SPEECH

McDonough: Semi-Annual Report to Congress under the Humphrey-Hughes Act

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Testimony by President William J. McDonough before the Committee on Banking and Financial Services of the U.S. House of Representatives

I welcome the opportunity to appear before the Committee on Banking and Financial Services this morning to provide my views on the conduct of monetary policy in conjunction with the semi-annual report to Congress under the Humphrey-Hawkins Act. There can be no doubt that the ultimate goal of monetary policy in the United States today must be to achieve the highest level of sustainable economic growth, which in turn will promote the highest possible standard of living for all our citizens and the greatest number of jobs. But in saying this, I want to be clear as to what we can expect monetary policy to do and what we know it cannot do.

What monetary policy can do is to anchor inflation at low levels over the long term and thereby lock in inflation expectations. In addition, monetary policy can help offset the effects of financial crises as well as prevent severe downturns of the economy.

Over the past twenty years, a widespread consensus has emerged among policymakers and economists that a monetary policy to stimulate output and reduce unemployment beyond its sustainable level leads to higher inflation, but not to lower unemployment or higher output. Moreover, 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.

One point is worth emphasizing: Allowing even a moderate level of inflation to persist without a commitment to bring that level downward toward price stability permits--and may even encourage--expectations for still sharper price rises in the future.

What monetary policy cannot do, in and of itself, is produce economic growth. Economic growth stems from increases in the supply of capital and labor and from the productivity with which labor and capital are used, neither of which is directly influenced by monetary policy. However, without doubt, monetary policy can help foster economic growth by ensuring a stable price environment.

Some would argue that establishing price stability as the primary goal of monetary policy means that a central bank would no longer be concerned about output or job growth. I would like to make explicit for the record that I believe this view to be simply wrong. Price stability is the absolutely essential means to produce sustained economic growth. Moreover, there need be no inconsistency between seeking long-run price stability and leaning against short-run business cycles. Indeed, a stable price and financial environment that the public expects to persist almost certainly will enhance the capacity of monetary policy to fight occasions of cyclical weakness in the economy. This is a key point--and is often overlooked.

In my view, a goal of price stability requires that monetary policy be oriented beyond the horizon of its immediate impact on inflation and the economy. This horizon is on the order of two to three years and it is important, in part because it sets the stage for what comes later. But the longer-run 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 most important to household and business 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.

A central bank's commitment to price stability over the longer term, however, does not mean that 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 inflation. The reality is that monetary policy is only one of many influences on the economy.

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. In the event of a shock to the financial system, the appropriate monetary policy might require a temporary reflation.

As you can see, I believe that monetary policy must be exercised cautiously. Why do I say this? Because the economy is not perfectly flexible and pushing hard in the face of rigidities can cause unnecessary problems. For example, contracts, especially wage contracts, can outlast a good part of, or even exceed the duration of, short-term shocks. 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.

In my view, therefore, a key principle for monetary policy is that price stability is a long-term goal and a means to an end--to promote sustainable economic growth. But, even if we agree that price stability must be the primary long-term goal of monetary policy, what exactly does price stability mean in practice? We know that, as currently measured, a zero inflation rate is not the same thing as price stability. This is because of well-known errors in measuring inflation that stem from many factors, including how quality improvements and new products are valued in the consumer price index. Although there is much research on this topic, economists and policymakers cannot agree upon a single number for the magnitude of this measurement error. In most studies, the error has been estimated to range from 0.5 percent to 2.0 percent. Therefore, as a practical matter, price stability may best be thought of as an inflation rate, measured by the CPI, falling somewhere within this range.

But, we may well ask, why is price stability so important and so desirable? Price stability is both important and desirable because a rising price level--inflation--even at moderate rates, imposes substantial costs on society. These costs are both economic and social. The economic costs entail, for example, 1) increased uncertainty about the outcome of business decisions, 2) negative effects on the cost of capital resulting from the interaction of inflation with the tax system, 3) reduced effectiveness of the price and market systems, and, 4) in particular, distortions that create perverse incentives to engage in nonproductive activities.

The costs of inflation-induced nonproductive activities--such as tax code dodges or overinvestment in the financial sector--decrease the resource base available to an economy for growth. A move to price stability gives an economy the necessary incentives to shift resources back to productive uses.

Rapid moves toward price stability from high inflation, however, do have their costs under certain circumstances. I have already described the rigidities caused by contracts. The overdevelopment of a sector for no reason other than the inflation rate is another of those circumstances. The removal of the distortionary incentive--inflation--leads to a rapid transfer of resources out of that sector, causing unemployment and business failures to follow: what was boom, goes bust. Countries which have seen overexpansion of the financial sector have experienced the sharp contraction of that sector when inflation finally was 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. These social costs are all too often underestimated in economists' typical calculations of inflation's costs. 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 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 an increase in prices they must pay. When the bust comes, they also suffer disproportionately by being among the first to lose their jobs. They also are not users of sophisticated financial instruments to protect their modest savings from confiscation by inflation.

There can be no doubt that a stop-go, boom-bust economy significantly reduces the overall economic welfare of its citizens. Such an economy produces serious and dangerous tensions within a society because the benefits and pain of an inflationary environment are unequally distributed. Because of these realities, I am convinced that price stability is important and desirable not simply for purely economic reasons, but for broader public policy reasons as well. In a word, I believe that the less fortunate in our society particularly benefit from an environment of price stability and the economic growth that it fosters, as we currently are seeing in our economy. Sustained economic growth brings a lower level of unemployment, higher labor force participation, and greater availability of jobs to those who are not easily hired because they need more training and help from their employers. Over the long term, I am convinced strong economic growth can be sustained only if the benefits of the economic pie--more and better jobs, higher incomes, improved housing, and a higher standard of living--are shared by all parts of our society--rich and poor, skilled and less skilled. Unless all parts of society share in--and therefore have a stake in--economic growth, we cannot have the social and political cohesion that is essential to sustain growth.

From a personal perspective, I am convinced that much of the success the Federal Reserve has had in containing inflation in recent years reflects monetary policy actions that pre-empted inflationary pressures before they actually showed up in general prices. When the Federal Reserve began firming monetary conditions in February 1994, it did so because of the potential it saw for inflation re-emerging. The main reason we need a pre-emptive approach, in my view, is because monetary policy works with uncertain and long time lags. Although most of its effects on output take place within one to two years, its effects on inflation take even longer--over a three-year time frame, which is the appropriate horizon for monetary policymakers.

When one stands back and considers monetary policy over the past several decades, the case is strengthened for a pre-emptive approach to squeeze off incipient inflation before it shows through in broader price increases. Economic analysis has shown not only that an overheating economy has a strong effect in raising inflation but also that reducing inflation is a very painful process. We learned these lessons during the long and costly disinflation of the early 1980s, following the explosion of inflation in the 1970s. Thus, both analysis and experience reinforce the need for pre-emptive monetary policy actions. Failure to contain inflationary pressures at an early stage makes it much costlier to deal with inflation later.

Because of its long and variable lags, monetary policy also requires of Federal Reserve officials the experience and courage to deal with what will always be a level of uncertainty. The FOMC has been willing to deal with the uncertainty caused by the overestimation of inflation and the underestimation of growth of most economic models in the last year or more. In my view, the Committee's policy has been an important ingredient in the excellent economic performance we have been enjoying.

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.

Finally, I am convinced that no central bank can maintain price stability over the longer term without public support for the necessary policies. 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 price stability to maximize economic growth. This is the goal we at the Federal Reserve work toward each day.

Thank you.