Sound Monetary Policy, Credibility, and Economic Performance

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History is a constant reminder that sustainable healthy economic development requires sound and credible monetary policy. This is true of all nations, industrial and developing. Frequently, economic policy conferences focus on issues that elicit tirades about how everything is going wrong and radical reform is required. But recent trends in the conduct of global monetary policies have been highly favorable, helping to generate dramatic improvement in international inflation and economic performance. My focus in this article is on the key foundations for sound and credible monetary policy, the plusses and minuses of when simple principles are followed or violated, and suggestions for maintaining recent favorable trends. The bottom line is that well-understood principles—such as zero inflation and the importance of maintaining inflation-fighting credibility, transparency, central bank independence, reliance on market-based mechanisms to address undesired imbalances—apply to both developing and industrialized nations, and must be pursued independently of fiscal and regulatory policies. If such independence is impossible—primarily because of the lack of independence between the monetary authorities and the treasury—other institutional arrangements are required to ensure monetary soundness and credibility.

A generation ago, around 1980, the circumstances and perceptions about central banks and monetary policy were far different than now. Inflation was very high and economic and financial market performance was poor in industrialized and developing nations alike. Central banks lacked credibility and inflationary expectations were high and volatile. Budget deficits were high and rising, and projections of soaring government debt-to-GDP ratios dominated the fiscal debate. The projected unsustainable rises in debt-to-GDP and the associated

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"unpleasant monetarist arithmetic" that pointed to eventual debt monetization suggested that monetary policy ultimately may be hostage to irresponsible fiscal policy. On top of the undesirable macroeconomic trends of the day, this perception undercut the implied independence and credibility of the monetary authorities. The potential for improvement seemed remote.

Other aspects of monetary policy were also distinctly different, and weighed heavily on central bank credibility. Many monetary authorities—including the U.S. Federal Reserve—either did not have sound objectives that included zero inflation, did not articulate them effectively, or were not credible. Central bank opacity of policies and actions was the rule, as it long had been, with market participants and the public purposely left in the dark. Some misunderstood the rational expectations school to imply that policy surprises, theoretically necessary in order to affect real activity, were somehow desirable. In fact, the key implication, as Milton Friedman, Robert Lucas, and others were early to recognize, is that fine-tuning in order to achieve multiple objectives is ultimately counterproductive.

It has not been a smooth ride by any means—there have been supply shocks, several "crises," including financial upheavals in Mexico and other Latin American nations, the Russian default and Asian tumult of 1997, Long-Term Capital Management in 1998, and the stock market bubble of 1999–2000—but the conduct of monetary policy globally has been significantly transformed for the better, and macroeconomic performance has improved accordingly. By and large, most leading central banks now pursue low inflation objectives and have gained significant credibility. Importantly, most know that this hard-won credibility cannot be taken for granted and must be maintained through adherence to sound principles.

Successful Disinflationary Policies

What seemed remote a generation ago has largely become a reality. Inflation has receded dramatically—far more than even the most optimistic observer had speculated was possible (Rogoff 2003). It has fallen everywhere: in large industrialized nations, in emerging nations in Latin America, Asia and Eastern Europe, and even in perennially poor African nations (see Table 1). In many industrialized nations, allowing for measurement error, price stability has been essentially achieved, and inflationary expectations play a negligible role in private economic decisions. Among emerging and transition nations, the number of outlier nations still plagued by high and disruptive inflation has diminished significantly.

TABLE 1

WORLD CPI INFLATION
(PERCENT PER ANNUM)

	1970–74	1975–79	1980–84	1985–89	1990–94	1995–99	2000–04	2005
World	9.0	12.7	16.6	14.8	22.3	8.3	3.8	3.6
Industrial Countries	7.6	9.8	8.6	3.9	3.6	1.9	2.0	2.3
United States	6.2	8.1	7.5	3.6	3.6	2.4	2.6	3.4
Japan	10.7	7.5	3.9	1.1	2.0	0.4	–0.5	–0.3
France	7.7	10.1	11.2	3.6	2.6	1.2	1.9	1.8
Germany	5.6	4.1	4.5	1.3	3.4	1.3	1.5	2.0
Italy	9.1	15.5	16.2	6.2	5.3	3.0	2.5	2.0
Developing Countries	12.8	19.4	34.4	39.2	56.0	16.8	6.0	5.1
Africa	8.0	7.3	16.9	17.7	34.2	17.5	8.8	6.4
Asia	12.2	7.6	10.8	7.2	9.2	6.9	2.5	3.6
Europe	7.7[a]	15.7	29.2	46.3	128.6	56.0	16.2	8.5
Middle East	7.2	14.0	18.2	19.3	12.6	11.3	5.6	6.4
Western Hemisphere	21.2	41.9	77.5	104.7	242.4	18.7	8.2	6.4
Mexico	10.3	19.1	56.1	82.0	16.3	24.5	6.0	4.0
Brazil	20.7	45.6	141.7	532.3	1,667.2	19.4	8.7	6.9
Argentina	38.3	227.6	268.1	863.3	505.1	0.8	8.3	9.6
Chile	198.7	150.4	22.4	20.3	17.5	6.0	2.8	3.1

[a]Inflation over 1971–74.

Sources: IMF, National Statistical Offices, Haver Analytics.

The declines in inflation have been attributable largely to successful disinflationary monetary policies, as central banks have slowed nominal spending growth relative to productive capacity and thus squeezed excess demand and inflation. The most dramatic reductions in inflation have occurred in select emerging nations in which central banks have been granted independence and have refused to extend credit to their governments, severing the linkage between fiscal irresponsibility and inflation.

Other "economic" factors have played a role. Global aggregate supply is expanding, reflecting the growth of output and trade by China, India, and other low-cost producers. Increased international competition, fueled by globalization, has increased productivity and reduced costs. Technological innovation and productivity growth have facilitated the trend toward lower global inflation and faster growth. However, evidence suggests this impact on inflation has not been universal: clearly, the jump in productivity gains since the mid-1990s has contributed to lower inflation in the United States, but inflation has fallen even in nations and regions where productivity has lagged—witness core European nations.

Sharply lower budget deficits or reductions in primary deficits or increases in primary surpluses (government budget imbalance less net interest) have also contributed to lower inflation in select developing nations, but the impact of deficits on inflation is not unambiguous or universal. In some declining inflation nations, the deficit-to-GDP ratio has receded but in others, like India, deficits have actually increased, as they did in deflation-plagued Japan in the 1990s. And, in any case, in most nations, the present value of government indebtedness, including unfunded liabilities of public pensions and health care, has risen unabated. The increasingly credible monetary policy of the past 20 years suggests that central banks may not readily bail out egregiously irresponsible fiscal policy—a realization that may encourage true fiscal reform—although the true test of this will be the resolution of the fiscal gaps created by the aging populations in industrialized nations. The bottom line is that sound monetary policies have been the primary reason for lower inflation—and enhanced inflation fighting credibility.

Why have these shifts occurred? The clearest answer is the widespread acknowledgement by governments, central bankers, and electorates of the high and potentially destructive economic and financial costs of inflation, and the benefits of stable, predictable low inflation. This is true of industrial and emerging nations alike. In the 1970s, inflation was associated with poor economic performance and recession, high and rising unemployment, and negative real returns in

financial markets in the United States and elsewhere. Standards of living suffered, and inflation was a primary culprit. Various financial crises in Mexico, Brazil, Argentina, and select Asian nations stemmed from a variety of monetary missteps that generated high and volatile inflation and dramatic currency devaluations.

What factors underlie the widespread change in institutional behavior? A combination: heightened central bank independence, vastly improved monetary frameworks, including a better understanding of the inflation process and the role of monetary policy, the higher priority placed on low inflation by monetary authorities and their willingness to tolerate temporarily higher unemployment to achieve lower long-run inflation, and a decided thrust toward transparency (Taylor 2002).

Certainly, improved understanding has been key, and the research literature on the pervasive economic benefits of stable low inflation and the critical role of monetary policy in maintaining low inflation is now well known and firmly engrained in leading central banks. But the impetus and support for change has become popularized and widespread. In the United States, the highly politicized "misery index" highlighting high inflation and high unemployment in the late 1970s became an effective catalyst for change. In referring to the experience of emerging nations, the Bank of Mexico's Guillermo Ortíz put it succinctly at a recent Jackson Hole Symposium sponsored by the Federal Reserve Bank of Kansas City: "People are simply fed up with inflation" (Ortíz 2003: 119). Select successes also encouraged new thinking and bold policy moves. Chile's early 1970s crackdown on hyperinflation and its ensuing strong economic growth provided a valuable benchmark for implementation of sound monetary and fiscal policies.

Central Bank Independence and Improved Monetary Frameworks

The heightened degree of independence granted to monetary authorities in developing and industrialized nations has been crucial in providing central banks flexibility to pursue a low inflation objective unencumbered by political pressures. Central banks have been granted independence in formerly inflation-plagued nations in Latin America, led by Chile, and other emerging nations, providing flexibility to pursue credible low inflation objectives. More recently, institutionalized independence of the Bank of England (BoE) and Bank of Japan (BoJ), as well as the establishment of the independent

European Central Bank (ECB), have changed the landscape of leading global monetary authorities.

Central bank independence has been linked empirically to low inflation, stronger economic growth, and more stable currencies—and is generally respected by most governments and electorates. Independent monetary authorities that no longer monetize rising government debt reveal more explicitly the irresponsibility of profligate fiscal policies, as real rates and risk premia rise. In addition, in developing and transition nations, there tends to be less corrosive corruption in independent central banks.

Not coincidently, those nations that still suffer from the highest inflation are those whose central banks lack independence. This includes many transition nations, primarily in Africa, in which monetary policy is not independent from the treasury and where the lack of access to global financial markets forces debt monetization. Oftentimes, the result is high inflation and a free-falling currency. Economic under-performance and lower standards of living are accentuated by financial market deterioration and uncertainty that increase the risk of capital flight and impinge upon access to global capital markets. In such cases, institutional arrangements must be changed to create a barrier between monetary and fiscal policies. This involves either the establishment of a currency board or a peg to a strong currency associated with a sound and credible central bank.

Lack of central bank independence is not just plaguing African nations; it now threatens Venezuela and Argentina, even though both of these nations' constitutions specifically provide central bank independence. The Central Bank of Venezuela's autonomy recently has been usurped by the government, which has established a financial institution parallel to the central bank with the ostensible mandate of managing international reserves, but which in reality allows the government to allocate funds for social purposes. Inflation has ranged between 15 and 31 percent in recent years, its central bank's credibility has been compromised, and access to global capital markets has been severely impaired. To a significantly lesser degree, threats to the independence of the Central Bank of Argentina have been associated with renewed double-digit inflation and loss of credibility.

Monetary independence must not be taken for granted; a reversal of the favorable global trend toward monetary independence poses perhaps the greatest threat to sound global monetary policies.

In most industrialized nations where the granting of monetary independence was not the primary watershed event that initiated disinflation, the change in thinking about the role of monetary policy and how it should be conducted has been remarkable. The current

widespread recognition that sustainable inflation is everywhere a monetary phenomenon represents a dramatic and seeming improbable turnaround from beliefs of the late 1970s, when cost-push, demand-pull, and monopoly pricing dominated inflation analysis.

The grudging rejection of the Phillips Curve removes the flawed notion of a long-run and exploitable tradeoff between inflation and unemployment (see Niskanen 2002). Importantly, central banks place a higher priority on low inflation, and they are much more tolerant of temporarily higher unemployment to achieve lower long-run inflation. In the 1970s, many thought the short-run costs outweighed the long-run benefits of low inflation (Meltzer 2005). Since then, numerous disinflationary experiences with favorable outcomes, and the long-run compatibility of low inflation and low employment have quieted that argument. Empirical studies of the Taylor Rule for different countries find an upward shift in the estimated coefficient on the inflation variable, suggesting a heightened monetary policy response to inflation relative to output and unemployment by central banks. At the same time, there has been a growing recognition that excessive short-run fine-tuning of real economic conditions undercuts long-run inflation objectives, and that monetary policy is an aggregate demand tool that should not respond to supply shocks or asset price fluctuations. In general, it is widely accepted that central bank effectiveness and credibility are undermined when monetary policy is stretched beyond its capabilities.

Inflation Targets

The adoption of inflation targets has been a crucial factor in lowering inflation in many nations and has institutionalized low inflation objectives and facilitated improved monetary policy. While experiences with targets have been overwhelmingly positive, it is noteworthy that among industrial nations, central banks without specific inflation targets have experienced similar success at lowering inflation (for example, the United States) as those central banks with targets (United Kingdom, Canada, and others). However, evidence shows that in developing nations that began with higher levels of inflation, inflation targeting has accelerated the disinflation process (IMF 2005). Again, Chile provides a successful example: after adopting a fixed exchange rate and associated restrictive monetary policy in 1973 to break its hyperinflation, the Central Bank of Chile used its subsequently granted independence to adopt an inflation target in 1994. Since then, Chile has enjoyed the fastest economic growth, lowest inflation, and most financial stability in Latin America.

Inflation targets or guidelines also provide other benefits in the conduct of monetary policy. In particular, they provide a policy anchor, promote a better public understanding of the objectives of monetary policy and improve central bank communications and transparency (Bernanke and Woodford 2005). Importantly, establishing an inflation target or guideline provides a sound platform for a central bank to convey its proper role to fiscal, tax, and other policymakers. The ECB relies on its mandated inflation target to effectively describe the limitations of monetary policy and the economic consequences of misguided fiscal, tax, and regulatory policies. Its clear statements of the proper role of monetary policy and high credibility raise the probability of successfully "exporting" economic reform to other government institutions. Pro-growth economic reforms in Europe have been implemented very slowly, but the ECB has played an important role in maintaining pressure on economic policymakers.

Inflation targeting makes it easier for central banks to articulate low inflation objectives, and if properly designed, it may provide sufficient flexibility to monetary policy. Fortunately, since the 1990s, even without inflation targeting, the U.S. Federal Reserve has successfully lowered inflation and built credibility, despite the short-run conflict between its jointly mandated goals of price stability and low unemployment. The Fed's clear focus on keeping inflation low, supported by its actions, statements and its semiannual central tendency forecasts, which are used as a signaling device, suggest that it is an implicit inflation targeter. Nevertheless, central banks that do not have inflation targets or guidelines must be extra vigilant to manage expectations and prevent erosion of credibility. And there may be more pressure on them to respond inappropriately to supply shocks.

The transformation of central banks from "black boxes" toward transparency has significantly improved the conduct of monetary policy and increased central bank credibility. Public announcements of objectives, the role of monetary policy, policy changes, and the release of the minutes of central bank meetings have contributed significantly to public understanding and credibility. General access to monetary policymakers has been greatly enhanced through the media and advanced communications. Inflation targeting has facilitated and enhanced central bank transparency by clarifying policymaker objectives.

Monetary credibility requires the establishment of sound and sustainable goals and the successful pursuit of those objectives. Stable low inflation is the proper and optimal long-run objective of monetary policy. Nothing breeds credibility like success. Once achieved, low and stable inflation is readily sustainable. The initial costs of

establishing credibility have been borne, and market participants then recognize the powerful incentives to maintain credibility (see Federal Reserve Bank of St. Louis 2002).

Sound Policies, Monetary Missteps, and Their Costs

The economic and financial benefits of credible monetary policy are pervasive and apparent to the public. Inflationary expectations have receded throughout the industrialized world and inflation risk premia have dissipated from government bond yields. The lower real costs of capital have stimulated investment, economic growth, and asset appreciation, and have lowered government debt service costs. Low inflation and monetary credibility have also reduced the volatility of economic output (Bernanke 2004). The moderation of the business cycle eases external political pressures to deviate from long-run inflation objectives to pursue short-run real fine-tuning.

Credible monetary policies anchor expectations and reduce the economic costs of external shocks. Examples illustrate the benefits of credible monetary policies in emerging and industrialized nations alike. In 1999, when the Brazilian *real* depreciated 50 percent in response to election-related fears of misguided economic policies and a dramatic fiscal deterioration under new government leadership, Brazil's inflation rose only 9 percent in 1999 and 6 percent in 2000, significantly constraining negative economic implications. The strikingly small currency depreciation pass-through to inflation was in direct response to the Central Bank of Brazil's prior adoption of inflation targeting and its strong inflation-fighting credibility. In contrast, in an associated episode, lack of a credible monetary authority in Argentina contributed to financial turmoil and deep recession. Although the adoption of a currency board abruptly in 1991 snapped Argentina's debilitating hyperinflation, "creative financing," two sizable Brazilian devaluations relative to the U.S. dollar, and sharp increases in government budget deficits raised speculation that Argentina's currency board would collapse. As a result, the Argentine peso plummeted, triggering a sharp rise in inflation and economic contraction.

In the United States and globally, the dramatic recent run-up in energy prices has had little impact on inflationary expectations and bond yields, a key factor facilitating sustained economic expansion. This phenomenon has been a direct result of the heightened inflation-fighting credibility of leading central banks. In contrast, the initial oil price shock of 1973 occurred amid a widespread lack of understanding of the inflation process and elicited a confused (and confusing)

response from central banks. In the United States, inflation expectations soared, which drove up actual inflation and bond yields, ultimately contributing to a deep recession. While amorphous, policymaking credibility and the effective management of expectations are a serious matter.

Misguided, unsustainable, or incompatible goals generate poor performance and drain credibility, and getting back on track can be costly and elongated. In the 1970s, the Fed's well-documented blunders resulted in soaring inflation and unemployment, and its lack of credibility accentuated the economic costs of disinflation. Although the Fed successfully reduced inflation in the 1980s and became more strident in asserting that low inflation is a necessary foundation for sustainable growth and low unemployment, the lingering perception of a short-run Phillips Curve plagued monetary policy and undercut the Fed's own disinflation policies. The Fed's willingness to "accept" stronger growth and lower unemployment during 1996–98, an effective rejection of the Phillips Curve, primarily at the insistence of Fed Chairman Greenspan, contributed significantly to the now widespread recognition that low inflation and low unemployment are long-run compatible.

The Bank of Japan's monetary policies of the 1980s and 1990s provide another valuable example of the high costs of monetary missteps. Its maintenance of negative real short-term interest rates that contributed to Japan's asset price bubble in the late 1980s was followed in the early 1990s by excessively high real interest rates that reduced real money balances. This shift generated sustained declines in nominal GDP, prolonged deflation and recessionary conditions that damaged household and business balance sheets, lowered expectations, and precluded quick repair of the banking system. The BoJ's weak policy leadership seemed to spawn, or at least was associated with, misguided tax and regulatory policies, like the untimely tax hike in 1997. Only recently, following more than four years of zero short-term interest rates and rapid money growth, has the dysfunctional banking system been restructured and recapitalized, nominal GDP risen, and the chances of sustained growth renewed.

The incompatibility of goals, a natural source of financial crises, often arises in emerging nations that rely on non-floating currency regimes. Mexico's periodic crises—in 1976, 1982, 1987–88, and 1994—have been associated with a variety of factors, including fiscal excesses, devaluation, excessive external indebtedness and fears of misguided leadership, but a common denominator of all of these was a fixed or managed exchange rate. Since then reformed institutions have restored central bank credibility. The Mexican peso was floated

in 1995 with only modest intervention, and the Bank of Mexico moved gradually toward inflation targeting and in 2000 instituted a target of 3 percent (+/– 1 percent) to be achieved in 2003. As a result, inflation has remained low, the impact of currency depreciation on inflation has been minimal, and economic performance has been strengthened.

Issues for Future Monetary Policy

From the vantage point of recent improvements in the conduct of global monetary policies, a dramatic deterioration in monetary discipline is difficult to envision. But the temptation for shortsighted policymakers to exploit a temporary tradeoff between inflation and output will always exist. While leading central banks are on the right track, global imbalances create political pressures that may lead to misguided policies, and key monetary authorities face specific issues that may jeopardize effective management.

The People's Bank of China's effective currency peg is unsustainable, as its surging reserves require excess money growth. Price and credit controls may be obscuring the macroeconomic impacts of the effective peg, and may complicate the move toward a freer floating currency. Japan's emergence from prolonged economic underperformance and deflation points will require the BoJ to end its zero interest rate policy and to reestablish its credibility. This may exert upward pressure on global real interest rates. The ECB must continue to pursue its low inflation mandate in an environment in which misguided tax and regulatory policies constrain potential growth and effectively reduce the ECB's degrees of freedom in conducting monetary policy.

Mexico also faces constrained potential growth due to the maintenance of inefficient state-run businesses, and the Bank of Mexico is often blamed for poor economic performance and loss in international competitiveness and is constantly urged to loosen monetary policy to stimulate growth. Admirably, strong Bank of Mexico leadership has rebuffed such pressures and used its credibility to urge a wide array of tax, regulatory, governance, and legal reforms. The Central Bank of Brazil also has displayed resolve, even though it is not formally independent. With the government's support, it has raised real rates significantly amid dramatic fiscal belt tightening (the primary fiscal surplus has risen from 2.4 percent of GDP in 2002 to more than 5 percent). The Bank's credibility has constrained inflation and is in part responsible for a pickup in economic growth.

While beyond the scope of this article, a structured system for

rating central banks based on factors that underlie sound and credible monetary policy would be instructive and potentially helpful. The criteria would include characteristics such as central bank independence, inflation trends, inflation expectations, risk premia in government bonds, reliance on inflation targets or guidelines, reliance on market-based solutions to imbalances, lack of capital controls, currency flexibility, and a measure of fiscal responsibility. While any attempt to impose numeric evaluations on central bank practices necessarily would be subjective, a relative ordering could prove useful by injecting further competition into policymaking. The criteria would apply equally to central banks in industrialized and emerging nations, although in light of the current healthy status of most leading monetary authorities, the results would be most revealing for select emerging nations.

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