REVERSING THE DRIFT TOWARDS INDEXATION:
THE BENEFITS OF MONETARY POLICY THAT TARGETS
THE LEVEL OF PRICES RATHER THAN INFLATION

Existing monetary policies generally target the rate of change of prices (inflation); some, such as the European Central Bank, also target the rate of change of the money supply. Patrick Minford will discuss new research recently carried out with fellow-researchers published in the latest *Economic Journal*; he argues that making the policy target the level of prices or of the money supply would bring significant benefits to the economy by reducing indexation of wages, which is damaging to economic stability.

The research aims to explain why people do not sign long-lasting wage contracts in money terms but instead index their wages. It suggests that the reason is the persistence of shocks to prices; the basic point being that a persistent shock upsets the purchasing power of a money-based (‘nominal’) wage contract for the whole duration of the contract. By contrast, if shocks to prices are temporary, then nominal contracts are preferable; since indexation is imperfect, occurring with a lag, it will not offset the shock but rather compound it by altering wages when it has gone away.

The significance of this is that indexation implies the economy has rather poor stability in the face of supply shocks. Supply shocks create a dilemma for monetary policy because they reduce output but also raise prices; demand shocks do not because, if they are offset by interest rate movements, both output and prices can be kept stable. The more indexation there is, the more prices respond to supply shocks, so that the dilemma facing monetary policy is starker. Hence, if indexation can be reduced there is a benefit to the management of the economy.

The implication of monetary policy that targets rates of change of prices and/or money supply is that when prices rise or fall unexpectedly compared with their target trajectory, there is no tendency for future prices to be brought back to this trajectory. Instead, the error is treated as a bygone and the target future change is kept the same.

Sometimes this is referred to as ‘base drift’: the target trajectory ‘drifts’ up or down according to the latest error. By implication, the shock to prices is permanent, infinitely persistent. This in turn tends to produce a high degree of indexation in wages. By making the policy target the level of prices or the money supply, such errors are offset in the future; persistence is reduced and with it indexation. This then brings a benefit to the economy in the form of greater stability.

To develop the argument, Minford and his colleagues set up a simple but complete model of an economy in which workers sign contracts with a view to protecting themselves against fluctuations in their real income. They assume that people may sign nominal, indexed or auction (fully contingent) wage contracts; and that they do so with the aim of stabilising their real living standards over the term of the potential contract period. This is a model of overlapping wage contracts where the motive for the contract is insurance against shocks to real income.
The researchers examine OECD experience and find that indeed OECD monetary policy has been highly persistent (a high degree of base drift), not merely in the 1970s but also in the less turbulent 1990s. Furthermore, the unpredictable element in money in both periods has been of similar magnitude.

Putting these policies country by country into the model reveals a picture of desired private indexation or equivalent protection via auction contracts that is fairly stable from the 1970s onwards. There is, in other words, no predicted change, as many have suggested, as a consequence of the lower inflation of the 1990s. This pattern of little change in the high extent of indexation is confirmed by wage equations for these countries. Real wages react about the same in both periods to unexpected inflation, that is, on the whole very little, indicating pretty high indexation or other protection throughout.

Minford’s research finds therefore that even though inflation has of course been brought down dramatically since the 1970s, the degree of price persistence has hardly changed; hence the continued prevalence of indexation, formal or informal. He concludes that monetary policy could benefit from a shift towards targeting the levels of money or prices. In the course of his talk he will also discuss some provisional results about the exact form that monetary policy shift might take to exploit the potential gains fully.

In particular he will discuss the application of such a policy in the context of deflation, such as has been occurring in Hong Kong, where price level targeting has the noted advantage that prices will be expected to return to their target level; this creates an expectation of rising prices which has the effect of stimulating spending in the deflationary situation, until prices have returned to target. Hence the price level target builds in an extra stabiliser against deflationary shocks.

* ‘Nominal Contracts and Monetary Targeting: Drifting into Indexation’ by Patrick Minford, Eric Nowell and Bruce Webb is published in the January 2003 issue of the Economic Journal. Minford and Webb are at Cardiff University; Nowell is at the University of Liverpool.