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# Price Stability and World Economic Recovery

by W. Lee Hoskins

During the past decade, we have enjoyed considerable success in reducing inflation. Despite an unusually long economic expansion, rates of inflation did not accelerate much during the 1980s. While this is heartening, I do not mark our success solely by the numbers; indeed, inflation remains unacceptably high. Instead, I find encouragement in changing attitudes, in both the United States and Europe, about the proper role of monetary policy. Policymakers and academic economists increasingly accept the view that monetary policy can promote stable economic growth only by focusing on long-term price stability.

We now stand at an important juncture. We face a rare opportunity to make further gains against inflation in the 1990s, but the commitment to this goal, while growing, remains fragile. With the economy struggling to edge out of recession and with credit demands looming large on the economic horizon, some observers are calling for a further easing of monetary policies. They wrongheadedly cling to once-fashionable illusions that nations can fine-tune economic activity and that the costs of achieving price stability are prohibitively high. To cloak these ideas in modern garb, they now stress the global nature of world markets and call for a coordinated *worldwide* easing of monetary policies.

In the weeks ahead, leaders of the major industrialized countries will once again consider the merits of the global fine-tuners' creed. They must distinguish the role that monetary policy and central banks can truly play from the role that many wish these forces could play. My intent in this *Economic Commentary* is to highlight this important distinction. Central banks can neither smooth short-term fluctuations in business conditions nor guarantee an abundance of credit at low interest rates. Monetary policy, however, can promote long-term investment and stable growth at the economy's long-run potential by guaranteeing price stability.

## The Current Economic Environment

Our efforts to pursue price stability will confront two challenges, one cyclical and the other structural. Current business conditions present the most immediate obstacle. Over the past year, the U.S. economy has experienced a recession. As downturns go, this one has been relatively mild. We now seem poised for a recovery, but the upturn may be modest by historical standards, at least during the year ahead.

In response to the weakening economic activity of the past year, monetary policy has been gradually eased. The Federal Reserve Board lowered the discount rate in three steps from 7 percent in late 1990 to 5.5 percent at present, and the Federal Open Market Committee (FOMC) has promoted a reduction in the federal funds rate. Responding both to these policy initiatives and to the sluggish economy, money market rates in the United States have declined significantly. Capital market rates, as is typical, have been much less responsive to our monetary policy initiatives.

**The challenges of weak economic activity and heavy credit demands have led some observers to advocate a coordinated global easing of monetary policies. This economic fine-tuning could jeopardize our recent gains against inflation and would damage central-bank credibility. Central banks contribute to long-term economic growth only by guaranteeing the stable purchasing power of money.**

Economic activity among the other major industrialized countries also has weakened, but with somewhat greater variation than we have come to expect. The United Kingdom and Canada have experienced relatively sharp economic declines since the middle of last year. Other countries, notably France and Italy, may have only recently begun to experience declining economic activity. As in the United States, most of these countries have eased monetary policies through reductions in official central-bank lending rates.

Although many expect economic growth in Germany and Japan to slow, it recently has remained strong, with productive capacity at high rates of utilization. Inflationary pressures, as reflected in both rising prices and growing wage demands, remain a primary policy concern, especially in Germany,

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where reunification has resulted in a recent surge in money growth and a sharper-than-expected rise in the budget deficit. Not wishing to accommodate these price pressures, both Germany and Japan have been reluctant to ease their monetary policies significantly. In fact, Germany has increased its official interest rates this year.

Beyond the immediate cyclical problems lies a structural challenge that central banks will inevitably face. As recovery proceeds, demands for credit will rise. In addition to the normal increases in business investment, credit demands will reflect an amalgam of unusual circumstances, including capital necessary to rebuild Eastern Europe, the Soviet Union, and Kuwait; hefty governmental borrowing; developing-country credit needs; and funds to restructure business. Although many expect private savings to rise worldwide, the increase is unlikely to satisfy these credit requirements without a rise in real interest rates.

Faced with these prospects, many contend that central banks should suspend their commitment to long-term price stability. Proponents of this view maintain that faster monetary growth among the largest industrialized countries would lower worldwide interest rates, encourage global investment, and stimulate real economic growth. Should such a policy later intensify inflationary pressures, a little ratcheting back on money growth could then hold inflation in check, they assert.

Last April and again in June, the British, Germans, and Japanese, among others, promptly rebuffed a proposal to undertake a coordinated expansion of their monetary policies. Many reports cited inflationary pressures in some countries as the primary cause of the rejection. Although this undoubtedly is partially true, it is not a full explanation. The European response fundamentally reflects these countries' changing attitudes about monetary policy. Whereas proponents of fine-tuning espouse a monetary policy to foster "low inflationary growth," the Europeans seek a monetary policy consistent with "noninflationary growth." The differences envisioned by the two sides are substantially greater than these adjectives suggest.

## ■ Price Stability and the Role of Central Banks

Economic policy should strive to maximize the standard of living. This is best accomplished in competitive markets that encourage private initiative and that clearly define the role of government. A properly functioning price mechanism is central to such a system, because it relays vital information about relative scarcities across all markets, thereby ensuring allocative efficiency. The recent experiences of Eastern Europe and the Soviet Union dramatically illustrate the plight of economies that do not allocate resources through price systems.

In market economies, the province of central banks is to ensure the allocative efficiency of the price mechanism by guaranteeing the purchasing power of money. To do so, central banks must focus monetary policy on long-term price stability, and gain credibility either through a statutory mandate for this objective or through a steadfast focus on the goal. Deviations from price stability erode central-bank credibility and impede the efficacy of the price mechanism. Inflation, even if fully anticipated, transfers wealth from the private sector to the government sector via taxes on inflated values of nominal wealth. Individuals will naturally attempt to protect their real wealth from higher taxes and the uncertainty associated with price instability. Such attempts direct resources away from more productive uses, especially those that require risky, long-term investments. Empirical studies indicate that countries with high, variable inflation rates typically experience slower real economic growth than countries with lower, more stable inflation rates.[1]

As this discussion illustrates, monetary policy can influence real growth and investment by creating a stable environment that encourages individuals to make long-term economic commitments. Despite the contentions of many observers, monetary policy cannot fine-tune the business cycle, and it cannot increase the real supply of savings available for investment.

## ■ Monetary Policy and Fine-Tuning

The belief that global monetary-policy coordination can fine-tune the world economy rests on assumptions and conditions that either do not hold in actuality or that central banks cannot successfully exploit. It assumes, for example, that monetary policy has a stable relationship with real economic growth over all phases of the business cycle. This simply is not the case. Economists continue to debate the relative importance of the various channels through which monetary policy might affect real economic activity and prices. The mechanisms are even more complicated when one affords proper consideration to international interactions. The greatest disagreements among competing large econometric models typically center on the global interactions of monetary policies.

In addition, monetary fine-tuning requires that central banks have an accurate economic forecast, particularly for the period before monetary policies influence economic activity and prices. Forecasts of real economic activity have often proved inaccurate, with the result that ill-timed policies can actually accentuate the business-cycle fluctuations they sought to moderate.

The Bonn Summit of 1978 provides a good example of this problem, one that recent advocates of coordinated monetary expansions might well consider. At that meeting, the major developed countries agreed to a joint expansion of their fiscal policies. The primary objective was to stimulate real economic growth and to reduce unemployment throughout the industrialized countries. Inflation was already high in many countries, but trading off a little more inflation for lower unemployment seemed a good bargain. Unfortunately, policymakers misjudged the world's ability to absorb additional workers and incorrectly interpreted the inflationary pressures in world markets. These forecast errors, together with an unforeseen rise in oil prices, swiftly translated the stimulus package into a rapidly accelerating inflation. In the United States, for example, the inflation rate doubled from approximately 6 percent in 1978 to 12 percent by 1980.

Perhaps most important, calls for fine-tuning economic activity assume that central banks can consistently surprise individuals about the nature of price changes. Monetary policy can affect real output and employment only when prices do not adjust rapidly. Even if we allow that prices are at times slow to adjust, individuals will eventually recognize attempts to exploit the situation—to trade higher inflation for additional growth—as a breach in the central bank's commitment to long-term price stability. They will come to anticipate future inflation and will make appropriate adjustments in their pricing policies and investment decisions, thereby misallocating resources.

## ■ Monetary Policy, Saving, and Investment

Besides being unable to fine-tune economic activity, monetary policy can neither directly alter world credit supplies nor set interest rates that will balance credit demands and supplies. Savings depend on the willingness of individuals to forgo current consumption for future consumption. Investment depends on the expected real returns on capital. When savings and investment decisions do not balance, economic variables adjust to bring them in line. Long-term real interest rates play a central role in the process. Given the expectations of large demands for credit over the next five years, high real interest rates may be necessary to encourage saving and to discourage the least-economical investments.

Those who believe faster money growth lowers interest rates and provides additional resources for investment fail to distinguish between nominal and real economic variables. While monetary policy can influence the former, it can affect the latter only to the extent that it creates confusion and uncertainty about future expected inflation. As I have indicated, the market becomes adept at forecasting inflation. The consequence has been that nominal long-term interest rates often increase as a result of monetary easing, while real interest rates show little long-term trend. Monetary policy does not afford central banks a channel through which they can systematically influence decisions about savings and capital accumulation.

## ■ Should We Coordinate?

Many economists and policymakers argue that, in an increasingly interdependent world, central banks of the major industrialized countries must coordinate their monetary policies. Certain types of international cooperation are indeed beneficial to policymaking and to the smooth functioning of markets. Empirical studies suggest, however, that most of the benefits from international policy coordination derive from the sharing of information, not from the joint determination of policy instruments.[2]

I have advocated, therefore, that countries adopt independent price-level targets based on their individual preferences for inflation. Nations might then cooperate in the sense of providing timely information about these price-level targets and about the nature of any underlying economic disturbances. Exchange markets would continue to function freely, with exchange rates between currencies adjusting to individual countries' preferences for inflation. Exchange rate depreciation in response to trade and capital flows might exert its own discipline in countries with inflationary biases, forcing an international convergence.

## ■ Price Stability: The Progress to Date, the Distance to Travel

Over the past few years, we have witnessed growing support for the objective of focusing monetary policy solely on long-term price stability. The performance of inflation in the United States over the last business cycle reflects this support. Throughout one of the longest business expansions on record, inflation held fairly steady in a 4 to 5 percent range.[3] Looking back over the 1970s, one would not have predicted such an outcome. Inflation accelerated dramatically over each business cycle, reaching successively higher peaks and troughs.

Our improved inflation performance reflects a changed pattern of money growth over the business cycle. During the 1970s, money growth (M2) rose dramatically when business activity weakened and grew rapidly through most of the subsequent recovery periods. When inflation accelerated sharply, and policy objectives abruptly shifted focus, money growth decelerated with equal drama. Over the business expansion of the 1980s, we surely saw fluctuations in money growth, but overall the Federal Reserve managed to slow trend money growth as the economy expanded.

Since the most recent recession began in mid-1990, policymakers have not undertaken an excessive monetary expansion. In fact, moderate money growth has helped to restrain price pressures, unlike the early stages of both recoveries in the 1970s, when rapid money growth caused inflation to surge. By avoiding this past cyclical pattern, the System has recouped much of the credibility that it lost in the 1970s. If we continue to moderate money growth as the economy strengthens, inflation should continue to slow.

Most other industrialized countries, notably Germany, Japan, France, and Canada, have also avoided an acceleration of inflation during the recent business recovery. Many have linked their currency values with the German mark through the European Monetary System (EMS) to ensure greater monetary discipline and to gain credibility in their pursuit of price stability. A big surprise to many analysts has been the willingness of European participants in the EMS to avoid currency realignments. This has often come at the expense of monetary policy independence. Moreover, those currency realignments that did occur intentionally did not fully restore competitiveness. This has afforded a further discipline against inflation.

Nevertheless, progress has been slow, and we are still a long way from our goal of price stability. Inflation rates as high as 4 or 5 percent can still have important resource implications through their interactions with the tax structure. We have come to a critical juncture. Our price performance to date provides us with a unique opportunity for making further gains, but the closer we come to approaching the objective, the more difficult it becomes to make these gains. As I have suggested, many policymakers in the United States and throughout the world maintain that the adjustment costs of reducing inflation further are simply too great. How, then, do we proceed?

## ■ Monetary Policy in the Current Environment

The United States should reaffirm its commitment to price stability over the long run. To increase its credibility, Congress should mandate this objective as the overriding priority of the Federal Reserve System. Germany, which has consistently enjoyed a rate of inflation below that of other industrialized countries, follows this approach. As mandated in the Deutsche Bundesbank Act, the primary function of the German central bank is to "safeguard the currency," that is, to guarantee the stable purchasing power of the German mark.

We must also avoid an acceleration of inflation as the recovery proceeds. The System should continue to lower the midpoint of its M2 target range and to keep money growth well inside its boundaries. Although the System uses the federal funds rate as an indicator of the direction of monetary policy, it is important, particularly in light of growing capital needs, that monetary policy not focus on interest rates, but continue to concentrate on price stability. With credit demands looming heavy, interest rates are likely to remain high from a historic perspective.

If the Federal Reserve fails to prevent a further acceleration of inflation at this juncture, the immediate, measurable costs will be in terms of higher inflation, but the immeasurable and lasting costs will be in terms of lost credibility. Credibility is often slow and difficult to build, but is quickly destroyed.

## ■ Conclusion

Monetary policy *can* influence real economic growth, but it does so only indirectly, to the extent that it protects the purchasing power of money and fosters a stable environment in which individuals can make long-term commitments. Those who advocate fine-tuning believe that central banks can buy faster short-term economic growth with higher inflation. The long-run terms of trade, as the past has shown, are much more costly. Any cyclical advantages that we might possibly gain from monetary fine-tuning surely will come at the expense of long-term growth, economic stability, and central-bank credibility. Instead, I support "noninflationary growth."

## ■ Footnotes

1. See, for example, David E. Lebow, John M. Roberts, and David J. Stockton, "Economic Performance under Price Stability," unpublished manuscript, Board of Governors of the Federal Reserve System, December 1990; and Laurence Ball and Stephen G. Cecchetti, "Inflation and Uncertainty at Long and Short Horizons," *Brookings Papers on Economic Activity*, vol. 1 (1990), pp. 215–45.

2. See Owen F. Humpage, "A Hitchhiker's Guide to International Macroeconomic Policy Coordination," Federal Reserve Bank of Cleveland, *Economic Review*, vol. 26, no. 1 (1990 Quarter 1), pp. 2–14.

3. Unless otherwise stated, I measure inflation by the Consumer Price Index less food and energy.

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