

PRESIDENT'S MESSAGE

Banking on Credibility



This issue of *Region Focus* comes at a time when inflation is on many people's minds. The prices of some commodities have been shattering records, putting pressure on companies that use those products to increase what they charge their customers. Consumer prices, excluding food and energy, rose at an annual rate of 3.1 percent in the first five months of 2006, compared with

2.2 percent for all of the previous year. During such periods, attention turns to the Fed to see what policy steps it will take. And with the spotlight so intense, the Fed understands that maintaining its credibility is of the utmost importance.

A central bank's monetary policy is considered credible if the public perceives that it is committed to keeping inflation low and stable. Without credibility, it would be difficult for the central bank to anchor the public's expectations of future inflation, which complicates monetary policymaking. A central bank ultimately would like its policy to affect the real interest rate through changes in the nominal target rate, the difference between the two being expectations of future inflation. But if inflation expectations are volatile, it will be harder to pin down what the policy rate should be.

Inflation expectations tend to be self-fulfilling in the sense that the anticipation of much higher prices in the future puts upward pressure on current prices. If a central bank's record in fighting off higher prices is weak, shocks that hit the economy can easily unhinge inflation expectations and push the inflation rate upward. By contrast, if a central bank's credibility is well-established, people are less jittery about every piece of news that can affect future inflation, making it easier for the central bank to pursue price stability.

The notion that credibility is critical to monetary policy follows from the recognition that people are rational when forming their expectations. They understand a central bank's preferences for low, stable inflation and will use this knowledge to predict future monetary policy moves. Because the Fed failed to adequately take forward-looking expectations into account during the "go-stop" monetary policy of the 1960s and 1970s, its attempts to exploit the perceived trade-off between output and employment were futile.

Each time the Fed stimulated the economy in the go phase of the policy cycle, it would wait too long before tightening policy in the stop phase. By this time, higher inflation expectations had already crept into the public's pricing decisions. After several go-stop cycles, inflation rose

to its highest level in three decades. Attempts by the Fed to "fine-tune" the economy had failed.

This inflationary phase ended when the Fed, under the guidance of Paul Volcker, tightened policy until inflation was brought under control and inflationary expectations were anchored at low levels. In October 1979, Volcker introduced a dramatic policy shift that eventually resulted in the fed funds rate rising to nearly 20 percent. This aggressive tightening came at the cost of a sharp recession in early 1980 and another that began in mid-1981 and lasted until well into 1982. But the Fed understood that its credibility was at stake. In order to return the economy to more stable times, the Fed needed to send a strong and unwavering signal of its commitment to fight inflation.

In the ensuing years, the Volcker Fed remained watchful in preserving its hard-won credibility, recognizing that it can easily be lost. Former Richmond Fed economist Marvin Goodfriend has observed that although inflation was only about 4 percent in 1983 to 1984, the long bond rate, an indicator of inflation expectations, was trading significantly higher. Knowing that it should not take such signals for granted, the Fed pre-empted this threat by raising the fed funds rate to about 11 percent. Since that time, there have been several "inflation scares" in which rising bond yields warned of potentially higher inflation. But each time, under Volcker and his successor Alan Greenspan, the Fed responded to pre-empt the threat.

The success of the Volcker and Greenspan Feds at keeping inflation expectations in check paved the way for the "Great Moderation," a long and sustained period of output and inflation stability. As a result, it is widely acknowledged that maintaining price stability is the best contribution a central bank can make to ensuring sustained growth in incomes and employment. But even after 25 years of relatively sound policy, the Fed understands that in a low inflation environment, as much as in a high one, it must remain vigilant.

Signs of rising inflation have surfaced this year. How serious those signs are remains unclear — productivity growth is strong and the cost of labor relative to output has barely moved since a year ago. Even so, preserving its credibility requires reacting appropriately to keep inflation low and stable. The Fed has spent much effort establishing a reputation for making price stability its primary objective. That has been a long and hard-fought battle, one that we must continue to wage.

A handwritten signature in black ink, appearing to read "Jeffrey M. Lacker". The signature is stylized and cursive.

JEFFREY M. LACKER
PRESIDENT
FEDERAL RESERVE BANK OF RICHMOND