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**"Price Stability: There is No Better Goal
for Monetary Policy"**

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Thank you for inviting me to talk to this joint meeting of economists and financial analysts about monetary policy. Overall, I think monetary policy has been reasonably sound in the 1990s, at least compared with our history from the mid-1960s through the early 1980s. Although inflation remains stubbornly high at 3 percent, the recent figures are certainly an improvement over the double-digit rates of the late 1970s and early 1980s. On the other hand, we should not forget that inflation had fallen to 3 percent in the mid-1980s, only to rebound to almost 6 percent by the end of the decade. So, while I am generally pleased with what monetary policy has achieved in recent years, I believe there is still room for improvement.

In considering how that improvement might be realized, I would like to address today three questions about the monetary policymaking process: What do we want from monetary policy, how can we go about achieving that, and how would the policymaking process be changed?

With respect to the first question, the ultimate goal of economic policy is to achieve the highest possible standard of living for all Americans. The fact is, however, that the Fed's direct influence over the long-term trends in output and employment is negligible. These trends depend largely on population and technology growth, the skill and education levels of the work force, and the accumulation of capital. The only lasting monetary policy contribution to the real output trend is to create an environment conducive to growth,

one in which relative price signals are clear and markets are not distorted by high and variable inflation. At the least, policy should aim to do nothing to prevent the economy from reaching its potential.

Cross-country evidence confirms that among developing nations, countries with low inflation, such as the Asian Newly Industrialized Economies, have outperformed their inflation-ridden counterparts. Among developed countries, those with comparatively low inflation like Japan and Germany have outgrown their high-inflation counterparts as well.

So what we want from monetary policy is both a lower and more predictable inflation rate. In fact, there is a growing consensus among policymakers around the world that the appropriate long-run objective of monetary policy is price stability. At the same time, current legislation and official Federal Reserve statements list multiple objectives for the U.S. economy, including real growth, low unemployment, stable prices and so forth. These objectives are typically expressed in somewhat vague language and leave the FOMC with no clear ranking of priorities. Multiple objectives also allow policymakers--as well as their critics--to shift from one priority to another at any given time. Although this ad hoc vacillation from goal to goal might seem to make sense from a short-term perspective, it creates substantial uncertainty in markets about our long-run objectives. In short, this is not conducive to the best use of productive factors.

Furthermore, by allowing the possibility of high inflation, the current framework causes people to behave differently than they would if monetary policy were committed to stable prices. Today, long-term inflation expectations, and thus long-term interest rates, change in response to short-term news about the economy. This feedback from public expectations makes monetary policy efforts to stimulate employment and output, however inappropriate, perverse. Repeated attempts to stimulate output can result in vicious cycles. This was the case in the 1960s and 1970s, a period in which each successive business cycle had ever higher levels of inflation and unemployment. This period culminated in the worst peace-time boom-bust cycle since the advent of the Great Depression.

A benefit of a believable, achievable price stability goal is that natural market forces would serve as automatic stabilizers. The FOMC would not have to react to every short-term blip in the CPI. The markets themselves would provide a shock absorber if price stability were ingrained in the psyche of the American public. In the case of positive demand shocks, markets would resist price increase pressures because they could anticipate a restrictive countervailing monetary policy. In the opposite circumstances, the public could anticipate an expansionary monetary policy to prevent deflation. In the case of supply shocks, the economy needs to be able to make real adjustments. Price stability is the best

environment in which to make relative price signals clear and allow markets to adjust as they must.

The inflationary distortion of market price signals may seem minor in 1995 compared with the past, but there is still widespread divergence in people's beliefs about the long-term inflation rate. This causes them to delay investments and increases the risk premium in long-term interest rates. The fact that long-term interest rates are roughly 3 percentage points lower in Japan than in the United States says a lot about how differently markets view inflation risks there and here.

Achieving price stability would also eliminate the detrimental effects of inflation interacting with the U.S. tax code, which is not indexed with respect to interest rates and capital gains. Investors continue to pay income taxes on the inflation component of interest and dividend income as well as on capital gains attributable to inflation. This tax effect is a deterrent to national saving, which consequently reduces the growth of the capital stock and national wealth. Such inflation-generated tax revenues support government spending at the expense of the private sector.

Finally, in a stable price environment, resources would not be wasted in activities created solely to deal with inflation. Some of the increased activity in options and futures markets over the last 20 years, for example, can be attributed to people's desire to hedge against the effects of unexpected changes in the long-term inflation rate. In fact,

many of the innovations in the payments system over the last 30 years simply reflect attempts by buyers to delay payment and sellers to speed up payment. These activities would not exist to the same degree in an inflation-free economy as we see them today.

For all of these reasons, several countries, including Canada, New Zealand and the United Kingdom, have adopted multi-year targets for inflation. Sweden and Finland began targeting the CPI this year. Others, including Germany, France, Switzerland and Italy, have begun to establish inflation objectives based on particular price indexes.

Let me now proceed to the second question, which concerns how we can go about achieving price stability. I believe an economic environment of price stability can be realized, but it will require vision, planning and a commitment to act decisively on the part of policymakers. A successful program to achieve a comparatively stable price level would contain such basic elements as setting objectives, measuring outcomes and adjusting the plan based on the feedback received.

This is not rocket science, but the same principles apply: If we're heading off course, we've got to make mid-course adjustments to get where we want to go. Rocket scientists need a clear definition of their targets and so do monetary policymakers. Once a clear destination is set, it is merely a matter of applying basic management principles to utilize all available information about the link between monetary policy instruments and the given objective.

If price stability is an objective, we have to define precisely what we mean by it. In my opinion, we should adopt a price index with broad coverage that is widely recognized by the public. The CPI is perhaps the best index to focus on because it is already used in indexing a variety of contracts and is constantly under review by the Bureau of Labor Statistics and others. The CPI is admittedly imperfect, but keeping changes in it close to zero would be a practical operational objective of monetary policy, at least until a better measure is created.

After defining the ultimate objective, policymakers have to consider how to get there. Should the approach be abrupt or gradual? Obviously, we cannot know how quickly pricing behavior would change in a world with a stated objective of stable prices until we actually adopt and implement such a policy regime. However, my guess is that it would not take long for markets to catch on that price stability was the lode-star toward which monetary policy was directed. Although we can never be certain whether a fast or slow trajectory toward price level stability is the best, choosing any reasonable path is better than choosing none at all.

Once the path is chosen, the role of monetary policy then is to make course corrections in anticipation of deviations along the way. Pursuing restrictive monetary policy actions in response to observed inflation is a little like locking the barn door after the horse has run away. But the fact that the horse is on the loose is no reason to give up the chase.

Lacking a clearly stated price stability objective, monetary policymakers did not take appropriate actions to moderate the deflation of the early 1930s or the inflation of the late 1970s. Ultimately, policymakers reacted, but these reactions came late and only after the nation had borne enormous costs because of distortions associated with variability in and uncertainty about inflation and the value of money. To repeat, deviations from a stable price level require policymakers to act to get back on course. The way we get there needs to be worked out in the planning process, which is where both economic analysis and the deliberations of policymakers with alternative views about the effects of policy instruments come into play.

Let's turn now to the third question I posed in my introduction: How would the policymaking process be changed? Adopting a long-run inflation objective would provide a coherent framework for policy. In the 1960s and 1970s, the Federal Reserve Bank of St. Louis played a role in changing the discussion about monetary policy by bringing monetary aggregates into the picture. Somewhat in the Chicago School tradition, the St. Louis Fed presidents, backed by staff economists, focused on the association between open market operations and various narrow and broad monetary aggregates. These aggregates in turn were related to total spending and its components: real output and the price level. On the evidence that real output trends are not positively influenced by money and demand growth, the line of causality was clear.

Major price level changes were largely determined by major changes in the supply and demand for money. Since the demand for money was reasonably well explained, the supply of money was the dominant factor accounting for persistent changes in the price level.

Today, despite the widespread willingness to scoff at the usefulness of monetary aggregate targets, we cannot hide from the necessity to study the linkages between monetary policy actions, the monetary aggregates, total spending, real growth and inflation. Thus, as I see it, the framework for how monetary policy influences the price level and inflation remains largely unaltered.

Although that framework holds up, I believe we should develop an alternative operating regime, one that is based on neither monetary aggregate targeting nor federal funds rate targeting, which is what we do now. Any regime must be based on the reality that the Fed's power lies in its control over the size of its own portfolio and, thus, the monetary base. The monetary base, which consists of currency and coin in circulation plus reserves that depository institutions hold with Federal Reserve Banks, is the ultimate monetary standard and final settlement vehicle. Although demand for the monetary base depends on many factors outside the Fed's control, the FOMC could, in principle, match major fluctuations in the demand for base money over longer periods. This would give the Fed substantial influence over the long-term trend in the price level. For all of the denigration of

the usefulness of monetary aggregates in recent years, I know of no exceptions to the statement that major shifts in inflation trends are "always and everywhere a monetary phenomenon."

Another implication of an inflation or price level targeting regime relates to the deliberative process at FOMC meetings. In my judgment, an important aspect of the current process is that a wide range of views about how the economy works is brought together. This is one of the most compelling reasons for maintaining an institutional structure for the Federal Reserve that accommodates independent Reserve Banks subject only to the general supervision of the Board of Governors. The divergent views expressed in FOMC deliberations represent a cross-section of the way people in our society think about policy. Unfortunately, the absence of a common objective causes confusion about contrasting policy positions. Often, one cannot be sure whether disparities exist because of different objectives or because people have different views about how shifts in monetary policy affect the economy. The deliberative process would be more useful, that is, we would likely learn more from one another and more about the way policy actions affect the economy, if deliberations focused on how to achieve price stability.

In this regard, I think the extensive research resources of the Federal Reserve System need to be concentrated on learning how the instruments of policy affect inflation. Setting a benchmark for the long-run outcome would give

policymakers and their research staffs a new basis for learning how open market operations and the monetary base are related to price stability. The fact that inflation hovers in the 3 percent range today, not 10 percent as in the early 1980s, suggests that the FOMC has indeed brought knowledge to bear on how to react to inflationary pressures. In any event, I can think of no more worthwhile research effort for a central bank than analyzing the linkage between monetary policy actions and the price level.

Having an up-front price stability objective would not only enhance the deliberative process and focus research on the effects of policy actions, but would also provide the public with the basis on which to judge the performance of monetary policymakers. There is a bottom line on which businesses are evaluated: It is in terms of profits and net worth. The comparable bottom line on which monetary policy should be evaluated is price level stability. Explicit targets would provide greater accountability of the FOMC to the Congress and the public at large. I strongly support the independence of the Fed from the short-run political process, but this independence can be maintained in a democratic society only if the Fed can be held accountable for its policies. With multiple objectives, it cannot. Accountability in terms of price stability represents an achievable and measurable objective. It is, therefore, likely to affect behavior and improve the performance of policymakers.

Let me conclude by expressing support for a new commitment to price stability as the sole monetary policy objective. The current commitment is so vague that the public is not buying it. Why else would the federal government have to pay 7.5 percent interest on long-term bonds, the real return on which would be extraordinarily high by historical standards if inflation remained at 3 percent or less? According to opinion surveys, long-term inflation expectations are well above current inflation rates. The FOMC has not regained the inflation credibility it held until the mid-1960s. In the early 1960s, the federal government had been borrowing long term at about 4 percent. Obviously, we've got a way to go to get back to that kind of confidence in the stability of the value of money, but that is undoubtedly where we should be headed.

Americans want a government that is open and responsive to the people. The members of the FOMC are stewards of the U.S. monetary system. I have argued that making price stability the primary objective of monetary policy would contribute positively to the nation's economic well being. That purpose would be more surely achieved if the Fed targeted a specific index for price stability. Such a conclusion puts me in the camp of the policymakers, economists and others who support redirecting the Humphrey-Hawkins legislation toward making price stability the primary objective of monetary policy. That ought to be our bottom line, the basis on which our success or failure should be judged by our Congressional

overseers, the public at large and, of course, business economists and financial analysts. As I see it, there is no better goal for monetary policy.

Thank you very much.