Strengthening Our Monetary Policy Framework

20th Annual Hyman P. Minsky Conference

April 14, 2011

New York, New York

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Federal Reserve Bank of Philadelphia

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The views expressed today are my own and not necessarily
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Introduction

I appreciate the invitation to participate in the 20th annual Hyman P. Minsky Conference on the State of the U.S. and World Economies. The purpose of this year's conference is to discuss the effects of the global financial crisis on the real economy and to examine some of the proposed policy responses that might prevent or mitigate the effects of such crises in the future. In that spirit, today I would like to recommend a way to strengthen our monetary policy framework. In particular, I want to propose that the Federal Reserve adopt an explicit numerical objective for inflation.

For the past three years, policymakers have been focused on near-term efforts to stabilize financial markets and the real economy in the face of the worst financial and economic crisis since the Great Depression. Today, there is ample evidence that our economy is on the mend and that a moderate but sustainable recovery is underway.

As the economic outlook improves, we have not only the opportunity but the duty to begin focusing on the longer run and to consider important monetary policy reforms that will lower the chances of experiencing such a severe crisis again. I believe adopting an explicit numerical inflation objective will enhance the ability of monetary policy to achieve the Federal Reserve's statutory mandates of price stability, moderate long-term interest rates, and maximum employment. As always, my remarks reflect my own views and do not necessarily represent the views of the Federal Reserve Board or my colleagues on the Federal Open Market Committee.

Recent events on the inflation front, I believe, are a useful place to start. In the last few months we have witnessed sharp increases in the prices of energy, food, and other commodities, and some are concerned that this will result in higher than desired overall price inflation. This is a remarkable turn of events. Less than a year ago the prevailing concern was not that inflation was becoming too high but that it was becoming too low. Indeed, some feared that the U.S. economy was on the verge of a deflationary spiral. I was not one of them; nor do I believe that we are in imminent danger of a strong acceleration in inflation. Yet the swing in views does concern me. It suggests that the public's confidence in the Federal Reserve's commitment to maintain price stability is not as firmly established as I would like. This is problematic for monetary policymakers, since this confidence is essential for a central bank's ability to actually deliver on the goal of price stability for the economy.

One need only remember the period of the Great Inflation, from the late 1960s to the early 1980s, to understand the importance of credibility, commitment, and expectations for economic performance. The Great Inflation occurred after a decade of very low and stable inflation, a period that seemed to firmly establish the Fed's reputation for maintaining price stability. Like today, many thought that the Fed's reputation was secure. Yet it didn't take long for accommodative monetary policy and gradually rising inflation to erode this reputation. Once that public confidence was lost, increases in the prices of oil and other commodities in the early 1970s were quickly incorporated into expectations of higher inflation and then transmitted to the prices of other goods and services, including wages. Attempts to quell the inflation with monetary policy were timid, and rising unemployment made policymakers reluctant to undertake the necessary actions. The result was an unprecedented surge in inflation that did not end until the Fed, under Chairman Paul Volcker, took aggressive steps to re-establish the Fed's reputation and commitment to low inflation. This came, though, at the cost of the recession of 1981-82, which took its toll on both individuals and businesses.

Over the past two decades, central banks around the world have grappled with ways to deliver on their price stability mandates and incorporate the lessons of the 1970s into a monetary policy framework. There is now broad agreement among monetary economists and policymakers that having a clear numerical objective for inflation – often referred to as an inflation target – can help a central bank maintain low and stable inflation by anchoring inflation expectations, enhancing policy transparency, and increasing central bank accountability for its actions. Countries that have adopted such a target have tended to have lower and more stable inflation, better-anchored inflation expectations, and real activity that is at least as stable as it was before adoption.[*] And now more than 20 central banks, including the Reserve Bank of Australia, the Bank of Canada, the Bank of England, the European Central Bank, and the Reserve Bank of New Zealand, have adopted an explicit inflation target. A glaring exception to this worldwide trend is the U.S. Federal Reserve.

As monetary policymakers begin to contemplate strategies for exiting this episode of extraordinary accommodation, I believe now is an opportune time for the Federal Reserve to move its monetary policy framework into the 21st century. We should adopt an explicit numerical inflation objective, communicate it to the public, and accept the responsibility for the outcomes relative to that objective. Let me talk about how such an objective would fit into the policy framework in the United States.

[*] See Truman (2003), Dotsey (2006), and Walsh (2009).

The Benefits of Price Stability

Congress has directed the Federal Reserve to conduct monetary policy "so as to promote effectively the goals of maximum employment, stable prices, and moderate long term interest rates." These long-run objectives complement one another. In fact, most monetary economists, myself included, agree that focusing on price stability is the most effective way for monetary policy to achieve its two other goals. Thus, price stability is at the core of any sound monetary policy framework.

Price stability plays a critical role in the health of the economy in at least four ways. First, it allows the economy to function in a more efficient and, therefore, more productive fashion. If prices are stable, then individuals and businesses can be confident that the purchasing power of their money will not erode. They will not have to divert their energies from productive activities in order to hedge against the risks of inflation or deflation and that allows them to make better long-run financial plans.

Second, price stability also supports the efficient functioning of product markets. In a market economy, changes in prices send signals about the relative supply of and demand for goods and services. These signals allow individuals and businesses to make informed decisions about where to allocate scarce resources. Inflation distorts those signals and makes it more difficult to determine if a price change reflects a true change in supply or demand or is simply a symptom of inflation. We see this today in the ongoing debate about the degree to which the sharp rise in oil prices is a relative price shock, simply reflecting global supply and demand conditions, or an early indicator of a general rise in inflation. This uncertainty can delay firms and households from making the appropriate reallocations of consumption and investment to alternative sources of energy or other adjustments that may be called for in response to such a relative supply shock.

Third, price stability allows tax laws, accounting rules, and contracts to be stated in dollar terms without concerns about changes in the value or purchasing power of the dollar. For example, tax rates are often based on dollar amounts or dollar thresholds that are not indexed by inflation. This means inflation can force individuals into higher tax brackets even though their real incomes are not rising. This has been particularly evident in recent years with the alternative minimum tax, or AMT. Because of the steady upward drift of the price level, Congress has had to increase the exemption level several times over the years in order to avoid subjecting more and more individuals to this additional tax that was once intended to affect only the very wealthy.

Fourth, price stability avoids the unexpected wealth transfers between lenders and borrowers that occur when there are unexpected changes in inflation. The S&L crisis of the 1980s was precipitated in part by the unanticipated inflation in the late 1970s. The S&Ls had made long-term loans in a low inflation environment, and then saw the value of these loans plunge and net income turn negative as inflation rose in the late 1970s and debtors repaid their loans in substantially devalued dollars. By minimizing these sorts of effects, price stability helps promote financial stability.

But price stability is more than just an end unto itself. Economists have come to understand that price stability also promotes the other two goals of the Federal Reserve's mandate. First, price stability works to promote moderate long-term interest rates. Long-term interest rates include compensation to make up for the loss of the purchasing power of money that inflation causes. They also include an additional risk premium to compensate the holders of long-term assets for uncertainty about future inflation. For these reasons, when inflation is high, long-term rates tend to be high. Thus, price stability is an effective means to achieve moderate long-term interest rates. Indeed, over the medium term, it is the only way in which monetary policy can achieve such an objective.

Price stability also promotes maximum employment in the medium to longer term. However, it is important to recognize that monetary policy's relationship to the employment part of the Fed's mandate is different from its relationship to inflation. While monetary policy determines the inflation rate over the medium to long run, it cannot achieve a long-run employment objective that is inconsistent with economic fundamentals. Maximum employment will vary over time due to changes in demographics, productivity and technology, labor laws and practices, taxes, and many other factors that are not influenced by monetary policy. So while inflation over the medium term is both observable and controllable through monetary policy, maximum employment is neither observable nor directly controllable with monetary policy.

Still, price stability can improve the prospects for growth and employment. When the public knows that the central bank is committed to low and stable inflation, inflation expectations will remain well anchored. This increases the central bank's ability to respond optimally to economic disturbances that affect real activity in the near term. If a negative shock implies that the short-term policy rate should fall, then with stable inflation, long rates will fall as well, making the impact of the policy change more effective. If the central bank lacks the commitment or credibility to keep inflation low and stable, lowering the policy rate could quickly lead to increases in expectations of inflation that can either completely or partially negate the effectiveness of the policy change. This is a large part of the reason why both unemployment and inflation rose together in the 1970s.

Economic instability often goes hand in hand with price instability. The Great Depression and the Great Inflation were periods of both economic instability and price instability. In contrast, the period between the end of the Korean War and the mid 1960s, and the period from the late 1980s through the end of the century, known as the Great Moderation, were characterized by low inflation and a growing economy.

I believe that price stability is an important goal for monetary policy in the United States and the most effective means for promoting the two other parts of our statutory mandate. In a modern world of fiat currencies, <u>only</u> the central bank can deliver on price stability. Thus, it behooves us as monetary policymakers to contemplate changes to our policy framework to improve our ability to meet that goal. I believe setting a numerical inflation objective is one important way to do that.

The Benefits of an Inflation Target

It is no secret that I have long advocated that the Fed make explicit its commitment to a numerical inflation objective. It is consistent with the view of central bankers and monetary economists around the world and widely viewed as a best practice of central banking. I see at least three interrelated advantages to being explicit and public about the goal.

First, it would increase transparency by clarifying what the Fed means by price stability. By reducing uncertainty, an inflation target would better align the public's view of monetary policy with the central bank's objectives. This would make policy more effective in promoting our long-term goals of price stability, maximum employment, and moderate long-term interest rates.

Second, the willingness of the central bank to publicly announce a numerical inflation goal it expects to achieve would help make explicit the Fed's commitment to price stability, thereby making that commitment more credible in the minds of the public and market participants. This would help anchor inflation expectations. Since, as I have discussed, expectations of inflation influence actual inflation, anchored inflation expectations would benefit the economy by helping to keep inflation stable.

Third, an explicit numerical target will increase the Fed's accountability and improve communication by making it easier for the public to monitor the Fed's monetary policy performance relative to its mandate. If the Fed failed to achieve its objective, a numerical target would require the central bank to communicate why it deviated and, more important, how it planned to return inflation to its objective. In a democracy, central banks owe the public this transparency and accountability. In addition, an explicit target would make it harder for the Fed to use its discretion to deviate from a stable inflation policy. This, in turn, will increase the credibility of the Fed's commitment to establish and maintain price stability, which will help anchor inflation expectations and produce better economic outcomes.

Now Is the Time for the Fed to Adopt an Inflation Target

These advantages persuade me that the Fed should adopt an explicit numerical inflation objective. Moreover, in my view, now is an opportune time to do so. The apparent strengthening of the U.S. economy suggests that, in the not-too-distant future, monetary policy will have to begin reversing course from a very accommodative policy stance. As we choreograph that exit, I believe that the Fed should do all it can to underscore its commitment to maintaining price stability.

During the recent crisis, many feared that the economy would enter into a sustained deflationary environment. We had a similar deflationary scare in 2003. Yet, over the course of both episodes, inflation expectations remained relatively stable, a circumstance that helped us avoid this potentially dire situation. Now we are experiencing sharp increases in oil and other commodity prices. While such price increases are typically associated with changes in relative supply and demand, we must not be too sanguine that high unemployment and output gaps will guarantee that these relative price shocks won't pass through to higher general inflation rates, particularly in an environment where monetary policy is very accommodative. By declaring an inflation objective, the Fed can underscore its commitment to keep inflation low and stable and protect against a loss of credibility, which, in turn will keep inflation expectations anchored despite volatile commodity prices.

Some people may argue that there is no need to articulate a numerical inflation objective because the Fed has established a strong record of maintaining low and stable inflation over the last two decades. But this is not an argument against an explicit target. It is an argument against commitment. As such, it is an argument that runs counter to the lessons of the 1970s and the theoretical and empirical research of the past two decades.

Another argument often heard against establishing an explicit inflation objective is that it downgrades the maximum employment goal within the Fed's mandate. Adopting an inflation objective does not mean controlling inflation at the expense of economic stability. On the contrary, it is arguably one of the best means by which the Fed can set policy that most effectively promotes all parts of its mandate.

At the same time, adopting a numerical objective for inflation does not imply that we should adopt a numerical target for maximum employment. Because monetary policy cannot influence the long-term maximum level of employment or how that maximum rate evolves over time, it doesn't make sense to set a numerical target for employment. Indeed, attempting to chase such a target with monetary policy would likely result in more instability in both inflation and the real economy, not less.

Conclusion

Although the Fed has been mostly successful over the past two decades at maintaining low and stable inflation, adopting an explicit numerical inflation objective would help ensure that this success continues. I believe having such an objective in place would prove particularly useful when we begin to unwind the extraordinary accommodation measures that we took to mitigate the crisis.

Inflation targets are employed by most of the major central banks around the world and are considered a best practice of central banking. Adopting an explicit numerical inflation goal is an important and natural next step in strengthening the Fed's monetary policy framework so that we are better able to deliver on our statutory mandate of long-run price stability, moderate long-term interest rates, and maximum employment.

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