

# Controversies on the Central Bank Main Objective of Price Stability

■

**Vasile Cocriș**  
**Bogdan Căpraru**  
„Al.I. Cuza” University, Iași

***Abstract.** In the present study we propose a critical approach to the concept of price stability. In the beginning we have considered a literature review regarding price stability issues. After that we have discussed about its implications in central banking and economy. Also, according to the statutes of 128 countries, we have done a statistical study of central banks in the light of the chosen statutory objective.*

**Key words:** price stability; central bank; final objective; implications; monetary policy.

■

**JEL Codes:** E42, E52, E58, E61.  
**REL Codes:** 6B, 8J.

## Introduction

A major concern in the activity of central banks represents the choice and implementation of monetary policy strategies. The *final objectives* of monetary policy pursued by the central bank may be: price stability, employment, economic growth, external balance. These objectives cannot be controlled directly and are practically general objectives for economic policy.

The objectives of monetary policy should be linked with other components of general economic policy of the country, the performance of each category of policy depending on the success of the entire package of measures.

Usually, the final objective of monetary policy which a central bank assumes is expressly stated in the statutes of the central bank, therefore final objectives are known as *statutory objectives*.

In recent years, it has become increasingly popular and pursued by the central bank the objective of *price stability*, rather than ones of stimulating production and reducing unemployment.

In the present study we propose a critical approach to the concept of price stability. Also, according to the statutes of 128 countries, we will perform a statistical study the central banks in light of the chosen statutory objective.

### Approaches to the concept of price stability

There are many approaches to defining price stability, since this is a controversial concept. Price stability can be interpreted as

representing a situation when the price level remains unchanged, there is no movement of prices, and the inflation rate is zero. But, this isn't the meaning of the final objective of price stability.

In the economic literature there is consensus regarding the definition of this term in connection with three elements (Isărescu, 2006, p. 2): price stability refers to the aggregate level of prices measured by the index; price stability is achieved when the money retains value over time or the speed erosion of the purchasing power is very slow; concept of monetary stability is the overlap of price stability.

A number of practitioners and academics link the notion of price stability with *inflation expectations*, giving it a *quantitative approach*. Thus, Paul Volcker considers price stability as a "situation in which expectations of generally rising (or falling) prices over a considerable period are not a pervasive influence on economic and financial behavior" (Volcker, 1983, p. 5).

In the same vein, Greenspan believes the objective of price stability is a situation in which "economic agents no longer take account of the prospective change in the general price level in their economic decision making" (Greenspan, 1996, p. 1).

Alan Blinder, also, sees price stability "when ordinary people in their ordinary course of business stop thinking and worrying about inflation" (Blinder, 1994, p. 7).

In the vision of the Bank of Japan price stability means "an environment where economic agents, including households and firms, can make decisions regarding economic activity such as consumption and

investment without being concerned about the fluctuation of the general price level” (Castelnuovo et al., 2003, p. 9).

The vision of the European Central Bank (ECB) tends to a quantitative approach to the concept of price stability. An explicit definition given by the Council in October 1998, price stability is an inflation rate, calculated on the basis of harmonized index of consumer prices in the Euro area, up to 2%.

Lucas Papademos, vice president of the ECB defines price stability as “a state in which the general price level is literally stable or the inflation rate is sufficiently low and stable, so that considerations concerning the nominal dimension of transactions cease to be a pertinent factor for economic decisions” (Papademos, 2006, p. 1).

Charles Freedman, a former member of the Board of the Bank of Canada, has also a quantitative approach: “aiming at the achievement of price stability by setting an explicit target for prices (whether stated in terms of a level or a rate of increase)”. (Freedman, 1996, p. 243).

While these approaches regarding qualitative nature definitions converge, there are more points of view regarding the *expression of quantitative objective of price stability*. Thus, the dilemma is whether it can be considered the definition of price stability as price level stability or low inflation. Also, there are different opinions regarding the price index taken into account in the transposition of price stability objective (Svensson, 1999, p. 198). There are approaches that consider price stability in *numerical terms*. Thus, ECB considers price

stability as an increase in prices of less than 2%. In other opinions, price stability means an inflation of 0%.

Fischer believes that from an operational stand point this goal must represent an inflation rate between 0% - 3% (Fischer, 1996, pp. 37-45).

Meltzer combines quantitative aspects with qualitative ones: price stability implies an inflation rate so close to zero, that it ceases to be a significant factor in long-term planning, considering that a 3% inflation is too high for this goal (Meltzer, 1997, pp. 3-8).

Other views see sufficient expression of this objective in an inflation rate of a single digit (Dornbusch, Fischer, 1993, pp. 1-44).

The views of many practitioners and academics are against the quantitative approach in terms of the concept of price stability, because the price indices used can not be precise enough for this purpose (Greenspan, 2002, p. 6). Even the explicit definition given by the ECB was criticized in the following three reasons (Issing, 2002): the definition is asymmetric, focusing only on the upper limit of price increase, without a minimum limit; the definition is quite ambitious, without room in flexibility for monetary policy, implying deflationary risk; it does not leave sufficient margin of fluctuation of prices, particularly between countries with different economic structures.

In many cases, *quantitative definitions practically explain the concept of price stability citing operational targets, which can lead to confusion with regard to the objectives of monetary policy strategies*.

## Targets of inflation or definition of price stability for some industrialized countries

Table 1

Country	Indicator	Numeric value Definition/goal
Euro Zone	The Harmonized Index of Consumer Prices	Under 2% (1999) Definition of price stability
Norway	Consumer price index	2.5% fluctuation of $\pm 1\%$ Target
Sweden	Consumer price index	2% with a margin of fluctuation of $\pm 1\%$ in January 1995 Target
Switzerland	Consumer price index	Under 2% Definition of price stability
Great Britain	Retail price index excluding interest payments on mortgages	1% -4% (October 1992 - June 1997) 2.5% (June 1997) Target
Australia	Consumer price index	2-3% (since January 1993) Target
Canada	Consumer price index (excluding food, energy and the effects of indirect taxes)	2-4% (February 1991 - the end of 1992) 1,5-3,5% (end of 1992 - half of 1994) 1-3% (December 1993 (revised) - February 2001, then renewed and valid until end of 2006 Target
Japan	Consumer price index	There are no numerical values Qualitative definition of price stability
New Zealand	Consumer price index (excluding credit services)	3-5% (March 1990 - December 1990) 2,5-4,5% (December 1990 - December 1991) 1,5-3,5% (December 1991 - December 1992) 0-2% (December 1992 - December 1996) 0-3% (December 1996 - November 2002) 1-3% (since November 2002) Target
United States	Not specified	There are no numerical values Qualitative definition of price stability

**Source:** Castelnuovo, E., Nicoletti-Altimari, S., Rodriguez-Palenzuela, D. - Definition of Price Stability, Range and Point Inflation Targets: The Anchoring of Long-term Inflation Expectations, ECB Working Paper no. 273, September 2003, p. 11.

We believe that in the definition of the concept of price stability there must be taken into account both visions, with qualitative emphasis. The quantitative approach needs to be defined depending on the situation of each country at different moments. Sometimes, the quantitative approach can lead to confusion in regards to the delimitation of hierarchical objectives of monetary policy. Also, the qualitative approach confers importance to inflation expectations, which have consistent implications for future developments of prices.

### Price stability implications in central banking and economy

Mishkin and Posen have *four arguments that enhance the effectiveness of price stability as final objective of monetary policy, rather than those concerning economic growth or employment* (Mishkin, Posen, 1997, pp. 9-110). One of them is based on considerations of Milton Friedman and Anna Schwartz, after which monetary policy has effects that appear after a certain period, which may be variable. Uncertainty regarding forecasting and measuring the effects of monetary policy make the attempt

to stabilize fluctuations in production through monetary policy measures to fail to deliver the expected results.

A second prerequisite is that there is no precise correlation between long-term inflation and unemployment. According to Phillips' curve, in the short term, empirically, a low unemployment rate can be achieved through an expansionary monetary policy, which causes a high inflation.

Following the increase in prices, both consumers and companies will produce more because nominal wages and profits increase. But in the long-term, this relationship can not be valid because inflation in the economy will persist even after increase in production and drop in unemployment, because the expectations regarding inflation will be incorporated into pricing. Thus, the favorable effects regarding unemployment and production obtained in the first phase will be wiped out by the harmful consequences of a high inflation.

Another argument brought against an active monetary policy, channeled to increase production and employment, is time inconsistency phenomenon of monetary policy. It is based on the behavior of determining prices and incomes, which take into account expectations regarding future monetary policy.

The expectations of private sector are determined on the basis of monetary policy decisions set at a time. In this case, the central bank will be tempted to conduct a monetary policy more expansive than it has initially proposed. Reasons for undertaking such measures are mixed.

The most frequently encountered concerns are: the desire of the monetary

authority (or pressures in this regard from the government) to increase the level of employment and, in a more general perspective, production, the possibility of obtaining revenue through senioraj together with erosion of the real value of public debt in case of inflationary surprises; inflationary consequences of devaluation undertaken in order to improve the current account; the use of monetary policy in order to safeguard the stability of the financial system.

However, the private sector will recognize the central bank's intentions regarding monetary policy and will adjust expectations according to new situations. This will lead to an increase in inflation. Private sector will never be misled by such expansionary strategies of uncertain monetary policy, and production will not be higher than the level established, because in turn inflation would be much higher. In this case the central bank will need to avoid situations in which the private sector will form expectation regarding revenue and prices on the basis of an expansive uncertain monetary policy.

A final argument is that currency stability and prices lead to the formation of an economic system that works much more efficiently and with a much higher standard of living. A policy that contributes to stability and stabilization of prices can contribute to redirecting resources to productive areas (Dănilă, 1999, p. 88).

Nevertheless, *it can not be denied the role of the central bank in regards to economic growth*. Through monetary policy, the central bank influences aggregate demand. We believe that the role of the central bank in economic growth should be

delimited in the way that it can not participate actively, by issuing inflationary money, but by *ensuring proper economic framework, through economic variables that it controls, for a sustainable economic growth without inflationary perpetuation of tensions.*

Thus, *the quantity and price effects of the instruments of monetary policy may render mechanisms conducive to economic growth, which, in fact, may help avoid situations of overheating of the economy.* For example, by using interest rate policy, the central bank can stimulate healthy growth.

The monetarists confer central bank the task of increasing the monetary mass in circulation, the pace of economic growth to sustain the amount of currency in circulation, according to the needs of the economy.

Also, it is known that deflation effects are as harmful to the economy as those of inflation, with profound implications in slowing the economic growth.

At the same time, we believe that this approach can bring into question *a concern in the hierarchy of objectives of central banks and a clearer delimitation of the role of each institution involved in the conduct of economic policies of the state.* The current economic environment requires a further concern for the central bank in the direction of control of the inflationary phenomenon. As stated by Mishkin and Posen in the arguments made in favor of promoting the objective of price stability, a stable economy from the perspective of increasing prices represents a propitious framework from the standpoint of sustainable economic growth.

Papademos sees the following advantages of price stability as the final objective: it protects the real purchasing

power of money and households' real disposable income; it enhances the proper functioning of markets and eliminates uncertainty created by high and volatile inflation rates. Also, price stability facilitates long-term planning and contracting as people can safely rely on money as a measure of value (Papademos, 2006, p. 3).

In the case of high inflation there are a number of costs<sup>(1)</sup>. Studies show that, on average, an increase of 1% in inflation, may cost the economy of a country a decrease of 0.1% - 0.5% in rate of GDP growth (Fischer, 1993, pp. 485-512).

*Although there are views regarding the overlap between the concept of price stability and monetary stability or currency, we believe that there is still some clear distinctions.*

Lately, *the use of the concept of price stability is the preferred over monetary stability for several reasons.* First, it is more anchored in inflation expectations, as a more transparent and objective meaning of the general public. It is more credible, but involves more responsibility from the central bank and requires the central bank to hold credibility.

However, *it is improper to say that the central bank can control prices in the economy.* They are formed freely on specialized markets, where the central bank can not intervene, especially administratively. We must take into account that *the final objective of the central bank is also the general objective for economic policy, involving collaboration and contribution of more decision makers, primarily the government.* The central bank, through use of monetary measures and

instruments, can intervene in ensuring the framework of price stability, by means of psychological nature, or by influencing inflation expectation.

*Price stability of the economy depends on several factors, which may or not be related to monetary phenomenon.* Moreover, in times of monetary instability we can see a stabilization of prices, gained arbitrarily, under the impact of other factors that have acted to the contrary, attenuating destabilizing effects of monetary policy.

Therefore we believe that *the fundamental objective of price stability can lead to the risk of assigning responsibilities that the central bank can not achieve by its nature and its specific functions, even though if it can have some clemency clauses. Public perception can be at a given moment that the central bank is guilty of missing inflation targets. Moreover, this idea could even be fed by other authorities participating in fulfilling this objective, based on populist grounds.*

To avoid such a situation the *central bank must be very active from the perspective of communication policy, precisely and accurately inform the public regarding the premises which are the basis for its decisions and to explain the results.* Also, it must be concerned about *education of the public* so that its messages can be understood by the vast majority.

In essence, *the central bank actions are aimed at monetary stability, with important implications in achieving the objectives of price stability in the economy.*

The notion of monetary stability is used in particular for developing countries or those that have recently acquired national identity. In the Euro area, the ECB provides the notion

of price stability, giving it, as I mentioned, an explicit definition.

Many of the former communist countries that joined the European Union or are about to become member states have harmonized legislation and have abandoned the objective of monetary stability in favor of price stability, including the National Bank of Romania.

Often, there is a connection between central bank independence and monetary policy objective of price stability (Cukierman, 2002, p. 15), the argument being *the inversely proportional ratio between inflation and central bank independence proved in practice*, Bundesbank as one of these examples.

In a study undertaken in 1992, there have been examined the statutory objectives of central banks from 72 countries, classifying them depending on the degree of independence (Isărescu, 2001, p. 177).

According to this classification, *a bank is more independent as long as it has as the main (only) objective price stability and has full discretion in the use of specific instruments to achieve this desideratum, if necessary even against the wishes of the government.*

The data are included for the '80s, and then a series of central banks (from France, Mexico, New Zealand, Canada, Sweden, Great Britain) have revised statutes, climbing in ranking. Taking into account the statute of Bundesbank, it specifies that the mandate for price stability is more important than the obligation to support governmental economic policies. This makes Germany have the most independent central bank of the sample of 72 countries.

## The objectives of central banks, as resulting from their statutes for the '80s

Table 2

Objective's description	Value	No. of developed countries	No. of countries from sample	Total percentage
Price stability only (it can deny governmental wishes)	1	1 (Germany)	2	3
Price stability only	0.8	4 (Finland, Greece, Ireland, Holland)	6	8
Price stability and a compatible objective	0.5	4 (Austria, Denmark, Luxemburg, Spain)	17	23
Price stability and compatible objectives	0.4	4 (Australia, Iceland, New Zealand, USA)	22	31
Without objectives	0.2	4 (Canada, Italy, Great Britain, Sweden)	10	14
Other objectives than price stability	0.0	4 (Belgium, France, Japan, Norway)	15	21
TOTAL		21	72	100

Sources: Isărescu, Murgur (2001). *Reflecții economice – Piețe, bani, bănci*, Ed. Expert, București, p. 177.

Starting from the central bank statutes of 128 countries, we have achieved the following statistics regarding statutory objectives of central banks in question:

## The objectives of central banks, as resulting from their statutes in August 2007

Table 3

Objective's description	No. of developed countries	Weight from total (%)	No. of former communist countries	Weight from total (%)	No. of developing countries	Weight from total (%)	No. of countries from sample	Weight from total (%)
Price stability only	15	53.5	15	51.7	8	11.2	38	29.6
Price stability and one other objective	1	3.5	1	3.4	10	14.0	12	9.4
Price stability and other objectives	3	10.7	3	10.3	4	5.6	10	7.8
Monetary stability	5	17.8	8	27.5	44	62.0	57	44.5
Economic growth or "for the purpose of economic growth"	8	28.5	1	3.4	29	40.8	38	29.6
Full employment	3	10.7	0	0	1	1.4	4	3.1
Other objectives	3	10.7	1	3.4	2	2.8	7	5.4
No stated objective	1	3.5	1	3.4	1	1.4	3	2.3
TOTAL	28	-	29	-	71	-	128	-

Sources: Statistics conducted by consulting the statutes of central banks, using their web pages, accessed in August 2007.

From presented data, it can be concluded that the final objective of price stability has the highest weight. Thus, 46.8% of the countries surveyed have as stated final objective *price stability*, and countries with *monetary stability* as stated final objective take up 44.5%.

Among the countries that have adopted price stability as final objective of monetary policy, developing countries and former communist countries are those which have adopted the most this objective (some of them adopted more than one final objective) with a ratio of 67.7% and 65.4% respectively,



and price stability only, 53.5% and 51.7% respectively<sup>(2)</sup>.

Developing countries, instead, prefer monetary stability as the final objective, in a proportion of 62%, only 30.8% taking as final objective price stability, and price stability only 11.2%.

Three of the central banks surveyed - Georgia, the Philippines, Venezuela, have both goals of price and monetary stability.

These arguments strengthen the idea according to which there are fine distinctions regarding the objective of price and monetary stability, as discussed above.

In regard to the objective of *economic growth* or the existence of the expression: “*for the purpose of economic growth*” in formulating the objective, these are found in 29.6% of the stated objectives in the sample, Libya being considered the only country which has the single objective economic growth: the developed countries – 8 cases, the ex-communist – 1 case (Tajikistan), the most frequently being met in developing countries – 29 cases.

The objective of *full employment* is very little met, only 4 cases: 3 developed countries – Australia, UK, USA and a developing country – Malawi.

Among the 128 central banks surveyed, only 7 have objectives other than price stability, monetary stability, economic growth and full employment, and 3 central banks having no stated objective: Canada, Montenegro and Thailand.

---

## Notes

---

<sup>(1)</sup> The cost of over investing in the financial sector - cost occurred as a result of interaction between the system of taxation and inflation, producing distortion of the market with advantages that determine employment decisions in unproductive activities.

## Conclusion

*The clarity in the definition of statutory or final objective of monetary policy represents an indispensable element in the establishment and implementation of a strategy of monetary policy.* This also brings *extra credibility*, especially in moments in which the central bank wants to radically alter monetary policy strategy.

A good definition of the objectives of monetary policy (final, interim, operational) contributes decisively to the success of central bank’s activity. This argument is strengthened by the central banks of countries which have a reputation already well established.

Nevertheless, it is not enough for a central bank to clearly define its objectives; it must be also *motivated to reach them*. This is possible through both an adequate legislative support, and by a high-capacity communication and transparency of monetary authorities, the public being the most capable to punish its lack of efficiency.

A better communication with the public would make much more effective monetary policy measures taken through the expectation that they form depending on monetary policy makers’ commitments. In this respect we can meet an application of the Sörös reflexivity principle – a relationship of feed-back (Soros, 1999, p. 29).

<sup>(2)</sup> The weight calculations were made as a number of countries that have adopted the objective/objectives of the number of countries in the sample specified: developed countries, former communist countries, developing countries.

---

## References

---

- Blinder, A., „Interview with Alan Blinder”, *The Region, Review of The Federal Reserve Bank of Minneapolis*, december, 1994, <http://www.minneapolisfed.org/pubs/region/94-12/int9412.cfm>
- Castelnuovo, E., Nicoletti-Altimari, S., Rodriguez-Palenzuela, D., „Definition of Price Stability, Range and Point Inflation Targets: The Anchoring of Long-Term Inflation Expectations”, *ECB Working Paper* no. 273, september 2003
- Cukierman, Al., „Are Contemporary Central Banks Transparent about Economic Models and Objectives and What Difference Does It Make?”, *Federal Reserve of St. Louis Review*, 84(4), July/August, 2002
- Dănilă, N. (1999). *Euro. Bipolarizarea monetară*, Editura Economică, București
- Dornbusch, R., Fischer, St., „Moderate Inflation”, *World Bank Economic Review*, 7, January 1993
- Fischer, St., „The Role of Macroeconomic Factors in Growth”, *Journal of Monetary Economics* no 32, 1993
- Fischer, St., „Why Are Central Banks Pursuing Long – Run Price Stability”, In Symposium on Achieving Price Stability. *Proceedings of a conference held by the Federal Reserve Bank of Kansas City*, August, 1996
- Freedman, Ch., „What Operating Procedures Should Be Adopted to Maintain Price Stability? – Practical Issues”, *The Federal Reserve Bank of Kansas City Symposium Proceedings „Achieving Price Stability”*, August 1996
- Greenspan, A., Opening Remarks on the Federal Reserve Bank of Kansas City Symposium „Achieving Price Stability”, *The Federal Reserve Bank of Kansas City Symposium Proceedings*, August 1996
- Greenspan, A., „Transperancy in Monetary Policy”, *Federal Reserve of St. Louis Review*, 84(4), July/August 2002
- Isărescu, M. (2001). *Reflecții economice – Piețe, bani, bănci*, Editura Expert, București
- Isărescu, M., „Stabilitatea prețurilor și stabilitatea financiară”, Pitești, 8 decembrie 2006, [www.bnr.ro](http://www.bnr.ro)
- Issing, Otmar (2002). „Panel Speech to the ECP Wtachers Conference: Monetary policy and the role of the price stability definition”, Milan, june 2002, <http://www.ecb.int/press/key/date/2002/html/sp020610.en.html>
- Meltzer, Th.C., „To Conclude: Keep Inflation Low and, in Principle, Eliminate It”, *Federal Reserve Bank of St. Louis Quarterly Review*, November/December 1997
- Mishkin, F.S., Posen, A.S., „Inflation Targeting: Lessons from Four Countries”, *Economic Policy Review*, August 1997
- Papademos, L., „Price Stability, Financial Stability and Efficiency, and Monetary Policy”, at the third conference of the Monetary Stability Foundation on „Challenges to the financial system – ageing and low growth”, Frankfurt am Main, 7 July 2006, *BIS Review* no 64, [www.bis.org/review/r060714d.pdf](http://www.bis.org/review/r060714d.pdf)
- Soros, G. (1999). *Criza capitalismului global*, Editura Polirom, Iași
- Svensson, L., „How Should Monetary Policy Be Conducted in an Era of Price Stability?”, on the *Federal Reserve Bank of Kansas City Symposium Proceedings „New challenges for monetary policy”*, August 1999
- Volcker, P., „Can We Survive Prosperity?”, December 28, [http://fraser.stlouisfed.org/historicaldocs/830/download/28424/Volcker\\_19831228.pdf](http://fraser.stlouisfed.org/historicaldocs/830/download/28424/Volcker_19831228.pdf)