FOR RELEASE ON DELIVERY
11:00 a.m. E.D.T.
Tuesday, September 25, 1990

Useful Indicators in a Commitment to Price Stability

Remarks by

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before the

1990 Farm Credit System's National Directors Conference

Orlando, Florida
September 25, 1990

Useful Indicators in a Commitment to Price Stability

I am honored to be here today to speak to the Farm Credit System's 1990 National Directors Conference. It is always a pleasure to discuss future prospects with farmers and farm credit leaders.

This morning I would like to talk about some key aspects of monetary policy in the current troubled economic environment. More specifically, I would like to discuss the meaning of a commitment to price stability in the context of our current circumstances.

After briefly describing our current policy environment, I want to discuss the implications of this environment in pursuing a price stability objective. I then will describe how certain financial market indicators may continue to be quite useful in this situation.

The Current Economic Environment

In mid-July, when I agreed to speak to this group, the monetary policy environment was beset by several key factors. First, the economy was showing signs of softening with inflation remaining higher than desirable. The growth of employment and industrial production, as well as consumption, had slowed. Orders and investment were sluggish, construction was stagnant and housing was deteriorating. I do not have to remind you that the economies of some regions of the country were weak. And concerns about a "credit crunch" were being voiced. In short, the expectations of an economic slowdown seemed to be increasing. Accordingly, calls for an easing of monetary policy were, if not widespread, at least frequently expressed.

A second factor affecting the monetary policy environment was the discussion of a budget agreement calling for spending cuts and tax increases, by conventional

definitions thought to be a contractionary fiscal policy. For this reason, some economists argued that the macroeconomic policy mix had to be altered; since fiscal policy was becoming contractionary, an offsetting stimulus should be provided by monetary policy.

Since accepting your invitation to speak, a third factor has come into play. The invasion of Kuwait and the associated increase in oil prices have heightened the concern that an economic slowdown would be even more pervasive. For this reason, additional calls for monetary stimulus have been voiced from many quarters.

In sum, the current economic environment embodies (1) significant risk of an economic slowdown, (2) the likelihood of a somewhat muted "contraction" of fiscal policy, and (3) an oil price shock exacerbating the vulnerabilities of the macroeconomy. All three of these complications have spawned calls for expansionary monetary policy: policy stimulus to offset the weak economy, to

offset a tightening of fiscal policy, to offset the effects of the oil shock.

Therefore, the role of monetary policy in this set of circumstances is both a timely and appropriate topic. In particular, it is opportune to express some reservations about these prescriptions for policy ease and discuss a more appropriate approach to policy in this troubled policy environment.

The Goal of Monetary Policy

While recent decades have witnessed considerable disagreement and controversy about alternative targets, indicators, and instruments of monetary policy, I think it is fair to say that this period has also witnessed a growing consensus about the proper goal of monetary policy.

Economists and policymakers have come to understand what the Fed can do and what it cannot do. In particular, both economists and central bankers have come to agree that price stability is the proper objective of

monetary policy; price stability or maintaining the value of money is one of the few objectives that monetary authorities are capable of achieving. And credibly attaining this goal promotes or complements the achievement of other objectives of macropolicy such as healthy economic growth.

Other members of the Board of Governors, Federal Reserve Bank Presidents, and myself have often voiced our support of price stability. Yet some critics of the Federal Reserve have correctly pointed out that while members of the Federal Reserve Board of Governors rhetorically support price stability, the Federal Reserve has not achieved that goal in about 25 years!

This brings us to the key issue facing monetary policy today, namely, what does a commitment to price stability mean in the face of the complicating factors I have just mentioned? More specifically, what does a commitment to price stability mean in the face of a slowing

economy, a contraction of fiscal policy, and an oil price shock?

Implications of a Commitment to Price Stability

An implication of Federal Reserve attempts to influence the economy's real growth rate while voicing a commitment to price stability is that such action creates confusion about monetary policy. The Federal Reserve cannot attempt to manipulate real economic activity without altering inflation expectations. I believe that whether the economy softens or strengthens, a disciplined, credible commitment to price stability is the best growth prescription; such a policy will bring about a moderation in long-term interest rates.

Should a policy aimed at bolstering real economic activity be undertaken without clear signs that progress will be made on inflation, Federal Reserve credibility could be severely affected. A loss of such credibility likely would be quickly registered in key financial markets.

Long-term nominal interest rate declines that would normally accompany perception of slower growth could be short circuited; lenders would demand higher premiums to cover both expectations of higher future inflation and higher uncertainties about policy. Similarly, the dollar could come under downward pressure as the stability of its purchasing power as well as its usefulness as either a vehicle for trade or as a reserve currency came into question. Finally, participants in commodity markets would be less apt to expect softened demand for commodities as a response to slower growth and be more apt to let the relative increase of oil prices spill over into precious metals and other commodities to hedge against inflation.

A credible commitment to price stability, on the other hand, would engender none of these adverse financial market impacts. Long-term bond rates would moderate with a continued unwinding of both inflationary expectations and uncertainty premiums built in over the last nine months.

And, the disruptive effects of inflation on both dollar exchange rates and commodity prices would be absent.

In short, all else equal, a credible commitment to price stability on the part of the Federal Reserve would foster lower bond rates, a more stable dollar, and more stable commodity prices. Such a commitment would, at the margin, enable the price system to better carry out its function of allocating resources and would thereby work to promote, rather than to hinder, economic growth.

The Federal Reserve's commitment to price stability must also be kept in mind during budget deliberations. Fiscal and monetary policies are likely not the perfect substitutes for managing aggregate demand that proponents of changing-the-policy-mix would have us believe. While shifts in IS and LM curves can theoretically substitute for one another in academic models of stabilization policy, empirical evidence suggests that monetary policy likely dominates fiscal policy as a

determinant of changes both in aggregate demand and inflation.

But monetary and fiscal policies are also different in other ways. Unlike changes in monetary policy, for example, alterations in fiscal policy can permanently impact incentives, relative prices, income distribution, and long-term economic growth. In short, fiscal policy, unlike monetary policy, can permanently influence real economic variables. It is for this reason that fiscal policy should be oriented to growth rather than stabilization.

Furthermore, the impact on aggregate demand of a given change in the budget deficit is not easily predictable. A budget agreement, after all, can take many forms, some consisting largely of tax changes, others comprised largely of changes in government spending. A budget agreement involving tax increases can have quite different effects than an agreement involving spending changes. And different forms of tax changes may have

different economic effects; the economic impact of a gasoline tax may differ significantly from that of an income tax. Similarly, the effects of a change in entitlement spending may differ significantly from the effects of a change in government spending on roads, bridges, or even national defense.

Rather than adjusting policy on the basis of anticipated changes in fiscal policy that may or may not be forthcoming, it is appropriate that the Federal Reserve also take account of the market assessment of the prospects for, and implications of, any budget agreement. Should a budget agreement lead to lower market interest rates, the Federal Reserve likely would not want to curtail such declines; in the face of falling market interest rates, it would not be desirable for the Federal Reserve to hold up the short end of the market. A credible commitment to price stability would not only be consistent with such a policy posture, but would foster the conditions for such a scenario to occur.

Nor is the recent increase in oil prices a reason to relax our commitment to price stability. Events which change oil supply reliability can be expected to show through as a relative price increase for oil. Supply side and conservation effects depend on this relative price change. Monetary policy ease designed to offset or mitigate the real effects of this oil price increase, risks turning a relative price increase into a general price increase. Should such an increase in general prices occur, it would dissipate the relative price change thereby limiting reactions of energy supply and conservation efforts. Moreover, should an easing policy move bring about a depreciation of the dollar -- the currency in which world oil prices are denominated -- oil producers may have incentives to further increase the nominal price of oil (as may have occurred in the 1970s). Another round of oil price increases brought about in this way could not only alter

inflationary expectations in financial markets, but such expectations could become embedded in labor markets as well.

Monetary policy ease to mitigate the effects of an oil price increase is risky for other reasons. Monetary growth in the three years preceding the oil shock has been restrained in an effort to fight inflation. And it is precisely this demonstrated commitment to price stability and its attendant influence on inflation expectations that might now help us to contain the additional inflationary pressures emanating from the oil shock. Attempting, through an easing of policy, to somehow avoid or postpone the implied real adjustments of the oil shock, would only serve to undermine the credibility of policy and lend to potentially more severe adjustments over the longer run.

A Commitment to Price Stability: the Test is Now

As my remarks suggest, I believe the inflationary risks of an easing of policy are very significant. The credibility of the Federal Reserve's commitment to price

stability is at stake; the Federal Reserve's anti-inflationary resolve is being tested now. Should policy error occur, the hard-fought gains against inflationary psychology achieved in the 1980s could be lost.

Some Useful Indicators

In previous speeches, testimony, and public statements, I have suggested that certain forward-looking market price indicators are quite useful for gauging the stance of monetary policy. In particular, I suggested that commodity prices, the foreign exchange rate, and bond yields may serve as useful indicators of monetary policy. These indicators may be particularly helpful in assessing monetary policy at the current time.

During portions of the 1987 to 1989 period, for example, some policy-critics focusing on real economic data argued that policy was too easy and the economy was overheating. Yet market price indicators were correctly signaling that policy had tightened to an appropriate

degree. During both 1988 and the first half of 1989, for example, the yield spread -- the spread between the fed funds rate and the long-Treasury bond rate -- continually narrowed and in fact inverted in late 1988. For a good part of this period, the long-bond rate was falling. Similarly, the dollar was persistently stronger than most analysts expected during the course of 1988 and well into the summer of 1989. Similarly, while some commodity price indices were relatively stable, the price of gold and other commodity price indices were falling from mid-1988 until mid-1989. In short, during the 1988 to mid-1989 period, market price indicators were signaling that monetary policy was appropriately tight.

Given the well-known lags of monetary policy, the reported economic weakness in 1989 and early 1990 is fully consistent with these signals.

These market price indicators are not only useful for evaluating the past, but also have a good bit of

relevance for our situation today. Notice that these market price signals have changed dramatically since the late summer or fall of 1989; they no longer indicate that monetary policy is tight. As the Fed funds rate has fallen in several steps and long-bond yields have increased, for example, the yield spread between these two rates has widened and become positively sloped. Similarly, the dollar has depreciated substantially since last autumn. And most indices of commodity prices -- even commodity prices ex-energy -- have trended up.

In short, these market price indicators all suggest that monetary policy had already become easier in late 1989. If these signals are correct, future economic activity may not be as weak as some have suggested.

All of this has important implications for monetary policy. These indicators suggest that an easier monetary policy posture is currently in place. If the economy shows further signs of weakness in 1991, I would

expect such weakness to immediately become evident in these forward-looking indicators. In that environment, it would be appropriate for falling long interest rates, falling commodity and gold prices, as well as a stronger dollar to be accompanied by lower short-term interest rates. A policy orientation that considers long-term interest rates as well as short-term rates is most likely to successfully ameliorate the current downturn in the building and real estate long cycle.

Conclusion

In sum, price stability is the key, lasting contribution that the Federal Reserve can make to the macroeconomic policy mix. The Federal Reserve cannot afford to give low priority to this key goal. A slowing economy, budget agreements, or oil price increases cannot deter the Federal Reserve from pursuing the one goal which will be most effective in stabilizing the real economy. Credible

adherence to price stability will yield beneficial, not detrimental, effects to the U.S. and world economies.

Certain forward-looking market prices can provide particularly useful signals for policymakers in our current troubled environment. Information from these prices can be helpful to monetary policymakers in achieving this very important goal.