tion for the failure of the easy monetary policy to reduce unemployment. Interest rates do not have a direct impact on unemployment; if it can be used, the real wage rate is the best policy instrument to assign to the reduction of unemployment.

In addition, recent experience suggests that the effects of falling interest rates may not be symmetrical with the effects of rising interest rates. One possible explanation for this is that whereas high interest rates cut firms' free cash flows and compel them to reduce investment and output, reductions in interest rates increase free cash flow but leave firms with the option of reducing debt rather than expanding their activities. The Reserve Bank of Australia (1993) suggests that many businesses have exercised this option.

A Monetary Rule?

This suggests that the appropriate assignment for monetary policy is the control of inflation. But is a monetary rule feasible in the present environment? Makin suggests some circumstances when such a rule would need to be adjusted. For example, structural changes resulting from financial innovation might affect the demand for base money. Makin also suggests that in some circumstances a little inflation might be desirable. He mentions inflation due to oil-price increases or currency depreciations, but this also applies to autonomous wage increases. If wages are increased autonomously (as they were under the Whitlam government), strict adherence to a monetary rule will simply create recession and unemployment. It would be better to allow inflation so that the level of real wages can be kept down.

This is the problem with the adoption of a monetary rule or even directing an independent reserve bank to concentrate on inflation. It would prevent the bank from reacting not only to exogenous shocks but also to poor control of other economic instruments such as the government budget and wages policy. In the end, Makin's prescription is a utopian one. It would be appropriate in the world created by the introduction of widespread reforms (generally deregulation) which would, inter alia, promote the effective use of other economic instruments. The federal budget must be brought under control and the wage-fixing process reformed so that wages perform a market-clearing function. In such circumstances, Makin's 'quick fix' would have a chance of success.

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COMMENT

David Archer

Strange as it may seem, I agree with much of what Tony Makin says. We do part company on a few key points, however, and it is these differences that I would like to stress in the following comments. Needless to say, my comments reflect experience in the New Zealand context, and should not be taken as advocacy of any particular monetary policy arrangements in Australia.

First, the common ground. Makin argues that monetary policy should not be directed towards short-term macroeconomic fine-tuning, because 'activist' monetary policy of this sort is more likely to destabilise than stabilise interest and exchange rates, and thereby increase uncertainty. This is certainly the experience of past New Zealand monetary policy, which was very much of the stop-go variety. The need for a consistent, medium-term monetary policy focus, which is seen as credible by the markets and the public, was the major reason behind the legislative framework under which we now operate (see Lloyd, 1992, for a fuller discussion.)

Our view, apparently similar to Makin's, has been that we do not have sufficient information, or sufficiently well-tuned monetary instruments, to attempt overall macroeconomic fine-tuning without risking raising doubts about the commitment to medium-term price stability. Far better, in our view, to stick to a single clear monetary policy objective of maintaining price stability — which, in any event, is essentially all that monetary policy can usefully achieve over the medium to longer run.

Makin also argues that the monetary policy framework should be chosen within the context of the rules versus discretion debate, and notes that removing direct political influence over monetary policy is not necessarily sufficient to set monetary policy on a consistent medium-term track - the interests and beliefs of central bankers themselves are relevant. I agree entirely on both scores. (Swinburne & Castello-Branco, 1991, contains a useful discussion on these points.) Again, such considerations were an important part of

the reasoning behind the current legislative framework for the Reserve Bank of New Zealand (RBNZ).

Makin and I would part company, first, in the view that a money-growth rule of some sort is a substitute for a legislative framework like that of the RBNZ. I would see them much more as (potential) complements rather than substitutes. If such an operating 'rule' were desirable and feasible here, we would still want to keep the same broader legislative framework in place, while modifying our operational framework accordingly.

But there are several problems. A basic empirical question is whether money base growth is related in a sufficiently stable way to inflation (the variable of ultimate interest) to be useful as a target or key indicator for policy, let alone a binding rule. In New Zealand's case, the analysis and research suggests it is not (Wong & Grimes, 1992.) Interestingly, no central bank has operated under a fully binding rule of any sort since at least the end of the gold standard. In particular, the Swiss monetary policy arrangements referred to by Makin do not constitute a fully binding rule. Rich (1987) makes it clear that they reserve the right to under- or over-shoot preannounced money-base targets under certain circumstances.

Beyond this empirical question, there is the question of operating such a rule in the absence of monetary policy credibility. As Makin acknowledges, a medium- to long-term money-base rule means that the price level jumps around in response to some sorts of shocks (shocks to money demand relationships in particular). A temporary burst of inflation (or deflation) resulting from maintaining the same base growth in the face of a money demand shock could seriously damage credibility unless there is a longer-term history of credible and consistent monetary policy already in place as a reputational buffer. After all, the same imperfect information problems that concern Makin make it very difficult for the public to distinguish the source of changes in inflation.

To counter this problem, one would need to allow for a move away from a fully binding rule. A key question is then: how much discretion should central bankers have, and what institutional arrangements can be established to ensure this discretion is used 'appropriately'? This is the area in which the RBNZ framework breaks new ground, and it is the second major point of departure between Makin and myself. In his references to the RBNZ, Makin gives little attention to the key features of our framework which help to shape our behaviour. There are four points I wish to highlight.

First, even though we have a significant degree of independence to 'formulate and implement' monetary policy, our discretion is limited in very important ways. The single statutory price stability objective prevents us from directly targeting any other macroeconomic objective (short-term growth or balance of payments considerations, for example). Switching between different macro objectives was the major reason for inconsistent past monetary policy in New Zealand. Similarly, switching between objectives is the very essence of the time inconsistency problem in monetary policy stressed in the formal literature.

Second, although it is true that RBNZ officials are unelected, it is not true that they are 'democratically unaccountable', as Makin puts it. In fact, the accountability arrangements in our legislation are very strong indeed, and focus especially on the Governor as an individual, not on the Reserve Bank as an amorphous entity in its own right. Monitorable and measurable monetary policy targets (currently, 0 - 2 per cent CPI inflation) are specified in a public Policy Targets Agreement (PTA) between the Governor and the Minister of Finance, which is essentially a performance contract for the Governor (Lloyd, 1992).

Third, the framework places considerable emphasis on transparency. In its formal six-monthly Monetary Policy Statements required under the legislation, the Bank must not only account for its recent monetary policy performance, but must also explain why it operates monetary policy in a particular way, and how it intends to operate policy in future. This means that we not only have to justify our decisions on the settings of monetary policy, but also explain and justify the major operational aspects of policy. More substantially, if the government (not the central bank, note) chooses to override the statutory price stability objective, as is its right, or if it requires a renegotiation of the PTA, all of this must be done in public.

The fourth feature of our current framework relates to Makin's comment that very low measured inflation is not always an appropriate goal, especially in the face of a significant relative price change. I agree. Our PTA allows the measured inflation targets to be over- or under-shot in the face of certain large specific relative price shocks, but stresses that the RBNZ's responsibility is to ensure that it is only the first-round effect that passes through, and that price stability is maintained thereafter. The onus remains on the RBNZ to fully justify its decisions and actions in the face of such shocks.

To conclude: The combination of a single, clear objective for monetary policy, specific, measurable and published targets for policy, and strong accountability and transparency arrangements, together represent a major force in aligning the incentives on relevant individuals, both inside and outside the RBNZ, with the statutory price stability objective. These factors create a strong incentive on New Zealand central bankers both to avoid taking their eyes off the ball, and to continue to evolve operational procedures that stand the best chance of meeting the statutory price stability objective over time. Even though we have not seen it as feasible to date to rely heavily on the money base or other monetary aggregates as key indicators or targets, and certainly not as a rule, we have an open mind as to whether underlying monetary relationships might be more settled in future. If they are, it would be in our own interests to modify our operational framework accordingly.

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COMMENT

Michael Parkin

Tony Makin is right about so many things that it is almost a pity to have to split a hair with him. In a nutshell, I believe that if we adopt his position we will achieve intellectual rectitude at the expense of practical progress. But let me begin with what is right about Makin's position.

Makin is surely right in his claim that the Reserve Bank's actions have exaggerated economic fluctuations, increased uncertainty, and brought excessive inflation. He is also surely right in his claim that the adoption of a fixed monetary rule would deliver a vastly improved macroeconomic performance. The evidence on both these points, from Australia's own monetary history and from the experiences of many other countries, is now in the overwhelming category. The problem is not with the conditional prediction: *if* a money-growth rule, then a better macroeconomic performance. It is with the unexplored *assumption* that a money-growth rule can in fact be achieved. I believe it is almost impossible to achieve such a rule, and this belief is the basis of my disagreement with Makin.

The difficulty in achieving a money-growth rule, even for the monetary base which the central bank unquestionably controls, is in confronting the central bank with the incentives that induce it to pursue the desired objective with sufficient energy and enthusiasm to have a chance of succeeding.

Start from the known facts. The Reserve Bank is not independent and has pursued a monetary policy that has destabilised the economy. Add a plausible assumption (and one that Makin appears to agree with) that the Reserve Bank is doing the best it can achieve its macroeconomic objectives. The conclusion that is quickly reached is that the Reserve Bank believes that it must exercise discretion in the pursuit of monetary policy.

Telling the Reserve Bank to follow a money-growth rule would be like telling a truck driver to wear a blindfold, set the cruise control at 100 kilometres per hour, and lock the steering wheel on straight ahead. You can be sure the driver would cheat. He would peep under the blindfold, nudge the brake and the accelerator, and move the steering wheel. He would protest that he was obeying the rules but that the traffic and the terrain were interfering with the way that vehicle behaved, making it appear as if he were cheating when in fact he was not.

... [the] proposal is ... too radical. Nobody wants to go for a ride on a highway which such severe constraints on their discretion to take actions designed to stay alive. We are stuck with discretion.

Similarly, the Reserve Bank would cheat. The only money-growth rule that I can see being difficult (perhaps impossible) to cheat on is one that fixes the monetary base for all time at $*n* - that, in effect, sets the nominal monetary base in stone. The number *n* would be picked to be a nice round number close to the actual value on the day of petrification. The Reserve Bank would simply not be permitted to trade in any markets. It would hold a fixed amount of government debt and a fixed amount of gold and foreign exchange (although it would need none of the latter) and its monetary policy job would be done. Cheating would be easily detected and, provided the penalty imposed on the Governor was sufficiently large, would not occur. Even in this case, the Reserve Bank might be tempted to cheat by conducting open market operations in art!

The operation of the economy with a fixed monetary base would be interesting and probably efficient. The price level would change, on the average, at a rate equal to the growth rate of GDP minus the growth rate of the velocity of circulation of the monetary base. There is no presumption as to the direction of the price level change and, in the limiting case in which technological change in the financial sector proceeds at the same rate as the rest of the economy, the price level would be stable.