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"Stable Prices: A Recipe For Growth"

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Last summer, a major paper in our region ran an editorial urging the Fed to stop worrying about inflation and to "go for growth." The editorial argued that—at an annual rate of approximately 3 percent—inflation is simply too low to be a significant concern. The Fed should cut interest rates immediately to encourage the economy to grow more rapidly, the writer urged.

We often hear such arguments—that the Fed is worried about the economy "overheating," or growing "too fast." Let me begin by saying for the record that the Fed is *not* against economic growth or low interest rates. It is my view—and I know it is the view of other Fed officials—that monetary policy should seek to promote the *maximum sustainable rate* of economic growth. My message today will focus on the fallacy that monetary policy must shift its focus away from controlling inflation in order to promote economic growth. Nothing could be further from the truth. In fact, I will argue that when the central bank protects the value of our nation's money, it is, indeed, pursuing a pro-growth policy.

What Determines Growth?

Let me begin by identifying the sources of economic growth. Economic growth has just two determinants: resources and productivity. Put more resources to work, or work a given stock of resources more productively, and output rises.

Because government policy can affect resource supplies and productivity, it can affect the growth of national output. For example, government policies that restrict the mining of coal or other minerals reduce the stock of resources available for production. Likewise, emission regulations can, in some cases, make power plants less productive.

Obviously there may be good reasons to have such policies, but they can affect economic growth.

What about monetary policy? Monetary policy comes into play through the working of markets. Economic growth involves the allocation of resources to productive outlets—coal and iron ore to steel plants, labor to automobile factories, lumber and other materials to construction of homes and businesses—and this allocation of resources takes place in markets. Without a medium of exchange—in other words, money—markets would virtually cease to operate. Money allows markets to allocate economic resources over space and time.

In a market economy, exchange value is expressed in terms of prices—which, in turn, are determined by the forces of supply and demand. For example, gasoline prices usually rise around Memorial Day because that date marks the start of the summer driving season, when the public demands more gasoline from suppliers. Recognizing the increased demand, suppliers tend to refine more gasoline—increasing supply—and prices may fall back, as they did last summer. Suppliers shift resources to respond to changes in relative prices, and productive allocation of resources requires clear signals from the price system.

That's where monetary policy fits in. Good monetary policy enhances the clarity of price signals. Bad monetary policy muddies the waters. A monetary policy that causes sharp fluctuations in the value of the dollar will make resource allocation more difficult and drag down economic performance. Let's look at one example: In the late 1970s the prices of many agricultural commodities were rising sharply. Farmers were uncertain, however, about whether these increases were caused by rising demand for

their output, or simply reflected the rapid inflation we were experiencing at the time. Farmers thus didn't know whether to increase production or leave it unchanged. Many farmers chose to expand by borrowing heavily to invest in new farm land, betting that the demand for farm output would continue to rise. As we know, farm prices did *not* continue to rise—the prices of commodities and farm land fell, both absolutely and relative to other prices—forcing many farmers into bankruptcy. The problem is this: inflation—even just the *possibility* of inflation—creates uncertainty about the true meaning of changes in the prices of individual goods and services. This uncertainty can lead to the misallocation of resources which, ultimately, can reduce economic growth.

Throughout the economy, farmers, home builders, retailers, even bankers must interpret market prices every day. If the public can be confident that the average price level will remain stable, they can be more certain that individual price changes reflect true shifts in demand. Obviously, then, a monetary policy that maintains stability of the price level can help markets work efficiently. This, in turn, promotes the full and productive employment of resources. In other words, a monetary policy that prevents inflation from being a factor in the decision making of businesses and consumers is a monetary policy that best promotes economic growth.

Why is the Role of Monetary Policy Confused?

If maintaining a stable price level promotes economic growth, why do we sometimes hear that monetary policy is "too tight"—that it is holding down real growth even though we have a positive rate of inflation? I believe the answer is that we sometimes expect more from monetary policy than it can deliver. We tend to confuse short-term fluctuations in output with long-term growth. This confusion comes about

because monetary policy affects aggregate spending, and, under the right conditions, a boost in spending can increase output. If there is substantial slack in the economy—if resources are under-employed—then increased spending can raise the level of output. However, both the level and the growth rate of output are limited by the supply of resources and the level of productivity. If resources are fully employed, then output cannot increase without a corresponding increase in productivity. At full employment, increased spending will generate higher prices but no increase in output.

Consider a simple example. Suppose a retailer suddenly experiences more traffic in her store—more customers are buying whatever she has to sell. The retailer may call her supplier and request an increased shipment of goods. If the supplier has been operating at substantially less than capacity, he may be glad for the extra business and willingly supply the additional goods at the usual price. Thus, increased demand stimulates increased output. If, on the other hand, he is already operating close to capacity, the supplier may demand a higher price from the retailer, or he may simply refuse to ship any more goods. The retailer, in turn, may determine that her best course of action is to raise her own prices, and expect to sell about the same quantity as before. In this case, increased demand leads to higher prices.

If we extend this example to the economy as a whole, we can readily see that, under some circumstances, increased demand can generate increased output and sales, with little change in prices. Under other conditions, however, increased demand causes inflation, with little or no boost in output.

What does all of this imply about the conduct of monetary policy? Because monetary policy has the potential to boost output in the short run, some may be tempted

to push for faster and faster growth by stepping on the monetary accelerator. Output may indeed go up for a time, but eventually inflation will be the only outcome of this experiment. Because economic growth is limited by the supply of real resources and the level of productivity, printing money simply can't boost the rate at which the economy can grow on a sustained basis.

I'm afraid the Fed—and many other central banks around the world—got into this trap in the 1960s and 1970s. Beginning in the early '60s, the Fed sought to encourage a higher level of economic activity by keeping interest rates artificially low. For a time, output rose, while inflation stayed low. The money supply, however, began to grow at an accelerating rate, and by 1965 inflation had begun to rise. In response, the Fed tapped on the brakes, causing the money supply growth rate to drop sharply and the inflation rate to dip. But, tight money also reduced the flow of credit to the housing market, so the Fed released the brakes and pushed down on the accelerator once more. As a result, the money supply expanded sharply, and inflation accelerated.

This stop-and-go cycle was repeated once again toward the end of the '60s and became a well-entrenched pattern in the '70s. The economy lurched from recession to recession, and each recession was followed by an expansion with a higher rate of inflation than the previous one. For the 1970s as a whole, average inflation was significantly higher than in any previous decade this century, except for the periods surrounding the two world wars. Meanwhile, the average growth of real output was lower in the '70s than in either the 1950s or 1960s, when inflation was much lower. The evidence thus suggests that the Fed's efforts to stimulate real growth in the 1960s and

'70s did nothing but raise the rate of inflation. Simply put, printing money does *not* increase the rate at which real economic output can grow.

An Uncertain Monetary Policy Is Costly

Our experience with stop-and-go monetary policy in the 1960s and 1970s was costly, both because it produced an inflation rate that was high and highly variable, and because it created uncertainty about the direction of policy going forward. Uncertainty about monetary policy clearly increases the volatility of financial markets: witness the gyrations in the stock and bond markets last July when guesses about near-term monetary policy moves abruptly changed after the announcement of a new employment number. I don't know how much of this instability could have been avoided if the Fed had a clear policy focus. Perhaps none of it. But, I am convinced that uncertainty about the Fed's monetary policy goals and methods produces greater volatility in markets than would otherwise occur.

Uncertainty about monetary policy also leads to increased use of resources to forecast policy, or to hedge against its effects. Some of the increased activity in options and futures markets over the last 20 years, for example, can be attributed to people's desire to hedge against unexpected monetary policy and inflation. Finally, as I have already stressed, an unfocused or uncertain monetary policy causes uncertainty about the nature of price changes in all markets, and such confusion interferes with the efficient operation of markets. If we make monetary policy transparent, our market economy can operate more efficiently.

Let me finally turn to how we might work to minimize the uncertainty about monetary policy. I'll focus on two key factors: The mandate we set for monetary policy, and the independence we give the Fed to carry out that mandate.

A Policy Mandate

Currently, legislation requires the Fed to pursue full employment and maximum real growth, as well as a stable price level. We tend to think that the Fed can raise the level of employment or economic growth by lowering interest rates. However, such a policy is also thought to increase the rate of inflation. This way of approaching policy sets up an apparent trade-off between faster growth and lower inflation. As a consequence, we're never quite sure which goal the Fed is going to pay more attention to—promoting faster growth or holding down the rate of inflation. People who tend to think the Fed is overly concerned with inflation believe that the Fed is not doing enough to boost the levels of employment and output. In any event, there's always uncertainty about which goal the Fed will pursue at any given moment.

We could eliminate a lot of this uncertainty if the Fed were given a mandate that recognized what monetary policy can do, and what it cannot do. In my view, monetary policy can reliably affect only the price level, so I favor a mandate that requires the Fed to pursue price stability. This does not mean that I'm unconcerned about employment or economic growth. Quite the contrary. But we need to recognize that printing money in the hope of pushing down interest rates and stimulating growth cannot work—at least not for long. The more money we put into the economy, the faster that money will decline in value. Moreover, as people become accustomed to expecting that money will not hold its value, they become less willing to save, and investors eventually demand

higher interest rates to compensate for the declining purchasing power of money. This is an important point: When monetary policymakers attempt to *lower* market interest rates by pushing too much new money into the economy, the resulting inflation can actually cause interest rates to *rise*. Because the central bank cannot increase output or employment, inflation will be the only outcome of policy. The appropriate mandate for monetary policy recognizes that, ultimately, monetary policy is capable of directly affecting only the price level.

Let me briefly note that the choice of a specific price level measure for monetary policy matters less than the mandate to make price stability the sole objective of policy. The Consumer Price Index is the most commonly watched measure of the price level. But, as both Chairman Greenspan and a panel of economists have said, the CPI appears to overstate the cost of living by about one percentage point. Roughly half of this bias arises because the CPI fails to account for the public's ability to shift its purchases quickly in response to changes in relative prices. If the price of beef rises too quickly, consumers eat more fish, and so forth. The CPI is not—and cannot be—adjusted fast enough to account for all such substitutions.

A second source of bias in the CPI comes from the introduction of new goods and services, and changes in the quality of existing products. When it computes the CPI, the Bureau of Labor Statistics attempts to account for these effects. The CPI commission believes that more should be done. Certainly the issue deserves careful study so that we can measure the cost of living as accurately as possible.

Despite its problems, the CPI has a number of advantages that make it a useful index for monetary policy. The CPI is widely recognized and used in a variety of

economic calculations. It is carefully constructed, updated monthly, and we have a reasonable estimate of its bias. Finally, there are numerous other sources of information that help us measure changes in the cost of living accurately. Questions about the best way to measure the cost of living should thus *not* keep us from reducing a truly fundamental uncertainty about monetary policy—the uncertainty caused by the absence of an explicit mandate for the Fed to control the price level.

Political Independence

Besides the lack of a clear policy mandate, another source of uncertainty about the course of monetary policy stems from the Fed's fragile political independence. I believe that much of the talk about reducing the Fed's independence stems more from frustration over the apparent lack of focus of monetary policy than from concern about the Fed's recent performance or the accountability of individuals. The Fed should be held accountable as an institution for what it can, and should, achieve: namely, price stability over time. Make the Fed's mandate clear and achievable, and accountability will cease to be an issue.

Independence from political pressures is very important for a central bank's ability to achieve low inflation. Looking across countries, scholars have found that inflation is generally lower in countries with relatively independent central banks. Inflation tends to be higher where the central bank is an arm of the treasury, or otherwise under the direct control of politicians. Speaking bluntly, central bank independence ensures that the policymakers charged with maintaining the stability of the nation's money supply are not the same people who spend the taxpayer's money. Pressure to finance the government by printing money—in essence to hold the yields on government debt

artificially low—has been a source of inflation in many countries. Limit such pressure, and a country will have a better chance at achieving price stability. There has never been a case of hyperinflation except when massive amounts of money have been printed to finance government expenditures. And hyperinflation has never been stopped except when the money supply growth rate has been made independent of government finance.

In my view, the primary role of monetary policy is thus to preserve the value of money. Give the Fed a clear mandate to preserve the purchasing power of the dollar, and maintain its independence to do so, and much of the current uncertainty about policy would melt away. Such an approach would provide a stable price backdrop for the efficient operation of our market economy, and this would promote full employment and economic growth.

Price stability is a key ingredient in the recipe for maximum sustainable economic growth, and it is the only ingredient that monetary policy can supply. Thus, in my view, there is no more important task for the Federal Reserve than preserving the value of our nation's money.

Thank you.