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Testimony by

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Committee on Banking, Finance and Urban Affairs

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Chairman Neal, Chairman Garcia, and members of the Subcommittees, I welcome the opportunity to appear here this morning to discuss the role of commodity prices in the international coordination of economic policy. The fact that the Subcommittees on Domestic Monetary Policy and on International Finance, Trade, and Monetary Policy are meeting jointly on this topic I take to be symptomatic of the impossibility of distinguishing the domestic and the international aspects of economic policy in today's financial environment.

Much attention in the press and elsewhere, following Secretary Baker's speech at the annual meeting of the World Bank and the International Monetary Fund on September 30, has been on the possibility of the adoption by the United States of a commodity standard, perhaps even a gold standard, to control its monetary economic policy. But that is a misreading of Secretary Baker's remarks. He said only that "...the United States is prepared to consider utilizing, as an additional indicator in the [international economic] coordination process, the relationship among our currencies

and a basket of commodities, including gold We are proposing consideration of a commodity price indicator as an analytical tool and an improvement to our indicator process, to be used in conjunction with other measures of our economic performance"

I believe Secretary Baker was right to suggest the possible useful role an index of commodity prices could play in an international context. He was also right to emphasize that it would be a technical supplement to existing procedures.

International policy discussions quite naturally center on the adjustment of external imbalances and the stability of exchange rates. These are matters that simply cannot be addressed unilaterally. One country's deficit is someone else's surplus. If the U.S. current account deficit is to decline, the combined surplus of the rest of the world must decline correspondingly.

Similarly, an exchange rate is the relative price of two currencies. The currency of one country cannot depreciate without the currency of another appreciating.

We must not lose sight of the fact, however, that -- as important as these variables are -- they are not in themselves the ultimate objectives of policy. Nor would the achievement of stable exchange rates and balanced external positions ensure a healthy world economy. It is conceivable, for example, that in the extreme, all nations could be undergoing simultaneous domestic recession, even as external equilibrium prevails. More germane to our discussion this morning is the possibility that exchange rates could be stable in a world of rampant global inflation. To use the jargon of the economics profession, relative prices -- including exchange rates -- can be stable but the general price level can move up or down unless it is anchored to something.

We need to make certain, as we seek stability for the world economy, that we do not put in place policies and procedures that foster a flight from currencies generally. Prices of internationally traded commodities can provide useful information in identifying such a phenomenon. When there is a flight from currency the flight is toward goods or commodities. This is not to say that various measures

of domestic wage and price inflation in individual countries and other indicators of actual or potential pressures on resources are not important also in analyzing global inflation. Indeed, such domestic measures of inflation are already included among the indicators utilized in international reviews of the consistency and compatibility of economic policies.

It is important to note that rising commodity prices expressed in dollars are not necessarily a sign of global inflation. Commodity prices must be rising in terms of all currencies if they are to be taken as evidence of a problem of potential global inflation. If the prices of a basket of commodities are rising on average in terms of one currency but falling in terms of other currencies, we can infer essentially only that there has been a change in exchange rates. For example, the Economist index of commodity prices, expressed in U.S. dollars, averaged 2.9 percent higher in November of this year than in October. Over the same period, that index, expressed in SDRs, averaged 1.3 percent lower in November than in October. The difference reflects the decline in the dollar over that period of

about 6 percent on average in terms of the other currencies included in the SDR basket. In this situation, it would not be appropriate to interpret the rise in dollar prices of commodities as indicating a generalized flight from all currencies.

We must also be wary of special factors that may affect the prices of individual commodities so strongly as to move overall commodity price averages significantly in the short run. Especially where the causes are of a transitory character -- for example, a temporary supply disruption -- the proper macroeconomic policy responses may well be different from those appropriate to major cyclical booms in commodity markets. For this reason the coverage of any index used in the international context should be broad.

Moreover, while a general rise or fall in the prices of commodities, which are traded internationally, could indicate global inflation or deflation, and in general may provide an earlier warning of potential inflation danger than measures such as consumer or even wholesale prices, it would have little to say about what policy makers in any individual country should do. A much broader range of

information, relating not just to the world economy but to the economic performance and prospects of each individual country, is necessary in order to disentangle the forces at work and to determine appropriate courses of action.

Let me discuss briefly the role of one particular commodity, gold. The appeal of a more formal role for gold in the monetary system, as I suggested in a statement to the Commission on the Role of Gold in the Domestic and International Monetary Systems in November 1981, is that it would impose discipline not just on monetary policy but on federal budget policy, as well. Unlimited dollar conversion into gold would limit the government's ability to issue dollar claims. If you cannot finance deficits, you cannot create them or sustain them. However, there are too many practical problems associated with restoration of a gold standard, not the least of which is the huge block of outstanding dollar claims in world financial markets today, to make this a useful avenue of development. I believe that the conclusion of the Gold Commission remains valid today, namely that "...under present circumstances, restoring a gold standard does not

appear to be a fruitful method for dealing with the continuing problem of inflation." (Report to the Congress, March 1982, page 17.)

That judgment, however, is quite consistent with the view that the price of gold should be included along with prices of other commodities as one indicator of global inflation or disinflation. Gold is relevant and useful in that regard wholly because of the historic and widespread perception of gold as an indicator of a flight from currency. However, we must be careful not to interpret every change in the price of gold as meaning that. Like prices of other commodities, we must consider whether it is changing in terms of just some currencies or of all currencies. Again, most if not all of the rise in the dollar price of gold over the past couple of years simply reflects the dollar's decline. As in the case of other commodities, special demand or supply factors need to be considered in connection with the price of gold. Nevertheless, the fact remains that a significant flight from currencies in general without an increase in the price of gold in terms of those currencies is unlikely.

Conclusion

The mandate for economic policy in the United States and elsewhere should be to maintain the maximum growth in real income and output that is feasible over the long run. A necessary condition for accomplishing that important objective is a stable price level, the responsibility for which has traditionally been assigned in large part to the central bank, in our case to the Federal Reserve.

In attempting to achieve our objectives, the Federal Reserve must take into account and respond to all factors that significantly affect the U.S. economy. Included in that category are commodity prices. In affirming this, we should distinguish between what we must evaluate, in a technical sense, and what we do. In particular, we should avoid any automatic policy response to movements in commodity prices.

This view of the manner in which the Federal Reserve should conduct policy is fully consistent, I believe, with our obligations under the Full Employment and Balanced Growth Act of 1978. To respond to a question posed by Chairman Neal in his letter to me, I also

believe that the Federal Reserve should not be required to report a projected range for the movement of an index of commodity prices. Our reports to Congress currently include discussion of a broad range of economic variables, and commodity prices typically have been among them. Beyond that, it would not make sense for us to cite a range for some commodity price index in addition to the ranges we report for the growth of money and credit aggregates. The growth of money and credit is much more directly influenced by our actions than are commodity prices.

Moreover, information on market expectations of commodity prices is already available in the form of futures prices, and it would be neither meaningful nor constructive for the Federal Reserve to add another view. Indeed, it is conceivable that such an action, if it were seen as having policy content, might well perturb established behavioral relationships in such a way as to obscure or distort the information value of commodity prices.

Instead, it makes more sense for us to focus on helping to achieve the long-run growth of the economy and its precondition,

stable prices. Moreover, we should work with central banks and finance ministries in other countries to enhance prospects for the sustainable growth of the world economy. Those are difficult tasks, and we would be foolish to ignore information, such as is contained in commodity prices, that could help us.