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The Power of Price Stability

Introduction

I am beginning my third year as president and CEO of the Federal Reserve Bank of Cleveland and as a participant of the Federal Open Market Committee, the Federal Reserve's policymaking arm. I will tell you that I have seen more than a few twists and turns in the path of the economy during that time.

The economy has been expanding for the past few years, but many people seem to think that, in spite of its fundamental underlying strength, the economy could face some challenges from fiscal and trade deficits. Today, I would like to explain how I think central banks can best meet those challenges and promote economic prosperity - by maintaining price stability, or low and stable rates of inflation. I will talk about three aspects of this message.

First, we have achieved a global consensus that central banks should pursue price stability.

Second, while large budget deficits are clearly undesirable and may add some complexity to monetary policy decision-making, they do not need to undermine our success in maintaining price stability.

Finally, a firm commitment to price stability is the best contribution monetary policy can make toward resolving the challenges posed by external account imbalances.

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 explaining why I believe we have achieved a global consensus in support of price stability. We know that central banks have a rather checkered past when it comes to the pursuit of price stability. 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 discussed. In *The Inferno*, Dante writes about the fate of counterfeiters and other "falsifiers of money"-the people who were responsible for devaluing the currency. He places them in one of the

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deepest parts of hell. Again in the third book of his Divine Comedy, Dante predicts a terrible fate for two officials who debased their currencies. According to a translator, 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.

Thankfully, we are not so severe with those who create inflation today. But we do understand that sooner or later, inflation introduces all sorts of costly economic distortions and uncertainty. When consumers and businesses come to realize that the purchasing power of their money is declining, they look for ways to avoid holding that money. Those of us who remember the 1970s can attest to the deep troubles brought on by spiraling inflation.

Over the past couple of decades, we have seen growing public support 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 6 percent - during those same two decades.

Dramatic reductions in inflation have also been accompanied by improved economic performance in many countries. In the United States, 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, whom President Bush recently nominated to chair his Council of Economic Advisers, is one observer who calls this post-inflation era "the Great Moderation."

People may disagree about how much of the improvement in economic growth and financial stability is the result of non-inflationary monetary policies, how much is due to structural changes in national economies, and how much we can chalk up to just plain good luck. But I am convinced that this improved performance would not have been possible and could not have been sustained if central banks had not suppressed the urge to solve problems through inflation.

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 have chosen to set explicit numerical inflation-rate objectives for their central banks. Others, like the United States, have been successful without them. I believe that overall, central banks are aiming in a similar direction: to promote sustained economic growth by maintaining low and stable inflation rates.

II. Monetary Policy in an Era of Fiscal Deficits: More Difficult, Not Impossible

Let me turn now to the issue of whether large budget deficits may undermine central banks' success in maintaining low and stable inflation rates.

In the United States, current budget deficits, as well as prospective deficits over the immediate horizon, seem to be well within the boundaries of historical experience. Relative to the size of gross domestic product, recent government budget shortfalls are still substantially below the peak levels of the 1980s. Nevertheless, the public is expressing growing concerns about fiscal discipline. In the United States, these concerns have been provoked by the rapid increase in the federal budget deficit, to about 3-1/2 percent of GDP

in 2004, from a budget surplus in 2001. And the concerns are not unique to our own country. In Europe, we have seen a revision of the Growth and Stability Pact, which originally required euro countries to maintain fiscal deficits below 3 percent of GDP.

The current level of budget deficits certainly understates the magnitude of fiscal pressures. Both the United States and Europe face demographic changes where we see entitlement liabilities growing faster than the tax base available to support them. While these issues are not new, they are serious and should be addressed sooner rather than later.

Of course, resolving fiscal imbalances is not the job of monetary policymakers, but that does not mean that we can ignore their consequences. The stance of monetary policy - that is, whether a specific setting of the federal funds rate target is determined to be "tight," "easy," or "neutral" - depends on the level of what economists usually refer to as the "equilibrium real interest rate." This is the interest rate that would match the demand for funds with their supply, assuming that markets are working efficiently.

It is not unreasonable to expect that persistent government deficits will eventually yield upward pressure on the equilibrium real interest rate. If central banks want to maintain their intended policy stance, they will need to respond to this pressure with corresponding movements in their policy rates. This process would be easier if the equilibrium real interest rate could be readily estimated-but it cannot. In the United States, with the shift from fiscal surplus to deficit, we now have the added complication of trying to incorporate the effects of fiscal imbalances on changes in the equilibrium real interest rate.

Of course, any change in the economic environment that puts pressure on interest-rate fundamentals could introduce the same complication. But, unlike many other complicating factors, large and persistent fiscal deficits introduce another risk-namely, that they could be the source of inflationary pressures.

However, there is no need for deficits to be inflationary. The prospect of inflation arises only if the central bank ignores or, even worse, tries to resist any rise in real interest rates. By doing so, the central bank would keep its policy rates too low and inadvertently ease monetary policy. Of course, the real risk of an excessively stimulative monetary policy is that inflation expectations may eventually become unanchored. History shows that once inflation expectations become unstable, more stringent policy actions might be required.

A central-bank commitment to price stability can avoid that outcome. A central bank 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 it is that an inflation premium will be built into market interest rates, and the less likely it is that rising inflation expectations will distort economic decisions.

I believe that the FOMC is trying very hard to preserve its credibility by being clear and unwavering in its commitment to low and stable inflation. However, it goes without saying that our job is made easier if the public expects that the fiscal authorities will address budgetary imbalances in a timely and effective fashion.

III. Monetary Policy in an Era of Current Account Deficits

Now I would like to discuss how monetary policy can best contribute

to resolving the challenges brought by external account imbalances. Substantial current account deficits developed in the 1980s, and these deficits now stand at record postwar levels as a share of GDP. I think everyone agrees that these levels are unsustainable, and that a reversal is inevitable, even if the timing and pace of the adjustment are uncertain.

Some people envision a soft landing. As we all know, a return to current account balance will ultimately require that U.S. households consume less and save more of their incomes. Households could become concerned about having enough money for future consumption and step up their saving, even at today's interest rates. The more commonly expected scenario, though, is that foreign savings coming into the United States could become less plentiful over time, driving up interest rates. Then, households might be induced to save more and spend less.

If a substantial turnaround in U.S. current account deficits results in higher equilibrium real interest rates, the FOMC would most likely need to adjust its federal funds rate target accordingly to prevent a change in its policy stance. It is also possible that a decline in the exchange value of the dollar could result in temporary upward pressure on the price level, due to rising import prices and the prices of import-competing goods. The first responsibility of the central bank is to ensure that these price pressures do not feed into higher inflation expectations in the long run. Once again, a clear commitment to price stability - in words and deeds - is the best contribution the central bank can make to the adjustment process toward more sustainable external account positions.

The soft-landing point of view is really just the expectation that the process of adjustment will be a smooth one. I believe that a gradual and orderly transition toward smaller current account deficits is the probable outcome. But of course, there are those who believe that the landing might not be so soft - and that the reversal of our large current account deficits will be sudden and disruptive.

Those who imagine this worst-case scenario seem to have in mind a magnified version of the stress on global financial markets that emerged in the last half of 1998. Of course, they believe that the impact on the U.S. economy would be more severe this time because our own imbalances would be at issue. In these circumstances, it is difficult to predict what the specific course of monetary policy ought to be, but the usual answer to financial market crises is for the central bank to provide enough liquidity to short-circuit systemic market failure.

How, then, should monetary policy deal with current account imbalances today? I do not think that the FOMC should take preemptive measures to address these imbalances. However, I do think that the Committee should continue to bring the federal funds rate target to a level that is consistent with maintaining price stability in the long run. If we achieve that, then we will be in a position of strength to address whatever challenges arise.

Conclusion

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

In the long run, a central bank cannot balance the government's budget, boost national saving, create more energy resources, or solve

the many economic problems that we must confront. But a credible monetary policy will help smooth the adjustment to economic circumstances that come our way.

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. The best way for an economy to adjust to challenges like government deficits and current account deficits is in an environment of low inflation and stable inflation expectations. That is the contribution that the Federal Reserve can reasonably deliver, and it is the contribution that I intend to pursue as a policymaker.

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