Commentary: What Operating Procedures Should Be Adopted to Maintain Price Stability?—Practical Issues

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Chuck Freedman has done quite a good job describing the analytical framework for how a modern central bank conducts monetary policy. The general process he describes—analyzing the forces affecting the economy, making a forecast (explicit or implicit) based on that analysis, adjusting a short-term interest rate to align the forecast better with objectives, modifying the forecast and the short-term rate in response to incoming data—applies in most key respects to the United States and, I suspect, many other central banks as well. Of course, the United States differs from Chuck's pattern in one important respect—the policy process is not focused on achieving a numerical inflation target over a specified period. I thought I would begin my comments with some thoughts about this difference.

One clear lesson from the late 1960s and 1970s, as the Bretton Woods system broke down, was that central banks needed new constraints on the longer-run inflationary consequences of their actions. When policy focused on output and employment, inflation rates became unanchored—shifting with each shock that hit the economy—and tended to move higher. Over the last decade, many countries have adopted inflation targets as the apparatus to provide longer-run discipline.

In the United States, long-run discipline on monetary policy has been provided not by numerical targets but the firm focus of an

independent central bank on reducing inflation over the long run, so as to eventually reach price stability—as specified in the Federal Reserve Act. This long-run focus has been especially important in two types of circumstances. When inflation has threatened to pick up, as in 1988 and 1994, it has triggered vigorous firming. And when the economy has been weak, as in the early 1990s, it has fostered attention to long-run inflation expectations, which has helped to discipline easing and avoid a subsequent overshooting of aggregate demand. The less quantitative and time-specific objective of the Federal Reserve has given it considerable flexibility in responding to unexpected developments, enabling it to smooth the path of output and vary the pace of progress toward price stability as circumstances seemed to dictate. The results largely speak for themselves. Inflation has been brought down to a low level, with only one mild recession since 1982.

Although in concept, short-run flexibility and long-run discipline are fully compatible, in practice, approaches to policy end up striking a balance between them. Quantitative inflation targeting shifts the emphasis toward long-run discipline. There are a number of reasons why this might be desirable. In many countries, flexibility produced high and erratic inflation rates. As compared to a less quantitative objective, inflation targets should result in more certain progress toward long-run inflation goals and less tendency toward backsliding once those goals are reached. In this regard, an important attribute of those targets is their effect on the government that agrees to them. That government is forced to recognize low inflation or price stability as the appropriate long-term goal of monetary policy, and should be constrained from pressuring or retaliating against a central bank striving to achieve it. In addition, the clarity of inflation targets enhances accountability and can help markets to act in ways that reinforce the intentions of the central bank.

Inflation targets come in many flavors, but the tradeoff, as I noted, was the possible loss of some flexibility—especially in those regimes that tie specific inflation outcomes to specific time periods—and I have some concerns in this regard. I suspect, for example, that some inflation targets might not be flexible enough to allow a central bank to follow a Taylor-rule type of regime, where the long-run

intention is explicit but the time it takes to get there is contingent on economic circumstances. In addition, one valuable use of flexibility is the potential for moving policy in directions that may seem counterintuitive to the general public under inflation targets. The Federal Reserve eased when inflation was moving higher in the last half of 1989 and early 1990 and again in mid-1995. To be sure, such actions might have been justified by reference to inflation forecasts, but one wonders whether these easings, which turned out to be well-advised, wouldn't have been more difficult with explicit inflation targets. Given the lags in the effects of policy, it is not surprising that inflation forecasts loom so large in Chuck's description of the policy process under inflation targets. Moreover, as he argues, because the central bank is being judged against specific outcomes, its response, or lack of response, to misses in the target under various circumstances needs to be specified in advance.

All monetary policy involves forecasts in one degree or another, but some forms of inflation targeting would seem to imply considerable weight on an inherently uncertain and imprecise projection and associated contingencies. We know that forecasts will be wrong and contingencies will arise in ways that are unanticipated. Central banks that are using forecasts know this, of course. And those that publish their forecasts, like the Bank of England, can emphasize the uncertainty, as it has done through the use of probability distributions. But the Bank's very efforts in this regard suggest difficulty in communicating the appropriate role for the forecast in policy, and even internally, policymakers may lose sight of the wide confidence bands around any forecast. The risk is that the central bank will be less able to react in a timely way to shifts in aggregate demand. In the early 1990s, private forecasters and Federal Reserve policymakers persistently projected more inflation than occurred. Although policymakers' forecasts played some role in their decisions, the impact might have been larger and the scope for easing to cushion shortfalls in demand somewhat less if policy had been tied explicitly to these projections.

The interaction of announcements of inflation targets and outcomes with central bank credibility was an important subtheme in

Chuck's paper. The credibility of low inflation is important. In particular, as Chuck notes, it buys what he calls "room for maneuver"—the opportunity for the central bank to assess the emerging situation and gauge its policy response without engendering major shifts in inflation expectations. Given the inevitable misses from inflation targets, it's natural to worry about credibility, or at least central bank reputation, in such a regime, and to design announcements to protect it.

As Chuck is well aware, however, empirical evidence that central bank announcements have broad effects on credibility is sparse, at best. Our experience in the United States may not be entirely relevant, but it has been that expectations of inflation wax and wane very gradually in response to experience over extended periods. Good behavior may be rewarded with inflation expectations that become slightly less sensitive to recent experience, so that temporary supply shocks are less threatening, but the changes occur quite slowly, and I suspect have little to do with Federal Reserve statements on seeking price stability. I would guess this applies to inflation targets and announcements as well. Announcements may very well condition behavior in financial markets, and these effects can be important, but they are less likely to carry over into product or labor markets where they count most for economic performance.

My second general topic is whether the monetary policy process ought to be modified when economies are operating close to or at price stability. Price stability differs from moderate inflation by bringing into greater play possible constraints around "zero." Chuck lists the concerns: To the extent there are downward rigidities of wages and prices at zero, Phillips curves will be non-linear and sacrifice ratios may rise as price stability is approached; because nominal interest rates are bounded at zero, monetary policy may be constrained in its ability to reduce real interest rates; and because price stability implies that the prices of some goods and services will be declining, asset prices may fall more frequently, with effects on the financial system.

Our recent experience in the United States supports Chuck's tendency to downplay the importance of these problems. As inflation has retreated to the lowest level in 30 years, we have not seen evidence that nominal wage and price rigidities have, in effect, raised nonaccelerating-inflation-rates of unemployment (NAIRUs); indeed, the surprises have been on the side of lower NAIRUs and higher levels of output than might be expected. The asset deflation and financial fragility issues we have dealt with occurred at inflation rates of 4 to 5 percent in the late 1980s, not at the 2.5 to 3 percent rates of the mid-1990s. Because asset prices build in expected inflation, widespread declines will occur primarily when inflation—at whatever level—falls short of these expectations, especially if the cause is a run-up in real interest rates. Swings in asset prices ought to be considerably damped if policy successfully and predictably holds inflation at very low or nonexistent levels.

But we can't dismiss these concerns about operating near price stability altogether. One possible response would be to aim for an average inflation rate a shade above price stability, and this seems to be the approach of many countries. But there are other strategies that may enable central banks to pursue true price stability, if research and analysis show some costs from even very low inflation. One would be to seek further reductions in inflation very gradually, to enable expectations to adjust and institutions in labor and product markets to adapt in ways that facilitate downward movements in labor compensation and prices. This also would give central banks a chance to look for signs that wage and price rigidities were beginning to impede economic performance. Financial markets might benefit as well from a very slow approach to price stability. If there is a tendency for asset price declines to be more widespread at price stability, such an approach would allow lenders to recognize potential problems and recalibrate loan standards, such as loan-to-value ratios and cash-flow requirements, for the new environment.

Another policy adaptation might make the zero floor on nominal interest rates less formidable. It is delayed or hesitant policy action that results in insufficient scope to reduce real rates when shocks turn out to be large and persistent, putting in motion deflationary

processes. To guard against this, central banks operating near price stability perhaps should be willing to act especially forcefully and quickly when they suspect downward demand shocks. Of course, the danger with such a tactic would be a possible tendency toward inflation; that is, responding more quickly to downward than to upward shocks would tend to give rise to an economy operating above its potential if shocks were symmetrically distributed. The central bank would need to compensate with other biases on the tightening side—for example, being especially quick to reverse easings that turned out to be unnecessary and being ready to tighten substantially in response to upward shocks that it had waited to confirm.

Other government policies may also need to be adapted to support a monetary policy focused on price stability. For example, the elimination of structural fiscal deficits would seem even more urgent so as to free fiscal policy for use as a countercyclical instrument in the event monetary policy confronts the zero interest rate constraint. In this context, however, eliminating the deficit using a rigid balanced budget constraint that short-circuited not only discretionary but automatic countercyclical properties of fiscal policy would only tend to reinforce the argument for aiming at a little inflation. The United States has undertaken significant deregulation in many industries over the last twenty years, and it seems likely that we have removed most artificial barriers to declines in prices and wages that would inadvertently become binding when some prices should be falling at overall price stability. Nonetheless, we need to be sure of this, and I suspect regulatory constraints on downward movements in prices and wages are an even more important issue in other countries. In addition, financial supervisory policies may need to be modified to take account of the fact that inflation will not be available to ameliorate the problems of debtors. Taken together these policies should help reduce some of the concerns that might be associated with price stability and strengthen the hand of the monetary authority in containing and eliminating inflation.

A final issue associated with policies at price stability is staying there—avoiding backsliding. Public support for price stability may

erode as unpleasant episodes of inflation recede further into history, adding to demands to run the economy at higher levels. If business cycles are damped when inflation is contained, as they have been in the United States, trends in the growth of output come into sharper focus. When the trend has slowed, there has been a tendency to look first to the institution that has a lot to do with the cyclical performance of the economy. The credibility of low inflation will only add to the pressures. Credible low inflation may look like a favorable supply shock; output can run higher for longer with muted inflation consequences if people expect inflation to return to previous low levels. It will be hard to distinguish between true favorable shocks, which may be exploitable for additional output, and credibility, which can not without inflationary consequences. Even legally mandated inflation objectives may not be a sufficient bulwark against public opinion that perceives considerable gains and little cost from boosting the economy.

I don't see any easy answers to this problem. Central banks and economists will need to continue to remind the public and their elected representatives of the limits of the power of the central bank to augment growth, and the adverse consequences of trying to do so.

Finally, I would like to turn to an explanation of "opportunism."[1] This subject is not directly related to Chuck's paper because opportunism is a description of a strategy to get to price stability rather than an aspect of operating there. But it has been the subject of much comment at this conference, and I thought it would be useful to clarify some attributes of this strategy.

At the outset, it is very important to recognize that the opportunistic strategy is not official Federal Reserve policy. Members of the Federal Open Market Committee (FOMC) do not necessarily agree on what strategy should be used for getting to price stability. Opportunism is one way people observing Federal Reserve actions in recent years have described what they have seen.

One distinguishing characteristic of the opportunistic approach is that it involves different modes of behavior on the part of the central

bank depending on the prevailing level of inflation. When inflation is high, an opportunistic policymaker would actively seek to bring it down. The period of 1979 to 1982 is an example of this sort of situation. Inflation in 1979 was clearly too high, and the Federal Reserve fought it, opening an output gap. On the other hand, when inflation is already low or moderate, the opportunistic policymaker does not take active measures to reduce it further. Once inflation had fallen into the 3.5 to 4.5 percent range in the mid-1980s, people observing the Federal Reserve thought they could not detect steps to lower it more.

There are certain actions the central bank is prepared to take when inflation is moderate, under this strategy. First, it leans very hard against increases in inflation. Examples of this in recent years would include the tightenings of 1984, 1988-89, and 1994. In these cases when inflation threatened to exceed its previous range, the Federal Reserve firmed policy to prevent the uptick or bring inflation back into the range again. Chairman Greenspan's Humphrey-Hawkins testimony of February 1990 explained the Federal Reserve's intentions in that episode. Inflation, in fact, had broken out of the previous range, and the Federal Reserve was going to bring it back down—to take out the increase in inflation that had occurred in 1989 and early 1990.

Second, when an output gap unexpectedly opens up under conditions of moderate inflation, through positive supply, or negative demand shocks, the opportunistic central bank moves to close that output gap, but not to overshoot. As a consequence, such shocks produce a period in which output is below potential and inflation falls toward price stability.

Opportunistic strategy is distinguished from a deliberate disinflation strategy under conditions of moderate inflation. Under both strategies, central banks would attempt to reduce high inflation. But, in contrast to the opportunistic strategy, the deliberate strategy would be at least midly restrictive even when inflation is only moderate, maintaining a small output gap until price stability is reached.

Two further points about the differences between these two strategies: On the one hand, in practice, the difference between them tends not to be very substantial. In fact, it has been very hard for observers to distinguish whether the Federal Reserve has been pursuing an opportunistic or a deliberate policy. For example, John Taylor looked at the Federal Reserve's actions over the 1987-93 period and thought that they fit his rule, which is a deliberate disinflationary policy strategy. In the Taylor rule, whenever inflation is above the goal—in his formulation the long-term goal is 2 percent—policy is on the restrictive side unless a significant output gap already exists. Other people looked at the same policy actions over the same period and saw the Federal Reserve operating in an opportunistic fashion. In theory, the deliberate strategy would be slightly more restrictive than the opportunistic policy at moderate inflation rates, but in actual operations, this difference might be so small it would be hard to detect.

But on the other hand, there is a real issue here. If in fact price stability is the right goal for policy because we think economies operate better without inflation, why not simply go ahead and pursue that goal? Even if you are above it by a small amount, why wait—as the opportunist would—to take the inflation down from a moderate rate to price stability? This is the genuine question to be asked when talking about opportunism. What are the underlying costs and benefits of taking the longer time that opportunism is likely to entail in getting to price stability?

One of the difficulties in evaluating this question, and one reason why a central bank might not move very decisively to go from low or moderate inflation to price stability, is we are still not very clear about the costs and benefits of that last little bit of disinflation. There are costs—principally the output gap that must be incurred to reduce inflation. There are benefits as well and we are making progress in identifying those benefits; Marty Feldstein's paper on the distortions caused by inflation interactions with the tax system identified a benefit of going to price stability. I think most of us feel that, on balance, it is likely that the benefits exceed the costs of going from moderate inflation to price stability. But the case for reducing

moderate inflation is not as clear-cut as for reducing high inflation. As a consequence, public opinion polls, like those Stan Fischer was citing, indicate that support is not strong for reducing inflation from moderate levels.

So there are genuine issues here about going from moderate inflation to price stability. The public's utility functions—how it values, or ought to value, the extra decline in inflation versus the output lost in getting there—is where the discussion should be, and is the crux of the opportunism versus deliberate policy choice.

Author's Note: The views expressed are solely my own and do not necessarily reflect the views of the Board or any other members of its staff.

Endnote

[1]For a full exposition see Orphanides and Wilcox, "An Opportunistic Approach to Disinflation," FEDS working paper 96-24, 1996.