

Overview

Andrew Crockett

When coming to a conference such as this, in which a group consisting largely of central bankers addresses the issue of price stability, the first question it is natural to ask is: how much room will there be for discussion and debate? But as usual, the Federal Reserve Bank of Kansas City has picked a topic where behind the scenes there is an interesting intellectual debate. There are some very tricky questions: how do you get to price stability? How do you judge when you have arrived? And when you are there, how do you stay there? And while many central banks, particularly in the industrial world, have succeeded in reducing the public's concern about inflation, this does not, by any means, dismiss the inherent interest or the policy importance of those three questions.

Let me say something about each of the questions, starting with the basic one that has come up in a number of the papers. How do you know when you have arrived at price stability? Put another way, what rate of inflation corresponds to the classic definition of Alan Greenspan and Paul Volcker of price stability as a situation in which inflation is no longer a factor in day-to-day economic decisionmaking?

I found it interesting how much consensus there seemed to be in yesterday's sessions regarding two of Stanley Fischer's propositions. First, industrialized countries that have already attained single-digit inflation should target a rate of inflation in the range of

1 to 3 percent. Second, the objective should be defined in terms of the inflation rate, not in terms of the price level. Those two propositions received somewhat more critical questioning today and they are issues that will be with us for a while. Personally, I tend to agree with Fischer's position. But there is clearly scope for debate.

On the one hand, some argue that genuine price stability (zero inflation) brings significant economic advantages. I am sure Marty Feldstein will speak in a moment about the findings in his paper in this respect. On the other hand, there are also views favoring a rate of inflation higher than 1 to 3 percent. As Otmar Issing reminded us this morning, there are plenty of people, not perhaps in this room, who are prepared to cite evidence that somewhat higher rates of inflation do not seem to have significant long-run adverse effects, and have short-run attractions, at least from a political standpoint. I am not among that group, but I think we would delude ourselves if we thought those views would not be expressed. So I see pressures being brought to bear from both sides on the consensus of a 1 to 3 percent inflation target that seems to be widely accepted here.

In that context, another point that I found interesting was Larry Summers' observation that price stability has to be something that sits comfortably with public opinion. I think Larry said, "If central banks' objectives do not appear reasonable or achievable to public opinion, then it is going to be very hard to maintain credibility in them and in the central banks." That raises the question of whether public opinion regarding price stability is immutable or whether a process of education might change it, especially if the public is persuaded by economic arguments that are tilted in one direction or the other. David Mullins' comments went along those lines.

Let me now turn to the second question: how to get inflation down when it is clearly too high? The precise definition of a price stability objective in a country that has already achieved low inflation is a far cry from the concerns that we heard yesterday about the problem of lowering inflation in formerly high-inflation countries. In yesterday's presentations there was a strong consensus that part of the process involves using the exchange rate as an anchor to bring down

expectations. There was also agreement that fiscal policy—the budget—is key. If the budget is not in a satisfactory state, then it is going to be very difficult to lower inflation from high levels.

What I found less conclusively answered in our discussions about reducing inflation was how to take the “last step” from satisfactory progress to genuine price stability. This is not a new problem. Many countries have had the problem and very few have satisfactorily taken that last step—too few to draw any credible lessons. After inflation has been down to the 10 to 20 percent range, or even under 10 percent, how do you go to the 1 to 3 percent level? It is clear to me that at some stage most countries will have to loosen the exchange rate anchor and find a domestic anchor. But how to do that is obviously a very difficult process. To mix the metaphor, if you stay on the horse too long you are liable to get thrown and find yourself in a worse situation, or at least in a more bruised situation, than if you dismount at an appropriate stage and find another and more satisfactory horse to carry you the rest of the way to price stability. That is my solution for countries starting from high inflation.

There is a parallel, but different, question for countries that start from moderate inflation as the industrial countries did in the 1980s and brought inflation down to where we are now, the 2 to 4 percent level. These countries have almost, but not quite, reached their long-run objective. The issues they face is the debate that we heard alluded to this morning in Donald Kohn’s remarks about “opportunistic disinflation.” How do you take that last step when you are almost at price stability? The central banks concerned are not prepared to accept the existing inflation rate as fully satisfactory on a permanent basis and yet they are not prepared to pay the price, in terms of lost output, to take the last step to full price stability. I see the opportunistic disinflation debate a little bit in that context. How do you carry public opinion with you in the best fashion, when you are taking a step that you believe is economically desirable but where there is not an enormous amount of public support?

The last of the three questions is: how do you stay at price stability once you get there? One of the points that was strongly made, and I

certainly agree with it, was this: if central banks can build up credibility in their long-run pursuit of a reasonable and acceptable definition of price stability, then they will have given themselves some room to maneuver to respond to disturbances (supply shocks) that in the short run may carry the inflation rate away from the long-run objective. This concept of building up credibility in order to increase room for maneuver in responding to shocks was not seriously questioned in our discussions. I don't question it myself. I think increased credibility of central banks makes it easier for them to respond to disturbances in a way that improves the tradeoff between output and inflation. There is not an enormous amount of empirical support for this proposition, however. Indeed, there are empirical papers that suggest that the notion of credibility improving the sacrifice ratio is very hard to substantiate. That is an area where I would like to see additional research because I have a rather profound conviction (perhaps not surprising from somebody living in Basle and coming from a central bank) that there is enormous benefit from credibility. This is not simply because it is nice to be believed and to have a good reputation, but because credibility can improve the economic tradeoffs that central banks have to deal with.

I hope I have succeeded in suggesting that the issues raised in this conference are not simply esoteric ones of interest to central bankers, but genuine policy concerns that are crucial to the goal of preserving a stable and well-functioning monetary environment.