Central Banks: Different Paths, Same Goal

Additional Information

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Milan, Italy

February 21, 2005

Introduction

As you know, I serve as president and CEO of the Federal Reserve Bank of Cleveland. This is one of 12 Reserve Banks that, along with the Board of Governors, make up the Federal Reserve System. One of the Federal Reserve's great strengths is its decentralized structure, which enables the different regions of the United States to be represented in the policymaking process. I also serve on the Federal Open Market Committee, or FOMC, the group that sets U.S. monetary policy.

Central bankers have achieved a remarkable consensus over the past two decades in the belief that our long-term policy goal should be achieving low and stable rates of inflation - or what we refer to as price stability. I would like to talk about why I believe that price stability is the most important contribution that central banks can make to economic prosperity in their nations.

I will discuss three aspects of this message. First, central bankers agree that price stability encourages greater economic growth and financial stability over time. Second, it is natural, and not at all contradictory, to see central banks using different policy tactics in the short run as they confront different economic conditions in their countries. Finally, a firm commitment to price stability means that central banks will not be diverted by economic problems that they cannot solve.

Please note that the views I express today are mine alone. I do not presume to speak for any of my colleagues in the Federal Reserve System.

I. The Price Stability Consensus

Let me begin by saying that central banks did not always believe so strongly in the pursuit of price stability. Indeed, throughout human history, when governments became involved with money, inflation typically followed. That is because when economic times got tough, or budgets were pinched, governments often yielded to the temptation to cheapen the value of money by printing too much of it, or sometimes by minting lighter coins. Perhaps they were trying to stimulate faster economic growth, or perhaps they were simply trying to finance their own spending without raising taxes. But whatever the reason, the result was the same - economies eventually suffered under an inflationary policy.

Even as early as the 14th century, the dangers of inflation were recognized. In The Inferno, Dante writes about the fate of counterfeiters and other "falsifiers of money" - people who were responsible for devaluing the currency. He places them in one of the deepest parts of hell. Again in the third book of his Divine Comedy, Dante predicts a terrible fate for two other officials, one French and one Serbian, who debased their countries' currencies. According to a translator of his writings, Dante envisioned this severe punishment not because he loved money, but because he believed that a sound coinage - or sound money - was an essential principle of social order.

We are not so quick to condemn those who practice inflation today. But we do understand that sooner or later, inflation introduces all sorts of costly economic distortions and uncertainty. Consumers and businesses come to realize that the purchasing power of their money is declining, and they look for ways to avoid holding that money. If inflation is unexpected or sustained, people even lose confidence in their central bank.

Those of us who remember the 1970s can attest to the deep troubles brought on by inflation. For a variety of reasons, the central banks of many industrialized nations slipped into inflationary territory during that decade, only to find that these policies made their problems even worse. In the United States, for example, the purchasing power of the dollar shrank so much that a person needed more than two dollars in 1980 to buy what would have cost only one dollar in 1970. A person's purchasing power was cut in half in just 10 years.

By 1981, the yield on 30-year U.S. Treasury bonds was driven up to 14 percent, as the Federal Reserve worked to reduce inflation. An inflation premium was built into interest rates, and people shifted their portfolios into physical assets such as houses, land, and commercial property to avoid uncertainty about the purchasing power of their assets.

Inflation became so intolerable in so many countries that the stage was set for a big turnaround. Over the past couple of decades, public support has developed for a return to low inflation, not just in the United States, but around the world. Inflation in the industrialized countries fell from 9 percent in the first half of the 1980s to 2 percent early in this decade. But even more impressive was the huge decline in inflation among the developing nations - from roughly 30 percent to 5 percent - during those same two decades.

Dramatic reductions in inflation have been accompanied by improved economic performance in many countries. In the United States, for example, real output growth has been higher, the frequency of business cycles has declined, and the swings in the business cycle seem to have become milder. Federal Reserve Board Governor Ben Bernanke is one observer who calls this post-inflation era "the Great Moderation."

People may disagree about how much of this Great Moderation is the result of non-inflationary monetary policies, how much is due to structural changes in national economies, and how much we can just chalk up to good luck. But I am convinced that this improved economic performance would not have been possible and could not have been sustained if central banks had not suppressed the urge to create too much money.

The consensus support for price stability among central banks has clearly made an important difference to the public and to their governments, and it remains strong around the world. In fact, some nations, along with the European Central Bank, have chosen to set explicit numerical inflation-rate objectives for their central banks. Others, like the United States, have been fairly successful without them. But overall, central banks are aiming in a similar direction: to promote sustained economic growth by maintaining low and stable inflation rates.

II. Different Policy Tactics

So, if we see that most central banks have the same ultimate goal, then why does it sometimes appear that they are pursuing different monetary policies? For example, why has the Federal Reserve been raising its federal funds rate target over the past several months, while the European Central Bank has been holding its target rate steady for more than a year and a half? And why has the Bank of Japan's policy resulted in overnight money market interest rates close to zero for more than three years?

The answers to these questions have everything to do with the cyclical and structural differences among the nations operating on these different monetary standards: the dollar, the euro, and the yen. National economies differ in fundamental ways - in their legal systems, labor and capital mobility, and trade policies, for example. Other differences are found in their natural resources, fiscal systems, property rights and demographics. Each of these factors affects how an economy will grow in the long term. They also determine a nation's vulnerability to economic shocks, such as a spike in energy prices.

Those differences can be challenging to overcome. Just think how much work was done over the past quarter-century before the euro could be adopted as the common currency for 12 national economies. The European Union adopted the single-market initiative, and all of the nations involved worked hard to harmonize their economic fundamentals. Fiscal positions and trade balances were brought much more into line, and national inflation rates had converged substantially even before the euro circulated.

While maintaining a long-term focus on price stability, central banks can adopt different short-term monetary policy tactics. Recent experience offers us some good examples. Many industrialized economies experienced either an economic slowdown or an outright recession a few years ago. But because inflation was already low, the danger arose that inflation could become too low. Several central banks, including the European Central Bank and the Federal Reserve, found themselves confronting the possibility of deflation - a decline in the price level - a situation that had already developed in Japan.

These developments made both central banks think more carefully about the lower bounds of their price stability goals. In the United States, this lower boundary had been irrelevant during the long disinflationary period of the previous 20 years. But once the complications of an outright deflation became a realistic possibility, the Federal Reserve took action. The Federal Open Market Committee implemented a more accommodative policy than it might have done in the past to insure against deflation. At the same time, the Committee communicated its intentions to the public openly and repeatedly.

But these days, deflation insurance is less important. For the most part, industrialized countries are now in various stages of expansion, and most central banks once again are likely to be preoccupied with more typical inflation-fighting issues. The FOMC, for example, has moved since last June to reduce the accommodative stance of U.S. monetary policy as economic conditions have improved. The Committee views this policy as consistent with its goal of maintaining long-term price stability.

At the same time, however, the European Central Bank and the Bank of Japan are responding to a more sluggish pace of economic recovery, so their policy tactics are different. These central banks are providing enough liquidity to accommodate economic growth, even though their short-term inflation situations differ. In Japan, the price level has been falling despite monetary accommodation; in Europe, inflation remains slightly above the European Central Bank's formal 2 percent inflation target. Yet, in each case, the public seems to recognize that the intent of their central bank is to pursue long-term price stability.

This is where the credibility of monetary policy really makes a difference. When central banks have consistently pursued price stability as their long-term goal, and demonstrated success, then temporary deviations - even minor adjustments to inflation targets - do not appear to change the public's expectations. In the late 1970s to early 1980s, as U.S. households witnessed rising inflation, they became skeptical about long-term price stability. Even as the inflation rate gradually declined during the 1980s, the public kept expecting the inflation rate to move back up. Only after a long period of actually experiencing lower inflation did people become convinced that the trend rate had in fact declined.

One way of illustrating this change in U.S. inflation psychology is to consider recent trends in inflation and inflation expectations. During the past five years, the U.S. Consumer Price Index has fluctuated around an annual increase of 2.5 percent. But even though the rate was 3.3 percent in 2004, nearly a full point higher than the five-year average, long-term inflation expectations have stayed in a fairly tight range around 2.5 percent. So we see that if central banks actually deliver price stability, then they can get enough public support to address short-term liquidity needs with greater confidence that inflation expectations will remain well anchored.

III. Monetary Policy Is Not a Cure-All

Over the past 20 years, price stability has contributed to better real economic performance through less-volatile interest rates, more efficiently allocated resources, and healthier financial systems. But nations must inevitably contend with economic issues that monetary policy cannot solve.

For example, a central bank needs to pay close attention to the effects of energy price shocks on the economy. Central banks must consider the possibility that energy price increases could slow the pace of economic activity and put upward pressure on inflation. During the past few years, the U.S. economy has been expanding even as energy prices have increased sharply. Once the expansion appeared to be on solid ground in 2004, the FOMC began a gradual retreat from its accommodative policy stance to contend with any potential inflationary pressures that might arise. In the long run, a central bank supplying more money cannot create more energy resources, but a credible monetary policy will help smooth economic adjustments that higher energy prices might require.

Also, a central bank supplying more money cannot boost national saving. A growing concern in many industrialized countries, including the United States, is the prospect of large and persistent federal budget deficits. I am not talking just about near-term borrowing needs, but also about potential shortfalls associated with future entitlement programs, including those for income and medical security.

Deficits can indeed be a problem. A government finances budget deficits by selling debt to its own citizens and to foreigners. Real interest rates could rise as government deficits crowd out business and consumer investment. But, despite what popular commentaries might suggest, there is no need for deficits to be inflationary. The prospect of inflation arises only if the central bank tries to resist the rise in real interest rates, thereby keeping its policy rates too low and inadvertently easing monetary policy.

A central-bank commitment to price stability cannot always offset the effects of government deficits on economic growth and stability. But the more credible the central bank's commitment to price stability, the less likely that an inflation premium will be built into market interest rates. The best way for an economy to adjust to outside shocks and government deficits is in an environment of low inflation and stable inflation expectations.

Conclusion

I hope that my comments have helped to clarify why I believe that price stability is the most important contribution that central banks can make to economic prosperity. If central banks do not deliver monetary conditions consistent with price stability, then no one else can.

Price stability clearly contributes to longer-term economic growth and financial stability. As policymakers confront different inflation and economic growth environments, however, it is natural for us to adopt different tactics at particular points in time for responding to these circumstances.

Nations do have economic problems for which there is no monetary policy cure. But price stability provides a solid foundation for responding to the inevitable short-term shocks and economic fluctuations.