

Monetary Policy in a Low Inflation Environment

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It's a pleasure to be here today and to have this opportunity to comment on conducting monetary policy in a low inflation environment. I've been at the Fed for more than thirty-two years and have had the privilege of either advising monetary policymakers or being a policymaker myself throughout my career. It has been quite a ride. For much of this period the Fed was struggling either to prevent inflation from rising further or to bring it down. As you know, over the last several years we have succeeded in reducing the inflation rate to about $1\frac{1}{2}$ percent as measured by the core personal consumption expenditures (PCE) price index—today's favored inflation index—and in stabilizing the rate at that level. In the parlance of the day, we have finally attained “price stability,” meaning both low *actual* inflation and the credible expectation in the minds of financial market participants and the general public that it will persist, which together constitute the monetary policy equivalent of finding the Holy Grail.

In my brief remarks I want to do four things. First, I will compactly review several key aspects of the evolution of monetary policy over the last thirty years. To appreciate fully the nature of the challenge that lies ahead, it is essential to understand *how* price stability was lost in the 1970s and regained in the '80s and '90s. Second, I will try to convey the essence of the current strategy of Fed monetary policy. I'll then close with a brief discussion of the challenges monetary policymakers face in today's low inflation environment, as I see them, and a pitch for explicit inflation targeting as a means of preserving the substantial improvement in the effectiveness of monetary policy during the Volcker-Greenspan years. As usual, these views are my own

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and don't necessarily reflect those of my Federal Open Market Committee (FOMC) colleagues. Also as usual, my views have been strongly influenced by discussions with, and the writings of, my longtime Richmond Fed colleague Marvin Goodfriend—in particular a preliminary version of a paper he will deliver at a National Bureau of Economic Research conference on inflation targeting later this month. He is not necessarily responsible, however, for anything I say here today.

1. HOW PRICE STABILITY WAS LOST AND REGAINED

It is probably fair to say that, after periods of moderate inflation in the 1950s, the economy returned to virtual price stability in the early 1960s. The core CPI inflation rate fluctuated in a narrow 1.0 to 1.6 percent range between 1960 and 1965. Subsequently, as you all know, it increased steadily to double-digit levels in the mid-1970s and again in the late '70s.

This extraordinary and debilitating increase in inflation has been attributed, in whole or in part, to many things: the two oil price shocks in the '70s, excess demand associated with the Vietnam War buildup and the Great Society social programs, the ineffectiveness of the Nixon Administration's price control program and the Ford Administration's "Whip Inflation Now" program, and even the failure of anchovy harvests off the coast of South America. Both theory and historical evidence, however, indicate that inflationary monetary policy was the central culprit.

The failure of monetary policy to contain inflation in this period can be approached from several directions. Economists of a monetarist persuasion argue that persistently above-target money supply growth, and the practice of adjusting the money supply target's base up each year to accommodate the preceding year's upside miss, was the principal operational deficiency. Currently, the more mainstream view focuses on the failure of the Fed's short-run interest rate policy to counter the rise of inflationary pressures promptly during business expansions. The 1970s and early 1980s are sometimes referred to as the period of "go-stop" monetary policy. Concerned about the potential impact of policy tightening on employment and production, the Fed would wait until a broad public consensus emerged that inflation was a serious problem before acting decisively to contain it. By then, however, it was generally too late to bring inflation down via tighter monetary policy without at the same time touching off a recession. The cycles surrounding the 1980 and 1981–82 recessions illustrate this pattern especially well.

More fundamentally, however, it is not an exaggeration to say that Fed monetary policy lost all or most of its *credibility* as an effective force against inflation in this period. As inflation began to rise, financial markets and the public—even in the early stages of expansions—quickly revised their inflation expectations upward. This reinforced the upward pressure on current

inflation, pushed up long-term interest rates, and in general helped foster the macroeconomic malaise described by the term *stagflation*.

Perhaps the most important lesson for monetary policy from this experience is how difficult and costly it is for the Fed to rebuild its credibility for low inflation once it has been lost—especially when, for all practical purposes, it has been totally lost, as in the late '70s and early '80s. Led by Chairman Volcker, the Fed had to raise nominal short-term interest rates to unprecedented levels and essentially induce one of the longest and deepest recessions in the entire post-World War II era just to *begin* the process of restoring its credibility for low inflation. It is highly doubtful that the process could have begun without this costly recession, in which real GDP declined 2.8 percent and the unemployment rate rose to 10.8 percent. And it has taken the Fed about twenty years—nearly a quarter century—to complete the process.

The essence of this process, in my view, has been the Fed's demonstration, particularly in two episodes, that it *can* preempt an increase in inflation without precipitating a recession, and its success in recent years in convincing the markets and the public that it *will* routinely do so in the future. One of these episodes came early in the process, in 1983 and 1984, as the economy recovered from the 1981–82 recession; the other was in 1994 when the recovery from the 1990–91 recession finally began to gather momentum. In both cases, incipient inflationary pressures were quickly picked up by financial markets, which produced what Goodfriend calls “inflation scares,” characterized by sharply rising nominal bond rates. In both instances the Fed acted swiftly and decisively to preempt inflation. The 1994 episode was especially important since it occurred at a time when Fed policy had become much more transparent than earlier, as evidenced by its decision that year to announce publicly its federal funds rate target immediately following each FOMC meeting.

2. THE CURRENT STRATEGY OF MONETARY POLICY

The U.S. economy has now enjoyed virtual price stability since about 1996. There seems to be a growing consensus currently among monetary policy-makers, close observers of the policy process in financial markets, Congress and the press, and individual Americans interested in policy that price stability and the Fed's credibility for low inflation should be sustained. This consensus is based partly on a broader public appreciation of the high costs of reestablishing lost credibility, as described above. More fundamentally, however, it appears to reflect a recognition that the Fed's revived credibility is beneficial to the economy—specifically, that the Fed can contribute meaningfully to an improved longer-term U.S. economic performance in the form of an increase in the sustainable growth of production and higher employment. Further, the public seems less concerned than earlier about possible short-run costs of low inflation, in terms of lower growth, perhaps because the transition to

low inflation has now been accomplished. And since low inflation is broadly expected to persist, the public would be surprised and disappointed if it were lost. Consequently, the consensus arguably sharpens the Fed's accountability for maintaining low inflation.

Against this background, I sense the emergence within the Fed of a more cohesive *strategy* of monetary policy than at any other time in the last three decades. To my mind it consists of two elements: (1) a strong commitment to maintaining high credibility for low inflation permanently, and (2) active management of real short-term interest rates to help stabilize the economy in the short run. Regarding the first, Goodfriend argues in his forthcoming paper that the Fed is now practicing "implicit" inflation targeting. As he points out, with the core inflation rate in the 1 to 2 percent range since the mid-1990s, it is hard to imagine the Fed now accepting a sustained inflation rate significantly above 2 percent. Nor would it be likely to accept a sustained rate significantly below 1 percent given the increased sensitivity to the risk of deflation and the proximity of the zero bound on nominal interest rates.

I personally believe that "implicit longer-term inflation targeting" is an accurate description of the first element of the Fed's current strategy. It is important to stress, however, that its ultimate objective is not price stability and high Fed credibility for its own sake, but the optimal financial foundation these conditions provide for strong real growth and high employment.

Moreover, these conditions enable the Fed to pursue the second element of the strategy: active countercyclical short-term interest rate policy. When the Fed's credibility was very low in the 1970s and early '80s, it was difficult—perhaps impossible—to conduct countercyclical interest rate policy effectively. With the Fed's long-run objective for inflation still unclear, the public could not confidently deduce the longer-term ramifications of particular short-term policy actions, and the Fed, in turn, could not confidently predict the public's reaction to its actions. With its credibility for low inflation now well established, the Fed *can* act both more promptly and more aggressively to counter the effects of unanticipated shocks and thereby stabilize the economy in the short run. Beginning exactly two years ago today, the Fed began to ease policy in response to the softening of the economy in the second half of 2000. It accelerated the easing process in the wake of 9/11, and over the course of the two-year period has reduced the federal funds rate $5\frac{1}{4}$ percentage points, from $6\frac{1}{2}$ percent to its present level of $1\frac{1}{4}$ percent. This is arguably the most aggressive series of policy easings taken to cushion a softening economy in the Fed's history and may well account for the apparent brevity of the recent recession despite the extraordinary decline in the stock market, 9/11, and other shocks.

The two elements of the Fed's current strategy, then, are complementary and mutually reinforcing. Implicit inflation targeting enhances the effectiveness of countercyclical interest rate policy. Conversely, active countercyclical

policy makes implicit inflation targeting acceptable, since the ability to act aggressively to stabilize the economy in the short run provides a clear and easily understood rationale for containing inflation.

3. CHALLENGES IN A LOW INFLATION ENVIRONMENT WITH IMPLICIT INFLATION TARGETING

After such a long struggle, one might expect that Fed monetary policymakers would be relatively comfortable now that price stability has been achieved and credibility for low inflation has been reestablished. And I think most, if not all, policymakers *are* more confident that the Fed can contribute constructively to the economy's longer-term performance rather than retarding it, as occurred when inflation was high and variable, and credibility was low.

But the Fed still faces significant policy challenges in the new low inflation environment. Historically, little practical attention has been given to the possibility of excessively sharp *disinflation* and *deflation*. And with the press here I need to emphasize at the outset that I do not believe deflation is a serious present risk to the economy. But policymakers obviously need to think more about how they would deal with a deflationary threat, should one emerge unexpectedly, when inflation is in a 1 to 2 percent range than when it is at 6, 7, or 8 percent. This is especially so with the nominal funds rate, our principal short-term policy instrument, only 125 basis points above zero.

We have been thinking about it, and I am quite confident that we could deal with a deflationary threat successfully. In October 1999 the Fed sponsored a conference in Woodstock, Vermont, on conducting monetary policy in a low inflation environment attended by a large number of leading monetary economists. The participants gave substantial attention to deflation and how to deal with it should it arise in the future. More recently, Fed Governor Ben Bernanke nicely summarized current thinking on this issue in a speech to the National Economists Club. There is now broad agreement that the most effective way to deal with deflation is to prevent it from developing in the first place. In the present situation, the Fed's aggressive easing over the last two years appears to have preempted any significant drift toward either excessive disinflation or deflation. Moreover, even if disinflation unexpectedly intensified and the funds rate were reduced close to the zero bound, the Fed would still have a number of channels available to reestablish a comfortably positive inflation rate. For example, it could increase broad liquidity by purchasing long-term bonds.

The other potential policy challenge I see in today's low inflation environment is how to handle an incipient *increase* in inflation above its implicit target range. This possibility is not on many radar screens currently, but it is obviously a longer-term risk—arguably the most likely longer-term risk. I believe that the policy experience of the 1970s, '80s, and '90s summarized

above argues strongly for prompt action to preempt any sustained increase in inflation. If policymakers had precise, detailed foreknowledge of the relative costs, in terms of lost production, of alternative paths back to price stability, it might be feasible to tune the return more finely. There is little evidence, however, that we have such knowledge. Hence, it seems reasonable to resist any deviations from price stability promptly and strongly—and preferably preempt them altogether.

4. CONCLUSION—SUSTAINING THE PROGRESS

Hopefully these comments have convinced you that the conduct of monetary policy in the U.S. has improved significantly during the last two decades, and that this improvement of policy holds out the prospect of an improved longer-term economic performance going forward. The trick now is to sustain the progress. Much of the progress, in my view, is due to the exceptionally strong leadership since 1979 of, first, Paul Volcker and now Alan Greenspan. But, ultimately, high-quality monetary policy—i.e., sustained credibility for low inflation as a foundation for strong real growth—is too important to be dependent on exceptional leadership alone, which, after all, cannot be guaranteed over the long pull. The progress in recent years needs to be institutionalized—“locked in”—in some manner.

There are probably several ways this could be accomplished. Earlier I referred to one element of the Fed’s current policy strategy as implicit inflation targeting. My personal preference for “hardening” our credibility is to make the implicit target both explicit and quantitative—specifically, 1 to 2 percent, based on the core PCE index. Explicit, quantitative inflation targeting is practiced by a number of other leading central banks around the world, and it would be consistent with the continuing evolution of Fed policy toward greater transparency and accountability. Most importantly, it would be a strong and visible step toward ensuring that the Fed’s current high credibility for low inflation will be maintained indefinitely so that we can make our strongest possible contribution to maximum sustainable growth in the long run and economic stability in the short run.