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## Is Opportunistic Monetary Policy Credible?

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Monetary policy actions are widely considered to be better implemented and more effective when they are credible—that is, when the goals and strategies of the central bank have been clearly and believably communicated to the public. Thus, credibility is highly valued by central banks. Indeed, among some central banks, credibility is almost a mantra of policy.

In apparent contrast, an “opportunistic” strategy for monetary policy has recently gathered attention. With an opportunistic strategy, monetary policymakers officially maintain an ultimate goal of low inflation but may do little to achieve it, waiting instead for good fortune to supply it. For example, as noted in the *Wall*

*Street Journal* (Wilke 1996), "...when inflation is relatively low, as it is today, [opportunistic] policymakers should wait for unforeseen recessions to make further progress against inflation...."

There is an obvious tension between credibility and opportunism. The public may be skeptical about the importance or validity of an ultimate inflation target when it is promulgated but not acted upon by an opportunistic central bank. This *Economic Letter* considers whether opportunism necessarily leads to such a credibility gap. It suggests that the dissonance between credibility and opportunism is not merely superficial but intrinsic.

### **What is opportunistic monetary policy?**

Federal Reserve Chairman Alan Greenspan has often stated a long-run goal of price stability, a situation where, as a practical matter, inflation does not play a significant role in the decisions of households and businesses. This goal is typically interpreted as one of very low inflation—say, around 1 percent in the CPI. The achievement of such price stability increasingly has been seen by many central banks as the primary focus of monetary policy. This new focus has been motivated, in part, by the view that the chief contribution that monetary authorities can make to the long-term growth of their economies is to eliminate the uncertainties and distortions associated with inflation.

Central banks in different countries have adopted different strategies for achieving price stability. One approach that has gained much attention in the 1990s is the use of inflation targets that prescribe an explicit path towards an ultimate goal of low inflation. For example, in early 1990, New Zealand's central bank announced interim inflation targets of between 3 and 5 percent by the end of 1990 and between 1.5 and 3.5 percent by the end of 1991, as well as an ultimate inflation target of between 0 and 2 percent by the end of 1992. Similarly, central banks in several other industrialized countries—such as Canada, the U.K., Sweden, and Finland—have adopted specific year-by-year numerical targets for future inflation. (See Leiderman and Svensson 1995 and Haldane 1995.)

An opportunistic monetary strategy also assumes an ultimate target of price stability and distinguishes an interim inflation target from the ultimate one. However, except when inflation is high, the opportunistic policymaker's interim

inflation target is simply the current rate of inflation. Thus, the opportunistic strategy eschews deliberate action to reduce inflation, but instead waits for unforeseen but favorable price surprises to reduce inflation.

An opportunistic scenario was described by a participant at the FOMC meeting in December 1989: “Now, sooner or later, we will have a recession. I don’t think anybody around the table wants a recession or is seeking one, but sooner or later we will have one. If in that recession we took advantage of the anti-inflation [impetus] and we got inflation down from 4 1/2 percent to 3 percent, and then in the next expansion we were able to keep inflation from accelerating, sooner or later there will be another recession out there. And so, ...we could bring inflation down from cycle to cycle...” Indeed, the gradual ratcheting down of inflation over time is the hallmark of opportunistic monetary policy. As long as inflation is not too high, the opportunistic policymaker takes no deliberate action to reduce inflation further, but waits to exploit recessions and favorable supply shocks to lower inflation. When inflation gets pushed down by a shock, the interim inflation target is re-set to equal the new prevailing lower rate, and, in this fashion, price stability is eventually achieved.

Table 1 provides a little evidence on how an opportunistic strategy might work in practice. For each postwar recession, Table 1 displays the difference between consumer price inflation measured during the twelve months before the recession and inflation measured during the twelve months after the recession. (The CPI excluding food and energy prices is used except for the first three recessions where, because of data availability, the total CPI is used.) For example, after the 1990-1991 recession, inflation fell 1.2 percentage points. Across all nine postwar recessions, the median decline in inflation was 1 percentage point. Of course, if an opportunistic strategy that “took advantage” of circumstances had been in place historically, the resulting disinflations might have been greater or smaller (depending on the degree of accommodation); indeed, some of the recessions and their associated disinflations might not have occurred at all. Still, Table 1 suggests that an opportunistic policy might be successful in ratcheting down inflation—if, during expansions, inflation were tightly controlled (i.e., the interim targets were strictly enforced). However, it should be noted that in the postwar period, recessions have occurred about once every five years. Thus, as a simple

historical average (ignoring supply shocks), reducing inflation in the CPI, which is currently about 3 percent, to an ultimate inflation target of 1 percent could take about a decade.

### **The importance of central bank credibility**

As Table 1 shows, the reduction in inflation after a recession varies considerably across recessions. In part, these differences reflect the varying severity of the recessions—with deeper recessions typically associated with greater disinflation. However, even for a given loss of output and employment, there are other factors that affect the resulting amount of disinflation. For example, the public's expectations of future inflation are often considered to be crucial. If people believe that inflation will fall, then inflation may be reduced with a smaller transitional cost in terms of lost output and employment, in part, because the necessary adjustments to nominal contracts may be made more quickly. In this way, anticipated disinflations may be less painful than unanticipated ones.

For policymakers, one implication of the important role played by expectations in the inflation process is that the cost of lowering inflation may be reduced when the anti-inflation policy is clearly understood and believed. That is, a credible disinflation policy will translate more quickly into lower inflation expectations and may require a smaller sacrifice of output and employment. Despite such compelling intuition, there is no empirical evidence that proves the general practical importance of central bank credibility; however, one suggestive new estimate is provided by an econometric model of the U.S. economy recently developed by researchers on the staff of the Federal Reserve Board (1996). In this model, as a rough rule of thumb, a credible policy to reduce inflation by 1 percentage point would require a 1 percentage point higher unemployment rate for one year than would otherwise be the case. (The cost is not zero because some nominal rigidities remain.) However, if the policy were not credible and the disinflation were not anticipated, then the unemployment cost would be over twice as high.

### **Table 1**

*The Difference in Inflation before a Recession and Inflation after a Recession  
(in percentage points)*

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<b>Recession Difference (Peak-Trough)</b>	<b>in Inflation</b>
Nov. 1948 – Oct. 1949	-1.0
July 1953 – May 1954	-0.7
Aug. 1957 – Apr. 1958	-3.3
Apr. 1960 – Feb. 1961	-0.7
Dec. 1969 – Nov. 1970	-2.6
Nov. 1973 – Mar. 1975	+1.9
Jan. 1980 – July 1980	-0.8
July 1981 – Nov. 1982	-6.8
July 1990 – Mar. 1991	-1.2
Median	-1.0

In light of such potential benefits, it is not surprising that central banks value credibility so highly. For example, inflation targets were adopted, in large part, because they provided a clarity of motive and of intent that presumably would enhance credibility. Also, credibility has been an important issue for those creating the new European Central Bank (ECB), which will set the single monetary policy of the European Monetary Union. In establishing the ECB, much attention is being paid to the organizational characteristics (such as budgetary

independence) and the operational characteristics (such as a transparent policy process) that will ensure the achievement and maintenance of credibility (Smaghi 1995).

### **Opportunism versus credibility**

How much credibility would an opportunistic monetary policy have? What is new about opportunistic policy is not the use of an interim inflation target (which is used in inflation targeting and elsewhere, including Anderson and Enzler 1987). What is unique about opportunistic policy is (1) the use of the current inflation rate as the interim target and (2) the fact that reductions in the interim target depend crucially on random events—such as the occurrence of recessions. Both of these attributes would appear to reduce credibility and undermine disinflationary expectations. The use of the current inflation rate as an interim target would always seem to foster questions about the importance of the professed ultimate target. It will be hard for the public to distinguish between central banker A, who is opportunistic and professes an ultimate target of price stability but is comfortable with the prevailing higher rate of inflation as an interim target, and central banker B, who is simply comfortable with the prevailing inflation rate as the ultimate target. As suggested by Table 1, it may take quite a long time—decades perhaps—before enough evidence is accumulated from recessionary episodes to distinguish between central bankers A and B. The confusion arising from the near observational equivalence of these two central bankers will limit the credibility of the opportunistic one. Of equal importance is the fact that under opportunism the future path of the inflation target is random and depends to a very large extent on the size and distribution of future shocks to the economy. As shown in Table 1, the variation in the amount of the disinflation following postwar recessions is large, as is the variation in the length of time between recessions. For example, under opportunism, the economy currently may be *one, two, or three* recessions away from price stability. In general, the public will have little notion of when the ultimate target will be reached, so uncertainty about the level of future inflation will loom large in household and business calculations. Under opportunism, for example, long-term nominal interest rates would likely have to incorporate a higher premium for inflation uncertainty risk than under a deliberate strategy. Finally, any opportunistic disinflation that does follow some

unforeseen shock will always be a surprise, so that the sacrifice in lost output may be greater than if the disinflation had resulted from a deliberate, anticipated policy.

## Conclusion

Of the two new strategies for monetary policy, it appears that credibility would be better achieved with inflation targets than with an opportunistic policy. Inflation targets provide a transparent, accountable, deliberate path to price stability—attributes lacking in an opportunistic approach.

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