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Success and Failure of Monetary Policy since the 1950s

Remarks

by

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at

Monetary Policy over Fifty Years
A conference to mark the fiftieth anniversary of the Deutsche Bundesbank

Frankfurt, Germany

September 21, 2007

I appreciate this opportunity to speak on the occasion of the Deutsche Bundesbank's fiftieth anniversary by participating on this panel on "Success and Failure of Monetary Policy since the 1950s." I was reassured in my acceptance of Axel's invitation by David Laidler's survey paper, which found more successes than not over the past two decades.[1]

A concise summary of this success is evident in the performance of consumer price inflation in the advanced economies. Median inflation in that group (as defined by the International Monetary Fund) has held near 2 percent for this decade. Indeed, in the IMF's latest *World Economic Outlook*, four out of five countries in this group are expected to post inflation rates between 1 percent and 3 percent this year. That good performance has helped to anchor inflation expectations, which, in turn, generates many benefits. Anchored inflation expectations damp the pass-through of supply-related price shocks. They also permit central banks to respond more forcefully to output fluctuations. Most significantly, the improved inflation performance has come with, not at the expense of, output stability. Although a consensus has not formed on how much of the "Great Moderation" in the growth of real output can be attributed to monetary policy, everyone agrees that at least a portion of it can.

David views these macroeconomic outcomes as a triumph of monetarism, but not because the formulaic policy prescription associated with that doctrine succeeded (or, for that matter, was even tried on a sustained basis). Rather, the underlying tenets of monetarism ultimately seeped into the collective central banking unconscious and fostered better decisionmaking. The beliefs that David identifies are threefold: That

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[1] Vincent Reinhart, of the Board's staff, contributed to the preparation of these remarks. The views expressed are my own and not necessarily shared by my colleagues on the Board or the Federal Open Market Committee.

market economies are inherently self-righting, that open economies perform best under flexible exchange rates, and that central bankers should focus on price stability as their long-run objective.

David suggests that monetarism failed when its proponents got too prescriptive by advocating rigid rules for money growth. Among the lessons he takes from the failed monetarist experiment are that central banking is an applied science and that our imperfect understanding of how economies and markets function implies that a good dose of humility is required--and I agree. As evidence of that humility on my part, let me also agree with David that two important questions about the conduct of monetary policy have not yet been resolved. This is unfortunate because these two questions are both longstanding sources of debate and central to current policy concerns. First, what is the best way to pursue price stability, and, second, how should asset prices be taken into account in steering policy?

In many countries, though not my own, the answer to the first question has been that price stability should be pursued through the formal apparatus of an inflation target, which typically includes establishing an inflation goal by the government, setting metrics to evaluate central bank performance, and periodically communicating progress to the public. Although correlation does not convey causation, the spread of such regimes has coincided with sustained low global inflation. In addition, no adopter of an inflation target has subsequently abandoned it.

Before anyone jumps to the conclusion that Frankfurt is a stop on my road to Damascus, let this Saul state that for me the case remains open. Inflation has come down worldwide, in countries without, as well as with, inflation targets. Moreover, I share

David's puzzlement about why an explicit inflation goal should make a substantial difference in performance given the paucity of evidence showing that choosing a target directly affects the level of the public's inflation expectations. That said, I am relatively more persuaded that inflation targeting helps reduce the variance of inflation expectations. Evidence has accumulated to suggest that stock prices, interest rates, and measures of inflation expectations seem to vary less in economies in which the central bank has an explicit long-run goal for inflation.

I suspect that this better anchoring of expectations and the success of inflation targeting in many countries is attributable in part to aspects of the political economy that David identified. A formal inflation target represents a national embrace of a goal, in which elected authorities recognize the primacy of price stability and publicly support--indeed, even require--the central bank's pursuit of that goal. To the extent that elected authorities channel the desires of the electorate, a central bank directed to adopt an inflation target is being given a strong signal as to the goal's importance to the public at large. This affirmation has often been reinforced by the granting of operational independence to the central bank to achieve that goal most effectively. An important effect of such public acceptance of price stability is that it erodes the standing of those who would direct central bank action toward other ends. In such an environment, workers, businesspeople, and investors can make plans with the expectation that nominal magnitudes will be predictable and so devote their attention to more productive matters.

For the European Central Bank, this framework was established by treaty. In most other instances, the adoption of an inflation target involved laws and mutual understandings, not constitutional changes. The early adopters of inflation targets were parliamentary democracies, which is not too surprising given that in such a system a single branch of government can enact laws and put them into effect. With regard to an inflation goal, the parliament can erect the formal apparatus and the finance minister can serve as the government's point of contact with the central bank.

The system in the United States is different in that two independent branches of government are responsible for economic policy making, making agreement on a single goal problematic. Moreover, those two branches have already spoken as to the appropriate aim of the nation's central bank: The Congress, in a law the President signed, has given the Federal Reserve a dual mandate that directs us to foster maximum employment and stable prices over time. This instruction is not an accident of history, in that, in the past, the Congress has shown no appetite to amend its legislation. Nor is this instruction unreasonable, in that the dual mandate has come to be interpreted as assigning us the responsibility for attaining price stability in the long run, which will bring with it maximum employment, and of being mindful of resource utilization in the succession of short runs that make up the long run. The dual mandate seems proper and fitting, given that economic costs are incurred both by having inflation stray from its long-run goal and by having output deviate from the economy's potential to produce; and it seems to produce results not too different in practice from those associated with central banks that are flexible inflation targeters.

As I said earlier, anchoring expectations has value, in that it makes planning easier, reduces resources spent on predicting and protecting against unexpected variations in nominal magnitudes, and grants a central bank greater scope to lean against fluctuations in output while keeping inflation contained. The latter is particularly attractive given our dual mandate, in that better-anchored inflation expectations could produce the win-win outcome of improving the attainment of both goals. For that reason, in its consideration of its communications strategies, the Federal Open Market Committee has been discussing whether mechanisms could be put in place that could better anchor inflation expectations in a manner consistent with the institutional framework of our dual mandate.

The second of David's open issues--whether central banks should lean against possible asset price bubbles--was the key topic in my discussion here eighteen months ago, at Otmar's festschrift. My answer then is my answer now. A central bank should focus on the outlook for the macroeconomy and generally relegate asset prices to the subordinate role of inputs to the forecast process. I view this as the simple application of humility that David and I find so admirable. Although economic theory provides no settled answers to any topic, its predictions are especially imprecise with regard to asset pricing, which has two implications for central bankers. First, little confidence can be attached to the determination that an asset bubble exists except in the most extreme of circumstances. Second, even less confidence can be attached to predictions of the effects of policy on asset prices, and in particular on any speculative element in those prices. Moreover, monetary policy actions addressed at a perceived bubble in one sector may have undesirable effects on other asset prices and the economy more generally.

As a result, my preferred policy framework remains three pronged: First, assign the single instrument of monetary policy to its macroeconomic objective; second, rely on regulation to erect a resilient financial structure; and, third, in the event that market judgments prove to be wrong and financial prices adjust sharply, apply the tool of monetary policy to the macroeconomic task at hand. That task is not always easily captured by simple statistical regularities. Relationships between financial markets and economic results are complex and nonlinear, especially when markets are not behaving normally. When investors are ebullient, their expectations of outsized capital gains can feed on themselves and back on the economy. On the way down, investors' loss of confidence, a reduction in credit availability, and a tightening of terms and conditions for credit have the potential to have pronounced effects on activity and inflation.

The world is, no doubt, different than when we gathered here eighteen months ago. However, it is far too soon to pass judgment on what went wrong in the U.S. housing market and why. I suspect that, when studies are done with cooler reflection, the causes of the swing in house prices will be seen as less a consequence of monetary policy and more a result of the emotions of excessive optimism followed by fear experienced every so often in the marketplace through the ages. To some extent, too, the amplitude of the housing cycle was heightened by the newness of the subprime market, the fragmentation of regulatory oversight responsibility for that market, and the complexity and opacity of the newer instruments for transforming and distributing risk. Low policy interest rates early in this decade helped feed the initial rise in house prices. However, the worst excesses in the market probably occurred when short-term rates were already well on their way to more normal levels, but longer-term rates were held down by a variety of forces. And similar, sometimes even sharper, trajectories of house prices have been witnessed in some economies in which the central banks said they were paying more attention to asset prices.

The action the Federal Open Market Committee took this Tuesday can be interpreted as the application of the third leg of my preferred policy triad, in that it was taken "to forestall some of the adverse effects on the broader economy that might otherwise arise from the disruptions in financial markets and promote moderate growth over time." In the past, such efforts to cushion the restraint induced by declines in asset prices have fueled the assertion that Federal Reserve policy is asymmetrical in its response to booms and busts in asset prices. Such an asymmetry is said to have the potential to feed "moral hazard" in that investors would spend less effort evaluating underlying values as they were lulled by the protection they expected to be provided by monetary policy action.

In point of fact, Federal Reserve policy makers have not been asymmetrical in intent or in actions, in that we have always focused sharply on the macroeconomy. Asset prices have mattered in the determination of policy because they have mattered for our outlook. I am confident that the federal funds rate would not have been as high in 2000 if it had not been for the level of equity prices that year, nor would the federal funds rate have been as elevated in 2006 in the absence of the tight credit spreads, low term premiums, and the impetus from housing wealth. And I doubt policy would have been eased this week if housing prices had continued their upward march. In each instance, however, policy was motivated not by the desire to achieve any particular level of asset prices, but rather by the Federal Reserve's assessment of how changes in asset prices were affecting the forecast of growth and inflation.

I would also caution that a symmetrical response to the macroeconomic outlook will need to reflect the inherent asymmetries in business cycles. In the typical boom-bust cycle, asset prices tend to rise relatively gradually over a protracted period but fall sharply in a shorter stretch of time, which financial economists refer to as "rising by the escalator and falling by the elevator." Perhaps because those asset prices are important to spending, key macroeconomic indicators, such as the unemployment rate, exhibit a similar pattern. It is not surprising then that a macro-focused monetary policy will leave an asymmetric footprint in the data.

In the end, my humble advice is to evaluate policymakers relative to the tasks the law has given them. In my judgment, the record over the past twenty-five years of steady growth with two mild recessions and gradually declining inflation to a reasonably low level does not betray an asymmetry in our policy responses in the metric that counts--macroeconomic performance.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

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