



Securing the Promise of Price Stability

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Shadow Open Market Committee
April 20, 2012

Introduction

Put into practice during the Volcker disinflation and perpetuated by the Greenspan Fed, price stability has proved its worth. Inflationary go-stop monetary policy precipitated recessions beginning in 1969, 1973, 1980, and 1981, the last with inflation and unemployment peaking above 10%. Since then, prior to the recent credit turmoil, mild recessions beginning in 1990 and 2001 were separated by two of the longest business expansions in US history.

With inflation then running near 1%, in 2003 Greenspan declared that measures of core consumer inflation had decelerated to a range that could be considered “effective price stability.” A milestone was reached this January 2012, when the Bernanke Fed formerly adopted an explicit 2% inflation target. Now it is Congress’s turn. To secure the priority for price stability, Congress should hold the Fed accountable for achieving the 2% targeted rate of inflation on average over time. Otherwise, the Fed’s commitment will lack the credibility for low long run inflation and inflation expectations that only a congressional acknowledgment can provide.

Partners for Price Stability: Congress and the Fed

The Federal Reserve needs Congress to be a “partner for price stability.” The Federal Reserve having taken the first step, Congress must take the next step to realize the promise of price stability. Representative Kevin Brady’s “Sound Dollar Act” would do that by mandating the Fed to promote the “goal of long-term price stability.” The Brady bill would evaluate whether long-term price stability is achieved against the Fed’s 2% inflation target.

Critically important, for purposes of oversight of the Fed, the Brady bill would require the Fed to explain to the congressional oversight committees why, if the inflation target is not being met, what actions the Fed will take to ensure the return of inflation to target. Equally important, the Brady bill asks for a description of the main policy instruments employed by the Fed to achieve its inflation target, and a description of the strategy the Fed employs to do so.

Effective monetary policy requires a mandated inflation target, the operational independence to achieve the inflation target, and robust congressional oversight. The Sound Dollar Act strikes the right balance. The Fed would retain “operational independence” to manage its monetary policy instruments as it sees fit to achieve the agreed 2% inflation target over time. Thus, the Act would promote “constrained operational independence.” Crucially, the Act would require the Fed to make available to the oversight committees in considerable detail the reasoning behind its tactical and strategic policy intentions. The assurance that Congress accepts a priority for 2% inflation on average would enable the Fed to be more transparent about how it strikes a balance between inflation and output in the short-run. Oversight hearings would become more focused and substantive than under the current “dual mandate” because the Fed’s operational independence would be protected subject to the Fed’s achieving its inflation target on average over time.

The questions at oversight hearings could be grouped according to whether committee members think current monetary policy is too easy, about right, or too tight. The opportunity for the Fed to address comments and questions in detail from all sides would enable the Fed to build public

understanding and confidence in its own position. More focused and substantive congressional hearings on monetary policy, in turn, would help to educate economists, the press, and financial markets. Eventually the public's confidence in monetary policy could be based not on the individuals who happen to lead the Fed, but on a deeper understanding of how inflation targeting works to optimize the economy's performance.

I would sum up this way. Currently, oversight hearings are largely dysfunctional. There is a chicken and egg problem. Without some assurance that Congress accepts a priority for low long-run inflation, the Fed is reluctant to be more transparent about how it strikes a balance between inflation and output in the short-run. But without a mechanism by which the Fed's reasoning about short-run policy can be assessed more fully, Congress is reluctant to recognize a priority for low long-run inflation. The Sound Dollar Act would end the stalemate which amounts to "don't ask, don't tell" congressional oversight, and pave the way for genuine, productive congressional oversight of monetary policy.

Recalling the Case for Price Stability

Exhibit A in the case for the priority for price stability is the tendency otherwise to develop inflationary go-stop policy. The disruptive potential of inflation is consistently underestimated. Each increase in inflation is tolerated in the belief that it will soon die down. The central bank is inclined to be responsive to the shifting balance of concerns between inflation and unemployment. Inflation becomes a public concern only after it moves persistently above its previous trend. But then, pricing decisions already embody higher inflation expectations; and the central bank needs a recession to bring inflation and inflation expectations back down.

An aggressive increase in short-term interest rates initiates the "stop" phase of the policy cycle. There is only a narrow window of public support for the Fed to raise interest rates. The window opens when rising inflation is widely judged to be a problem and closes after tighter monetary policy causes unemployment to rise. So the central bank settles for a higher trend rate of inflation.

The problem during the Great Inflation prior to the Volcker disinflation was that the Fed tended to justify its periodic inflation-fighting actions against an implicit objective for low unemployment. In doing so, the Fed made monetary policy a source of instability and wound up worsening both inflation and unemployment. Eventually, the Fed recognized that it would be better to justify its actions to stimulate employment against a commitment to low inflation. The reversal of priorities since the Volcker disinflation has enabled monetary policy to reduce both inflation and unemployment on average.

The key to the Fed's success is its preemptive interest rate policy actions against inflation, the first in 1983-84 and the second in 1994. Both circumstances were marked by a significant inflation scare in long-term bond rates. The 30-year Treasury bond rate rose by 3 percentage points from the summer of 1983 to the summer of 1984. The bond rate rose by 2 percentage points from the fall of 1993 to the fall of 1994. On both occasions, the Fed raised short-term interest rates by 3 percentage points to contain the inflation scare, even though actual inflation had not begun to rise. And on both occasions the Fed's preemptive interest rate policy actions

prevented a subsequent rise in inflation, reversed the inflation scare in bond rates, and did so without an increase in unemployment. Thus, the priority for price stability enforced by preemptive interest rate policy has worked in practice to sustain low inflation and low unemployment.

The Sound Dollar Act and Foreign Exchange Operations

The Sound Dollar Act has two provisions related to foreign exchange. The first provision requires the Fed to provide Congress with an analysis of how its monetary policy affects the foreign exchange value of the United States dollar. The second provision requires the Treasury's Exchange Stabilization Fund (ESF) hold only Special Drawing Rights. All other ESF assets would be sold with proceeds used to pay down the public debt.

The first of these provisions is potentially subversive of the primary price stability objective of the Sound Dollar Act. The second provision is potentially supportive of price stability. Neither of these points is recognized in the Act. Clarification is needed.

In practice, one of the greatest impediments to the achievement of domestic price stability is a government or public reluctance to accept fluctuations in the foreign exchange rate that accompany monetary policy that stabilizes domestic inflation. A tightening of interest rate policy to preempt rising inflation tends to appreciate the currency on foreign exchange markets; an easing of interest rate policy to preempt deflation depreciates the currency.

The credibility of the country's commitment to low and stable inflation is sensitive to any perceived unwillingness to allow fluctuations in the foreign exchange rate that might cause the central bank to shy away from interest rate policy actions otherwise deemed necessary to preserve domestic price stability. Therefore, theory and practice suggest that it is best for legislation meant to strengthen a nation's commitment to domestic price stability to make no mention of the foreign exchange rate, or to recognize the preeminence of a freely floating exchange rate.¹ So the concern with the foreign exchange rate in the Sound Dollar Act is problematic at best and destructive at worst.

With regard to the Treasury's Exchange Stabilization Fund, the Sound Dollar Act would deprive the Treasury of the discretion to utilize ESF funds for fiscal policy purposes. For instance, had the Act been in place earlier, it would have precluded the Treasury's power to make a loan to Mexico via the ESF in 1995 without an explicit congressional authorization, and it would have precluded the Treasury's guarantee of money market funds via the ESF in 2008 without the authorization of Congress.

More relevant to the issue at hand, but not emphasized in the Act, the ESF has provided the Treasury with a degree of flexibility and discretion in its foreign exchange operations. The ESF has served the purpose of funding foreign exchange interventions to influence dollar exchange rates. In much the same way that securities dealers use repurchase agreements with banks to

¹ This point is elaborated in detail in J. A. Broaddus and M. Goodfriend, "Foreign Exchange Operations and the Federal Reserve," Federal Reserve Bank of Richmond *Economic Quarterly*, 1996, 82/1, Winter, pp. 1-19.

finance their portfolios, the ESF has financed its purchases of foreign exchange with dollars borrowed from the Fed via “warehousing.”

Proscribing the ESF would limit the Treasury’s discretionary power to intervene in foreign exchange markets to influence exchange rates. Limiting the Treasury’s power to intervene in foreign exchange markets would enhance the nation’s commitment to a floating exchange rate, and facilitate the credibility of preemptive interest rate policy geared to sustaining price stability. The Act should explain that it is important to proscribe the ESF’s powers to intervene in foreign exchange markets in order to assure the nation’s commitment to price stability.

Fed Governance in the Sound Dollar Act

The Sound Dollar Act contains provisions relating to Fed governance in addition to those discussed above bearing directly on the implementation of monetary policy to preserve price stability. Most closely related to monetary policy are the provisions calling for 1) extending permanent FOMC voting membership to all regional Federal Reserve presidents, and 2) releasing the FOMC transcripts with a three year lag.

These two provisions would have relatively little impact either way on the effectiveness of monetary policy if the primary provisions in the Act discussed at length above improve congressional oversight and accountability of monetary policy. Personalities would matter less once the inflation target mandate is clarified and the oversight hearings themselves become more focused and substantive. Reserve bank presidents would be valued nevertheless for bringing a diverse set of perspectives to internal deliberations and external debate on monetary policy.

Two provisions of the Sound Dollar Act deal with “credit policy.” The first calls for the Fed to articulate its “lender of last resort” policy. The second calls for the Fed to maintain a “Treasury only” asset acquisition policy except for temporary acquisition of non-Treasury assets in emergencies. Circumscribing Fed credit policy in this way is essential to get the Fed out of credit allocation, and to keep it from being drawn into credit allocation in the future. Credit allocation is neither necessary nor sufficient for the Fed to achieve its primary price stability objective.²

The Sound Dollar Act requires the Consumer Protection Bureau to be funded through regular appropriations instead of through the Fed’s net interest income. The Fed is given “financial independence” to fund itself from net interest income only to keep its money creation powers from being abused in the budgeting process. Given that the Fed’s net interest income fluctuates, diverting that income for purposes that can be funded elsewhere needlessly weakens the Fed’s financial independence.

² See M. Goodfriend, “Clarifying Central Bank Responsibilities for Monetary Policy, Credit Policy, and Financial Stability,” SOMC Symposium, March 26, 2010 (ShadowFed.org)