

Commentary: Why Are Central Banks Pursuing Long-Run Price Stability?

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It is good to be back in Jackson Hole. Let me begin my remarks with a predictable caution. Nothing in what I say is intended as or would properly be interpreted as a comment, either descriptive or prescriptive, on the current or future behavior of the U.S. Federal Reserve, about whose actions the Clinton administration does not comment. Instead, the focus of my remarks will be the broader questions raised in Stan Fischer's paper as well as those of the other authors at this conference about the right framework for monetary policy.

Before saying anything else, I think it is worth highlighting the extent to which economic thinking does change and the impact that the changes have. The core macroeconomic message that I absorbed as a not-very-conscientious MIT undergraduate economics major between 1971 and 1975 was that governments should be more willing to run budget deficits so there would be more demand and more jobs in the economy, and that they were held back by various financial sector troglodytes supported intellectually by people from Chicago. My wife, who was a much better and more conscientious student, came away from her Yale education between 1974 and 1978 with the same set of views along with the additional insight that the Phillips curve was there to be exploited to generate more output since any costs of inflation could be mitigated by indexation.

While there will be differences of opinion here at this conference—it is worth highlighting a central conclusion which is almost universally shared by those concerned with monetary policy. From the starting conditions currently prevailing in almost all economies, there is no continuing benefit in either output, growth, or employment that can be gained by continuously more expansionary monetary policy. Bad monetary policy can have costs—certainly in the form of chronic and costly inflation, and probably in terms of excessively protracted recessions and excessively volatile output, but there are no monetary policy free lunches.

In my comments, I shall address three issues—the choice of an inflation target, the conduct of policy with an inflation target, and the question of multiple objectives for monetary policy.

Choosing an inflation target

I think it is clear enough that high rates of inflation, by which I mean rates that exceed 4 or 5 percent, have obvious costs that outweigh any possible benefits. In addition to the costs usually listed, I would add the cost of efforts to win the zero sum game of getting float. As nominal interest rates rise, it becomes more profitable to delay paying debts one owes, and to collect money owed more quickly. Business success comes to depend more on financial sharpness and less on engineering and marketing. Financial intermediation expands at the expense of real economic activity to an extent not fully reflected by the area under the money demand curve.

The harder questions involve just what low inflation rate is right to shoot for. The universal acclaim accorded to Alan Greenspan's definition of price stability as the level where inflation is not a factor in economic calculations is a tribute to its wisdom and also to its central bankerly ambiguity. Stan Fischer comes down in favor of a range of 1 to 3 percent for target inflation which looks about right to me though it will seem high to some. However, I have some problems with his as well as the standard analysis.

Stan makes two arguments pointing toward a low inflation target that I do not think are quite right. The first points toward growing internationalization and suggests that this reduces optimal inflation on seigniorage grounds. Unless the interest elasticity of foreign demand for U.S. currency is greater than one, which is inconsistent with much of the available evidence on money demand, seigniorage revenues would be maximized and so would the efficiency of U.S. revenue collection by an increase in the inflation rate. Second, he cites Feldstein's calculations of the welfare consequences of inflation-induced increases in capital taxation. Since a country can choose its capital income tax regime knowing its inflation target, I am not sure these costs should really be included. Furthermore, I am suspicious of any analysis which, like Feldstein's, implies that significant deflation would be optimal.

On the other hand, I do not find the argument that one should add to the target rate of inflation to adjust for the consumer price index (CPI)'s failure to take full account of quality change very persuasive. When I think about my future, I think about what it will cost in the future to buy a house or a tennis racket or a college education for my kids, and it's the sticker price, not the quality-adjusted change in cost, that I care about.

I think the central issue in deciding how little inflation is too little is the risk that at excessively low inflation, cyclical downturns will last unnecessarily long. One possible reason is nominal wage rigidity. With low inflation, you can't get real wage reductions without nominal wage cuts, making it harder to get the needed labor market adjustments during downturns. Another reason that I have stressed in earlier work is the zero interest floor on nominal interest rates which translates into a floor on real interest rates; the lower the inflation rate, the higher the floor on real rates. Historically, negative real interest rates have played an important role in facilitating recoveries, particularly in situations of financial strain, and ruling out this degree of freedom for the central bank by achieving zero inflation seems to me to have real risks.

There is another conceptual issue here that I don't think has been

adequately aired. As central bankers are fond of stressing, credibility is of the utmost importance. It seems to me that, over some range, a higher inflation objective may actually increase credibility. Because not just the total but also the marginal costs of inflation rise with the inflation rate, it will be easier to convince the public that the central bank will stick with a modest positive inflation rate than that it will stick with a lower rate. The implication of this observation is that expectational errors where the public anticipates more expansionary policy than is delivered are minimized at some non-zero inflation rate. To put this in simpler language—the central banks represented in this room would have a harder time convincing their publics that they would not tolerate any inflation than that they would not tolerate more than 1 percent inflation.

As Stan Fischer's discussion of the available evidence suggests, we do not really have a sound basis for judging the consequences of very low rates of inflation for the behavior of output. There is one empirical fact coming out of the historical experience of the G-10 countries that impresses me. Over the past thirty-five years, countries with less than 3 percent nominal GDP growth in a particular year did not perform well; on average, real GDP growth was negative whenever nominal GDP growth was so low. While this finding may have a number of interpretations, I think there is an important point here: Any central bank that is forecasting nominal GDP growth of less than 3 or 4 percent ought to think carefully about its policy stance regardless of its inflation forecast.

Operating with a commitment to price stability

Many of the papers here discuss the important question of the appropriate pace of disinflation. This question essentially involves weighing the credibility benefits of rapid disinflation against the extra transitional costs involved. This distinction seems right to me. I suspect that standard treatments may overemphasize the costs associated with nominally rigid wages and prices and underemphasize costs associated with long-term fixed nominal financial contracts. An important and appropriate brake on the pace of disinflation is the need to avoid excessive damage to the financial system.

I want to focus on what I think is an important innovation that will support monetary policy in the United States in the years ahead—the Treasury’s decision to issue indexed bonds. Indexed bonds are important in two respects. First, their issuance reduces the government’s incentive to inflate because indexed debt cannot be inflated away, and because of the direct link they create between increased inflation and higher interest payments in the government deficit. Just as those who sell fire insurance work to prevent arson, and those who sell life insurance worry about the health of their customers, governments that sell inflation insurance will tend to avoid inflating. It is noteworthy in this regard that the industrialized countries that have issued indexed bonds in recent years have all seen significant subsequent improvements in their inflation performance. (See Chart 1.)

Second, and perhaps more important, indexed bonds provide a market-based measure of inflation expectations. Of course, the interpretation needs some care because of tax considerations, risk premia (which may affect the spread between indexed and non-indexed debt), and possible clientele effects. However, these factors change slowly and are unlikely to prevent yield spreads from giving an indication of rising inflation expectations. My own judgment is that markets will over time in the United States prove to be good assimilators of information bearing on future inflation. Note, however, that for the purposes of monetary policy and its credibility, it is not just the rational expectation of future inflation that is relevant but also the actual expectation that is important, and here the indexed bond market will be very hard to beat. If one considers the tremendous stakes that we as a nation have in avoiding increases in inflation or needless sacrifices of output in response to false inflationary indications, it is hard to escape the conclusion that even a small increase in the accuracy of monetary policy would have great value.

There is, of course, the alternative view that indexed bonds erode the natural constituency against inflation and thereby will over time tend to promote inflation. While I think this argument may have merit when applied to certain kinds of inflation indexation, I find it hard to believe that any effects of this kind would be serious as long

Chart 1
Inflation and Indexed Bonds
Year Over Year Percent Change in Inflation Indexes

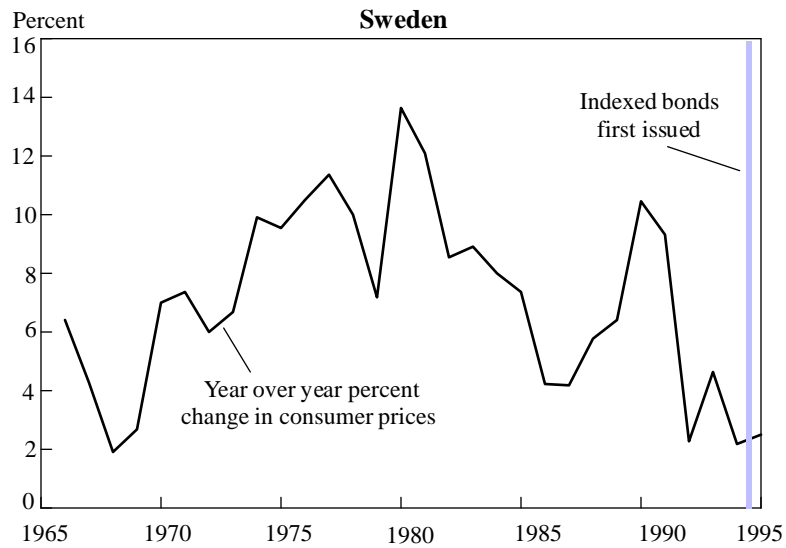
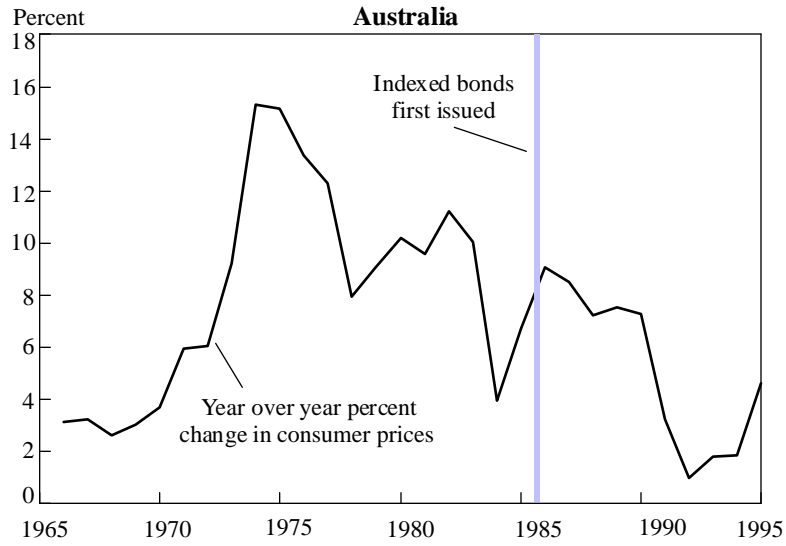
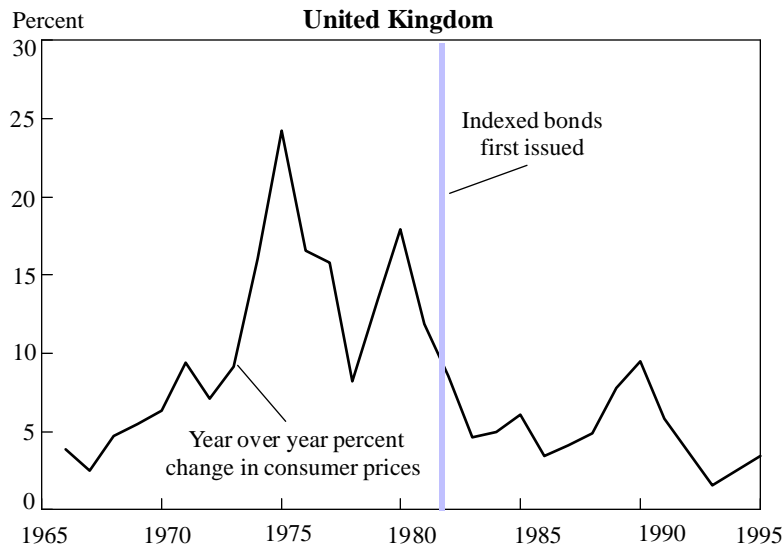
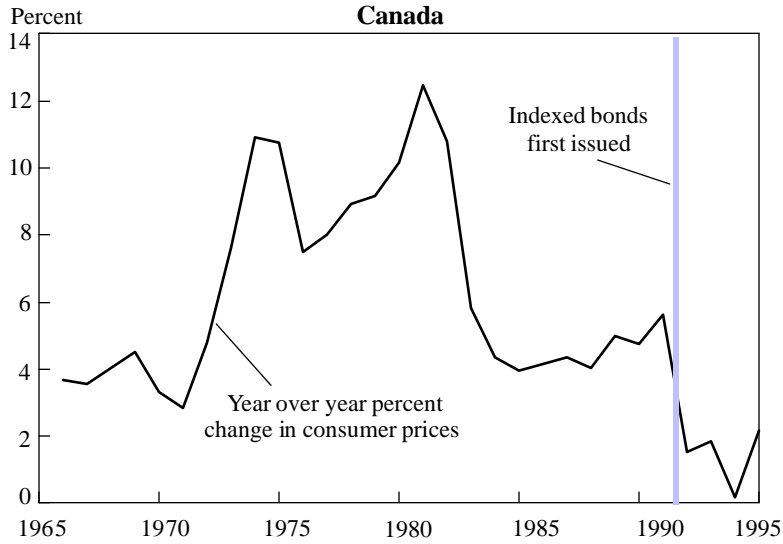


Chart 1 (continued)
Inflation and Indexed Bonds
Year Over Year Percent Change in Inflation Indexes



Source: U.S. Treasury: Federal Finance Policy Analysis

as the vast majority of a government's debt is unindexed. In any event, the experience of industrial countries that have introduced indexed bonds is encouraging.

Should only inflation be targeted?

The core of the argument for inflation targeting seems to be this: The overriding goal of a central bank should be price stability somehow defined. An inflation-targeting regime allows for responses to cyclical fluctuations because of the short-run Phillips curve mechanism. Inflation targeting therefore places the appropriate emphasis on price stability, provides for appropriate accountability, and, at the same time, avoids a straitjacket that could cause too much output volatility.

I think this is a reasonable argument as far as it goes. Given the dynamic consistency problem, there is certainly a case for asymmetry in central banks' treatment of output and inflation fluctuations. But I am troubled by the apparent rigidity of some inflation-targeting approaches.

Take an episode like the stock market crash of 1987 or the banking problems encountered in many countries over the last decade. I doubt very much that it would be wise for central banks to consider them only through the prism of their impact on the inflation rate. There must be at least some circumstances where it is appropriate to drive down short-term interest rates to protect financial stability. Indeed, as the world moves away from treating institutions as too large to fail, I suspect the potential role of monetary policy in responding to strains may be increased.

Exchange rates provide a different kind of example illustrating the dangers of rigid targeting. While it is generally felt in countries like the United States that operate with a flexible exchange rate, that monetary policy is best used to pursue domestic objectives rather than to target exchange rates, I think it is reasonable to assert that, in at least some circumstances, monetary policy may need to respond to exchange rate fluctuations. At a minimum, a clear commitment

that it would not respond could be quite destabilizing.

A third type of example where overly rigid approaches run risks is situations where fiscal policy is changing rapidly. The virtue of independent central banks as an antidote to the dynamic consistency problem is clear enough. Their disadvantage is that they make coordination of fiscal and monetary policy more difficult. An inflation-targeting approach, mechanically applied, would treat surges of government demand and of export demand in almost the same way. This may not be appropriate, especially if the central bank wants to encourage deficit reduction.

There are many more examples such as these. I think the crucial point is that even if price stability is the overriding objective of a central bank, there are considerations bearing on long-run economic performance that may call for policy responses not captured by simple rules. There is, in the end, no substitute for wise discretion.

Conclusion

I began my remarks by highlighting the magnitude of the changes in macroeconomic thinking over the last twenty years. Similar changes would have been observable over the 1956-1976 period as the importance of money came to be recognized, or over the 1936-1956 period as the Keynesian perspective percolated. It would be a misreading of history to think that we have now identified final truth or that some of the views expressed here will not look archaic twenty years from now. Conditions and analysis will both keep changing and provide grist for the Jackson Hole mill.

