A Fed Focused on Price Stability

The Benefits of a Single Target

by Kevin L. Kliesen

Recently, the United Kingdom, New Zealand, and Canada have enacted legislation making price stability the primary objective of monetary policy. They have chosen this route based primarily on accumulated evidence that countries committed to price stability—most notably, Germany and Switzerland—tend to have the lowest inflation rates over time. Today, a growing chorus of economists and policymakers in the United States are arguing that Congress should likewise enact legislation stipulating that long-run price stability should be the primary objective of the Federal Reserve's monetary policy.

Naturally, any attempt to alter the Fed's current Congressional mandate raises questions, but two stand out. First, what is it about the current deliberative process that has led many to conclude that legislative action is needed to ensure long-run price stability? And second, what exactly are the benefits of price stability?

The Current Monetary Policy Process

As laid out in the Full Employment and Balanced Growth Act of 1978 (known as the Humphrey-Hawkins Act), the nation's economic policymakers should strive to accomplish the following objectives: full employment, increased real incomes, balanced growth, a balanced federal budget, growth in productivity, an improved balance of trade and price stability. The Act requires the Chairman of the Federal Reserve to explain before Congress twice a year how the Fed's policies are consistent with attaining the goals set forth in Humphrey-Hawkins. In other words, Congress expects the Fed to conduct monetary policy with the intent of meeting these objectives.

Some believe that the Fed's Humphrey-Hawkins mandate is an appropriate guidepost for monetary policy, and that any attempt to alter it will render policymakers to the sidelines, unable to respond in an effective fashion to current events. In their view, the Fed must have considerable latitude to adjust policy in response to adverse short-term economic disturbances, and it should consider other objectives besides long-term price stability, like keeping the unemployment rate as low as possible.

Those who want to make long-run price stability the overriding goal of monetary policy do not quibble with keeping the unemployment rate as low as possible. Rather, they believe that a commitment to long-term price stability is the best way to do it. In essence, those who advocate changing the Fed's Humphrey-Hawkins mandate do so because its multiple goals and objectives create incentives to offset short-run economic disturbances—incents that are not conducive to long-run price stability or long-term economic growth.

The problem with a short-run focus of multiple goals and objectives, most economists believe, is that monetary policy has its greatest impact principally in the long run—and primarily on the price level only. In other words, responding to "too little employment growth," "real output growth that is below its long-run potential," or "interest rates that are too high," usually leads Federal Reserve policymakers astray from their long-term objectives of price stability and sustainable output growth. To paraphrase an old saying, the Fed should "do one thing and do it well."

The Many Benefits of Price Stability

Prices play a crucial role in a market economy like that of the United States, because they ration a limited supply of goods and services among unlimited and competing demands. Accordingly, one important benefit of price stability is that it reduces the risk and uncertainty associated with economic decisionmaking, which by necessity must be forward-looking. For instance, during periods of high and variable inflation, many individuals and firms attempt to protect themselves against rising prices by engaging in activities that tend to be speculative in nature, such as investing in assets like gold, commodities or real estate. While perhaps prudent from an individual standpoint, these activities are not usually prudent from society's point of view.

Curbing these social welfare losses leads to a second benefit of price stability, the interplay between low inflation and faster productivity growth. Economically speaking, increases in productivity allow a firm to produce more with less; thus, a firm does not have to raise its prices to offset the increased costs associated with producing more output. If a rising inflation rate pushes a country...
to divert scarce resources toward relatively risky assets that offer little long-run benefit, instead of investing in plant, machinery and other capital goods that boost productivity growth, then its long-term living standards will be lower than they otherwise might be.

Of course, productivity growth rates are also influenced by capital investment rates, technological advances and prudent regulatory policies. But it is still the case that a low-inflation economy is needed for optimal productivity growth. Why? Because a low-inflation environment reduces economic uncertainty, which lets resources flow to their best uses, enhancing capital formation and leading to increased output growth, higher levels of employment and rising living standards in the long run.

The reduced economic uncertainty in an environment of price stability leads to an additional benefit of price stability: low and stable long-term interest rates. Economists consider long-term interest rates to be the sum of two components: first, the real return from saving, investment and capital formation, and second, the risk premium, which reflects the uncertainty associated with lending money over long periods. Since inflation erodes the real value of an asset over time, the risk premium is strongly affected by the lender’s expectation of the future inflation rate.

Consider what happens to long-term rates when inflation is relatively high and rising: Uncertainty among lenders will rise, and lenders will attempt to compensate for this heightened uncertainty by charging a higher interest rate, which manifests itself in the risk premium. All other things equal, higher long-term interest rates will reduce investment by individuals (for example, housing) and firms (for example, plant and equipment), leading to lower growth rates of output and higher levels of unemployment.

The table at right compares the behavior of inflation with the growth rates of productivity, real gross domestic product (GDP) and the average of the long-term interest rate over five-year periods between 1954 and 1994. The table provides evidence that low inflation is associated with low long-term interest rates, increased productivity growth and increased output growth. During periods when inflation is low—for example, 1954 to 1964—interest rates tended to be low while productivity and GDP growth rates were relatively high. In contrast, when inflation was high and appeared to be quite volatile (1969-84), the opposite tended to occur. Admittedly, not every period of high inflation is associated with low output growth and diminished productivity growth, and vice versa; it is still the case, however, that when inflation is low and stable, the economy does better than when inflation behaves otherwise.

In fact, a similar pattern has developed recently. Since mid-1993, productivity of the business sector has advanced at a 2.5 percent annual rate, while real GDP has risen at 4.2 percent rate, and the long-term interest rate has averaged 6.59 percent. These numbers, which are roughly comparable to the 1950s and early 1960s, are associated with the relatively low trend rate of inflation recently (the CPI has grown at 2.6 percent rate over this period). In short, rather than punishing growth, as some detractors maintain, the Fed’s efforts to promote price stability actually enhances economic growth.

### Inflation and Measures of Economic Performance

<table>
<thead>
<tr>
<th>Period</th>
<th>Inflation</th>
<th>Productivity Growth</th>
<th>Long-Term Interest Rate</th>
<th>Growth of Real Gross Domestic Product</th>
</tr>
</thead>
<tbody>
<tr>
<td>1954-59</td>
<td>1.6%</td>
<td>2.5%</td>
<td>3.46%</td>
<td>2.9%</td>
</tr>
<tr>
<td>1959-64</td>
<td>1.3%</td>
<td>3.4%</td>
<td>4.03%</td>
<td>3.9%</td>
</tr>
<tr>
<td>1964-69</td>
<td>3.4%</td>
<td>2.3%</td>
<td>5.32%</td>
<td>4.2%</td>
</tr>
<tr>
<td>1969-74</td>
<td>6.1%</td>
<td>1.7%</td>
<td>6.82%</td>
<td>2.5%</td>
</tr>
<tr>
<td>1974-79</td>
<td>8.0%</td>
<td>1.3%</td>
<td>8.17%</td>
<td>3.2%</td>
</tr>
<tr>
<td>1979-84</td>
<td>7.4%</td>
<td>1.1%</td>
<td>12.38%</td>
<td>1.8%</td>
</tr>
<tr>
<td>1984-89</td>
<td>3.6%</td>
<td>1.0%</td>
<td>8.81%</td>
<td>3.1%</td>
</tr>
<tr>
<td>1989-94</td>
<td>3.6%</td>
<td>1.8%</td>
<td>7.27%</td>
<td>2.0%</td>
</tr>
</tbody>
</table>

SOURCE: Federal Reserve Bank of St. Louis

So, how does the Fed achieve long-run price stability? One way that is gaining favor with many economists is a multi-year inflation or price level target. Although beyond the scope of this article, such a rule would require the Fed to implement policies consistent with achieving a pre-determined price level over a given time period. While such a rule requires monetary policy to be more concerned with the long view, many economists believe that, in addition to the benefits mentioned above, the process of developing, implementing and maintaining monetary policy would be more consistent over time. Moreover, such a mandate would provide clear and convincing evidence of the Fed’s commitment to maintaining an economic environment consistent with maximum growth, low unemployment and long-term price stability—in short, all of the goals set forth in the Humphrey-Hawkins Act.

NOTE: Except for the long-term interest rate, which is the yield on the 10-year Treasury bond, all statistics are expressed at compounded annual rates.

Kevin L. Kliesen is an economist at the Federal Reserve Bank of St. Louis. Heidi L. Bryan provided research assistance.

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