

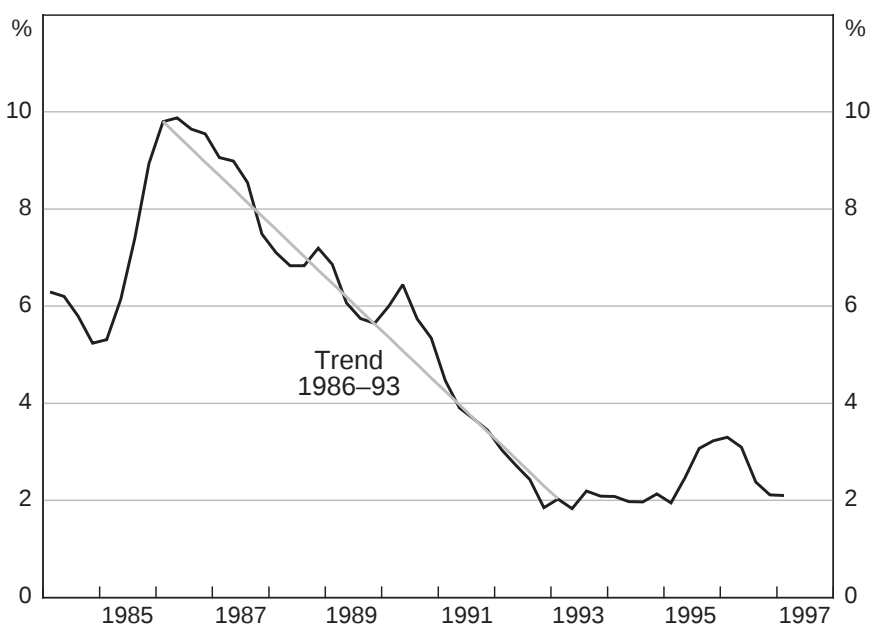
Discussion

1. Barry Hughes

This paper tip-toes skilfully through a field of undetonated mines left over from previous policy wars, defending the Bank's actions here and there, while pushing the message that the institution has now largely cleaned up its act in a series of steps from the late 1980s onwards culminating in the adoption of an inflation target earlier in the 1990s. From the late 1980s onward the Bank had become serious about stable low inflation. As Dr Grenville says, 'the mind-set had changed (in the late 1980s), and policy was being set with lower inflation as the objective but the opportunity to achieve this had not yet arrived' and 'while price stability had always been an important objective for the Bank, until the 1990s it had been on a "best endeavours" basis'.

It is not appropriate to re-fight old debates here, so I am given to understand, except insofar as they are ongoing issues. So my comments do not represent a critique of Stephen Grenville's economic history lesson, although there are disagreements with a number of slants here and there. Instead, I will attempt to place a different perspective on Dr Grenville's central message, claiming that both the numbers and the facts of history are open to a quite different interpretation of events than the one presented. I will then consider how much of the monetary-policy debate has changed from the start to end of Dr Grenville's period.

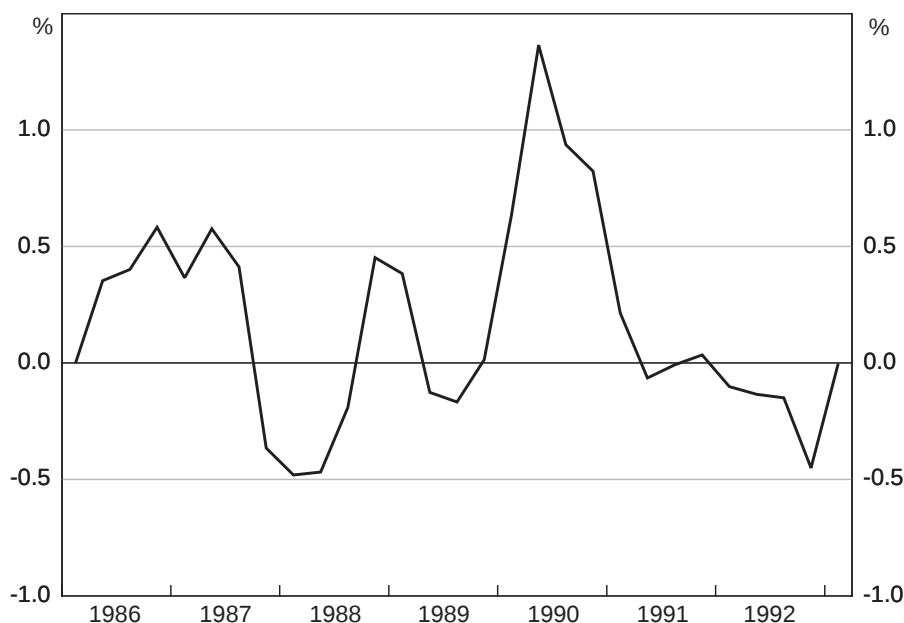
Figure 1: Annual Change in the Underlying CPI



History, it is said, is written by the survivors. Their predecessors might have a different view:

- Far from it being a dramatic happening since the late 1980s, disinflation of the underlying rate was remarkably consistent from 1986 to 1993. Figure 1 shows a linear trend alongside the underlying inflation time series. Figure 2 shows deviations from this trend line, which, save for a brief period in 1990, have never been greater than about one half of a percentage point.

Figure 2: Deviations from Trend Underlying Inflation



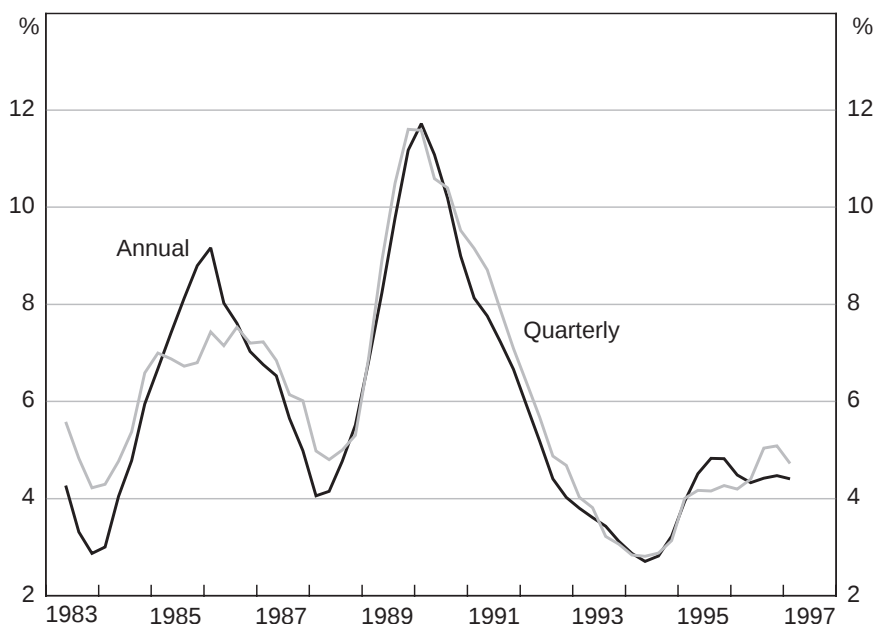
- Nor, with hindsight, should this be any great surprise. Whatever the opacity of the statements, and for whatever reasons, policy-makers behaved throughout the period since 1984 as sadistically as any Taylor rule would have demanded. Real rates (defined RBA-style¹) were 5.95 per cent on average in 1984, and remained each quarter consistently above these levels, 1987–88 apart (when the fiscal-year average was 4.15 per cent), until December quarter 1991. (Figure 3 shows four-quarter moving averages of the real cash rate both on the RBA method and using contemporaneous quarterly deflation.) One wonders what the monetary policy-makers thought they were doing *throughout this period* (including substantial experience prior to the emergence of current-account concerns) if they were not serious about disinflation.

1. In times of disinflation, which is most of the period covered here, the RBA method of calculating real rates (i.e. deflating by trailing *annual* inflation), imparts a non-trivial downward bias. Compared to deflation by contemporaneous inflation changes, *ex post* real rates during the period of disinflation are downwardly biased to a non-trivial extent. For example, the average real rate in 1984 was 6.59 per cent when contemporaneous deflation is applied. Annual moving averages of real cash on this basis stayed above this figure until September quarter 1987.

- Moreover, from the outset in 1983, discarding the policy slogan of ‘fighting inflation first’ did not result in the dropping of disinflation ambitions. The new slogan was to ‘fight inflation and unemployment simultaneously’. Both the Labor government (anxious to distance itself from the Whitlam-era reputation) and the key union leaders (for whom inflation was a nuisance) had strong reasons for pursuing disinflation.

Figure 3: Real Cash Rates

Four-quarter moving averages, deflated by trailing annual and compound quarterly changes in underlying inflation



Intent, actions and results added up to disinflation throughout the period. There is no suggestion that policy-makers had a schedule at the outset that called for steady disinflation (though the fact of the outcome suggests the need for some research into why disinflation happened this way despite some substantial outside influences). On the contrary, the plan was of the ‘just do it’ variety. The evidence that policy-makers had become serious about disinflation well before the late 1980s is compelling. Dr Grenville makes much of the monetary-policy response to the 1989–90 setback. But there are other contenders for the title of inflation dispersants during this period, and in any event the response to the larger setback in 1985–86 was even more impressive, both in containing the swelling and dispersing it. It is not at all obvious, even on the score of inflation alone, that monetary policy was uniquely or even especially successful after 1989.

But if Dr Grenville has not succeeded in making his case in this paper, he is surely right in saying that the Bank was much nearer centre-stage in the 1990s than in the earlier period. Part of this was due to the growing influence on policy of financial markets, from which the RBA has benefited at the expense of Treasury. But part of it was due to the tighter nature of the Accord in earlier periods, from whose periodic negotiations the Bank

was largely excluded. The Bank was ‘out of the loop’ in the early days, its task being to advise on the implementation of monetary policy after Accord macroeconomic targets had been set. There was no clean break with the past, but for a variety of reasons (from troubles with the IRC over implementing the wages formula to the deep recession and the attainment of low inflation), the Accord was a very different animal in 1994 than it was in 1984. The transfer of Bernie Fraser from Treasury to the Bank in 1989 may also have helped make the Bank feel more at the centre of policy.

Dr Grenville is also correct in saying that the Bank has cleaned up its presentation considerably. There is little point in trying to defend the Bank’s theoretical framework (the check-list) in the mid to late 1980s. It is close to indefensible. Adding to the difficulties existing then, the Bank carried some very heavy baggage from the earlier days of quasi-monetarism and commitments to free markets. The rhetoric about setting quantities and leaving markets to look after prices remained for some time after 1985, let alone 1983. This is one of the reasons why the Bank made such heavy weather of admitting its cash-rate decisions in the later 1980s. The fixing of a price stood out like an ugly outcrop in a sea of free markets. That hang-up having disappeared, the Bank no longer needs to dissemble.

What has changed?

The remainder of my comments consider the question of what has changed over the interval of Dr Grenville’s period. At first glance a lot has changed. In more basic terms, however, the shades of policy differences remain, albeit about changed parameters. No perfect solution has been found, as indeed Stephen Grenville emphasises.

Elsewhere in this conference, Malcolm Edey has described money-supply targeting as a subset of the broader class of inflation targeting. Other papers examine Taylor rules in detail. The notion of going easy on real interest rates when there was a large output gap, while tightening up when inflation was rising (or threatened to be, as in the case of looming currency-induced inflation acceleration) would not have been the slightest bit foreign to the policy-makers of 1983, even if, obviously, they had never heard of a Taylor rule. As usual, the policy rub is over the emphases or the numbers (the targets or neutral rates and the Taylor weights) attached to the general approach (on which more in a moment).

Much is also made of the recent attack of the George Washingtons, or the outbreak of transparency. Without wishing to pass comment either on the worth of such policy at present, or on the correspondence of RBA practice with the aim, it seems fairly obvious that it is a lot easier to be transparent about maintaining low inflation than about the ultimate intent of disinflation when the rate is near double digits. It is frequently said of good politicians (whose ranks ought not to exclude RBA governors) that they had the ability to talk tough one way as cover for moving the other way. Some say that about aspects of the present Governor’s speeches. It is an open question of what the public at large would have made of Bob Johnston had he said that ultimately he wanted inflation to be two-point-something in 1986. Certainly he would have made a rod for his back, and would have aroused major suspicions over the Bank’s agenda. And he would have made another for Paul Keating (or Peter Costello had he been Treasurer at the time). More to the point, it is not at all obvious that such candour would have advanced the cause of monetary policy at the time.

Finally, not even the notion of inflation targets is new. What is different at first glance is the commitment to return to them if disturbed. An intrinsic part of policy-making in the mid to late 1980s was a very detailed consideration of wages targets, and public announcements of the result. It is true that aggregate wage movements were given more prominence than the CPI, but it was not very difficult to work out the latter from the former. More publicity was given when the government (and the unions) went into bat to argue in public for the numbers. The forecasts had a good track record, though it is true that occasionally they came unstuck. But so too have the forecasts under the new version of inflation targeting, to date under lesser provocation than their predecessors. As long ago as December 1984 policy-makers were contemplating inflation rates not far from today's level. It is the good fortune of the present incumbents that they can live in this era. Their predecessors were able to bring the vehicle back onto the rails without explicit commitments to do so. I note with interest the efforts of researchers, some at this conference, to evaluate the possible benefits of making explicit the promise to repair any damage.

What stays the same?

There can be disagreement, and there is, over whether the inflation norm should be two-point-something, or one-point-something, or even three-point-something. But it is hard to argue against stable, low inflation, especially when that happy state has been attained. The difficulty in the early 1980s, as now, is what to do about future departures from the norm *and* what weight to give now, and in the future to other considerations, especially output and unemployment. As mentioned earlier, the generic Taylor rule is broad enough to encompass almost all. The argument is about the numbers in the reaction function. It is still the same broad policy argument as in 1980; it is just couched differently.

What frightened some in the early 1980s about monetary targeting was that the enthusiasm for disinflation might be considerably greater than the economy's capacity for recuperating from it. As my former colleague, Mike Artis, said here five years ago, 'any fool can disinflate'; the trick is to do it without plunging the economy into chaos. Another British economist, Alan Budd, said that while it was considered legitimate for generals to use up whole regiments winning the Falklands war, the public did not have the same stomach for economic policy-making on a similar basis. The passions are not now running as highly as these last two sentences read, but it is a mistake to ignore the sentiments.

The papers for this conference are full of the damaging biases that 'well-meaning' policy-makers carry. But unless I have missed something, there is not a word to be seen about the opposite bias carried by the 'monetary-policy club', i.e. most of the participants to this conference and their counterparts elsewhere.² Two examples of the fear will

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2. Unless members have been so immersed in its intricacies that perspective has been lost, the club is easily recognised as a lobby group. That they dress up their arguments in terms of the national interest is close to being proof positive for the case. And that what was derided as finetuning for decades has suddenly become acceptable as pre-emptive policy raises the suspicions further. But it is fairly obvious that here we have a club that puts a higher premium on avoiding inflation over other matters than most in society. Indeed, there are frequent calls, including at this conference, for the natural inclinations of the club to be ingrained further by the payment of rent as a reward for doing what would have been done anyway.

suffice. One concern is over the size of the neutral real short rate for Australia. Do we know what it is? Elsewhere, in the United States for example, estimates flow freely at around $2\frac{1}{4}$ to $2\frac{1}{2}$ per cent. Here, the corresponding number is conspicuous by its absence. It lives in this conference largely as an algebraic symbol. Since past Australian averages contain a premium for disinflation, presumably no longer relevant, there is a reasonable argument that a neutral real rate is now three-point-something. But, as Gordon de Brouwer and James O'Regan show in their paper, if an artificially high estimate is included in the reaction function, the RBA Research version of the result will be a temporary period of low activity and inflation until the 'mistake' is worked out of the system. Perhaps we have been going through one of these episodes recently? In general, how long and how damaging that mistake will be, depends in part on its arithmetic extent, but also on whether there are cohort effects in operation (by which I mean something broader than the usual macroeconomic hysteresis effects). There is also the matter of whether, in a changing world, there are repeat 'mistakes'. Of course, in principle, mistakes can go both ways. The fear is, given the attitudes of the club, the bias in the run of mistakes will be one way.

A second concern is with the forecasts to be plugged into forward-looking operational versions of the Taylor rule. Will the authorities be too optimistic about output and too pessimistic about inflation prospects, to the cost of suboptimal activity performance? Again, the reverse set of forecasting errors are conceivable, this time to the detriment initially of the inflation outcome. Here, unlike the problem with neutral real interest rates, estimates for which ought to settle down eventually, forecasting biases may be congenital. Given the priority attached to successful inflation outcomes, will central bankers be compelled perpetually to jump at wage and other price shadows, with their suspicions being confirmed only occasionally? If so, the result will be a series of negative shocks of the sort described by de Brouwer and O'Regan.

Of course, the proof of the pudding is in the eating. Just as we can look back over the past decade in judgment on central bank actions, not necessarily in agreement with Dr Grenville, the same sorts of issues are likely to recur in the future. There may be a generic framework (the Taylor rule) to which all can subscribe in its algebraic version, but it seems dubious that it, or other developments, can provide the one perfect solution. These are seen not to exist in industrial relations. That is likely to be the case also with monetary policy. Nearly 20 years ago some colleagues and I published the first edition of a policy book about expansionists and restrictionists. There is likely to be plenty of work left mining that seam before the coal runs out. And it would be surprising if occasionally some heat were not vented.

2. General Discussion

The discussion focused primarily on the issue of the objectives for monetary policy during the 'check-list' period in the second half of the 1980s. Some argued that monetary policy had been directed primarily at curbing asset-price inflation, some the current account deficit, while others supported the paper's conclusion that inflation increasingly became the priority of monetary policy.

The argument that monetary policy had focused on curbing asset-price inflation led to a general discussion of the links between asset-price inflation and consumer price inflation and the issue of whether monetary policy should be concerned with asset prices *per se*. (This issue was also discussed following the paper by Frank Smets.) Some participants argued that rising asset prices could generate perceptions of increased wealth and thus stimulate private demand; they could also increase general inflation expectations. These developments might require a monetary-policy response. Others noted that if asset-price bubbles are allowed to continue unchecked, the eventual bursting of the bubble might cause serious deflationary forces through balance-sheet problems for corporations and financial institutions. Judging whether or not this possibility requires a monetary-policy response is complicated by the fact that it is difficult to assess whether changes in asset prices are underpinned by fundamentals or represent a bubble, particularly in the early phase. There was general acceptance of the idea that, in part, asset-price movements in the late 1980s represented a bubble, but some participants argued that taxation or prudential policy, rather than monetary policy, should have been used to deal with the problem.

There was considerable disagreement regarding the place of the current account in monetary-policy decisions in the latter part of the 1980s. Some saw the current account at centre-stage; others viewed it as making only periodic appearances, while still others saw it as having little, or no, role. There was, however, general agreement that a range of public statements at the time made it difficult to understand the Bank's strategy, and this probably diluted the desired impact of the tightening in monetary policy. Some thought that the comparison with today's framework was instructive. There is now a high level of understanding that the Bank's ultimate goal is medium-term price stability, with changes in interest rates explained in terms of creating an environment in which the economy can grow as quickly as is possible while maintaining low inflation.

Some participants argued that if inflation was the primary objective of monetary policy in the late 1980s, then the stance of policy at the time was too restrictive. In particular, their view was that the level of interest rates was not consistent with the stated preference for a gradual, rather than a rapid, disinflation; thus, the fall in inflation that occurred could be regarded as, in part, accidental. While there was little disagreement with the idea that the extent of the fall in inflation came as a surprise to most observers, it was noted that the public comments by the Bank at the time had expressed a clear desire for disinflation in advance of its occurrence. The process of financial deregulation and changing labour-market arrangements meant that there was no clear calibration of the linkage between interest rates and inflation, complicating any assessment of the appropriate stance of monetary policy.

There was also a discussion of the role of personalities in the conduct of monetary policy. It was argued that when assessing the history of policy, one must be careful not to overly personalise the decisions taken. Rather, one should compare the decisions with the benchmark of a generic monetary policy-maker. In this regard, it is interesting to consider the role of the monetary-policy framework. Is the choice of the framework dependent on the personality of the policy-maker? Is the critical element in the disinflation process the willpower of the policy-makers or is it the framework that is in place? Some participants wondered whether the inflation rate would have continued to fall in 1985/86 if the exchange-rate depreciation had not taken place, or whether given the monetary-policy framework in place at the time, inflation would have risen again.