

A U.S. PERSPECTIVE ON ZERO INFLATION

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Good afternoon. I am pleased to have this opportunity to address the C.D. Howe Institute on the merits of a monetary policy that strives for zero inflation; a policy that has been widely debated in both Canada and the United States over the past several years.

Policymakers in Canada and the United States have become more aware that a commitment to price stability is the most important contribution monetary policy can make to achieve full employment and maximum sustainable growth. Governor Crow and other Bank of Canada officials have publicly supported the goal of price stability. In the U.S., Federal Reserve Chairman Alan Greenspan and the 12 Federal Reserve Bank presidents have publicly supported House Joint Resolution 409 introduced by Congressman Stephen Neal of North Carolina. This resolution would make zero inflation the primary, overriding goal of the Federal Reserve.

Today, I would like to discuss the U.S. perspective on zero inflation. Policymakers and businessmen are beginning to recognize that inflationary monetary policies are very costly, and I believe that support for a goal of price stability will continue. Nevertheless, there are signs of complacency in the United States that concern me. Inflation has hovered around 4 percent for most of the current expansion in the U.S. and has exceeded 4 percent for the past 3 years. In August 1971, the President of the United States and his administration were so disturbed by a rate of inflation just above 4 percent that wage and price controls were imposed. We should not be complacent about a 4 percent inflation rate. Even a low rate of inflation interferes with economic efficiency and productivity. Only in an environment of price stability can the economy achieve maximum, sustainable growth.

Price Stability: Reduces Uncertainty and Spurs Growth

An important benefit of price stability is that it would stabilize the economy and spur growth. High and variable inflation has always been one of the prime causes of financial crises and economic recessions in the United States and Canada. Every recession in our recent history has been preceded by an outburst of cost and price pressures and the associated imbalances and distortions. A monetary policy that strives for price stability, or zero inflation, would help markets avoid distortions and imbalances, stabilize the business cycle, and promote the highest sustainable growth in our economy.

Even fully anticipated inflation can have a profound impact on economic growth. Inflation interacts with the tax structure to stifle incentives to invest. Research at the Federal Reserve Bank of Cleveland indicates that a steady, fully anticipated 4 percent rate of inflation would reduce the U.S. capital stock and lead to a future loss in production of about \$600 billion. This estimate is much greater than the output loss typically associated with recessions. Moreover, the \$600 billion estimate includes only the loss associated with the failure to fully index taxes on capital income, ignoring the costs to decisionmakers of the uncertainty caused by inflation.

Unfortunately, the costs associated with unanticipated and uncertain inflation can be substantial. Random and unanticipated inflation can disrupt and disturb otherwise prudent and productive investments. The uncertainty created by inflation surprises stifles growth by adding risk to decisions and by retarding long-term investments. Furthermore, inflation causes people to invest scarce resources in activities that have the sole purpose of hedging against these adverse price fluctuations. A number of studies have shown that higher inflation or higher uncertainty about inflation is associated with lower real economic growth.

Sound Policy, Credibility, and the Neal Resolution

Through sound economic policies, policymakers seek to minimize this disruptive uncertainty. As long as we live in a world of imperfection, some uncertainty will always exist. But, economic policy should not create unnecessary confusion. Sound economic policies must have clear objectives, verifiable outcomes, and rules that are consistently adhered to in order to minimize uncertainty. Predictable, verifiable policies ensure that long-term planning and resource allocation decisions will be efficient.

Monetary policy can and should be guided by these characteristics of sound policy. Representative Stephen Neal's resolution satisfies the key requirements of sound policy: it is clear, it is verifiable, and it has consistent rules. The Neal Resolution would mandate the Federal Reserve to eliminate inflation over a five-year time period, and maintain price stability thereafter.

If policymakers have learned anything over the past 20 years, it is that policy is a dynamic process. That is, the effect of monetary policy depends greatly on people's expectations of future policy. The commitment to price stability supported by a legislative mandate would increase the credibility of the Federal Reserve. Improving the credibility of the central bank would strengthen the expectation that prices will be stable, contributing to price and wage decisions that would make price stability easier to achieve and maintain.

The Neal Resolution would not only contribute to the Federal Reserve's credibility, but it would also enhance the Fed's independence from political pressures as it pursues that goal. A commitment by the United States Congress to price stability would reduce the political pressure to deviate from that goal. Thus, a distinction can be made between a central bank that is accountable for long-run performance and a central bank that can be influenced to pursue short-run goals that might be incompatible with desirable long-term economic performance.

A History of Multiple Goals

Why does the Federal Reserve have the need for an explicit declaration of a single goal for monetary policy? Over the years, legislation in the U.S. has assigned multiple objectives for economic policy. Stability and growth of the economy, a high level of employment, stability in the purchasing power in the dollar, and a reasonable balance in transactions with foreign countries were recognized by Congress as objectives for governmental economic policy in the Employment Act of 1946. More recently, the Federal Reserve Reform Act of 1977 amended the Federal Reserve Act so that it now requires the Fed "...to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates." However, it is the Federal Reserve's responsibility to decide how best to pursue those goals.

Up to now, the Federal Reserve has attempted to achieve a balance among its congressionally mandated objectives. We have strived to balance the economic goals of full employment, economic growth, and low long-term interest rates with low rates of inflation. However, as policymakers have discovered over the past several decades, pursuing multiple policy goals is confusing to markets and disruptive to long-term economic growth.

A more promising approach is to select one objective, the only one that the Fed can influence directly -- price stability. Under the provisions of the Neal Resolution, the Fed would seek to maintain a stable price level over time. Price stability is defined in the resolution as an inflation rate so small that it does not systematically affect economic decisions. The definition may appear less specific than some would like, but I believe that by monitoring the decisions of economic agents we can measure the success in achieving price stability. In practice, the size of the inflation premium in long-term interest rates, surveys of the public's inflation expectations, and other market-generated measures of inflation expectations can be very useful. If policy is credible, both the inflation component and the inflation uncertainty risk premium would be eliminated from interest rates.

Enactment of the Neal Resolution would create a situation similar to that of West Germany's central bank. More than one goal is specified by law for the Bundesbank, but German law states that the goal of price stability is to be given highest priority whenever another goal might conflict. This is the major reason that West Germany's price level doubled between 1950 and 1988, while the U.S. price level quadrupled.

While monetary policy may be capable of influencing the economy in the short run, these effects are only temporary. Ultimately, excessive money growth results in higher rates of inflation and higher interest rates. The rate of inflation affects all dimensions of economic performance, including output, employment, and interest rates. Over time, maximum production and employment along with low interest rates can be achieved only with price stability.

U.S. Fiscal Policy and Zero Inflation

As I said earlier, support of a monetary policy that strives for zero inflation is building in the United States. However, opponents of the Neal Resolution often argue that particular economic conditions make the pursuit of price stability too costly. For example, it is argued that high federal budget deficits in the U.S. make a monetary policy of zero inflation impossible. Federal budget deficits should not compromise either the central bank's goal of price stability or the adoption of a specific timetable to achieve it. I do not mean to suggest or imply that current fiscal policy, in either the U.S. or Canada, is ideal. But, we should recognize that monetary policy cannot offset whatever harm may result from inappropriate fiscal policies; indeed, it can only add to those costs.

In the United States, we are familiar with the argument that large federal budget deficits cause high interest rates, forcing the Fed to ease monetary policy in order to keep interest rates at levels consistent with full employment. Even if larger deficits were to put upward pressure on interest rates, and there is little consensus among economists that this is the case, it is far from clear that the Federal Reserve can do anything to alleviate the economic consequences of that problem. Ultimately, it is real interest rates that affect the consumption and production decisions of individuals and businesses and the allocation of resources over time. Real rates of return are based on the productivity of labor, capital, and other real assets in a society, and have very little, if any, connection with monetary policy.

In an inflationary environment, nominal rates of return include an inflation premium to compensate lenders for being repaid in money of reduced purchasing power. The correlation between monetary policy and nominal interest rates that dominates discussion in the financial press tells us next to nothing about the relationship between monetary policy and the real interest rates that govern the allocation of resources over time. Every movement in the central bank discount rate does not produce equivalent changes in real interest rates, in the productivity of our capital stock, or in any of the other important real variables that affect economic activity.

It is unnecessary and undesirable for sound monetary policy choices to await sound fiscal policy choices. Sound fiscal policy decisions, like sound private economic decisions, require the stable price environment that a commitment to zero inflation would provide. The tax-related distortions and economic complexities associated with even stable, positive rates of inflation argue strongly for price stability.

Information and the Current Policy Process

Critics argue that the Federal Reserve should release more information about monetary policy in a more timely fashion. In the 1950s and 1960s, the Federal Reserve provided less information than it does today. But the information provided in the 1950s and 1960s was adequate because price level stability was the generally expected norm. Moreover, the intentions of policy were more apparent because monetary velocity was thought to be highly predictable, making monetary aggregates more reliable indicators of policy intentions. In the 1970s and early 1980s, the increased uncertainty about monetary velocity, associated with variable inflation and deregulation of the financial services industry, left much doubt and uncertainty about the goals and objectives of monetary policy, giving rise to calls for more information.

Monetary policy information comes in two forms: policy **actions** and policy **intentions**. Policy actions refer to open market operations and discount rate changes. They might also include reserve requirement changes, but I will restrict my comments to the most often-used policy tool -- open market operations. The Federal Open Market Committee (FOMC), the Federal Reserve's monetary policymaking body, describes these actions as decisions to maintain or change the degree of reserve pressure, a characterization that at present is generally interpreted in terms of its effect on the level of the federal funds rate.

Policy intentions, sometimes called the "policy reaction function," refer to potential future policy actions in response to evolving economic and financial conditions. Knowledge of policy intentions helps rational agents plan and carry out their market activities with minimum losses due to surprises.

Monetary policy intentions are difficult to characterize because the FOMC has discretion in formulating policy within the scope of its multiple objectives. Even though each individual FOMC member may have policy intentions, the FOMC as an official body has not specified either its ultimate objectives or its intended reaction to new information. And, in the context of multiple goals, it is not always clear in advance how the Committee will respond to new information about the economy, or how fast or slow policy should move to correct deviations from those goals.

A rotating committee of 12 people pursuing multiple objectives surely would be expected to have difficulty trying to reach agreement both on a single, unambiguous policy intention and on a policy action consistent with that intention. In effect, the members of the Committee must reach agreement at each meeting on acceptable current policy, even though there may be differences in ultimate policy goals or the way members would pursue those goals. Reaching agreement on an immediate, explicit policy action at each meeting has been the method by which the 12 members have reconciled their differences in policy goals and methods of implementation until the next meeting.

Improving the Policy Process

A lack of credibility and predictability in the policy process is the problem. More specifically, policy lacks an explicit, attainable objective. Under the current policy process, the relative importance of the various objectives changes with economic fluctuations. To accurately assess past and future decisions, market participants must constantly update their best guess about the central bank's long-run objectives. In the current environment, the market monitors policy actions to detect policymaker's intentions. But the lack of a clearly defined long-term goal makes market expectations of the goal vary with the latest economic news. This uncertainty reflects an economic policy that is neither predictable nor sound.

Some people believe that more information about current policy actions would reduce uncertainty and improve market efficiency. There is legislation under consideration in the United States that would require earlier release of the FOMC's decisions. But, would earlier release of information regarding the FOMC's actions reduce uncertainty? I think not. More timely information about open market decisions cannot substitute for other needed and more important changes in policy procedures.

Economic decisionmakers need more information about the long-run goal of monetary policy, not more information about yesterday's open market operations. More information about policy actions may help markets operate more efficiently in the current environment, but the improvements may not be very large and may carry with them the cost of diverting attention from the fundamental information problem. To be fully efficient, markets need to know that the long-term inflation rate will be zero. This requires a monumental change in the current policy process. The Neal Resolution, with its clear focus on price stability, would help bring about this change.

Conclusion

The ultimate goal of monetary policy must be to provide a credible and predictable commitment to price stability -- a requirement for peak performance of our market economy. Achieving this goal at the least cost requires that policymakers provide markets with certain basic information that will minimize uncertainty about the commitment and about the timeframe within which it is to be accomplished.

If central banks and governments were to commit to an explicit plan for price stability, nations could realize benefits that would be large and permanent. An explicit commitment to zero inflation would be a milestone in modern economic policy-making because it would shift the focus of monetary policy away from short-term fine-tuning to the long term, where it belongs.