming his drinking; the wife does not have goal independence. Indeed, the husband delegates to his wife the job of advancing the goal he has himself selected in his wiser moments.

Suppose you were to argue against political independence of the central bank. What would be the most powerful case you could make? The most compelling concern about many proposals for central bank independence is their failure to provide for democratic accountability. If a central bank were to have goal independence, it would be free to chart a separate course from the path that the rest of society really wishes to follow. The reasons I gave you for favoring central-bank independence are clear justifications for instrument independence, but not for goal independence.

Imagine that the alcoholic's wife is free unilaterally to change objectives. Suppose she decides she will accept nothing less from her husband than complete abstinence. So she descends to the wine cellar, empties all the bottles down the drain, and furthermore demands that the husband attend Alcoholics Anonymous meetings four times a week. The husband could justifiably complain that his original delegation of day-to-day monitoring authority was not intended to grant her such goal independence.

The distinctions just made provide insight into New Zealand's current institutional framework for monetary policy. The Reserve Bank Act assures instrument independence. The Cabinet and Treasury may not interfere with day-to-day and month-to-month decisions at the Reserve Bank (as they had been interfered with in the Muldoon era). But the Policy Targets

Agreements worked out with the Minister of Finance set the actual goals to be sought by the Reserve Bank. Furthermore, Government can mandate a change in the goals in the Policy Targets Agreement by an Order in Council, or can negotiate a new Agreement. The Reserve Bank Governor can be dismissed if his performance in achieving the mandated goals is considered inadequate. Detailed provisions of the Act require transparency in the entire process, which inhibit the Government from proposing changed goals primarily for short-run gains.

These unique aspects of the institutional arrangements for monetary policy in New Zealand seem wise and salutary to me. New Zealand has political independence for the central bank at its best. Instrument independence and transparency assure a distancing of the central bank from the vagaries of the political process. But the Reserve Bank does not have latitude to depart from society-wide goals as determined by the electoral and parliamentary process. The Reserve Bank Act rules out goal independence and emphasizes democratic accountability.

New Zealand's arrangements contrast favorably with those in other countries, in particular with the quite different way that Europeans and many academics have argued for central bank independence. The Maastricht Treaty and the design for a European System of Central Banks, for example, seek <u>both</u> instrument independence and goal independence for the new institution. Mechanisms for accountability and transparency are largely absent. New Zealand's arrangements seem to me much more thoughtful and robust.

Price Stability as the Exclusive Goal of Monetary Policy

Now we come to a more difficult question: Should a politically independent central bank be given the single, exclusive goal of "price stability"?

For clarity, we need to acknowledge the distinction between a target of avoiding inflation and a target of literal stability in the price level. Both targets could pay exclusive attention to inflation. But mandating a target for maintaining an unchanged level of prices (literal price stability) has some different implications from mandating a target of an unchanged rate of inflation. If some unexpected event causes the price level and hence the inflation rate to change, a target of literal price stability would require the Reserve Bank to induce a further change in the price level that reverses the initial change, thus bringing the price level back to its original path. In contrast, when the Reserve Bank targets the rate of inflation, the inflation rate must be brought back to the initial rate; but "bygones are bygones" in the sense that the consequences of the unexpected event for the price level do not have to be reversed.

This distinction between the two interpretations of "price stability" is widely recognized inside the Reserve Bank and the Treasury. Arguments can be made for and against each interpretation. The Government and the Reserve Bank tend to target an unchanged low inflation rate, not literal stability of the price level. I believe they are probably correct in that choice. And the inflation-rate choice appears to be consistent with legal interpretations of the Reserve Bank Act. To avoid possible confusion between the two different interpretations, I will henceforth use the term "inflation avoidance" rather than "price stability."[1]

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[1] Research continues on the relative merits of the two interpretations. Thus the decision of the Government and Reserve Bank in favor of targeting the inflation rate rather than an

(continued...)

So why would a nation stipulate that its central bank singlemindedly emphasize the goal of inflation avoidance? Some arguments offered as an answer are, in my view, simply wrong or misleading. For example, one sometimes hears it said that monetary policy has essentially only one instrument, so that it should have only a single goal. Another contention -- voiced by extreme advocates of the so-called new neoclassical macroeconomics -- is that monetary policy has no significant effects on output and employment even in the short run, so that monetary policy should focus exclusively on nominal variables -- in particular the rate of inflation.[2]

Such arguments appear not to have been given significant weight in New Zealand -- rightly so in my view. So I will concentrate on the much more serious, and subtle, line of reasoning which leads thoughtful New Zealanders to be opposed to the Reserve Bank having multiple goals.

The line of reasoning begins with two propositions. First, monetary policy <u>does</u> significantly influence output as well as inflation in the short run. This proposition is overwhelmingly supported by empirical evidence, for New Zealand and for other countries. The second proposition is that minimization of inflation over the long run is strongly desirable if the economy is to achieve the most robust long-run growth of which it is capable. The evidence

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[1](...continued)
unchanged price level could conceivably change in the future.

[2] In contrast to the extreme view that monetary policy cannot affect real variables such as output and employment <u>in the short run</u>, most economists do accept the hypothesis that monetary policy has little if any effect on output and employment <u>in the long run</u>. This proposition in the technical economics literature is often referred to as the "natural rate hypothesis." The contention is that the economy in the long run moves to a non-accelerating rate of unemployment (the "NAIRU") which is independent of the conduct of monetary policy. Though most of the economics profession shares this long-run view, it is a notable fact of political life that many non-economists do not accept it.

about this second proposition, although on balance supportive, is unfortunately less decisive than we economists would wish. But for the purposes of this lecture, let us assert the truth of both propositions.

We observed earlier that preoccupation with the short run, either by opportunistic politicians or by the society at large, could lead to a costly inflation bias. Some institutional insurance against this shortsightedness can be purchased by making the central bank politically independent. But we now have to consider a set of arguments asserting that the incentives facing the central bank can be perverse and thus can cause an inflation bias. These arguments stem from recent developments in economic theory that have focused intensively on expectations, issues of "time consistency" and reputation, interactions between "principals" and their "agents," and the potential benefits of credible commitment to an announced policy rule.

The thrust of these arguments is that the central bank -- the "agent" of the society and its government -- will itself be tempted to choose an inflationary policy unless its hands are tied by legislation mandating exclusive attention to the goal of inflation avoidance. It is not enough, according to this line of reasoning, to give the central bank political independence. <u>Double</u> insurance is required. The central bank agent cannot be trusted with discretion. An institutional contract -- a "rule" -- is required that prevents the central bank from succumbing to temptation.

What are these temptations? The existence of short-run effects of monetary policy on output (so goes the argument) confronts the central bank with unbalanced incentives. Asymmetries in the price-wage process, which make it harder for nominal prices and wages to fall than to rise, mean that output may fall more when monetary policy is tightened than output will rise when monetary policy is eased. This asymmetry will on average make it more difficult for the central bank to tighten than to ease, thus aggravating a bias towards inflation. Even more important, expectational interactions with the private sector will induce a central bank that makes discretionary decisions to abandon a "time-consistent" policy of inflation avoidance.[3] If the central bank's hands are not tied, it is argued, the private sector will not believe policy announcements about a low inflation target. It will continue to expect higher inflation. Because of those expectations and the shorter-run costs of disappointing them, the central bank will have incentives to depart from its low-inflation target despite everyone's understanding that inflation avoidance is the best policy in the long run.[4]

From this time-consistency perspective, therefore, the central bank as the agent of society must be enjoined from pursuing multiple goals -- it must not worry about output and employment as well as inflation -- even though the true goals of the society are in fact multiple. Only by deliberately forswearing macroeconomic stabilization can the central bank achieve the desirable long-run goal of a low inflation rate.

Think again about the wife in our analogy. In her role as monitor and agent, suppose she

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[3] A policy announced by the central bank is "time consistent" if there is no incentive for the central bank to depart from the policy even though it is free to do so. In contrast, a "time-inconsistent" policy will be plagued by such incentives and thus will not be credible.

[4] It has been argued in the academic literature that a central bank has incentives to promote inflation because it will want to increase its own reserve-money liabilities to be able to increase its income and expenditures (that is, it will wish to expand what is technically called "seignorage"). I doubt myself that this is an important consideration in most nations. Interestingly, New Zealand's Reserve Bank Act deals with even this problem in a thoughtful way. Five-year funding agreements between the Minister of Finance and the Reserve Bank Governor determine the amount of the Bank's income that can be applied to its operating expenditure. These funding agreements ensure accountability to the elected Government for use of taxpayer resources but in a way that guards against political interference in the day-to-day implementation of monetary policy.

were allowed to seek multiple goals. Not only does she wish to reform her husband's excessive drinking; she also wishes to maintain family peace and quiet, which means in part trying to keep her husband in a reasonably cheerful mood. One way to foster cheer would be to bring one bottle up out of the wine cellar for Sunday lunch. But then, you will ask, what of the husband's incentives? If the husband understands that a little more irritability will raise the probability of the wine cellar being opened up intermittently, might he not indulge his irritability somewhat more often, which might lead the wife to provide a bottle of wine at least three times per week, which could encourage still more irritability, which could -- but you see the point. The economist emphasizing expectational interactions and credibility considerations will argue that the only time-consistent policy is for the key to the liquor cabinets and the wine cellar to be taken away from the wife too!

I do not have space to say more about the technical academic literature on this subject (of which there is in fact a great deal). Nor can I survey the empirical evidence that might be brought to bear, drawing inferences from the experience of other countries that have tried both to get long-run inflation under control and to smooth the medium-run cyclical fluctuations in their economies. Such evidence as exists is in any case not conclusive.

Rather, for this lecture let us simply accept, as at least partially if not wholly valid, the view that macroeconomic stabilization can undercut the credibility of the central bank's commitment to long-run inflation avoidance.

To be sure, as I try to fall asleep at night I do not put as much emphasis on this worry as it often receives in New Zealand. I am a bit less zealous on the matter because I believe that the principal danger associated with macroeconomic stabilization efforts is that, if attempted, they will not be adequately insulated from the short-run pressures of the political process (for example, that they may be hijacked to achieve narrowly conceived electoral objectives). The attainment of political independence for the central bank, it seems to me, goes a major part of the way toward assuring that a central bank's commitment to inflation avoidance will be genuine and will be credible.[5]

So the question that is more likely to run through my mind as I try to fall asleep at night is whether it really is necessary to give the Reserve Bank the exclusive goal of inflation avoidance <u>in addition to</u> provisions ensuring its political independence. The leadership and the staff of the Reserve Bank are keenly aware of the risks and temptations that could, if allowed to operate, cause an inflation bias in the New Zealand economy. Given the instrument independence of the Reserve Bank and given its commendable history of competent leadership, I think I could still reliably fall asleep even if the Bank were asked to pursue not only inflation avoidance but also the goals of macroeconomic stabilization and a sustainable evolution of the external sector of New Zealand's economy.

Nevertheless, there is no question that the time-consistency and credibility arguments have some validity. If one wants unquestionable assurance that the alcoholic will successfully complete the reform process, the wife must be blind and deaf to irritability, the bottles in the wine cellar must be emptied down the gurgler, and the husband must go cold turkey. Analogously, if New Zealand insists on the <u>maximum possible</u> commitment to long-run inflation avoidance, Don Brash must be enjoined never even to dream about macroeconomic stabilization,

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[5] I conjecture that I would hold this view even if I were a New Zealand citizen and had personally experienced the stabilization abuses of the Muldoon period.

much less contemplate it in actual practice.

Macroeconomic Stabilization as a Component of Fiscal Policy

If the Cabinet and Treasury were paying some attention to the goal of macroeconomic stabilization, it might be argued that the Reserve Bank could justifiably ignore cyclical fluctuations in output and employment and concentrate singlemindedly on targeting the rate of inflation. But as I observed at the beginning, the Cabinet and Treasury also appear to de-emphasize macroeconomic stabilization.

That leaning is evident, for example, in the important legislation passed in June 1994, the Fiscal Responsibility Act. The Act stresses five principles of "responsible fiscal management." None of the five gives any priority to shorter-run macroeconomic stabilization. A few details in the language of the Act can be interpreted as leaving the door a little bit open. But not much. Nor does shorter-run macroeconomic stabilization receive much emphasis in budget documents, such as the Budget Policy Statements and Fiscal Strategy Reports required by the 1994 Act.[6]

For a New Zealand citizen outside the government, and even more so for a visitor like myself, it is of course difficult to ascertain how much consideration may be given to stabilization concerns during confidential discussions within the Cabinet and Treasury. It is possible that the concerns do get full discussion and receive substantial weight when fiscal decisions are being

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[6] The five principles in the Fiscal Responsibility Act are: reducing Crown debt to prudent levels; maintaining Crown debt at prudent levels (after those levels are attained) by ensuring that, on average, over a reasonable period of time, total operating expenses do not exceed total operating revenues; achieving levels of Crown net worth that provide a buffer against adverse future events; managing prudently the risks facing the Crown; and pursuing policies that are consistent with a reasonable degree of predictability about the level and stability of tax rates for future years. These principles are, of course, very much concerned with the long-run, intertemporal characteristics of macroeconomic stabilization. My point in the text is that they do not address the shorter-run aspects.

made. My impression, however, is that shorter-run stabilization considerations get significantly less weight in fiscal policy in New Zealand than they receive (for better or worse!) in most other OECD countries.

Why? The main parts of the answer are presumably similar to the arguments we already rehearsed for monetary policy. If fiscal policy were to engage in macroeconomic stabilization, such a stance could in principle undermine achievement of long-run sustainability in budget trends and reduction in the debt stock relative to the economy. Shortsighted political opportunism could lead to abuse of macroeconomic stabilization, as it did prior to 1984. Indeed, the risks that short-run political considerations could contaminate decisions are greater than for monetary policy. After all, fiscal policy is, and should be, much closer to the political process. The Cabinet will inevitably be concerned with reelection prospects.

Even if the possibility of political abuse could be discounted, questions of credibility and time consistency are relevant for fiscal policy, too. If fiscal policy has multiple goals, the incentives facing the fiscal authority have similarities to the choices facing the alcoholic’s wife. The pressures for sacrificing long-run goals in exchange for short-run gains may be formidable. Once more, however, we have to recognize the other horn of the dilemma. Abstinence from macroeconomic stabilization may leave the economy more vulnerable to nonpolicy disturbances.

The "Mix" of Monetary Policy and Fiscal Policy

Monetary policy and fiscal policy interact strongly with each other. The consequences of any given stance of the Reserve Bank's monetary policy depend significantly on how fiscal policy is being conducted. And vice versa: the effects of any given fiscal stance depend on the implementation of monetary policy. In view of this interdependence between monetary policy and fiscal policy, what should be the division of labor between the two? Should the goals of each be chosen in a coordinated way?

For the long-run aspects of policies, the division of labor seems relatively straightforward. Monetary policy should focus on its primary goal of keeping inflation low.[7] Fiscal policy should worry about microeconomic efficiency, resource allocation, and placing the government budget and government debt on sustainable trends.

For the short and medium runs, however, the division of labor is not straightforward. The essence of the problem stems from two facts: monetary policy has substantial effects in the short run on <u>both</u> inflation and output; and fiscal policy likewise significantly influences both inflation and output. The two policies can constructively support each other. But a potential also exists for their working at cross purposes.

In other nations, where it is commonly presumed that both branches of macroeconomic policy should pay attention to stabilization, issues about the shorter-run interactions between monetary policy and fiscal policy are discussed under the heading of an appropriate "policy mix." One seldom hears discussion in New Zealand about the appropriate mix of fiscal and monetary policies. This omission goes along with the general posture that monetary policy and fiscal policy should eschew macroeconomic stabilization.

Might occasions not arise in New Zealand, I ask myself, when policymakers would be well advised to focus on the policy mix? Consider an example from the past. In the years 1987-

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[7] As pointed out earlier, most economists believe that there is little if any <u>long-run</u> tradeoff between inflation and unemployment. Empirical evidence, though not definitive, tends to support the majority consensus. Thus little controversy exists about the appropriateness of asking monetary policy to be primarily responsible for the long-run goal of inflation avoidance.

90, fiscal policy was running large overall deficits while monetary policy was kept very tight to attack high inflation and promote disinflation. To be sure, the Labour Government's policies were causing the primary budget balance (the budget balance excluding interest payments on government debt) to move in a contractionary rather than expansionary direction. Real (inflation-adjusted) interest rates were not as high as nominal interest rates. Even so, real interest rates were at historically high levels and the real exchange value of the New Zealand dollar had also appreciated to high levels. The mix of policies in those years certainly placed the main burden of disinflation on the Reserve Bank. Matters may even have turned worse in the last year or so of the Labour Government. Consensus within the Labour Party about economic policies was crumbling. Fiscal policy appears to have become looser in 1989-90, perhaps in part because of electoral considerations. Monetary policy had to stay tight, real interest rates were still high, and the real exchange rate remained at an appreciated level (though not as much as in 1987-88). I have found myself wondering whether the mix of very tight monetary policy and not-so-tight fiscal policy in those years may have played a contributing role to the non-robust performance of the economy in the difficult 1989-91 period.

If we look down the road ahead rather than in the rear view mirror, it is also not too difficult to imagine circumstances in which the mix of New Zealand's macroeconomic policies could be problematic. I have even found myself pondering the next few years. The reduction in the government's budget surplus associated with the tax reductions planned for 1996 and 1997 will of course give an expansionary stimulus to output and to prices relative to the evolution of the economy that would have occurred without the tax reductions. It now appears that the incremental stimulus will come in a period when the Government and the Reserve Bank are concerned with inflation turning out to be at or above the top end of the target band for the inflation rate. Could there be a policy-mix complication here to worry about alongside the many long-run considerations that rightly motivate decisions about monetary policy and fiscal policy?[8]

I hasten to add that my examples here may be faulty or misleading. But my general point is valid for other nations, and it may well be valid for New Zealand, too. Fiscal policy can create "unpleasant arithmetic" for monetary policy, and monetary policy can create unpleasant arithmetic for fiscal policy. Think of a car operated by two drivers, each in the front seat with a hand on the steering wheel. One driver controls the accelerator, the other the brakes. A minimal degree of cooperation is called for between the two drivers if the vehicle is to navigate safely, especially if the road becomes winding or bumpy.

Macroeconomic Stabilization and Long-run Goals: Complements, not Substitutes!

By suggesting that you worry about macroeconomic stabilization more than many of you are typically inclined to do, I could easily be misinterpreted. In this election year, some might even deliberately misrepresent what I am saying. I want to stress, therefore, that shorter-run macroeconomic stabilization should not be a pre-eminent goal for either monetary policy or fiscal policy. Not at all! The long-run aspects of monetary policy and fiscal policy should have

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[8] When the tax reductions were first under consideration, this potential problem did not seem a major cause for concern. Moreover, the Government indicated that "there will be no introduction of tax cuts if there are significant risks of strong inflationary or balance of payments pressures emerging as a result" (*Budget Policy Statement 1995*, released 23 February 1995, p. 17). This quotation undercuts my generalization that policy-mix considerations receive little weight in public discussions of fiscal policy. If I had complete information on past and ongoing discussions between the Government and Reserve Bank about the tax reductions, I might well conclude that the issue had received and is receiving appropriate attention.

the highest priority. The Reserve Bank ought to accord primacy to the long-run goal of inflation avoidance. The Cabinet and Treasury ought to assign highest priority to establishing tax and regulatory systems with appropriate microeconomic incentives, to achieving sustainable balance over the long run in government spending and revenues, and to avoiding an excessive expansion in government debt.

Macroeconomic stabilization cannot be considered a <u>substitute</u> for getting the long-run aspects of policy correct. My purpose here is to ask whether macroeconomic stabilization should be a <u>complement</u> to the long-run goals, but not in any sense a substitute.

To get the long-run aspects of macroeconomic policies "right" is of course extremely difficult. Most countries seem to be doing less well than New Zealand on this score. I cannot help but draw an obvious comparison with my own country, the United States. The President, his Administration, and the Congress have done a miserable job of getting the long-run dimensions of fiscal policy right. What an improvement it would be if the United States could somehow pass credible and binding legislation that copied some of the key principles and transparency provisions of New Zealand's Fiscal Responsibility Act!

It is also pertinent to observe here that New Zealanders' preoccupation with the long-run aspects of economic policy seems especially understandable given the adverse history leading up to the 1984 election and economic crisis. The overwhelming priority in the mid-1980s was to get the New Zealand economy back on a sustainable long-run track. In that environment, more than ever, it was appropriate to emphasize the long-run aspects of policies -- particularly the microeconomic and allocative aspects.

Why Macroeconomic Stabilization May Be Helpful

We now have to say more about the potential costs to which the New Zealand economy could be vulnerable if neither the Reserve Bank nor the Government were to engage in macroeconomic stabilization. The most basic point is obvious, but its ramifications appear to be less so. The New Zealand economy is small relative to the global economy, and it is now -- especially given the reforms of the last dozen years -- substantially open to the rest of the world. Thus if large disturbances occur in the world economy, New Zealand will inevitably be buffeted by those events. Large shocks originating abroad have the potential for causing large changes in New Zealand -- sometimes adverse, sometimes favorable. A hands-off posture in New Zealand about macroeconomic stabilization means, in effect, that adjustments in response to such shocks will not be influenced by policy initiatives intended to deflect the consequences of the shocks into more rather than less appropriate channels.

The stabilization aspects of different approaches to the conduct of monetary policy and fiscal policy is a subject still under active study by researchers. Many details are controversial. Conclusions depend on the types of shocks and alternative policy rules that are considered. Uncertainty about how policymakers can identify shocks and about how the economy actually responds to them are major issues, which in turn leads to debate about the information requirements for a successful stabilization policy. A balanced appraisal of existing knowledge has to admit that the jury has not yet brought in a clear-cut verdict about how much ability policymakers have -- or do not have -- to re-channel the consequences of different types of economic disturbances.[9]

My reading of the general literature and my own research inclines me toward the view that macroeconomic stabilization, conducted cautiously and without abuses, can make a marginally helpful contribution to the performance of national economies. My research while here in New Zealand is, in fact, focused on precisely this issue. By the end of my visit, I hope to have added a little bit to an understanding of what the consequences might be of adopting alternative approaches to conducting monetary policy and fiscal policy, including specifically approaches that accord some role to the shorter-run stabilization of output.

To illustrate how stabilization might be helpful, consider an example. Suppose the largest foreign nations simultaneously fall into a major recession, with foreign outputs, prices, and interest rates declining sharply at first but then subsequently recovering. The initial effects of the foreign recession on New Zealand would include a sizable depreciation of the New Zealand dollar in nominal terms, an appreciation of the currency in real terms, and significant falls in both nominal and real interest rates. New Zealand output would decline at first, in part because exports would fall sharply. New Zealand's price level would also fall initially (despite the depreciation in the nominal exchange rate). But then output in New Zealand, and with a longer lag prices, would recover strongly as the temporary recession passed away and economies began to recover their footing. Although New Zealand output and prices would initially move in the same direction, the directions of movement and the sizes of changes in subsequent periods would be quite different.

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[9] The research literature is also trying to sort out another tradeoff issue, namely, the degree to which policy rules that lower the variability of output and employment tend to raise the variability of inflation, and vice versa.

In such an environment, might it not be possible for stabilization adjustments in the Reserve Bank's normal inflation targeting or in the Treasury's fiscal policy to help cushion the effects on the New Zealand economy? Of course there is no way that New Zealand could be "insulated." A sizable New Zealand recession would in some degree be inevitable. But, if it were possible to make appropriate short-term adjustments in monetary or fiscal policies, the extent of the decline in New Zealand output (and in its subsequent bounceback) could be somewhat mitigated <u>without</u> any undercutting of the long-run goal of inflation avoidance.

Consider a second illustration. Suppose New Zealand experiences a sudden downward shock to its capital stock. For concreteness you might think of an earthquake which destroys buildings and machines that cannot be rebuilt immediately, or perhaps a sudden disease that destroys ten percent of the nation's dairy herds. The initial effects of the shock would be to cause output and employment to fall precipitously. Goods prices most affected by the shock would experience incipient upward pressure; but the price level would fall as the economy absorbed the loss of output. If the Reserve Bank's policy were to focus exclusively on the inflation rate, monetary policy would ease only a little. If instead the Reserve Bank saw its job as helping to cushion the large fall in output, it would take stronger easing steps. Alternatively, the Cabinet might implement temporary tax remissions or temporary increases in expenditures. Giving some weight to cushioning the fall in output and employment could mitigate the shorter-run costs of adjustment (for example, consumption would not fall quite as far as it otherwise would).

Again it has to be emphasized that the shock would have adverse welfare consequences no matter how monetary policy and fiscal policy were conducted. If the wider public wrongly expected miracles from stabilization policy, they would be badly disappointed. Their unwarranted expectations, moreover, would be a problem in itself. When the New Zealand economy experiences shocks that are likely to be persistent rather than transitory, to which the best response will often be prompt rather than cushioned adjustment, such unwarranted expectations could be especially troublesome because of the resulting political pressures on the Government and Reserve Bank to misuse shorter-run stabilization.

My basic point remains germane despite these qualifications. Shorter-run stabilization initiatives, if wisely and cautiously conducted, may be able to facilitate the economy's adjustment to nonpolicy shocks.

The Inflation Target, Band Widths, and the Caveats

Although monetary policy and fiscal policy in New Zealand in the last decade have certainly not highlighted macroeconomic stabilization, one should not oversimplify by implying that such considerations have been entirely missing (as I acknowledged at the beginning). To finish our exploration, I will now remind you of several respects in which stabilization issues have played a significant role.

The decisions setting the Reserve Bank's inflation target and the width of the band around it are an important example. As everyone knows, the Policy Targets Agreements since their inception have specified a band width of 0 to 2 percent as the acceptable range within which the underlying CPI inflation rate, measured over the most recent four quarters, may be expected to fluctuate. The midpoint of this band, a 1 percent inflation rate, is the single best summary indication of how in practice the Government and Reserve Bank interpret the long-run goal of inflation avoidance.

Decisions about these crucial aspects of inflation targeting mean that the tradeoff between long-run goals and macroeconomic stabilization is already implicitly at the heart of existing monetary policy. Consider the width of the band. Might this two percentage point range be too narrow? Could it be too broad? How can one tell? A very narrow band width would be favorable for the influencing of inflation expectations and for establishing the credibility of monetary policy but could have unfavorable consequences for flexibility in macroeconomic stabilization. Conversely, if the band width for inflation were made very wide, substantial scope for stabilization flexibility would exist but at the risk of seriously undercutting credibility.

The discomforting tradeoff will likewise have played, inescapably, a role in the decisions about how to determine the midpoint of the band. Is the 1 percent midpoint target not low enough to command full credibility? Or are there valid reasons why even 1 percent may be too low, given that nominal interest rates cannot fall below a value of zero and given that complex institutional features of the economy cause nominal wages to be sticky downwards to a much greater extent than upwards? Although the point is not widely discussed, this choice of the 1 percent target rate reflects a collective judgment by the Government and the Reserve Bank about how to weigh credibility and stabilization considerations against each other. The absolutely pure perspective on credibility -- pouring all the wine in the cellar down the drain and joining Alcoholics Anonymous -- would have argued for a target rate of zero, if not actually a negative rate.

The so-called "caveats" in the Policy Targets Agreements for monetary policy (PTAs) are the most important example of all. (The caveat cognoscenti among you, reacting to my example of the shock that destroys part of the capital stock, will already have been itching to discuss this subject.) The existence of the PTA caveats is evidence that Government and the Reserve Bank are not rigid on the matter of leaving some room for macroeconomic stabilization.

Caveats, you will remember, refer to particular circumstances under which the Reserve Bank would not have to adhere singlemindedly to its targeting of the inflation rate. Loosely speaking, the caveats pertain to situations in which the inflation rate is affected significantly by particular types of shocks that are "quite outside the direct influence of monetary policy" -- for example, significant changes to the external terms of trade, indirect tax changes, changes in relative prices such as an oil-price shock, or natural disasters. My example of an earthquake or livestock epidemic would definitely fall into this category. Though it is agreed that such shocks might cause the inflation rate to move outside the range normally considered acceptable, the Reserve Bank is expected to react to such shocks in a manner which ensures that the effects on inflation are transitory.

Here is a quotation from the Reserve Bank's post-election briefing in 1993 referring to the caveats and their interpretation: "...it is unlikely to be sensible to maintain the general level of prices unchanged in the face of all of the pressures on the economy....Rather than forcing other prices to shift in an offsetting fashion in the face of a change in the relative price of some goods, so as to keep the overall price level constant, it might be less costly to allow the overall price level to shift, but prevent that from spilling over into ongoing inflation."[10]

As that quotation suggests, and a detailed examination of what has been written about the caveats makes clear, the fundamental rationale for the caveats is that, in certain specified circumstances, the Reserve Bank should be paying attention to consequences for variables such

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[10] Reserve Bank of New Zealand, *Post-Election Briefing Paper for the Incoming Minister of Finance*, November 1993 (pp. 22-23).

as output and employment rather than concentrating singlemindedly on the inflation rate. In other words, because of the caveats, the nose of the camel of macroeconomic stabilization, perhaps even its neck and right front foot, are already well inside the tent.

Though the intent of the Policy Targets Agreements is to identify in advance, transparently, the types of shocks that would justify a temporary abrogation of the 0 - 2 percent inflation target, in practice the identification and interpretation of "caveatable" events poses substantial difficulties. For example, many shocks influence both relative prices and the general price level; many have both supply and demand elements. In principle, the Reserve Bank is permitted to ignore the "first-round" effects of a shock but not its second- and subsequent-round effects. Yet analytical uncertainties complicate separation of the first-round from the subsequent effects.

Because of the complications associated with the caveats, the current procedure for implementing monetary policy could have its own set of credibility and transparency problems. Agnostic that I am, I have even found myself considering the following question. Which approach to monetary policy here in New Zealand would be the more transparent and more credible: the current procedure, which mandates that inflation avoidance is the only goal of monetary policy, except in somewhat ambiguous circumstances in which caveatable events justify temporary abrogation; or an alternative approach, with no caveats at all, that permits some continuing role for output smoothing all the time even while enforcing the primacy of the long-run goal of inflation avoidance?

Concluding Summary

I will conclude by recapitulating the main points I hope you will take away from the lecture.

The Reserve Bank Act provides admirable institutional arrangements for the political independence of the central bank in New Zealand. Insulation from the political process protects against excessively short-sighted pressures on monetary-policy decisions. Because the Reserve Bank has instrument independence, but not goal independence, monetary policy is appropriately subject to democratic accountability.

In principle, the credibility and time consistency of policies can be enhanced by mandating that neither the Reserve Bank nor the Government should engage in macroeconomic stabilization. Yet the economy might incur avoidable costs if policymakers stay completely out of that business. Accordingly, the tradeoff between credibility and time-consistency advantages on the one hand and potential gains from stabilization flexibility on the other deserves more careful attention than it typically receives in New Zealand.

The emphasis in New Zealand on getting the long-run aspects of economic policies right is easily explained by recent history. Furthermore, the long-run aspects should continue to have priority. But putting primacy on the long run need not preclude some complementary role for shorter-run macroeconomic stabilization. The credibility advantages of complete abstinence are probably not so overwhelming as to justify keeping macroeconomic stabilization locked up in the closet.

I will invoke my analogy one last time. During the crucial initial periods when a man is first trying to break his habit of excessive drinking, the wife -- acting in the husband's true interest -- may well need to adopt an exclusively long-run view of family tranquillity. No bending to irritability. No short-run exceptions. But now suppose months and months have passed with the wine cellar locked and the husband proving a stalwart member of Alcoholics Anonymous. Might it not now be permissible to have that occasional glass of wine at Sunday lunch? It would be a tragedy if restraint were abandoned, slipping back to the old bad habits of the past. But maybe the husband is a new man, who has learned to practice moderation? And in any case, doesn't the wife -- quite a trustworthy soul -- still have the key to the wine cellar?

To put my main theme less provocatively: given the impressive progress of microeconomic reforms in recent years, might not the time be approaching for a relative upgrading -- a "mini-revival" -- of New Zealand macroeconomics? At their best, microeconomics and macroeconomics are complementary. Every opera has, inescapably, both a libretto and a score. In a fine opera, the libretto and score work together as an integrated whole. New Zealand has already received, appropriately, worldwide commendation for its many reforms to microeconomic efficiency and its commitment to long-run inflation avoidance and long-run fiscal responsibility. My conjecture is that the opera can be improved still further. And my hope for New Zealand is that, in this way too, your nation's performance may come to serve as a role model for other nations.