Is Price Stability Attainable?

Additional Information

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Global Interdependence Center Conference: GIC Abroad in Ireland

Dublin, ireland

June 11, 2007

Introduction

I have just arrived here from Frankfurt, where the Federal Reserve Bank of Cleveland sponsored a conference with the Deutsche Bundesbank on some of the challenges facing central bankers. It is clear to me that we all share many of the same concerns, and importantly, we share the same priority - price stability.

For the European Central Bank, price stability is the sole objective. For the Federal Reserve, price stability is one pillar of our dual mandate, the other being maximum sustainable economic growth. Producing price stability is the surest way to enable the economy to grow at its maximum sustainable rate.

For the past two decades, central banks around the world have done an impressive job of achieving price stability. Despite our past successes, however, we must always stand ready to deal with challenges that could eventually confront us.

Recently in the United States, the Federal Reserve's Federal Open Market Committee has described our core rate of inflation as being uncomfortably high and has stressed the importance of further moderation in inflation. We have held our federal funds rate target at 5.25 percent for nearly a year, and we have stated that our predominant concern is "the risk that inflation will fail to moderate as expected."

In my remarks this morning, I will first explain why maintaining price stability requires keeping inflation expectations low and secure. Second, I will describe some inflationary risks that may become significant down the road. Finally, I will discuss why, in the face of these risks, central banks' ability to maintain price stability will depend on the clarity and transparency of their communications.

Please note that my comments today are my own. I do not presume to speak for any of my colleagues on the Federal Open Market Committee.

I. Why Maintaining Price Stability Requires More than Just Keeping Inflation Low

A few years ago, former Federal Reserve Chairman Alan Greenspan stated that "price stability is best thought of as an environment in which inflation is so low and stable over time that it does not materially enter into the decisions of households and firms."[1] This is a fairly common definition of price stability, and it has two essential characteristics. First, actual inflation must remain low and stable, and second, people must have every confidence that inflation will remain low and stable. This second characteristic may not get as much emphasis as it deserves. Price stability is more than keeping inflation in check - it also means keeping inflation expectations in check.

Of course, actions speak louder than words, and ultimately, the public will judge a central bank's resolve to keep inflation low and stable by whether it actually delivers low and stable inflation.

Expectations can become unglued under some circumstances, even if the current inflation measures appear contained. From time to time, there are pressures on a central bank to "buy" relief from economic troubles with artificially low short-term interest rates. The public understands these pressures, of course, and if they believe that their central bank will yield to the pressures, inflation expectations can rise. Also problematic is that inflation uncertainty can rise. Both of these outcomes impose costs on the economy by misdirecting how resources are allocated. Most notably, long-term interest rates move higher than they otherwise would, interfering with saving and investment decisions.

Central bankers face an unpleasant dilemma when inflation expectations become unanchored. Central banks could validate these expectations of rising inflation by actually delivering higher inflation, but that outcome would be contrary to our policy objective. Alternatively, central banks could pursue policies that generate lower inflation than the public expected. This, in my opinion, is the correct course, but there can be costs in terms of lower short-term growth - costs that would not be incurred if expectations had remained aligned with the central bank's inflation goal in the first place.

The past quarter-century has brought relatively good times for central banks. But the credibility test comes when the economic currents are not so favorable. History has not always been kind to central bankers, so if we are prudent, we must prepare for the challenges to price stability that may still lie ahead of us.

II. Potential Inflationary Risks Down the Road

Now let me describe some potential risks that I believe could challenge central banks down the road. Although there are many such risks, this morning I will focus on three familiar risks: relative price shocks, extraordinary liquidity crises, and fiscal imbalances. Please note that I do not regard these risks as imminent, but rather as representative of the risks that central banks face from time to time.

The first inflationary risk can occur when large and persistent relative price shocks temporarily ripple through the inflation data. The obvious example is energy prices, although we see such changes in commodity prices more generally. These price pressures are temporary and so do not represent changes in the inflation trend. Still, a central bank cannot ignore them if it hopes to maintain credibility for delivering low and stable inflation.

Since 2005, the three- to five-year moving average of U.S. inflation has hovered around 3 percent.[2] This is above where I would like to see the trend settle in the longer run. The reality of rising oil and commodity prices is evident, and my Federal Reserve colleagues and I have been clear that we believe the impact of these influences will dissipate over time. But until our beliefs are validated by the data, there is a risk that the public's trust could erode and inflation expectations could move higher.

The second inflationary risk that central banks should be prepared for could come about when responding to extraordinary liquidity crises. This is an important lesson learned from experience. Just consider a few examples of what the world's major central banks have dealt with in the past few decades: the U.S. stock-market crash of 1987, the Asian currency crisis in 1997, and the collapse of the Brazilian real in 1999.

Central banks have often provided liquidity in times of large-scale financial stress, and I think this is the appropriate response. But in any given case, there are still questions of how much to intervene, and for how long. How those questions are answered can have longer-term consequences for inflation expectations.

If central banks remove liquidity too quickly following a crisis, financial markets might not fully stabilize. However, if central banks maintain an accommodative policy too long after a crisis has passed - and the demand for liquidity has diminished - then inflation expectations can come unglued and future inflation can take root.

We live in an era of financial innovation and increasingly integrated financial markets. Clearly, these changes have fostered a more secure economic environment and have improved the wealth-generating capacity of the global economy. But great change rarely proceeds without challenges. We need to explore how best to meet those challenges in ways that will preserve the public's confidence in our commitment to price stability.

The final inflationary risk I want to emphasize is fiscal imbalances - in both the United States and Europe.

In the 1970s, economists Tom Sargent and Neil Wallace gave us a lesson in "unpleasant monetarist arithmetic." They noted that fiscal imbalances provide a temptation to inflate away the value of the government's debt, and this possibility may become embedded in inflation expectations. Those lessons are even more relevant when an important share of a nation's debt is held abroad. The political cost of inflating away debt is lower when that debt is held by predominantly by foreigners.

Unless the fiscal problem is addressed through explicit fiscal policies or changes in national saving rates, creditors might reasonably conclude that debtor governments will resort to inflationary policies. Ultimately, however, central banks cannot control either fiscal policy adjustments or private consumption decisions. If fiscal dynamics don't improve, central bankers could once again face the difficult challenge of maintaining price stability in a world where expectations are moving in the wrong direction.

III. The Importance of Clear Communications

So what assurances can central banks provide to secure inflation expectations in the face of these risks? Here, I believe, we are still learning. We actually know very little about how the public forms its expectations and the specifics about how best to secure them. In fact, just last month, the Federal Reserve Bank of Cleveland held a joint conference with the Federal Reserve Bank of Dallas to better understand inflation expectations. Central banks from 22 countries were represented, underscoring the universal interest in this topic.

What seems clear enough is that without guidance from the central bank, the public is left to guess about future inflation based only on the central bank's history. Clearly, history alone could be insufficient to hold expectations stable in times of crisis.[3] And so central banks are developing strategies to provide that guidance.

Suppose I asked you to describe the most important ways central banks have changed in the past quarter-century. What would you say? First, I think you would say we have shown a much greater vigilance against inflation. But second on that list, I think, would be that central banks today spend a lot of time communicating - about the economy, about their policy objectives, and about the risks to achieving those objectives.

In the United States, the Federal Open Market Committee issues a press release immediately following our meetings, with minutes of each meeting released only a few weeks afterward. I can assure you that every word and every nuance in our communications are carefully considered. It is essential that the public understand our interpretation of the economic situation and that they support our policies. In a very real sense, our communications have become a part of the policy process, because we understand that influencing inflation expectations is an important dimension of monetary policy.

Some central banks hold regular press conferences. And, of course, some have established explicit numerical objectives - or inflation targets - and publish economic projections that clearly show what they are aiming at and how they expect to get there. Our different approaches are, in part, a result of our different histories and governance structures. But also, I think, central banks are still developing "best practices" for securing inflation expectations in the face of unknown future risks.

However, differences in tactics should not be confused with differences in intent. I believe that my colleagues - and indeed, most central bankers today - are working to achieve the same end. We are all trying to create an environment in which inflation is so low and stable that it does not influence the decisions that households and businesses would otherwise make.

Conclusion

At the present time, inflation expectations appear to be well-anchored. But we cannot afford to be complacent. However, I continue to be optimistic that central bankers will successfully meet the challenges that lie ahead.

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[1] Alan Greenspan, "Transparency in Monetary Policy," Federal Reserve Bank of St. Louis Review, July/August 2002, p. 6.

[2] These figures are measured by the Consumer Price Index.

[3] This issue is discussed at length by Ben Bernanke in "Central Bank Talk and Monetary Policy," address to the Japan Society, October 7, 2004.