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INFLATION, GROWTH AND MONETARY POLICY CREDIBILITY

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Critics of the Fed often charge that monetary policy has been too concerned about fighting inflation and indifferent about lowering unemployment and stimulating the economy. The Fed, they say, is too independent and needs to be more accountable. Such criticisms, interestingly, buck the trend in many other countries, where control of inflation has recently been made the paramount objective of monetary policy and where central banks are being made more independent. This morning, I would like to talk about the reforms taking place in New Zealand, Canada and the United Kingdom and how their experiences inform the debates about monetary policymaking in our own country.

Each of these countries has adopted a low target range for inflation--typically zero to 2 percent--and has publicly announced the pace by which it intends to reduce inflation. By announcing a specific inflation target, a central bank firmly commits itself to a course of action, while helping the public plan for the future by reducing uncertainty about the central bank's objectives. As we know, the consumption and investment decisions of households and firms are affected by what they expect the government's policy actions will be in the future. When the objectives of policy are clear, households and firms are better able to allocate their resources efficiently.

To demonstrate their resolve toward controlling inflation, a number of countries, including New Zealand and the United Kingdom, have bolstered the independence of their

central bank. In a democracy, there is always a tension between the desire to keep any policymaking institution accountable to the people and a necessity to insulate its decisions from short-term political pressures. Policymakers must be able to look beyond the next six months, or the next election, in controlling inflation. As researchers have found, countries that have achieved the best records in controlling inflation are typically those with independent central banks, like Germany, Switzerland or the United States. When the central bank is an arm of the Treasury or is otherwise political, as in Italy, Brazil or, until recently, New Zealand, inflation rates are usually higher. Thus, by increasing the independence of the central bank, a commitment to low inflation can be made more credible.

In countries that have adopted inflation targets, the strength of the central bank's long-term commitment to price stability has been enhanced further by a provision that allows the bank to suspend inflation targets temporarily in the face of extreme events, like oil price shocks. In such circumstances, an increase in the inflation rate is tolerated as long as policy is redirected toward reducing inflation once the crisis has passed. By explicitly allowing flexibility during unusual circumstances, the policy of achieving price stability over the long run is made more credible.

Budgetary reforms can also enhance credibility. Even the best monetary policy can be foiled by irresponsible fiscal policy, especially when monetary policy is subservient to

government finance. When the government can't pay its bills, it is often tempted to pressure the central bank to pump out money to fund budget deficits or finance the operations of state-owned enterprises. New Zealand has wisely adopted budgetary reforms to reduce its deficit and thereby lessen the likelihood that its central bank will be called upon to finance government expenditures.

The nations that have chosen to pursue inflation targeting have given their central banks not only an explicit mandate to control inflation, but also the independence to act as needed to achieve the objective. In New Zealand, for example, the government determined what the objective of monetary policy would be--price stability--but under the country's Reserve Bank Act, the government is forbidden from instructing the Bank on how to carry out that policy. Central bank officials are held accountable for meeting the inflation targets, however. In New Zealand, the governor of the central bank can be dismissed if he fails to meet the inflation objective.

Thus far, the governor has kept his job! Indeed, the experiments with inflation targeting in New Zealand, Canada and the United Kingdom seem to have been quite successful in bringing down inflation. These countries are now enjoying lower inflation and higher growth than the average industrialized country.

The policy changes adopted in New Zealand and other countries are instructive for two reasons. First, the move to

adopt inflation control as the paramount objective of monetary policy reflects an understanding of what such policy can and cannot do. Despite the lure of using monetary policy to manipulate interest rates or spur economic activity, there is a growing recognition that its impact on the pace of economic activity or the level of employment will be short-lived and unpredictable. Over time, monetary policy can directly affect only the rate of inflation. Inflation, however, can hinder growth; thus, a monetary policy aimed at price level stability is the best policy for achieving maximum sustainable economic growth.

The second lesson of the reforms taking place abroad is the importance of credibility in monetary policymaking. When the public believes that the central bank is firmly committed to achieving price stability, the decisions of firms and households will not be distorted by expectations of inflation. Moreover, the cost of lowering inflation will be less when the central bank sets clear and believable objectives. As we saw in the United States in the early '80s, the costs of ending an inflationary spiral can be high. Each country that has recently adopted a price stability objective experienced some decline in economic activity that accompanied its disinflation, despite taking various measures to make its policy more believable. Clearly, the best way of avoiding such costs is to maintain a monetary policy that is credibly committed to price stability.

I believe that one reason New Zealand, Canada and the United Kingdom have moved toward a greater focus on controlling inflation is that their economies have not done as well as the U.S. economy. Dissatisfaction with high inflation, slow economic growth and political meddling in monetary policy has led to these reforms. In New Zealand, monetary policy had always been highly politicized, and, under government control of the central bank, inflation had been high and variable. The Canadian record on inflation was much better, but inflation had surged shortly before reforms were adopted. Finally, the United Kingdom had suffered through a painful disinflation and did not want to lose its hard-fought gains. Although their histories differ, each country learned that higher output cannot be purchased with higher inflation.

Here in the U.S., on the other hand, our economy has performed pretty well. During the 1980s, we witnessed the longest peace-time expansion since World War II, while at the same time we managed to bring inflation down from double-digit rates to just under 4 percent on average from 1982 to '89. Like much of the rest of the world, we suffered through a recession in 1991, but our downturn was relatively mild and our recovery came sooner than it did in Europe or Asia.

The Federal Reserve was very active in promoting recovery during the '91 recession. Despite this, critics claimed that the Fed was slow to reduce interest rates and didn't do enough to stimulate the economy or create jobs. Today, a few years later and well into the third year of recovery, we are told

that policy has been too focused on fighting an imaginary inflation.

In my view, these charges reflect a misunderstanding not only of the nature of inflation and interest rates, but also--more fundamentally--about how monetary policy can bring about its legislated objective of maximum sustainable, non-inflationary economic growth. I believe that by pursuing a credible policy of limiting fluctuations in the general price level, the Fed can best ensure such growth. Let me now comment further on the costs of inflation and the importance of monetary policy credibility, the two lessons of foreign monetary reform.

Generally speaking, countries that attempt to grow faster by adopting inflationary monetary policies do not, in the end, grow any faster than countries that maintain low inflation rates. In fact, they often grow more slowly. Countries that have consistently kept their inflation rates low, such as Germany, Japan and the United States, can claim among the world's highest standards of living. High-inflation countries, by contrast, often have low growth rates and low living standards.

The key to economic growth is the allocation of resources to their most productive uses. In capitalist economies, markets serve this function. Financial markets, for example, allocate flows of savings and investment. Inflation can interfere with this process by discouraging saving and causing its misallocation. As inflation eats away at the dollar's

value, savers realize that the interest and capital income they receive in tomorrow's dollars will buy fewer goods and services than they did today. Thus, when savers expect inflation, they demand higher yields as compensation, and interest rates are said to imbed an "inflation premium."

If you were to examine a chart of long-term interest rates and the rate of the inflation over time, you would see a close, positive relationship between the two. In the early '60s, the rate of inflation in the U.S. was about 2 percent per year. Interest rates were also low: The yield on 10-year government securities was 4 percent, the prime rate was 4-1/2 percent and home mortgage rates were about 5 percent. Beginning in the late '60s and continuing through the '70s, however, inflation rose, and long-term interest rates rose with it. The rate of inflation peaked at 13 percent in 1980, and within a year, the 10-year bond yield was more than 15 percent, while the prime rate hit an astounding 20 percent.

Although inflation was finally contained in the early '80s, long-term interest rates remained exceptionally high. In 1983, for example, the Consumer Price Index rose less than 4 percent. The 10-year bond yield remained over 10-1/2 percent, however, and with a whiff of renewed inflation in 1984, it jumped back to over 13 percent.

Why did long-term interest rates not fall with the decline in inflation? One answer, I believe, is that the public was unconvinced that the Fed was serious about controlling inflation. In other words, the Fed had lost

credibility about its commitment to low inflation. Savers had grown tired of having their interest income buy fewer goods and services and their holdings decline in value. Because the public was wary of the Fed's willingness to keep inflation down--let alone to reduce it further--savers were unwilling to accept lower returns on their long-term investments, despite low prevailing rates of inflation. It was not until 1986, when the rate of inflation dipped below 2 percent, that long-term interest rates fell substantially below 10 percent.

My point is that, when the possibility of even a low rate of inflation exists, savers will demand an extra return on their long-term investments as compensation for the anticipated decline in their purchasing power. Inflation thus raises the cost of capital and depresses investment spending by firms. Interest rates will be lower only when the public believes that the dollar will remain stable over time, that is, when there is little or no risk of inflation.

Another problem with inflation is that it is often highly variable. When the rate of inflation varies widely from year to year, business people and consumers have difficulty planning their investments and expenditures. Under these circumstances, the inflation premium they demand will be higher. Keep inflation down, however, and long-term interest rates will be low.

Finally, high and unstable inflation interferes with the working of a market economy by making it difficult for firms and consumers to distinguish changes in relative prices from

changes in the price level. Moreover, it encourages people to divert resources from productive investment into inflation hedges and speculative ventures, often on a leveraged basis. Overbuilding in commercial real estate, high land values and the speculative frenzy that gripped many metals and commodity markets in the late '70s and early '80s reflected expectations of continued price increases, not fundamental values. By misallocating resources and encouraging excessive debt, inflation can thus inhibit real economic growth.

This brings me back full circle to the role of monetary policy. Even though the distortions caused by inflation can be serious, policymakers are sometimes tempted to accept higher inflation in return for faster growth. History shows clearly, however, that attempts to exploit a tradeoff between economic growth or employment and inflation are futile. Any gains in production or employment from adopting an inflationary monetary policy will be short-lived, while the higher inflation persists, ultimately requiring painful measures to restrain it. As we've seen many times over, countries that continually adopt highly inflationary policies often end up with slower growth rates than low-inflation countries. The monetary policy that best seems to promote sustainable growth over the long term is one that is credibly committed to a stable price level. Credibility is important because if the public believes the central bank will maintain a stable price level, the inflation premium in interest rates will be minimized, as will the inefficient allocation of

resources caused by uncertainty about the nature of price and interest rate changes.

But this message is apparently lost on some people. The Fed, as I mentioned, has been criticized for recent interest rate hikes. There have been renewed calls to rein in the Fed's independence, to make Fed officials more accountable. Over the past two years, Congress has considered a number of proposals that would reduce the Fed's independence. For example, one proposal would dismantle the Federal Open Market Committee, the Fed's chief monetary policymaking body, and eliminate the regional Reserve Bank presidents' vote on monetary policy decisions. The Board of Governors alone would determine monetary policy. An alternative would retain the FOMC, but make Reserve Bank presidents appointees of the President, with Senate confirmation.

If enacted, any of these proposals would subject monetary policy decisions to greater political pressure. Bluntly speaking, those who spend the public's money would have greater influence over those who determine the nation's money supply. Surely, the public must wonder about the Fed's ability to hold the line on inflation should any of these proposals be enacted.

We would all like lower interest rates and faster growth. But we must ask ourselves whether monetary policy and economic performance would be better if the Fed were less vigilant about limiting inflation and less insulated from political pressures. Or, are there perhaps good reasons why countries

around the world are choosing to adopt price stability as the paramount objective of monetary policy and making their central banks more independent of politics? To me, the evidence from the U.S. and other countries is clear. Sustained economic growth cannot be purchased at the cost of higher inflation. Indeed, because price stability contributes to better economic decision-making and a better allocation of resources, a credible commitment to price stability should, over time, produce the maximum sustainable rate of economic growth. Put simply, a policy committed to price stability is a pro-growth policy.