THE IMPORTANCE OF PRICE STABILITY
Remarks by
William J. McDonough, President
Federal Reserve Bank of New York
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It is a great pleasure to be here this evening, sharing the podium with my good friend and colleague, Hans Tietmeyer of the Deutsche Bundesbank. It is often said that there is a worldwide community of central bankers. I certainly feel that way. Central bankers in all countries share a number of concerns. Perhaps the most important of these is the desire for price stability. While central bankers may differ in the ways they seek to achieve price stability—differences grounded in our respective histories, customs, and institutions—the goal we all strive for is no less important.

This evening, recognizing that no one country's central bank has a monopoly on the right answers, I would like to share my views on why I believe price stability is so important and what approaches can be taken to achieve this goal. Before turning to these issues, we must first be clear about what we mean by price stability and how to recognize it when we see it.

A goal of price stability requires that monetary policy be oriented beyond the horizon of its immediate impact on inflation and the economy. This immediate horizon is on the order of two to three years. But the purpose of today's policy actions should be to lay the foundation for price stability and sound economic growth over the coming decade.

This orientation properly puts the focus of a forward-looking policy on the time horizon over which households and businesses will do most of their planning. This is the horizon that is relevant for the definition of price stability articulated by Chairman Greenspan: that price stability exists when inflation is not a consideration in household and business decisions.

What is critical in the operation of such a definition is that inflation expectations are anchored over the longer term by some transparent commitment by the central bank to an articulated standard. Unavoidable deviations from the longer term goal of price stability may then be explained with reference to that standard. For these purposes, a consistent measure of price stability is more important than what that exact number is.

A central bank's commitment to price stability over the longer term, however, does not mean the monetary authorities can ignore the short-term impact of economic events. It is important to recognize that, even if we set ourselves successfully on the path to price stability and even if, as a result, price expectations are contained, we still will not have eliminated all sources of potential inflationary shocks. The reality is that monetary policy can never put the economy exactly where we want it to be.

For example, supply shocks that drive prices up sharply and suddenly—such as the two oil shocks of the 1970s—are always possible. In such an eventuality, the appropriate monetary policy consistent with a goal of price stability would not be to tighten precipitously, but rather to bring inflation down gradually over time, as the economy adjusts to the shift in relative prices.

As you can see, I believe that monetary policy must be exercised cautiously. Why do I say this? Because contracts, especially wage contracts, can outlast a good part of, or even exceed, short-term shocks in duration. In the short term, therefore, monetary policy must accept as given the rigidities in wages and prices that these contracts create. Abrupt shifts in policy, given these rigidities, especially a monetary tightening in the face of wages that are unlikely to be cut, can cause unacceptable rises in unemployment and drops in output.

Before considering some of the specific ways central banks have sought to achieve price stability over the longer term, I would like to make clear why I believe price stability is so important and so desirable. In my view, a key principle for monetary policy is that price stability is a means to an end—to promote sustainable economic growth. Price stability is both important and desirable because a rising price level— inflation—even at moderate rates, imposes substantial economic costs on society. All countries incur these costs. They entail, for example:

• increased uncertainty about the outcome of business decisions and profitability;
• negative effects on the cost of capital resulting from the interaction of inflation with the tax system;
• reduced effectiveness of the price and market systems; and
• in particular, distortions that create perverse incentives to engage in nonproductive activities.

Let me be even more explicit about the negative effects of one particular type of nonproductive activity induced by inflation's distortion of incentives—the overinvestment of resources in the financial sector. As a former commercial banker, I am especially aware of the significance of this cost, and I believe that it deserves greater attention than it often receives in economists' lists of the costs of inflation.

The resources in high-inflation economies diverted from productive activities to nonproductive financial transactions are enormous. In the hyperinflations in Europe in the 1920s and again in various emerging market countries in the 1980s, we saw financial sectors grow severalfold. A number of estimates put the rise in the financial sector share of GDP on the order of 1 percent for every 10 percentage points of inflation up to inflation of about 100 percent. The economies that experienced high inflation consumed more financial transactions for an essentially given amount of real goods and services.

If individuals must spend more time, effort, and resources engaging in financial transactions because of the uncertainty inflation engenders, then more of the economy's productive capacity is transferred to the activity of handling transactions. Clearly, given my background, I am not opposed to an expansion of the financial sector that stems from growth of productivity, growth that offers benefits to the public. Equally clearly, I see an expansion of the financial sector that stems from an increasing number of people employed as middlemen, where none would be needed without the distortion of rising inflation and its attendant uncertainty, as growth that diverts resources better employed elsewhere. A bank branch on every corner means a corner store on none.
In short, the costs of overinvestment in the financial sector, like the costs of all inflation-induced nonproductive activities—such as tax code dodges—decrease the resource base available to the economy for growth. A move to price stability would give these economies the necessary incentives to shift resources back to productive uses. In the case of the financial sector in a high-inflation economy, the transfer of resources to productive uses could be as large as a few percentage points of GDP. This can be serious money indeed. And this is just one of the benefits of regaining price stability.

Rapid moves toward price stability from high inflation, however, do have their costs under certain circumstances. The over development of a sector for no reason other than the inflation rate is precisely one of those circumstances. The removal of the distortionary incentive leads to a rapid transfer of resources out of that sector, causing unemployment and business failures to follow: what was boom, goes bust. In those very same countries, we saw the severe contraction of the financial sector when inflation was finally brought down. This implies an additional argument for price stability. Namely, in a low-inflation environment, these boom-bust cycles created by distortionary incentives are less likely to emerge and can be more easily contained when they arise.

The avoidance of such unnecessary boom-bust cycles also limits the serious social costs that inflation can impose. For one, inflation may strain a country's social fabric, pitting different groups in a society against each other as each group seeks to make certain its wages keep up with the rising level of prices. Moreover, as we all know, inflation also tends to fall particularly hard on the less fortunate in society, often the last to get employment and the first to lose it. These people do not possess the economic clout to keep their income streams steady, or even buy necessities, when a bout of inflation leads to a boom-bust scenario for the economy. When the bust comes, they also suffer disproportionately.

Some would argue that establishing price stability as the primary goal of monetary policy means that central banks will no longer be concerned about output or growth. As I hope I have made clear, I believe this view is simply wrong. A stable price and financial environment almost certainly will enhance the capacity of monetary policy to fight occasions of cyclical weakness in the economy. Over the long run, price stability is the one sustainable contribution monetary policy can make to growth. This applies to all countries.

Over the past twenty years, there has been an emerging consensus among policymakers and economists that an activist monetary policy to stimulate output and reduce unemployment beyond its sustainable level, leads to higher inflation, but not to lower unemployment or higher output. Rather, although some countries have managed to experience rapid growth in the presence of high inflation rates, often with the help of extensive indexation, none has been able to do so without encountering severe difficulties at a later stage. It is thus widely recognized today that there is no long-run trade-off between inflation and unemployment. As a result, we have witnessed a growing commitment among central banks throughout the world to price stability as the primary goal of monetary policy.

How have central banks sought to achieve price stability? Some countries have begun to commit their central banks statutorily to pursuing the objective of price stability and are granting them a high degree of independence to do so. Empirical research in recent years has shown that both the average rate of inflation and its variability tend to decline in the presence of increased independence for central banks. This is why so many governments, particularly among the emerging market countries, have been providing their central banks with increased autonomy, following examples set by, among others, both the Bundesbank and the Federal Reserve.

Once a commitment has been made to price stability as the goal of monetary policy—and that commitment has been entrusted to an independent central bank—there are several possible approaches to implementing that goal. While the choice will depend on a country's history, economic conditions, and traditions, all successful approaches share two important features: first, they focus on a long-term time horizon and, second, they provide a transparent standard for the assessment of policy. For many of these approaches, what guides monetary policy is an announced target. Such a target is one proven means of credibly conveying to the public the commitment to price stability and thereby locking in inflation expectations.

There are a number of possible targets for monetary policy. All have been used with success in some countries while meeting with failure in others, depending upon the economic context in which they have been implemented. It is useful to step back and review briefly the advantages and drawbacks, as I see them, of three different targeting frameworks—exchange rates, monetary aggregates, and inflation.

Fixing the value of the domestic currency relative to that of a low-inflation country is one approach central banks have used to pursue price stability. The advantage of an exchange rate target is its clarity, which makes it easily understood by the public. In practice, it obliges the central bank to limit money creation to levels comparable to those of the country to whose currency it is pegged. When credibly maintained, an exchange rate target can lower inflation expectations to the level prevailing in the anchor country. Experiences with fixed exchange rates, however, have shown that a number of drawbacks. A country that fixes its exchange rate surrenders control of its domestic monetary policy. It can neither respond to domestic shocks that are not felt by the anchor country nor avoid shocks transmitted by the anchor country. Moreover, in the environment of open global capital markets, fixed exchange rate regimes are subject to sudden speculative attacks when markets perceive that domestic needs and exchange commitments diverge. These speculative attacks can be very disruptive to any country's economy.

On balance, it seems that a fixed exchange rate approach to price stability makes most sense when the country adopting it has an economy closely tied to the country or countries it is pegging to and is thus subject to similar international shocks in any case. This approach could also be worthwhile if a country is unable—for whatever reason—to make a credible commitment to price stability on a domestic basis alone. In either situation, the country must have available a large, low-inflation anchor country to which it can peg its currency.

Targeting monetary aggregates is another approach many central banks used in the 1970s and 1980s. This approach has been successfully maintained by a few prominent countries. Given a dependable relationship between the targeted monetary aggregate and the goal of price stability—where movement in the monetary aggregate predicts movement in prices—this framework offers a number of advantages. Like an exchange rate targeting, an announced monetary target is easily understood by the public. In fact, it conveys more information than an exchange rate target because it shows where monetary policy is and where inflation is likely to be going. The targeting of monetary aggregates has the additional advantage of focusing policy on a quantity that a central bank can control quickly, easily, and directly.

It is important to emphasize that the advantages of a monetary aggregate target are totally dependent upon the predictability of the relationship between the money target and the inflation goal. If fluctuations in the velocity of money—perhaps due to financial innovation—weaken this relationship, this framework will not bring price stability. In the United States, these relationships are not sufficiently stable for the monetary targeting approach to work. Of course, this does not mean that the approach has not or cannot work well in other countries.

A third approach to price stability is to target inflation. This approach has been adopted by a number of central banks over the past several years, and the initial results appear positive. The advantage inflation targeting shares with exchange rate and monetary targeting is its transparency to the public. The commitment to price stability is made clear in policy terms, and deviations from the pursuit of the inflation target over the longer term are obvious. Like a monetary aggregate target, an inflation target also provides monetary policy with the necessary flexibility to respond to economic needs in the short term. Finally, targeting inflation avoids the problem of velocity shocks because monetary policy is no longer dependent upon the money-inflation relationship.

The main drawback of inflation targeting is that inflation itself is not directly or even easily controllable by the monetary authorities. Furthermore, movements in pursuit of the inflation target only take effect with a lag, so that success in hitting the target is not quickly apparent. This is a problem that is not present in either exchange rate or monetary aggregate targeting. These difficulties may mean that the inflation target cannot strictly be met at times which, at a minimum, could lead to a rise in inflation expectations. Nevertheless, for countries that are unable or unwilling to fix their exchange rate to that of another country and cannot rely on stable relationships between monetary aggregates and goals, the inflation target approach offers a transparent means of commitment over the longer term. I believe that the inflation
targeting approach to price stability merits further study and consideration.

Which approach a central bank chooses will depend on the individual country's situation and experience. What is most significant is not the specific way the central bank chooses to seek price stability, but rather the mounting worldwide convergence of views on the importance of price stability as the primary goal of monetary policy. I believe that there is broad support within the United States today for a rigorous and consistent anti-inflation policy. Moreover, I am pleased by the credibility the Federal Reserve appears to have earned in controlling inflation over the past several years, while encouraging both growth of the real economy and financial system stability.

Let us imagine for a moment what might happen if we manage to keep inflation and inflation expectations low for another five or more years, as we have for the past five. I want to raise the possibility that, by maintaining price stability for an extended period of a decade or more, we might induce a more flexible mindset about price and wage-setting in the economy. The very rigidities I pointed to as constraining monetary policy in the short term might well diminish substantially if policy is successful in producing low inflation over the very long term. There is little or no evidence, however, that this will happen. Since most studies—and most of our experiences—have been about times of at least recurring inflation, we would not, to date, expect to have seen a substantial reduction of these rigidities.

Such a scenario is not by any means a forecast. I raise it with you because I want to emphasize that the maintenance of price stability over a decade or more opens up opportunities for monetary policy beyond those we can pursue even in the longer time frame I have been discussing this evening. In short, we should not be rigidly wedded to our present operational definition of price stability, or any specific number, as times change, whether for the better or the worse. It is the underlying commitment to price stability that must persist.

The commitment to price stability as the primary goal of monetary policy, I want to stress, in no way implies that the health of the economy should be sacrificed. On the contrary, what is important to bear in mind is that by ensuring a stable price environment, monetary policy helps foster economic growth. This is a key point—and is often overlooked. Therefore, while its one explicit goal must be price stability, monetary policy can and must also maintain the broad environment for sustainable economic growth.

In my view, no central bank can maintain price stability over the longer term without public support for the necessary policies. Moreover, today's globalized markets leave central banks with no margin for complacency. Only with the confidence of the public in their policies and their own vigilance in implementing these policies can central banks in democracies ultimately succeed in achieving a goal of price stability. This is the goal we at the Federal Reserve work toward each day.

Thank you.