In Support of Price Stability

Statement by
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EDITOR'S NOTE: *Rep. Stephen Neal of North Carolina has introduced House Joint Resolution 409, directing the Federal Reserve to reduce inflation to zero within five years and maintain price stability thereafter. On February 6, Mr. Black and three other Federal Reserve Bank presidents testified in support of the Resolution before the Subcommittee on Domestic Monetary Policy of the U.S. House of Representatives Committee on Banking, Finance, and Urban Affairs. Following is Mr. Black's testimony.*

Mr. Chairman, I am delighted to be here today to testify in favor of H.J. Resolution 409, which would instruct the Federal Reserve to achieve price stability within five years. I believe passage of the Resolution by Congress would significantly improve the overall framework in which monetary policy is conducted and increase our chances of achieving price stability and steady economic growth in the years ahead.

I have been associated with the Federal Reserve Bank of Richmond for over thirty-five years and have attended at least some of the meetings of the Federal Open Market Committee for about thirty of those years. For seventeen years, I have been the Richmond Bank's official representative at those meetings. My work with the Committee has convinced me that price stability should be the primary long-run objective for monetary policy and that the Federal Reserve can make its greatest contribution to the economic health of our country through pursuit of that objective.

The Case for Making Price Stability the Overriding Objective of Monetary Policy

The case for making price stability the primary objective of monetary policy is a compelling one, Mr. Chairman. First, inflation imposes pervasive costs on our society, especially if it is not anticipated. Inflation distorts the signals that prices send in our market economy, which leads to serious inefficiencies in the allocation of resources. These distortions and inefficiencies reduce the long-run rate of growth of the economy below its full potential. In a similar way, inflation disrupts the functioning of our financial markets and on balance discourages saving and investment. Moreover, its volatility increases the risk associated with particular business decisions. Finally, inflation redistributes income and wealth in arbitrary ways, which creates dissatisfaction within the social and economic groups whose incomes and wealth are adversely affected.

Although many of these costs are hard to measure, there is good reason to believe that they are significant in the aggregate. First, there is a negative correlation between inflation and long-term economic growth across different countries. Second, our citizens have repeatedly made it clear that they strongly dislike inflation. Finally, persistently high rates of inflation in peacetime in the U.S. have frequently been associated with relatively low rates of real economic growth.

Inflation is still a major problem today, despite the belief in some quarters that it has been conquered. It disturbs me to hear people talk as if inflation were dead when we have been experiencing an underlying inflation rate in the neighborhood of 4 to 4½ percent. The current rate is clearly an improvement over the very high rates prevailing in the late 1970s and early 1980s, but it is not a particularly low rate when judged by longer-run historical standards. As you may know, the consumer price index rose at an average annual rate of 1.5 percent between the end of the Korean War and 1965. What is now considered by some to be moderate inflation was regarded as an intolerable condition only a few years ago. President Nixon imposed a comprehensive price and wage control program on the economy in August 1971 when the rate of inflation was even lower than the rates of recent years.

Moreover—and I believe this is one of the critical issues addressed by the Resolution—inflation may well reaccelerate in the absence of a clear signal to

the public that Congress fully supports the Federal Reserve's commitment to reduce it further. As we all know, the System is under constant pressure to "do something" with monetary policy in the short run to improve the economy's performance or deal with some other current problem. In the past such pressures have, at times, led the System to take actions that have eventually contributed to an acceleration of inflation. There is obviously a risk that history will repeat itself unless an effort is made to reduce these pressures.

I say this even though I believe the present members of the Federal Open Market Committee as a group are especially strongly committed to fighting inflation and the public still has vivid memories of the rampant inflation of the late 1970s and early 1980s. The composition of the Federal Open Market Committee will change, and the memories of double-digit inflation will gradually fade, but the pressures on the Federal Reserve to make its monetary policy decisions on the basis of short-run considerations without adequate regard for the long-run inflationary consequences of these decisions will surely persist in the years ahead.

One problem the Federal Reserve faces in conducting monetary policy currently, in my view, is that our mandate is too broad. A clear and attainable objective is a necessary condition for the success of any policy strategy. Unfortunately, current law does not provide the Federal Reserve with such an objective. Instead, our current mandate instructs us to consider a wide range of economic conditions in carrying out monetary policy. Specifically, Section 2A of the Federal Reserve Act requires the System to take account of ". . . past and prospective developments in employment, unemployment, production, investment, real income, productivity, international trade and payments, and prices. . . ." in setting its annual objectives for the growth of the monetary and credit aggregates.

A mandate that instructs the Federal Reserve to consider such a broad range of economic conditions may not be the strongest foundation for an effective strategy for monetary policy. Faced with the requirement to take account of all these conditions, policy choices necessarily are made in a discretionary manner which gives substantial weight to current economic and financial conditions and prospects for the near-term future. This approach to policy fosters the notion that the Fed can fine-tune the economy even though both actual experience and much of the most important recent research in macroeconomics argue persuasively to the contrary. It also encourages special interest groups to try to pressure the System to pursue the particular goals they consider important. These circumstances tend to impart an inflationary bias to monetary policy.

The Resolution would help us overcome these problems by specifying clearly a single, feasible objective for monetary policy and instructing the Federal Reserve to achieve that objective. Price stability is obviously an appropriate objective for any central bank. Further, it is a feasible objective since there is no question that the System can achieve price stability over the long run by controlling the rate of growth of the monetary aggregates.

Moreover, I believe price stability is really the only feasible objective for monetary policy. Some might argue that increasing long-run economic growth or fine-tuning economic activity in the short run are alternative objectives. Most economists now agree, however, that the long-run rate of real economic growth is determined by nonmonetary factors such as population growth, increases in productivity, and the rate of saving and investment. Accordingly, most conclude that expansionary monetary policies can raise the growth rate only temporarily, if at all. There is also a growing consensus that the System could make its greatest contribution to long-run economic growth by fostering price stability so that economic decisions could be made on the basis of reliable information on both current and future prices.

There also is very little evidence that the Federal Reserve can use monetary policy to fine-tune the economy in the short run. Monetary policy affects the economy with both long and variable lags. These lags, in conjunction with the inability of economists to forecast future economic conditions with much confidence, make it very difficult for the System to determine what policy actions it should take today to produce a particular result at some point in the near-term future. Moreover, as I indicated earlier, focusing too narrowly on relatively short-run economic conditions tends to give monetary policy an inflationary bias. This is not to say that the Federal Reserve should ignore extraordinary events such as the stock market crash in October 1987. But, as I believe we demonstrated in late 1987, the System can react to such shocks to the economy without weakening its long-run commitment to price stability.

One might argue, of course, that price stability has always been one of the System's primary objectives

and therefore that the Resolution is not needed since it simply instructs the Federal Reserve to seek an objective it is already pursuing. I strongly disagree with this view. Despite our best intentions, prices have not yet stabilized, as evidenced by the fourfold increase in the price level since 1964. Moreover, surveys of expected inflation consistently indicate that the public does not expect the Federal Reserve to make much further progress in reducing inflation in the future, let alone achieve price stability. Confidence in the System's commitment to price stability suffers because its policy decisions are necessarily influenced by numerous other considerations. Passage of the Resolution would send an unambiguous signal to the public and the financial markets that price stability is the overriding goal of the Federal Reserve. The credibility of the System's efforts to reduce inflation would therefore rise. This increased credibility would, in turn, lower the public's expectations of future inflation because these expectations would be less influenced by the relatively high inflation rates in the recent past. Further, lower expected inflation would tend to reduce the costs of achieving price stability in terms of any temporary loss of output and employment. This reduction would occur in part because producers, when faced with monetary restraint, would be more inclined to reduce prices, or raise them at a slower pace, and less likely to reduce output and employment. Similarly, workers would be more inclined to restrain their wage demands. It is worth emphasizing that a truly clear and unambiguous Congressional mandate to eliminate inflation would play a vital role in this process.

Responses to Some Likely Arguments Against the Resolution

The major arguments that will be made against the Resolution are fairly predictable, and I would like to say a few words about them. One argument obviously concerns the potential transitional cost of implementing the Resolution. Specifically, some will argue that trying to eliminate inflation altogether would risk a recession. It is impossible to predict the future, so we cannot dismiss this argument out of hand. In evaluating the argument, however, we should not simply extrapolate from our experience in dealing with past inflationary episodes such as the ones in 1973-74 and 1979-81. In those periods, the System acted forcefully in a crisis atmosphere to reduce the rate of inflation over a short period of time and economic activity contracted sharply. In contrast, Resolution 409 would require a gradual reduction in inflation over a relatively long period of time following an extended period in which substantial progress has already been made. As I indicated earlier, there is good reason to believe that passage of the Resolution would enable us to achieve such a reduction in inflation with relatively small costs to the economy. Moreover, it is very important to weigh any short-run costs of achieving price stability as provided by the Resolution against the longer-run costs of not achieving it. These latter costs could be particularly great if, at some future time, the Federal Reserve were forced to follow policies resulting in a recession in order to rein in an accelerating rate of inflation.

A second possible argument against the Resolution is that it would prevent the Federal Reserve from reacting appropriately to unanticipated "shocks" to the economy, such as the stock market crash in October 1987. As I suggested a moment ago, however, there is simply no reason why shocks that may affect the System's actions in the short-run should prevent us from achieving price stability over a period as long as five years. This would be especially true if the policy had credibility in the eyes of the general public and financial market participants, as I believe it would if the Resolution were enacted. In evaluating this argument, it is also important to distinguish between temporary adjustments in our policy instruments or intermediate targets and changes in our ultimate policy objectives. Adjustments in our policy instruments or intermediate targets do not require us to alter our long-run objectives. Following the stock market crash in 1987, for example, the System temporarily supplied additional reserves to meet the greater demand for liquidity induced by the crash, but this action did not change our longer-run policy goals.

Implementation of the Resolution

A final question regarding the Resolution concerns how it would be implemented. I realize the Resolution leaves this matter to the Federal Reserve. Nevertheless, in evaluating the Resolution I think it is important to appreciate that from a technical standpoint the System is quite capable of achieving price stability over a five-year period and that pursuing this objective would require at most minor changes in our current procedures. Recent research both at the Board of Governors and at the Richmond Reserve Bank has provided strong evidence that the public's total demand for balances included in the monetary aggregate M2 has remained stable since the early 1950s, despite the substantial amount of financial

innovation in recent years. This innovation has affected the behavior of the *components* of M2, but it has had little effect on the behavior of *total* M2. Consequently, the velocity of M2, which is simply current-dollar GNP divided by M2, has not exhibited any trend either upward or downward in this period. This constancy in the velocity of M2 over time implies that the System could bring the trend rate of inflation to zero within a five-year period by gradually lowering the trend rate of growth of M2 to the longer-run potential rate of growth of real GNP.

It is worth noting that implementing the Resolution would not require any major change in the Federal Reserve's operating procedures, since we already set annual targets for M2 and announce them to Congress. Under the Resolution we would simply have to reduce these targets gradually and persistently until they declined to the trend rate of growth of real GNP, which is probably somewhere in the neighborhood of 2½ to 3 percent a year.

One fairly straightforward change in our procedures that I would favor would be to establish multi-year targets for M2 rather than the one-year targets we currently set. Under the current procedure, growth in M2 above or below the target for a given year is effectively forgiven at the end of the year. Thus, the base for the next year's target is the *actual* level of M2 at the end of the current year rather than the targeted level. As a result of this "base drift" in M2, the price level can drift up or down over time even though the individual annual M2 targets may be consistent with a zero rate of inflation. Consequently, I believe the likelihood of achieving true long-run price stability would be increased if we eliminated base drift by setting a multi-year path for M2.

This last point raises a corresponding point regarding how, in practice, the System would pursue the price stability objective mandated by the Resolution. One approach would be to seek to hold the price level at a particular permanent level on average over the long run. A second approach would be to try to maintain the price level at its current level at any point in time irrespective of any past movements in the level. Under the first approach, the System would act to bring prices back to their permanent target level if they moved away from that level in response, for example, to an unanticipated change in M2 velocity. Under the second approach, the System would not attempt to offset the one-time effects of such shocks on the price level, but would simply try to hold the price level at its then current level. We prefer the first approach, although we recognize that it might take considerable time to reattain the permanent objective in some instances in order to avoid significant transitory disruptions to real economic activity. Under the second approach, the price level would almost certainly change permanently from time to time, and it is not unreasonable to expect that political and other pressures would tend to bias these movements upward.

Conclusion

In conclusion, Mr. Chairman, I strongly support Resolution 409 and its objective of achieving price stability in five years. The costs of the persistent inflation in this country are substantial. Without a significant change in the framework in which monetary policy decisions are made, inflation is likely to continue to be a serious problem in the years ahead, and it is entirely possible that the rate of inflation could reaccelerate. Resolution 409 goes to the heart of the policy problem, which stems to a large extent from the Federal Reserve's overly broad current mandate. Price stability can and should be the overriding objective of monetary policy. Achieving and maintaining price stability is the best contribution monetary policy can make to the successful performance of the economy over the long run.