Outline for

Jerry Jordan's Remarks to

STARK DEVELOPMENT BOARD, INC. BOARD OF TRUSTEES

Stark Technical College
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I. OPENING REMARKS

A. Thank speaker for introduction

B. Pleasure to be here, etc.

C. Tell a joke??

II. INTRODUCTION

A. Over the past 12 months, nation has witnessed dramatic decline in long-term interest rates.

  1. A year ago, the interest rate on 30-year Treasury bonds stood at 7.5%. Now, the rate is under 6%.

  2. Rate on 10-year notes was 7-1/4% a year ago. Now, the rate is about 5.4%

B. Three reasons have been advanced to explain decline:

  1. After more than a decade of working at it, the Federal Reserve is gradually persuading investors we are serious about keeping inflation in check, so inflation premium built into rates is declining.

  2. Investors believe the fiscal authorities -- Congress and the White House -- are serious about long-term deficit reduction, reducing concern government will attempt to monetize its debt in the future.

  3. Many believe that the budget package Congress passed earlier this year will slow economic expansion, thereby reducing inflationary pressures.

C. In other times, such a large drop in the cost of borrowing might be expected to bring about upsurge in economic activity.

D. But despite last year's solid performance, economic activity in the first half of this year faltered. This development led some in government, business, and media to call for Federal Reserve to push interest rates still lower.

E. Most important contribution of the Federal Reserve, or any other central bank, to the creation and maintenance of prosperity, is to bring about price stability. This morning I'd like to discuss three questions relating to price stability:

1. What is it?

2. Why is it important?

3. How does the Federal Reserve's charter affect its ability to bring about price stability?

III. WHAT MONETARY POLICY *CANNOT* DO

A. Before answering these questions directly, it might help to state what monetary policy *cannot* do:

1. Increase production of real goods and services.

2. Permanently lower the unemployment rate.

3. Create employment.

4. Peg, or permanently lower, the real interest rate.

B. For proof of limitations of monetary policy, one need only look at current state of economy, reasons behind slow recovery from recession:

1. Historically high indebtedness of businesses and consumers, which has made both groups reluctant to spend.

2. Overbuilding in commercial real estate market.

3. Cutbacks in defense spending, resulting from end of the Cold War, and the political decision to fund other things.

4. Budget problems among state and local governments, resulting in layoffs, tax increases, reductions in transfer payments.

5. Contraction of the savings & loan industry, disrupting many long-standing lending relationships.

6. Commercial bank extensions of credit have been slow, due in part to weak loan demand in some areas of the country, and in part to banks setting higher standards of credit worthiness.

7. Uncertainty over long-term effects of government's budget and health care reform packages.

C. These are structural, or in some cases political, problems. Debasing the nation's money supply will not solve them.

D. Moreover, it's not true to say "there's no harm in trying." If the Federal Reserve uses monetary expansion to attempt to do those things, it can harm the economy by reigniting inflation. Motto of a central bank should be, "Do no harm."

E. Ultimately, it is the private sector which creates jobs and prosperity. The role of the Federal Reserve is to help create an environment in which the private sector can accomplish these ends. Fed can best do this by creating price stability.

IV. WHAT DO WE MEAN BY PRICE STABILITY?

A. It's a term that can mean different things to different people.

1. To some, it's a condition of low inflation, where year-to-year changes in the price level, as measured by the Consumer Price Index and other indices, are minimal.

a. I don't think that's good enough, because even at what seems like low inflation, the purchasing power of our currency diminishes with surprising speed. At an annual inflation rate of 4%, the price level doubles in 18 years.

2. To some, it refers to stability in the aggregate price level of goods and services.

a. That definition is closer to the mark, but I believe it should be expanded to include the prices of assets.

b. If our goal is to maintain the purchasing power of the currency, then the prices of assets that are important to households and businesses need to be reflected in calculations of the price level.

3. To others it means a target of zero inflation, that is, a zero percent year-to-year change in the aggregate price level.

a. I believe the target should be **stability** of the aggregate price level.

b. Distinction is small, but crucial:

(1) We might aim for zero inflation, but if we miss the target, even by a little each year, over the long run that can still add up to a significant reduction in the value of the currency.

(2) By aiming for stability in the aggregate price level, we make it clear that, over time, there will be no cumulation of errors. If we do go above the target price level, our intention to come back down to that price level is clear.

V. WHY IS PRICE STABILITY GOAL IMPORTANT?

A. Without it, inflation is more likely.

B. How inflation is costly to economy:

1. Inflation hampers efficiency by distorting price signals.

a. When the price of a good or service increases during inflation, it's not clear how much of the increase is relative, and how much is due to the increase in the aggregate price level.

b. Result is to reduce efficiency of decision-making by households regarding consumption, savings, and employment, and of firms regarding output levels, capital-labor ratios, and material inputs to production processes.

2. Uncertainty adds to investment risks, increasing the risk premiums in interest rates, reducing investment, and shifting it toward shorter-lived capital goods and projects with quicker pay-backs.

3. Inflation interacts with tax code to discourage savings and investment.

   a. Interest earned on assets is taxed in full, even though part of the return is merely an inflation premium.

   b. Business investment is discouraged, because business profits are overstated, and therefore overtaxed. The tax code allows depreciation only with respect to the purchase price of capital equipment, rather than the replacement cost.

4. Unexpected inflation redistributes wealth and earned income:

   a. Wealth from net creditors to net debtors.

   b. Earned income from those with inflexible wage contracts to those with ability to raise wages or prices faster than inflation.

5. Inflation creates incentives for households and businesses to use their resources in finding ways to hedge against inflation, rather than in productive capacities:

   a. Households hedge against inflation by, for example, buying houses larger than what they really need, or purchasing assets such as gold for which they would otherwise have no need.

   b. Businesses keep inventories that are larger than needed for most efficient production, consultants sell advice for methods of hedging against inflation, financial institutions develop tools to be used as inflation hedges.

c. Result is people and businesses diverting some of their resources to try to alter inflation's redistributive effects to their benefit, rather than adding to the existing stock of the nation's wealth.

6. In sum, a policy of price stability would enable the Federal Reserve to have the maximum positive impact on the nation's economic well-being.

   a. Businesses could plan for the future without worrying if inflation will upset their plans.

   b. Efficiency would be increased, as confusion in price signals is reduced.

   c. Disincentives for savings and investment are reduced.

   d. Resources once used for hedging against inflation can be redeployed to other, more productive uses.

VI. HOW DOES THE FEDERAL RESERVE'S CHARTER AFFECT ITS ABILITY TO BRING ABOUT PRICE STABILITY?

A. Although price stability is a noble ideal, the Fed's charter does not specify a goal of pursuing it singlemindedly.

B. Since the Fed's establishment 80 years ago, Congress has enacted numerous, and sometimes contradictory, laws designed to give direction to Federal Reserve policies. Among these have been:

1. The Employment Act of 1946.

2. Federal Reserve Reform Act of 1977.

3. Full Employment and Balanced Growth Act of 1978, more commonly known as the Humphrey-Hawkins Act.

   a. 1977 Reform Act amended Federal Reserve Act of 1913 so that the Fed now is required "to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates."

b. Many people regard these goals as contradictory, but properly understood, they are really the same thing, and are not in conflict.

c. In the long run, the only way to ensure steady growth and maximum employment is through price stability.

C. Other nations, including some of our chief competitors, are aware of the connection between prosperity and price stability.

1. In what used to be West Germany, for example, the central bank had a variety of goals specified by law, but the law also stated that whenever any of its goals conflicted, price stability was to be assigned the highest priority.

2. Helps to explain why West Germany's price level rose 135% between 1967 and 1992, versus 308% for the U.S.

D. I believe the nation would be better off if we followed the example of Germany, and made price-level stability the number one priority of the Federal Reserve. Furthermore, I believe the Federal Reserve should state explicitly when it intends to reach that objective, and should be held accountable if it does not stay on schedule.

E. Price-level stability is not only consistent with full employment, maximum sustainable growth, and low interest rates, but it makes a significant contribution to their achievement. Indeed, it is the most important contribution the Federal Reserve can make.

VII. CONCLUSION

A. At beginning of my talk, I said there were three possible explanations for decline in long-term interest rates.

B. In fact, it's probably a combination of them.

1. Public starting to believe government is serious about tackling deficit, although funding of the President's health care reform package is raising eyebrows again.

2. Public is gaining faith in Federal Reserve's pledge to seek price stability.

3. "Fiscal drag" effect of budget package.

C. Result has been lowest interest rates nation has seen in decades.

D. I believe this is an excellent time, therefore, to consolidate these hard-earned gains with a firm and clear commitment to price stability on the part of the Federal Reserve. It is the most important contribution we can make to the nation's long-term economic well-being.

E. Thank you. Now I'll be happy to take your questions.