

ECONOMIC COMMENTARY

Federal Reserve Bank of Cleveland

Credibility Begins with a Clear Commitment to Price Stability

by Jerry L. Jordan

In the summer of 1971, the United States suspended the limited convertibility of the dollar for gold. Convertibility had not been operational for some time, except to foreign governments by special arrangement. Nevertheless, with the suspension came the recognition that America had cast aside its last formal commitment to gold convertibility and was now operating on a purely fiat currency. The idea of the dollar first being one-twentieth and then one-thirty-fifth of an ounce of gold, then being "worth" what a dollar would buy, without reference to some more basic standard of value, was a gradual process.

The performance of currencies lacking a nominal anchor has been an important factor in determining economic conditions in the United States—and throughout the world—since that time. Without a long-run anchor of valuation such as gold, the decisions and actions of monetary policy authorities start to have a significant influence on long-run economic performance. The vagaries of the gold market that often led to sharp upswings and downturns in the price level, but around a constant trend, have been replaced by the day-to-day judgments of central bankers. Although policymakers have eliminated the large cyclical fluctuations in the price level, they have done so at the cost of a long-term decline in the purchasing power of money.

The actual effects of Federal Reserve policy actions depend, in part, on the public's prior expectations of current policies and on its current expectations of future policies. Expectations influence

the results of policy through a variety of channels. Expectations of future prices in financial markets affect interest rates and a wide variety of contracts that, in turn, affect prices and real economic activity, particularly through decisions about saving and investing.

A broad set of factors influences the public's expectations of Federal Reserve policy, including history, recent public announcements, and individual perceptions of the views held by monetary policymakers. *Actual* policy decisions depend importantly on the incentives and constraints facing policymakers. These incentives and constraints color how people form expectations about future inflation and how firmly they adhere to them in the face of changing economic circumstances and political pressures.

■ The Importance of Expectations

Almost every decision we make in our lives is based on expectations about the behavior of others. When driving on a two-lane road passing motorists going the other way at 60 miles per hour, you do so under the assumption that they will stay in their own lane: After all, this is the law, the custom, and in the self-interest of everyone involved. Such expectations are so well founded and so seldom wrong that we don't give them a second thought.

Another example might be our expectations about work, which also consider the future behavior of others. Employees expect certain working conditions, pay, and job security, whether or not these

Federal Reserve Bank of Cleveland President Jerry L. Jordan advocates a policy of price stability based on an explicit objective for the Consumer Price Index, a plan that would provide a nominal anchor for the dollar as well as a clear standard by which to measure the success of monetary policy.

factors are written into contracts. Policies, both governmental and within the company, help people form expectations: how the company has treated others in the past also enters the equation. The employer gets a reputation for playing (or not playing) by the rules, which affects the quality of the people that apply for future employment.

Many of the stressful situations we see in the labor arena today are a result of frustrated expectations. Some companies have found that they promised employees too much relative to current and expected future income. This change in expectations leads to difficult adjustments that may show up in national economic statistics and represent substantial human suffering.

Expectations about economic policy are also important. The recent tax policy changes will have profound effects on the economy. Apart from the merits of the particular changes, though, is the adjustment cost that occurs just because the policies were enacted. People who

made decisions based on one tax structure now find themselves living in a world with different rules. It can be a little like pulling onto the highway, only to find that everyone else is suddenly driving on the left side of the road.

Expectations about future monetary policy are my immediate concern. Think about the problems people have encountered by investing in real estate over the last two decades. The run-up of inflation in the 1960s and 1970s led many investors to bet on land, real estate, and other inflation-sensitive assets. Real estate prices rose much faster than the general price level for decades. As the rate of inflation accelerated in the 1960s and 1970s, real estate prices soared to levels that could be supported only by a continuation and, in some cases, a further acceleration of inflation.

■ The Need for a Credible Commitment to Price Stability

The lack of a credible commitment to price stability after the gold standard was abolished meant the end of a crucial constraint on monetary policy actions. Without a clear nominal objective, money growth and the consequent implications for prices were set adrift. In the past 20 years, they have floated where the political winds and various external shocks have taken them.

Today we are left in a situation in which expectations about the future value of the dollar reflect the public's knowledge—borne of and verified by experience—that while monetary policymakers may have the best of intentions, the value of the dollar depends strongly on their judgments about the nature of economic conditions and about the appropriate level of short-term interest rates. As a result, expectations vary greatly among economic decision-makers and respond to events in largely unpredictable ways. At present, expectations embody higher long-term inflation than is healthy for the economy or than the monetary policymakers desire and plan to produce.

When people base their decisions on the assumption that future inflation will be higher than policymakers intend to deliver, the economy's performance

shudders, like a machine with sand in the gears. An inflation risk premium is built into long-term interest rates and raises the cost of capital. Labor negotiations become contentious as workers try to protect themselves from the expected inflation while employers try to insulate themselves from the risk of being caught with rising costs in a world where price stability is possible.

Because they have been fooled so often in the past, people are reluctant to modify their expectations without hard evidence—and quite rightly so. It wouldn't do policymakers any good to revise their objectives upward, because people would then simply adjust their expectations even higher. The only solution is to find a way to enable the central bank to commit to an explicit long-term objective of price stability.

■ Households and Inflation

Although the rising inflationary trend of the 1970s was halted in the 1980s, inflation has continued to lift the general price level by 3 to 4 percent per year. Consequently, it should come as no surprise that people do not believe that the Federal Reserve is committed to a long-term objective of purchasing power stability. In the University of Michigan's Survey of Consumers, for example, households continue to forecast inflation exceeding 4 percent over the next five to ten years. Although long-term interest rates have declined substantially, current levels still indicate that the public expects inflation to trudge forward. At best, the steeply upward-sloping yield curve suggests that market participants envision little further progress on price stability. The key to even lower long-term bond yields and mortgage rates is tied to the public's beliefs about the future purchasing power of the dollar.

In the 1950s and early 1960s, people were more inclined than they are today to view *increases* in inflation and interest rates as temporary. Consumers, it seemed, expected a sound dollar. Then, sometime in the late 1960s and 1970s, people began to view *declines* in inflation and interest rates as temporary. They have now come to expect a continuing depreciation in the value of the dollar. The challenge to today's monetary policymakers is to reverse that expectation

once again—to persuade people to make decisions as they did in the 1950s, on the belief that any rise in inflation and interest rates will be temporary.

The Federal Reserve System was created, in part, to deal with short-run liquidity problems and cyclically variable prices that were pervasive under the gold standard. These problems have been largely solved, but a new one was created.

Instead of being anchored by a credible commitment to price stability, today's monetary policy process focuses on the current state of the economy and on short-term policy actions. One of the reasons why the policy process is difficult to understand is that economic conditions are complex and subject to change. But these complications reflect the problems of choosing among short-term monetary actions in the absence of a clear, credible long-term objective.

Short-term monetary actions without such an objective are no more sensible or coherent than a driver's decisions on which direction to turn without first determining a destination. As the popular saying goes, "If you don't know where you are going, any road will take you there." The view might be nicer on the road to the left, but a better path may lie straight ahead. Short-term monetary actions—even if chosen optimally—have less desirable effects on the economy without a clear and credible long-term goal.

■ Time Consistency and Commitment

The well-known analysis of the time consistency of policy conclusively demonstrates that a central bank's ability to commit credibly to a long-term objective enhances the effectiveness of its policy and can improve overall economic performance. The problem stems from people's response to expected policy actions. Perhaps the clearest example of the time consistency problem is the public's reaction to government provision of flood insurance. If people know that the government will pay for rebuilding homes that are destroyed by floods, then they will tend to keep building homes in floodplains despite the negative consequences.

The time consistency problem arises because many Americans are under the mistaken impression that a little more inflation would lead to a healthier economy. There is some logic that suggests a surprise increase in the inflation rate will have a temporary, and positive, effect on real growth. This is thought to occur if prices rise faster than wages and if firms respond to inflated profits by increasing production. In this case, inflation must be not only a little higher, but a little higher than people *expect* it to be, if it is to have these supposedly beneficial effects. But if people know the government has an incentive to surprise them with a little more inflation, then they will count on an even higher inflation rate, and so on, until the rate is so astronomical that its detrimental effects are obvious and no one would seek a higher rate. The result of this kind of thinking is what led to the spiraling inflation of the late 1970s and the political support for the disinflationary policies of the early 1980s.

The challenge is to restore credibility to the idea that the price level will be stable over long periods of time. The ideal is a monetary regime that would have the credibility of the pre-World War I gold standard without the destabilizing elements that led to its demise. Establishment of such an environment requires a clear and credible commitment, backed by incentives and constraints, to maintaining the purchasing power of the dollar—and not simply in the short term.

■ A Specific Proposal

An anchor for the value of money can be created by adopting a long-term objective for the Consumer Price Index. The research staff at the Federal Reserve Bank of Cleveland has been studying the strengths and weaknesses of the CPI for this purpose. We urge others in the Federal Reserve System and in academic research centers to continue such work. So far, we have found little reason to choose anything but the CPI as a long-run measure of the purchasing power of the dollar. Over shorter horizons, however, we do find it useful to look closely at the index and to temporarily disregard erratic movements in sectors that are suffering extreme supply conditions. For example, there have been several times in the last decade when

the CPI excluding food and energy was a better measure of the underlying inflation trend than was the full index. But this is important only in using the CPI as a short-run guide; over the long haul, these factors wash out.

Our long-run goal should be to stabilize the level of the CPI at some future date. Because the decisions of businesses and households are conditioned by past experience, an immediate move to price-level stability would cause significant misallocation of resources and redistribution of wealth. Minimization of such transitional effects requires the adoption of both a valuation and a future date that delivers the purchasing power that is widely expected over the short term. The CPI averaged 100 during the 1982–84 period; today, the index stands at 145, meaning that the average level of prices is now almost 50 percent higher than it was 10 years ago. Stated differently, a dollar today buys just under two-thirds of what it did in 1983. Rather than attempting to freeze the dollar's purchasing power at the current level, it seems wise to allow current expectations of some further erosion to be fulfilled.

In my view, it would make sense to reduce the current rate of inflation gradually, perhaps by one-half percentage point per year, until the price level is stabilized. We could seek this objective in a number of ways. For instance, assuming that the CPI increases by 3 percent this year, annual successive half-percentage-point decelerations would stabilize the price level in 1999 at 154 percent of the 1982–84 base. So, one method of reaching price level stability would be to target a CPI level of 155 in the year 2000, and then conduct monetary policy to keep the index fluctuating around that value. There are, of course, other acceptable paths to a similar end.

No one should expect the CPI to follow such a predetermined path slavishly. My judgment is that the index would probably fluctuate within one-and-a-half percentage points around such a trend. It would be useful to establish limits, say 3 percent above and 3 percent below its permanent trend, in order to make explicit some range of discretion—a band within which the Federal Reserve could be given a free rein to respond to changing

economic conditions. These 3 percent limits would serve as a warning, alerting policymakers and the public when short-term policies were becoming inconsistent with the long-term objective.

■ The Implementation

Short-run policy decisions would be based on the long-term path and, as they are now, on incoming information and on the Federal Open Market Committee's best judgment about the future effect of recent policy actions. Explanations for the policy decisions would be framed in the context of the long-term objective. Publication of actual price data and the Federal Reserve's explanations about policy actions would help the public to decide whether policymakers were acting credibly to achieve the objective.

It would be important not to overreact to short-term movements in the CPI. The role of incoming information about the index would become more critical as the CPI deviated from the long-run path: When it began to move in a way that was unexpected and contrary to stated policy, we would pay more attention to the data and rely less on judgment. Monetary policymakers could use this framework in deciding how to vote on the annual monetary targets and on short-term policy actions. In explaining policy actions to the public, reference to *future* objectives would be superior to reference to real economic variables.

It is a mistake to think that a monetary policy that tolerates inflation would be better for the economic prospects of this nation. The financial press has not been effective in its coverage of this message. Reporters like to see everything in simple contrasts: hawks versus doves, or real growth versus inflation.

Academic researchers have moved beyond the simple monetarist/Keynesian debate that gave rise to the hawks versus doves analogy and have now adopted the view that expectations are important for price formation in *all* markets. Under this general view, targeting the price level directly is a good idea because it allows expectations to work for the policymaker to help achieve the objective.

This research doesn't seem to have had much impact in the policy arena, however. There, where policymakers have lost confidence in the M2 target as a guide for policy, the latest fashion is a *credit view* of monetary policy. This is really just another attempt to oversimplify a rather complicated process. People who take this view think that monetary policy operates by creating a gap between the cost of funds to banks and the rate at which they lend. It also suggests that understanding the stance of monetary policy requires a close look at interest rates and bank lending.

This is not a new view, but I find it increasingly less compelling as people and firms find ever-new sources of financing. While it is certainly important to keep communication simple, it is also useful for many purposes to understand how monetary policy affects bank lending and how bank lending, in turn, affects the real economy. But the channels of policy encompass more than this

one view. Both concepts, the monetarist emphasis on the monetary aggregates and the recent reemphasis on credit, are incomplete: They fail to account for the way expectations about future inflation influence economic decision-making at all levels and in all markets.

■ Benefits of an Explicit Objective for the CPI

We argue for a nominal anchor for the price level because we want to limit the range of expectations about future inflation, as well as to ensure that the outcome will be consistent with those expectations. In the last 30 years, economists have uncovered little additional information about how monetary policy works, except for the finding that expectations of future policy are vitally important in the process. We have learned that resource allocation decisions today depend on individuals' expectations about the future price level, a situation that in turn depends on what people expect of monetary policy.

Unfortunately, without a nominal anchor, it is difficult for people to learn about future monetary policy. A policy of price stability based on a constant value of the CPI would provide a nominal anchor for the dollar. Further, it would enhance credibility by providing a clear standard by which to measure the success of policy.


Jerry L. Jordan is president and chief executive officer of the Federal Reserve Bank of Cleveland. This paper is based on a speech that President Jordan presented to the Iowa Society of Financial Analysts in Des Moines on October 6, 1993.


Federal Reserve Bank of Cleveland
Research Department
P.O. Box 6387
Cleveland, Ohio 44101

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