

Price Stability and Economic Welfare

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Introduction

It is a pleasure to be here today speaking at the Global Interdependence Center's 25th Annual Monetary & Trade Conference. I have enjoyed meeting with many of the members of the GIC, and I appreciate all the hard work they do and have been doing for over three decades. The Federal Reserve Bank of Philadelphia has enjoyed an excellent relationship with the GIC for many years, and I look forward to continuing that relationship for many years to come.

I must say it is also great to have this opportunity to come and speak at this conference and to meet fellow central bankers. I hope you all take the time to enjoy this great historic city and perhaps even get yourselves a cheesesteak.

Today's conference is on the economic and social consequences of European Union expansion. In my brief remarks today I want to discuss the importance of monetary policy for economic welfare. In particular, I will argue that, in my view, the best way for monetary policy to contribute to economic welfare is by maintaining a stable price environment. Thus, the European Central Bank, in its role as the centralized monetary authority for the euro-zone, has an important role to play in the EU's success and its expansion.

Importance of Price Stability

A striking feature of the last two decades is the overall decline in volatility of economic growth and inflation. In many circles this phenomenon has come to be called the "great

moderation.” The fact is that during this time worldwide inflation rates, in general, have been lower and more stable than they have been in the past. In the United States, the average annual rate of inflation from 1966 to 1986 was about 6.2 percent and its volatility, as measured by its standard deviation, was 3 percent. This inflation meant that goods that cost the consumer \$100 in 1966 cost about \$340 in 1986. However, from 1986 to 2006, the average inflation rate was cut in half, to 3.1 percent and its standard deviation fell by two-thirds. This was a considerable improvement, but even this low rate of inflation results in a considerable depreciation in the purchasing power of the dollar. In other words, goods that the consumer paid \$100 for in 1986 cost more than \$180 by 2006.

Although the timing has varied somewhat, this decline in inflation has occurred around the world. For the advanced developed countries, inflation fell from about 6 percent in the 1980s to an average of about 2.5 percent from 1990 to 2006. Even in the developing world, inflation declined from over 10 percent during the 1980s and early 1990s to about 4 percent between 1996 and 2006. And while we do not want to pat ourselves on the back too much, much of the credit for this does go to monetary policymakers, who have broadly recognized the importance of low and stable inflation.

To put it directly, policymakers have come to accept the fact that price stability is and should be the primary focus of monetary policy. I think almost every economist would agree that sustained inflation is ultimately a monetary phenomenon, and, of course, we, as central bankers, represent the monetary authority. Thus, achieving and maintaining a stable price level is uniquely our responsibility. I often explain that month-to-month changes in inflation are very hard to predict, but that over a longer term, central banks create inflation and it is important that we acknowledge and take responsibility for that fact.

Maintaining a stable price level is important. It allows the economy to function in a more efficient and thus more productive fashion. If people and businesses don't have to worry that the purchasing power of their money will erode because of inflation, they won't have

to divert resources from productive activities to conserve their money holdings or to hedge the risks of inflation or deflation. Stable prices also make it easier for households and businesses to make long-term plans and long-term commitments, since they will know what the long-term value of their money will be.

Price stability also promotes efficiency in product markets. In a market economy, prices give signals about the relative supplies and demands of goods and services. With a stable price level, changes in prices can easily be recognized as changes in relative prices. With price signals undistorted by inflation, individuals and businesses are able to make better decisions about where to allocate their resources. Thus, price stability helps a market economy allocate resources efficiently and operate at its peak level of productivity.

Price Stability in the European Union

Long-run price stability is the most powerful tool the central bank has to promote economic growth, high employment, and financial stability. Clearly this is an idea accepted by the European Central Bank. The primary objective of the ECB's monetary policy is to maintain price stability. The ECB takes this to mean maintaining an inflation rate of below, but close to, 2 percent over the medium term.

The 13 countries that have adopted the euro at this point have had success at maintaining a stable price environment for some time. In fact, average consumer price inflation for the euro-zone over the past 10 years has averaged just below 2 percent and has not risen above 2 ½ percent for the past 5 years.

But in addition the countries that have been part of the expansion of the European Union and are currently on a path that will lead to the adoption of the euro have also had success in reducing inflation. Part of the reason for this is that one of the four convergence criteria that a country must meet before adopting the euro is meeting a pre-specified condition on price stability.

By establishing a commitment to low inflation and following through on that commitment, the ECB has enhanced the attractiveness of the EU and contributed to a more productive economic environment for member countries.

Commitment to Price Stability

Making a credible commitment to price stability is an important part of conducting an effective monetary policy. Without commitment, the central bank falls prey to what has come to be called the time-inconsistency problem. The key point here is that people's current economic decisions are affected by their expectations about the future course of monetary policy. They know the central bank will be tempted to pursue policies that deliver temporary economic benefits but are inconsistent with the longer-term goal of price stability. If people believe the central bank is committed to price stability, they will make decisions that lead to better outcomes than if they believe the central bank will give into temptation and create higher inflation.

As I stated earlier, the European Central Bank does this by clearly stating price stability as its main objective and announcing a target for where it is going to keep the inflation rate. The countries that are going to adopt the euro clearly believe that monetary policy that is committed to price stability is in their best interest. Therefore, they give up an independent monetary policy to gain the benefit of a credible commitment to price stability.

By publicly announcing a target for inflation, the European Central Bank and, consequently, all euro-zone countries are institutionalizing their commitment to price stability. That is to say, the commitment does not reside in the hands of a person or a group of people, but rather it resides within the institution. This institutionalization increases the central bank's credibility, since the goal of policy does not change as the members of the policymaking body change.

This question of commitment and transparency is one that is being discussed in the United States as well. For certain, the current Federal Reserve is the most open and

transparent in history. We announce policy moves and issue policy statements. Further, the minutes of FOMC meetings are released on a timely basis so that the public can get a better sense of the range of views on the FOMC.

Although the Fed is much more transparent than at any time in its history, it is arguably less transparent than a number of other central banks. As you may well be aware, the FOMC is currently studying ways to further improve its communications. It is too early, however, to say precisely what the results of that inquiry will be. Suffice it to say that there is a realization in monetary policy-making circles, gained through recent advances in monetary theory and the experience of the last 30 years, that maintaining credibility for low inflation is an important aspect of good monetary policy.

Limitations of Monetary Policy

However, I must add that while price stability enhances the ability of the economy to achieve its maximum potential growth rate, monetary policy plays no role in determining what that growth rate is. In the long run, the economy's potential growth rate largely reflects two factors. The first is the growth rate of the labor force, which is determined by demographic factors like the birth rate, age distribution, and immigration.

The second factor is the growth in the productivity of the labor force, which depends on both physical and human capital and incentives for research and innovation. Monetary policy cannot be used to achieve a long-run growth rate that is inconsistent with these economic fundamentals.

Therefore, sound monetary policy that promotes a stable price environment is not a sufficient condition for maximizing social welfare; it is, however, a necessary condition. Moreover, it is the best way, we as monetary policymakers can contribute to social welfare.