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Summer Institute, Monetary Economics**

July 17, 1997

Cambridge, Massachusetts

I Theoretical and Practical Issues in Monetary Policy

A. Price Stability

Central Bank Independence

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B. ~~Fighting the last war~~--what John Taylor has referred to as "the great disinflation" of the late '70s and early '80s

C. Issues for the next war:

--how to make economic growth happen in the face of increasing global competition and technological change;

--how to manage the institutional aspects of change with an eye on financial stability.

II Price Stability

A. What is price stability? Keeping prices level, or maintaining some low rate of growth? Clearly an issue here, but from a practical point of view it seems to me price stability can only be the achievement of a low positive rate of inflationary growth.

B. Should price stability be the sole goal of monetary policy?

--**First things first: The ultimate goal of monetary policy is to attain the highest possible standard of living for the citizens of the country.**

--**Thus the answer to the question is no, price stability should not be the sole goal. It is one of the means to achieving the end of high living standards, but not the only one.**

--**Should price stability be a pre-eminent goal of monetary policy? Yes, other things being equal.**

--**In the end, I really care about price stability not for its own sake, but because I believe that price stability is a key determinant of long-run sustainable growth.**

--**Empirical evidence on the benefits of very low rates of inflation is murky, probably because we don't have enough low-inflation history.**

--**But for moderate to high inflation, there seems to be a very direct link between higher (and more variable) inflation and less satisfactory growth.**

--Thus the Fed's commitment to price stability derives from its desire to maintain a high, sustainable rate of economic growth.

C. Obviously, pursuit of price stability should not preclude sensible responses to abnormally high unemployment, to banking crises, or to disruptions to the payments system, for example. Economic and financial stability--which includes stable employment, a healthy banking system, and a robust payments system--are key ingredients to a strong economy with sustainable high long-run growth. In fact, it is often said internally that we seek to achieve price stability and financial stability in our pursuit of higher standards of living.

D. Should Price Stability Be a Legislated Goal for the Central Bank?

--Yes. Establishing a legislated price stability goal may be helpful, especially for a country with a history of high inflation, such as the Latin American countries. It may re-focus the central bank, and may help in establishing a credible new monetary regime. Ultimately, however, the proof is in the pudding: The consistent actions of the central bank over a long span of time establishes its credibility. In that regard, it is my view that the Federal Reserve has garnered considerable credibility over the years without a specifically legislated price stability goal.

E. Should We Be Bind Ourselves to Numerical Inflation Targets?

--Maybe. Advantages of adopting and publishing numerical targets:

(1) **Would likely improve central bank accountability.** A clearly-defined objective for the Fed enhances accountability.

(2) Allows Fed to communicate more clearly its intentions to markets and the public. This might remove uncertainty among financial markets and public as to our intentions.

(3) Certainly preferable to legislated numerical targets.

If the choice is between targets chosen for us and targets chosen by us, go for internally-generated numerical targets.

A number of difficulties with numerical targets:

(1) Difficulty in agreeing upon an exact number, target path, or time frame among FOMC members. The current arrangement allows some disagreement as to precise goals. Nonetheless, the FOMC still manages to make progress towards an implicitly-agreed-upon goal.

(2) Difficulty in communicating to Congress our progress toward goals. Our job in communicating the performance of monetary policy could become more complex with numerical inflation targets. In particular, we must now be sure that Congress understands that

inflation can and will move for reasons that the Fed cannot directly control--changes in prices of imported goods, changes in fiscal stance, large relative price changes--and for which we should not be held responsible in the short run.

(3) This complicates the definition of appropriate monetary policy: we can only conduct monetary policy that is *ex ante* appropriate. *Ex post*, the inflation and output outcomes may deviate from our and society's desired levels, but this will most often be due to factors beyond our control. Communicating this without confusing Congress or appearing self-serving (or actually being self-serving) would be a challenge. The same challenges arise under the current system, but to a much lesser extent.

F. How should we measure whether we've achieved price stability? There are any number of possible indices, but at least the major ones reflecting prices paid on final goods don't really vary much among

themselves at least over the long-run. May as well use the CPI since that's the most familiar to everybody.

- G. And finally, how should we get to price stability--by continual movement toward a target, by following a rule, by being opportunistic?

--I don't think a single-focus on moving inflation down to a target, come hell or high water, makes sense.

And I'm a little agnostic about rules though we in Boston do track John Taylor's rule as an aid in analysis. And I must say I like the explicit nature of the trade offs that form the mathematical basis for each rule. However, the black box nature of the rule, and its potential insensitivity to factors not captured within the rule bother me a bit.

--What does make sense to me is what is being called "opportunism" that is a process of holding the line on inflationary rise, and taking advantage of inflationary decrease when it occurs as a result of positive shocks.

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--Not everyone interprets opportunism the same way; some view it as being soft on inflation since there is no constant pressure downward on rates of inflation, only the maximizing of good fortune. Moreover, being opportunistic implies a different view of say 3% inflation depending on where you are--if the economy has a 5% inflation rate and it drops to 3, that 's good. If your current rate is 2%, a rise to 3% would not be good, all other things being equal.

--I recognize this, but I also think such a view might be sensible for the same reason as not setting a specific numerical target may be a good way to go. With a target of 2%, 3% inflation looks bad even if its a drop from 5%. I would prefer that a reduction in the rate of inflation be viewed as an unequivocal good, even if we might have more to do.

III Central Bank Independence (CBI) and Price Stability: Old and New Issues

- A. First, what do we mean by central bank independence- What I mean is the ability, if not the obligation, of a central bank to set its own path for monetary policy, a path that can be at odds with prevailing politics, but inherently reflects the internal culture and values of a country.**
- B. Does CBI matter for the effective conduct of monetary policy?**

- Yes, at some level independence (or the lack of it) must matter.

(1) Independence from Treasury: If monetary authority must finance the exploits of an unrestrained fiscal authority, it cannot properly pursue monetary goals of price and employment stabilization that will maximize the welfare of its citizens. Thus, independence from the fiscal side is critical.

(2) Short-Run Independence from Political

Pressure: If the monetary authority is subject to continued pressure from the legislative arm to create jobs, regardless of inflationary consequences, then it will likely attain suboptimal performance with regard to both inflation and employment.

(3) In the long run, however, a central bank must be dependent on the will of the governed. The goals chosen by the central bank and its methods for achieving those goals must jibe with the priorities of the electorate. If this is not the case, then long-run political pressure can and should alter the conduct of monetary policy.

This issue of political accountability has become critical in my view--as countries around the world pursue stringent fiscal policies aimed at reining in budget deficits, monetary policy literally becomes the only macroeconomic game in town. This has

the tendency to increase public focus on the central bank, and intensify demands for transparency and political accountability--even though if taken to extremes in the short-run this could undermine the success central banks have encountered in fighting inflation.

- C. How much independence helps the central bank achieve its goals, and how should independence be structured and insured?

(1) This first part of this question is empirical.

Evidence: most independent and (presumably) credible banks still appear to pay high sacrifice ratios. More extensive studies show that the link between independence and economic performance (low inflation, low inflation variability, low unemployment, etc.) is fragile for all countries, both developed and developing. This doesn't mean that independence doesn't matter in the way described above. However, it

means that we don't know (quantitatively) at what margin independence becomes beneficial.

(2) As to structure an emerging (and sensible) consensus suggests that central banks should be *goal-dependent* (i.e., their long-run goals should be set by the political process), but *instrument-independent* (the way that they manipulate reserves and rates to achieve these goals should be up to them).

- IV. Finally, why are these issues of price stability and central bank independence like fighting the last war?
- A. These issues, as interesting and intriguing as they are, grew out of the central bank failures to rein in inflation during the '70s.
- B. Central bankers here and around the world have gotten religion on the subject of price stability--inflation isn't tolerated and is being reduced--albeit from high levels in some places--nearly everywhere. In Europe, for example, average inflation rates from 1970-82 were 8.2%; from 1983-95 they fell to 3.7.

In non-Japan Asia, 1970-82 was 10.5%; 1983-95 averaged 8.0. In South America the trend from 1985-95 reflects a significant deterioration over earlier years, largely because of Brazil and Surinam. Looking at just 1995, however, inflation rates were just over half the rate from 1970-82 and progress in '96 and to date in '97 has been significant.

- C. Central bank independence also is slowly being achieved--U.K., Japan, etc.
- D. The biggest issue now is how to keep economic growth at levels consistent with providing economic opportunity for everyone--obviously, price stability creates the necessary environment for growth and here central banks make a critical contribution but clearly they can't do it all--and here I see two forms of challenges: structural and institutional

V Structural

- A. On the structural side, two issues exist:

- (1) In economies where the governmental social safety net has become too expensive in a time of competition and technological change, reform in labor markets to increase worker flexibility is vital--this would appear to be the only way to address high unemployment rates in Germany, for example.
 - (2) In economies where markets are already reasonably flexible (U.S., U.K.) the issue is how to ensure all boats rise in a time of economic growth, or, in other words, how to deal with racial, spacial and educational inequality which inevitably lead to income inequality. This, I think, will be the major economic issue of the early new century.
- B. On the institutional side, I'm a true believer that banks are special, not just here in the U.S. but, more importantly, in other developed and developing countries where financial markets and institutions are less broad and deep than in the U.S.

1. Here we see a very great parallel between weak banking sectors and weakened growth patterns and bouts of financial instability--Japan, Thailand, Malaysia, Mexico, Argentina--banking crises propelled by asset bubbles, lax or nonexistent supervision, less than arms-length loan practices, prompt runs on currency and shatter economic plans.
2. Obviously, much greater care must be taken to ensure the major collectors and distributors of money within the economy are sound--but who should do this?
3. It seems to me central banks with their focus on financial as well as price stability need to play an important, and with large institutions, hands-on role.
4. This is not a fashionable view--in part because of concerns about central bank independence, central banks are being taken out of their supervisory role-- U.K., Japan, Korea.

-- The (misguided) argument for removing supervisory responsibility is based on one of the "last war"

concerns: excessive familiarity of the central bank with banks will breed a monetary policy that caters to the will of the banking sector. That is, active bank supervision compromises CBI, and therefore leads to suboptimal monetary policy.

-- There is no evidence that I'm aware of that U.S. monetary policy has suffered because of our involvement in bank regulation. Quite the contrary: as a result of our experience with New England banks, we gave the FOMC early warning of excess real estate lending and the resultant "credit crunch," after the real estate bubble burst. This helped shape appropriate monetary policy in the early 1990s.

-- More generally, the onsite presence of the Fed in the banking system allows it to keep close tabs on the health of the financial system and ultimately on the levers necessary to ensure a stable financial system.

-- It would be impossible in my view to fulfill this duty as one member on a Board of supervisors (as in some recent supervisory reform proposals).

-- In addition, the Basle Accord says to me that we *have* to be involved onsite, at the very least in the holding companies of the major international banks. If we were not, we would be violating the spirit, if not the letter, of the Accord.

- So should the Fed be responsible for bank Sup and Reg? YES.

Summary:

- We need to move past discussions of time inconsistency, rules vs. discretion, central bank independence---the old issues which have essentially become moot in the modern monetary policy environment. The experience of the past 15 years demonstrates that the central bank does not "cheat" on employment to the detriment of inflation performance.
- Our new challenges are the long-run maintenance of price stability, in order to contribute to long-run sustainable economic growth. The question is not how to bind central banks to do the right thing; central banks around the world have largely done that without such constraints. We do need more settled definitions of price stability, however, and more consensus on what level of inflationary growth--0 or some low positive--has the most net benefit to society. But, in the end, we really need more research into how growth can be fostered. [We need to understand better the structural and institutional barriers that can keep economic

↳ rewrite this one sentence in "positive" fashion

growth from affecting everyone, or, on the institutional side, produce real sources of financialⁱⁿ stability that, in the end, are destructive to growth.]

- In addition, and I hope this is not viewed as too self-serving, I think it would be wise to be wary of grand proposals to change either how the Fed works, or what its oversight responsibilities are. Arguably, at least for now, success is at hand. We may not fully understand all the reasons why we've had such a streak of luck with solid growth, low unemployment and low inflation but we have. While nothing is perfect--certainly not the Fed--something approaching a macro-economic version of near perfection has been achieved. Its tempting, I know, to challenge success but maybe we should also consider leaving it alone.