

Roger W Ferguson, Jr: Panel discussion - safeguarding good policy practice through maintaining flexibility

Remarks by Mr Roger W Ferguson, Jr, Vice-Chairman of the Board of Governors of the US Federal Reserve System, to the Conference on Reflections on Monetary Policy 25 Years after October 1979, Federal Reserve Bank of St Louis, St Louis, Missouri, 8 October 2004.

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I am pleased to address this conference commemorating the twenty-fifth anniversary of the historic monetary policy changes implemented in October 1979. In my prepared remarks, I would like to focus on two issues with respect to safeguarding good monetary policy practice. First, I will discuss what constitutes good monetary policy practice and review the Federal Reserve's record in satisfying its mandates in recent decades. Then, I will speculate on how good policy outcomes come about. In particular, I will discuss the role of policy transparency, central bank leadership, and alternative monetary policy regimes in preserving effective monetary policy. Of course, the usual caveat to my remarks applies: I will express my own views, and you should not interpret them as the position of the Federal Open Market Committee or of the Board of Governors.

Assessing the Federal Reserve's performance after 1979

When assessing what constitutes good monetary policy practice, I prefer to focus not on theory but on the reality of the Federal Reserve's objectives. In contrast to many other central banks, the Federal Reserve has been assigned a "dual mandate" - to pursue policies that both maintain price stability and achieve maximum sustainable economic growth and employment. Good policy practice can be judged by the outcomes achieved. Therefore, I would like to briefly outline the Federal Reserve's performance with respect to the level and the variability of inflation and growth. To be sure, the strong economic performance over the past two decades has several possible explanations, but the practice of monetary policy has likely contributed by helping to preserve macroeconomic stability.

With respect to price stability, inflation in the United States over the past decade or so has clearly been lower and more stable than it was earlier in our history. In fact, annual inflation in the price index of personal consumption expenditures excluding food and energy - core PCE - averaged just over 2 percent from 1990 through the end of last year and consistently remained within a range - roughly 1 to 4 percent - that is relatively narrow compared with historical experience. This period contrasts sharply to the fourteen-year period from 1965 through the end of 1979, when annual core-PCE inflation averaged just over 5 percent and fluctuated between 3 and 10 percent. The recent experience of the United States with inflation has been similar in some respects and dissimilar in others to that of other countries. For example, based on the Organisation for Economic Co-operation and Development's measures of overall consumer price inflation, prices rose at an annual average rate of about 3 percent in the United States from 1990 through 2003, compared with about 3 percent in the euro area and in the United Kingdom and roughly 1 percent in Japan.¹ But, more important, the volatility of inflation was lower in the United States than in these other economies.

An equally important indicator of the success of the Federal Reserve's monetary policy is private expectations for future inflation. Measures of inflation expectations obtained from financial asset prices clearly indicate that market participants expect that the Federal Reserve will maintain low and stable inflation. For example, although the difference between the yields on nominal inflation-indexed and Treasury securities is an imperfect measure that includes complicating factors such as inflation risk and liquidity premiums, the five-year break-even inflation rate five years ahead has averaged about 2-1/2 percent over the past five years and has fluctuated in a narrow range of about 1-1/2 to 3-1/2 percent. Survey measures confirm that inflation expectations over this period have been subdued and well anchored. The University of Michigan's survey of ten-year inflation expectations has averaged less than 3 percent and has stayed within a very narrow range over the past five years.

¹ Data are from the most recent OECD Economic Outlook (No. 75) (Excel spreadsheet).

Assessing the outcomes with respect to the Federal Reserve's goal of maximum sustainable output growth is inherently more difficult. Estimates of the relevant measures, such as the nonaccelerating-inflation rate of unemployment (NAIRU), which in recent years has been decreasing according to some estimates, have very wide confidence intervals. But we can point to some evidence suggesting that the United States has enjoyed, besides subdued and stable inflation, some favorable developments with respect to output and employment. Certainly, we can document substantial gains in productivity in recent decades in the United States. According to the OECD, business sector labor productivity growth in the United States averaged about 2 percent from 1990 through the end of 2003, compared with about 1-1/2 percent in the euro area and in Japan over the same period. And since the mid-1990s, this gap has widened, with annual productivity growth averaging about 2-1/2 percent since 1995 in the United States, compared with about 1-1/2 percent in Japan and just less than 1 percent in the euro area over the same period.²

Another important measure of the success of monetary policy is how well the FOMC has responded to threats to our nation's financial stability. This claim is surely hard to quantify. But everyone would agree that, compared especially with the deleterious effects of the Federal Reserve's policy response during the Great Depression, the Fed has responded effectively to more-recent crises so as to help minimize the impact of such shocks on the greater economy. These episodes include the stock market crash of October 1987, the Asian financial crisis, and the collapse of Long-Term Capital Management in the late 1990s. Thanks in no small part to the flexibility of our policy framework, which I will discuss in greater detail in a few moments, the Federal Reserve appropriately discharged its responsibility as lender of last resort by providing ample liquidity and ensuring confidence during these and other troubling episodes, including the aftermath of the terrorist attacks of September 11, 2001.

There is greater disagreement about how well the Federal Reserve responded to the bursting in recent years of the so-called bubble in technology stocks. This topic is broad, but I would like to note that, as many of my colleagues and I have previously argued, prospectively addressing perceived asset-price bubbles is a matter of such great uncertainty that, even with the benefit of hindsight, it is not clear that policy decisions in the late 1990s, for example, should have been any different. In any case, the recession that followed the sharp decline in stock prices was shallow by historical standards.

How can we safeguard good policy outcomes?

I would now like to turn to issues related to preserving, as best we can, a continuation of good policy practice in the future.

Central bank transparency

Consider first the important role of central bank transparency. Transparency of central bank decisionmaking is desirable, not only for economic reasons, but also because it is supportive of central bank independence within a democratic society. Because of the lagged effects of monetary policy on output and prices, the time horizon of central bankers is necessarily more distant than that of other policymakers. Thus, the central bank needs substantial insulation from political pressures to execute policy: An independent monetary authority is less tempted to make policy for the short term, such as boosting output or refinancing national budgets, at the expense of long-run objectives. Of course, the goals of monetary policy should be determined within the democratic process, but the central bank should have discretion to achieve those ends. In short, an appropriate arrangement within democratic societies is for central banks to have independence with respect to the instruments, but not the goals of monetary policy, and transparency is an appropriate condition for that independence.

Besides its inherent virtues in a democratic society, transparency can enhance monetary policy's economic effectiveness by more closely aligning financial market forces with central bankers' intentions. Like other central banks, the Federal Reserve controls only a very short-term interest rate, the overnight federal funds rate. However, theory and empirical evidence suggest that longer-term interest rates and conditions in other financial markets, which reflect expectations for short-term rates, matter most for monetary policy transmission to the economy. If the monetary authority is transparent

² These data on productivity growth are also from the most recent OECD Economic Outlook (No. 75) (Excel spreadsheet).

about the rationale and the stance of policy as well as its perception of the economic outlook, then investors can improve their expectations of future short rates.³

The path that monetary policy will follow in the future is uncertain even to policymakers because that trajectory will depend on incoming news about the economy and the implications of that news for the economic outlook. But announcing policy decisions in a timely manner and explaining those decisions fully allows market participants to better anticipate the response of policy to unexpected developments and to speed needed financial adjustments.

Central bank leadership

Next, I consider the role of the individuals entrusted with the responsibility for making policy decisions. Although monetary policy frameworks have a potentially great influence on macroeconomic outcomes, we should not forget that the individuals who serve in central banks themselves have a crucial role in preserving policy outcomes. Even with a monetary policy regime that follows best practices and shapes the decisionmaking process, ultimately individuals' beliefs and perceptions still matter for the actual policy taken.

An interesting recent study of the history of the Federal Reserve by Christina Romer and David Romer finds a very strong link between the skill and knowledge of the FOMC, particularly the Chairman, and macroeconomic outcomes.⁴ For example, with little reference to transformations in the disclosure policy and the independence of the Federal Reserve over the years, they ascribe the policy successes of two periods - the 1950s and the 1980s and 1990s - to a conviction of Federal Reserve Chairmen regarding the high costs of inflation and their tempered views about the sustainable levels of output and employment. In contrast, they attribute the deflationary and counterproductive policies of the 1930s to the erroneous belief that monetary policy can do little to stimulate output and that the economy can actually overheat at low levels of capacity utilization.

But there is one aspect of the process that Romer and Romer do not emphasize enough - the ability of central bankers in general, and indeed members of the FOMC in particular, to withstand political pressures. In addition, central bankers should have a thorough and practical, rather than a purely academic, understanding of the economy and, given the Federal Reserve's objective to preserve financial stability, of financial markets and institutions.

The committee's institutional memory may also matter in this context. Today, the FOMC is well versed in the monetary history of the 1970s and 1980s, for example, and recognizes the great efforts that previous members of the FOMC undertook to achieve price stability. I trust that future generations of policymakers will continue to share that understanding and thus help to preserve good policy outcomes.

Will inflation targets preserve good policy practice?

Finally, I would like to touch on a topic that is perhaps more controversial in the context of safeguarding good policy practice. Several academic and professional economists, including distinguished colleagues of mine at this conference, have eloquently advocated the adoption of explicit numerical goals for central bank objectives, most notably inflation targets. The adoption of numerical targets, it is argued, facilitates central bank accountability and better anchors private expectations about inflation and monetary policy and thereby yields better macroeconomic outcomes.

Quantifying central bank objectives has some positive aspects and, certainly, vigorous advocates. Nonetheless, I harbor significant reservations about this approach regarding both its practical implementation, in the specific context of the Federal Reserve System, and its demonstrated

³ See Joe Lange, Brian Sack, and William Whitesell (2003), "Anticipations of Monetary Policy in Financial Markets," *Journal of Money, Credit, and Banking*, vol. 35 (December), pp. 889-909; William Poole, Robert H. Rasche, and Daniel L. Thornton (2002), "Market Anticipations of Monetary Policy Actions," (253 KB PDF) Federal Reserve Bank of St Louis, *Review*, vol. 84 (July/August), pp. 65-93; and Ben S. Bernanke, Vincent R. Reinhart, and Brian P. Sack (2004), "Monetary Policy Alternatives at the Zero Bound: An Empirical Assessment," *Finance and Economics Discussion Series 2004-48* (Washington: Board of Governors of the Federal Reserve System, September), for evidence relating to the increased transparency of the FOMC over the past several years to the predictability of short-term interest rates.

⁴ See Christina D. Romer and David H. Romer (2004), "Choosing the Federal Reserve Chair: Lessons from History," *Journal of Economic Perspectives*, vol. 18 (Winter), pp. 129-62.

effectiveness based on inferences from the recent experience of regimes that have specific numerical targets, particularly with respect to inflation, around the world.

A basic, yet difficult, issue is the selection of a particular price index to guide policy, even in the case of a single goal such as inflation. Experience tells us that economies and the composition of productive enterprises change over time, and therefore the appropriate index and inflation value for the monetary authority would also need to change to reflect technological and other advances. In light of this inherent uncertainty associated with the construction of a price index, one might be concerned that choosing and rigidly adhering to an inappropriate index could have negative economic consequences that might outweigh prospective benefits.

Also, we must consider the ramifications of quantified goals in the context of our democracy. That is, the quantification of objectives becomes even more problematic for central banks such as the Federal Reserve with multiple democratically based mandates, some of which are notably less disposed to quantification than others. For example, considering our dual mandate from the Congress, how do we measure maximum sustainable employment? Indeed, as I mentioned previously, estimates of the NAIRU and other possible related measures that address the full-employment objective such as the output gap have uncomfortably wide confidence intervals and are far more controversial than selecting a target for a specific price index.

Of course, the central bank could in principle quantify only the inflation objective. However, I fear that quantifying one goal and not the other would present problems because the monetary authority might inadvertently place more emphasis on the quantified goal at the expense of the nonquantified objective. Doing so would seem inappropriate. The ease of quantification should not influence how the Federal Reserve pursues its dual mandate.

In addition, I worry about the potential loss of flexibility from the implementation of an inflation target, as explicit numerical goals might inhibit the central bank's focus on output variation or financial stability. I would argue that, besides the episodes of financial turmoil in the late 1990s mentioned earlier, supply shocks, such as large increases in oil prices that simultaneously increase the price level and decrease aggregate output, can be problematic for inflation-targeting regimes.

Of course, some variants of the approach - so-called flexible inflation targeting for instance - can address the issues I just raised by stipulating wide target ranges, by maintaining escape clauses that allow inflation to diverge from the target, or by aiming at average inflation over the business cycle. But the credibility gains from inflation targeting seem to me to be inversely related to its flexibility. Simply, credibility is less likely to be gained and expectations are less likely to be anchored if the central bank frequently uses escape clauses, widens the target bands, or pushes out its time horizon.

Ultimately, real credibility for achieving goals must come from performance, and predetermined frameworks do not seem to be a necessary or a sufficient condition to safeguard desirable policy outcomes. Observation of more-recent Federal Reserve actions reveals the apparent preferences of policymakers. In recent years, the Federal Reserve has apparently leaned against disinflation when core inflation threatens to fall much below 1 percent, and, similarly, against inflation when the core rate threatens to rise above 2 to 2-1/2 percent. The Federal Reserve has demonstrated this strategy without the formal adoption of a specific inflation target or range for the FOMC.

Given the subdued and stable inflation witnessed over the past fourteen years, I have to ask: What would be gained from a formal goal for inflation? Can we draw compelling general inferences from the recent experience of inflation-targeting central banks? As a caveat regarding this evidence, economists have very limited data to work with, as the first recognizable inflation targeting regime appeared in New Zealand in 1990. But to date, I would argue that the case for inflation targeting has yet to be proved.

Certainly, I would not deny that numerical inflation targets have proven useful for several countries in particular circumstances. One example is the United Kingdom, where, in the aftermath of "Black Wednesday" in October 1992, an inflation target helped provide a nominal anchor after sterling was removed from the European exchange rate mechanism. I should also add that the Bank of England has quite successfully helped to achieve low and stable inflation ever since. In addition, inflation targeting can have demonstrable benefits in lower-income countries that have experienced high and variable inflation rates in the recent past.

In several cases, quantified inflation targeting has served as a means of achieving the central bank independence necessary to focus more effectively on controlling inflation. That is, the adoption of an inflation target is frequently part of a broader program to increase the autonomy and transparency of

central bank practice. But inflation targeting is not the only means by which to achieve these ends. Again, the recent experience in the United States that I have noted is an object lesson in this regard.

Unfortunately, the empirical evidence for industrial countries available to date generally appears insufficient to assess the success of the inflation-targeting approach with confidence. For example, it is unclear whether the announcement of quantitative inflation targets lessens the short-run tradeoff between employment and inflation, and whether it helps anchor inflation expectations. In addition, some research, controlling for other factors, fails to isolate the benefits of an inflation target with respect to the level of inflation or its volatility over time, and output does not seem to fluctuate more stably around its potential for countries that have adopted numerical targets.⁵ Future data may or may not produce compelling evidence, but I maintain that the case today for inflation targets in countries that already enjoy low and stable inflation rates has certainly not been proved.

With respect to both its practical implementation, particularly in the United States, and the empirical evidence to date, I submit that the adoption of a numerical inflation target does not promise any obvious incremental benefits, at least in countries that have already achieved reasonable price stability. That said, a continuing commitment to price stability is certainly important, and the Federal Reserve has established a solid record of such commitment.

Conclusion

Based on this brief review, I conclude that, at least since the policy reform of October 1979, most observers would agree that the Federal Reserve has achieved generally good policy practice and outcomes. In my assessment, good policy practice cannot be safeguarded with certainty using a single rule or framework, such as inflation targeting. Good outcomes ultimately depend on flexible execution of an evolving strategy and policymakers with an unwavering commitment to low and stable inflation as the foundation for maximum sustainable growth.

⁵ See for example, Laurence Ball and Niamh Sheridan (2003), "Does Inflation Targeting Matter?" NBER Working Papers Series, no. 9577 (March), and E. Castelnuovo, S. Nicoletti-Altimari, and D. Rodriguez-Palenzuela (2003), "Definition of Price Stability, Range and Point Inflation Targets: The Anchoring of Long-term Inflation Expectations," (413 KB PDF) ECB Working Paper No. 273 (September).