ESTABLISHING FEDERAL RESERVE INFLATION GOALS

A JOINT ECONOMIC COMMITTEE STUDY

Jim Saxton (R-NJ)
Chairman

Joint Economic Committee
United States Congress

April 1997

Executive Summary

Recently, several Members of Congress have endorsed the concept of price stability as the principal policy objective for Federal Reserve monetary policy. After outlining current institutional arrangements and congressional responsibilities, the reasons why the goal of stabilizing the purchasing power of money is appropriate are detailed. Moreover, this paper demonstrates that such a goal (1) has a rich historical heritage, (2) recently has been successfully adopted in several countries, (3) in effect, implicitly has worked in the United States in recent years, and (4) has already been endorsed by a number of Federal Reserve officials.

Although inflation has receded, and hence price stability is no longer a "headline-grabbing" issue, the paper highlights several important reasons why now is the opportune time to adopt such a strategy. The U.S. legislative history of this approach is summarized and essentials of current price stability legislation presented.

Joint Economic Committee
G-01 Dirksen Building
Washington, DC 20510
Phone: 202-224-5171
Fax: 202-224-0240

Internet Address:
http://www.house.gov/jec/

ESTABLISHING FEDERAL RESERVE INFLATION GOALS

INTRODUCTION

Recently, several Members of Congress have endorsed the concept of price stability as the principal policy objective for Federal Reserve monetary policy. After outlining current institutional arrangements and congressional responsibilities, the reasons why the goal of stabilizing the purchasing power of money is appropriate are detailed. Moreover, this paper demonstrates that such a goal (1) has a rich historical heritage, (2) recently has been successfully adopted in several countries, (3) in effect, implicitly has worked in the United States in recent years, and (4) has already been endorsed by a number of Federal Reserve officials.

Although inflation has receded, and hence price stability is no longer a "headline-grabbing" issue, the paper highlights several important reasons why now is the opportune time to adopt such a strategy. The U.S. legislative history of this approach is summarized and essentials of current price stability legislation presented.

In the context of this paper, the policy of price stability will generally refer to inflation targeting whereby target bands are used for changes in some conventional broad price index or measure of inflation.

BACKGROUND: INSTITUTIONAL ARRANGEMENTS, CONGRESSIONAL RESPONSIBILITIES, AND PREVIOUS APPROACHES

In order to assess the appropriateness of adopting the monetary policy goal of price stability, some background material—a brief review of the current monetary regime as well as congressional responsibilities—is essential.

The Current Monetary Regime

A cogent description of current monetary institutional arrangements perhaps is best provided by Milton Friedman:

> ... a world monetary system has emerged that has no historical precedent: a system in which every major currency in the world is, directly or indirectly, on an irredeemable paper money standard . . . It is worth stressing how little

> precedent there is for the present situation. Throughout recorded history . . . commodity money has been the rule. So long as money was predominantly coin or bullion, very rapid inflation was not physically feasible . . . The existence of a commodity standard widely supported by the public served as a check on inflation . . . The key challenge that now faces us in reforming our monetary and fiscal institutions is to find a substitute for convertibility into specie that will serve the same function: maintaining pressure on the government to refrain from its resort to inflation as a source of revenue. To put it another way, we must find a nominal anchor for the price level to replace the physical limit on a monetary commodity. [1]

In other words, the emergence of this fiat money, flexible exchange rate system (after the demise of the Bretton Woods System in the early 1970s), means there is no reliable mechanism anchoring the price system; no reliable store or standard of value exists. [2] Instead, the stability of the current monetary regime fully depends on the competence of central bankers to provide these critical functions of a dependable monetary system: to substitute for the reliability of a commodity standard.

Congressional Authority

At the same time, the Congress has clear legal authority over regulating the value of money. Specifically, the U.S. Constitution (Article I, Section 8) explicitly gives Congress the power over money and the regulation of its value. This responsibility was delegated by Congress to the Federal Reserve; the Federal Reserve was created by an act of Congress. This delegation implies that Congress has important responsibilities for overseeing the conduct of Federal Reserve monetary policy.

Of course, at the time of the creation of the Federal Reserve and for most of the period until the demise of the Bretton Woods System, the United States was on some form of commodity standard so that no explicit price anchor mandate was essential. [3] With the emergence of fiat money/flexible exchange rate arrangements in the early 70s, however, such a mandate—which Congress clearly has the authority to implement—is not only appropriate but necessary.

---

[1]Milton Friedman, "Monetary Policy in a Fiat World," in Money Mischief: Episodes in Monetary History, Harcourt Brace Jovanovich, New York, 1992, pp. 249, 252-4.

[2]Furthermore, current monetary arrangements are unlikely to change in the near future. Specifically, because the potential for sharply changing demands for international monetary reserves is associated with the rapid growth of emerging markets and the evolution of the European Monetary Union, a near-term stable, international monetary anchor appears unlikely.

[3]With the existence of a fixed exchange-rate gold standard at the time the Federal Reserve was created, monetary policy was not seen as a potent tool of government economic policy making. (Federal Reserve policy was guided by the behavior of the gold reserve ratio following Central Bank practice under the gold standard.) Accordingly, congressional oversight was not seen as a high priority responsibility. With the emergence of the fiat system described above, this mechanism has changed, and monetary oversight now is accorded more importance.

The Failure of Other Approaches

Unfortunately, inappropriate or multiple and conflicting monetary policy goals for the Federal Reserve have been prescribed and found wanting during much of the period since the demise of Bretton Woods. In part, such prescription reflects Keynesian predilection for managing real economic activity and full employment macroeconomic policy goals, culminating in the Full Employment and Balanced Growth Act of 1978 (Humphrey-Hawkins Act). This Act prescribes multiple and conflicting policy goals and, accordingly, has made it more difficult to achieve viable objectives of monetary policy such as price stability.

But (intermediate) monetary targeting for the Federal Reserve also was prescribed during this period. These monetary targets proved less reliable than expected for a number of reasons relating partly to deregulation.

This post-Bretton Woods experience has culminated in the realization that price stability is the single, appropriate goal for monetary policy; a monetary standard securely anchoring the price system is essential. This view is now embodied in current price stability legislation described below.

RATIONALE FOR ADOPTING THE GOAL OF PRICE STABILITY

Given this background, it is natural that Congress should move to consider making price stability the explicit key objective for monetary policy. A number of specific reasons indicate why price stability is the appropriate monetary policy goal; these reasons relate not only to efficient provision of monetary services but to minimizing the many disruptive costs of inflation.

- **Price stability enables money to best perform its various functions**: Money can best provide its functions of a medium of exchange, a store of value, and a standard of value under a regime fostering price stability. Such stability anchors the price system so that comparative values can be established and accurately measured.

- **Price stability enables the price system to work better**: Price stability enables the price system—the information or signaling mechanism of free-market economies—to function effectively by directing resources to their most beneficial use. Price stability is associated with both lower inflation volatility and with lower (relative) price dispersion than inflation-ary circumstances. Lower inflation reduces the variability between individual prices or reduces the noise and distortions in the price system. [4] This allows the price system to better serve its information and allocative functions. As a result, the economy operates more efficiently and therefore grows faster.

---

[4] See, for example, Guy Debelle and Owen Lamont, "Relative Price Variability and Inflation: Evidence From U.S. Cities," Journal of Political Economy, vol. 105, no. 1, February 1997.

- **Price stability promotes transparency, accountability, and credibility** : Explicitly adopting price stability as the principal monetary policy goal serves to promote transparency, accountability, and credibility to monetary policy. Furthermore, explicit inflation targets reduce incentives of the monetary authority to renege or backslide on its commitment to price stability.

- **Price stability enhances fiscal discipline**: Explicit price or inflation targeting prevents the use of inflation as a revenue source for the government. More specifically, price stability minimizes seignorage as well as government's ability to reduce its outstanding debt via inflation. Moreover, price stability minimizes those interactions of inflation with non-indexed portions of the tax code that effectively result in higher taxation. Lowering inflation, therefore, in many ways acts like a tax cut by removing these potential sources of revenue.[5]

Moreover, adopting the goal of price stability and moving to lower inflation has a number of beneficial economic effects relating to minimizing the disruptive costs of inflation:

- **Price stability lowers interest rates**: A credible, sustained reduction of inflation will lower expectations of future inflation. Accordingly, the inflationary expectations component of interest rates will dissipate from the structure of both short- and long-term interest rates and interest rates will decline.

- **Price stability works to stabilize financial markets and interest-sensitive sectors of the economy**: As inflation diminishes, the variability of inflation also is reduced. Lower inflation is associated with lower volatility of inflation. Accordingly, financial markets have less tendency to overshoot or undershoot their fundamental values. This lower volatility has the effect of reducing uncertainty premiums of interest rates; financial markets tend to become more stable and predictable. Thus, lower inflation stabilizes financial markets. As a result, market participants tend to become more confident or self-assured and more willing to invest, take risk, and innovate. Businesses are better able to plan and coordinate, thereby improving efficiency. Furthermore, this enhanced financial stability works to stabilize interest-rate-sensitive sectors of the economy and, therefore, the macro economy as well.
- **Price stability promotes growth**: By enabling the price system to work better, enhancing fiscal discipline and minimizing tax distortions, lowering interest rates, and helping to stabilize both financial markets and interest-sensitive sectors of the economy, price stability promotes economic growth. Resources can engage in productive activities rather than finding ways to circumvent costs of inflation. Several recent empirical studies have

[5]This argument is especially relevant in circumstances when tax limitation provisions and/or balanced budget regimes are being implemented: i.e., when stricter fiscal regimes are put in place. It is in these circumstances that government will look for new revenue sources.

found that lower inflation is associated with higher growth. [6]

ADDITIONAL CONSIDERATIONS

In addition to these important reasons for adopting price stability as the primary goal of monetary policy, a number of additional considerations lend further support to the argument.

(1) **Historically, this view has been endorsed by many of the world's most preeminent monetary economists**: Support for the goal of price stability under fiat money is, of course, not novel. Many of the economic profession's most revered monetary writers have supported this objective.

Probably history's most famous monetary debate occurred during the Napoleonic era when Britain went off the gold standard. During this period, classical bullionist writers such as Henry Thornton and David Ricardo recognized that under these circumstances the Bank of England had responsibility to regulate the value of money; in effect, to provide a stable monetary standard substitute for gold convertibility. This endorsement of price stability under fiat money was later supported by such eminent economists as John Stuart Mill and Alfred Marshall. Knut Wicksell further refined existing approaches to achieving price stability; his views were widely embraced by other Swedish economists such as Gustav Cassel. Famous British economists during the interwar period such as Ralph Hawtrey and John Maynard Keynes also endorsed price stability as the appropriate goal for monetary policy. [7] The view was also supported by esteemed economists in the United States such as Irving Fisher, Henry Simons, and Lloyd Mints, as well as most modern-day monetarists. [8]

(2) **Both historical and contemporaneous evidence indicate that the price stability objective can work quite successfully**: A good deal of empirical evidence shows that price stability or inflation targeting regimes have worked successfully. Historically, the first such regime was the Swedish price stabilization regime of the early 1930s. Upon suspending gold payments in 1931, Swedish authorities explicitly announced the adoption of a price stability standard, a monetary policy explicitly directed to stabilize the internal purchasing power of the krona. The policy was remarkably successful: prices were stabilized, contributing significantly to the stability of the domestic economy and insulating the Swedish economy from the 1930s'

[6] See, for example, Robert Barro, "Inflation and Economic Growth," National Bureau of Economic Research Working Paper No. 5326, October 1995; Brian Motley, "Growth and Inflation: A Cross-Country Study," Center for Economic Policy Research, publication no. 395, March 1994; and Todd E. Clark, "Cross-Country Evidence on Long-Run Growth and Inflation," Economic Inquiry, vol. 35, no. 1, January 1997.

[7] This support is especially evident in Keynes' Tract on Monetary Reform, as well as his Treatise on Money.

[8] A history of the price stabilization movement was published by Irving Fisher in 1934. See Stable Money: A History of the Movement. Adelphi Co., New York, 1934.

world-wide depression.[9]

More recently, the single monetary policy goal of price stability has been successfully implemented in a number of countries. Explicit, quantifiable inflation targets have been adopted by Canada, the United Kingdom, Australia, New Zealand, Sweden, Spain, and Finland. In fact, the summary of a recent conference sponsored by the Federal Reserve proclaimed that, “Central banks throughout the world are moving to adopt long-term price stability as their primary goal.”[10] The evidence to date indicates these policies have been quite successful. Those countries adopting a price stability goal, for example, significantly improved their inflation performance. Specifically, they have all dramatically lowered their inflation rates since adopting targets for inflation, often to lower rates not observed for decades. Several of these countries reached their inflation objectives well ahead of schedule; inflation targets have often been met or undershot. Preliminary studies have shown that those countries adopting explicit inflation targets have outperformed other countries not only in terms of lowering inflation but in a number of other criteria as well.[11] This evidence underscores the argument that explicit, quantifiable goals of price stability can be implemented successfully.

(3) Recent Federal Reserve policy focus on price stability has also been successful: The Federal Reserve’s emphasis on price stability in recent years has also worked to lower inflation, thereby contributing to the sustainability of the current expansion. While the Federal Reserve has not adopted explicit, quantifiable inflation targets like the central banks of countries cited above, Federal Reserve officials have repeatedly endorsed price stability in speeches, testimony, interviews, and official publications. The preemptive policy move to tighten monetary policy beginning in February 1994 demonstrated that these public pronouncements were genuine and so this move not only worked to reduce inflation but also enhanced the central bank’s inflation fighting credibility.

This credible disinflation policy has worked to lower interest rates, stabilize financial markets and interest sensitive sectors of the economy, promote the efficient operation of the

[9]The Swedish experience led Irving Fisher to assert that “This achievement of Sweden will always be the most important landmark up to its time in the history of (price) stabilization,” Irving Fisher, Stable Money, Adelphi Co., New York, 1934, pp. 408-9. (parenthesis added). For further documentation of this episode, see Manuel Johnson and Robert Keleher, Monetary Policy, A Market Price Approach, chapter 13, Quorum Books, Westport, Connecticut, 1996.

[10]George A. Kahn, “Achieving Price Stability: A Summary of the Bank’s 1996 Symposium,” Economic Review, Federal Reserve Bank of Kansas City, vol. 81 no. 4, fourth-quarter 1996, p. 53.

[11]See, for example, Bennett T. McCallem, “Inflation Targeting in Canada, New Zealand, Sweden, the United Kingdom, and in general,” National Bureau of Economic Research Working Paper no. 5579, May 1996. p. 9.

price system, and, in effect, act like a tax cut in many ways. [12] All of this has contributed to promoting the sustainability of the expansion and further demonstrates the value of price stability as a principal policy goal.

(4) Price stability as the principal goal of monetary policy has already been endorsed by several Federal Reserve policy-makers: Adopting price stability as the primary goal of monetary policy has received the support of many academic economists as well as many officials and policy-makers of the Federal Reserve system itself. For example, Federal Reserve regional bank presidents from the New York, Richmond, St. Louis, San Francisco, and Cleveland banks have all explicitly endorsed price stability as monetary policy's primary policy goal.

THE OPPORTUNE TIME TO ADOPT TARGETS FOR PRICE STABILITY

Although inflation has receded and hence price stability is no longer a "headline-grabbing" issue, there are several important reasons why now is the opportune time to adopt targets for price stability:

- **Cement current gains**: Adopting targets for price stability would ensure the many beneficial economic effects of low inflation are maintained. Such targets are easiest to implement when inflation is already low, political opposition is relatively weak, and price stability has attained a degree of credibility as a proper goal for monetary policy. In short, the current period is the politically opportune time to cement gains and credibility that have been achieved, thereby minimizing the costs of moving to price stability. [13] Adopting formal price stabilization goals now when political barriers are relatively low ensures that procedures for maintaining price stability are in place when inevitable difficult tightening decisions have to be made in the future.

- **Remove incentives to backslide**: As memories of high inflation fade, interest groups increasingly emphasize near-term benefits of stimulative monetary policy; demands for monetary relief from adverse changes in interest rates, foreign exchange rates, or output proliferate. Implementing explicit targets for price stability would serve to insulate the Federal Reserve from such political pressures.

---

[12]See Robert Keleher, *The Roots of the Current Expansion*, a Joint Economic Committee study, April 1997, for a more detailed discussion of the contribution of monetary policy to the sustainability of the expansion.

[13]Targets for price stability should be introduced when there is a realistic chance of reducing inflation (i.e., when inflation is low or trending down); credibility is an important reason for targets and hitting the first target is especially significant for establishing credibility. See Charles Freedman, "The Canadian Experience with Targets for Reducing and Controlling Inflation," Inflation Targets, edited by Leonardo Leiderman and Lars Svensson, Center for Economic Policy Research, Glasgow, 1995, p. 28.

Furthermore, without targets for price stability, incentives grow for inflationary policies when inflation is low. Specifically, short-sighted policy-makers recognize that surprise (unexpected) expansionary policies are more potent than expected policy changes. So when inflation is reduced and is expected to remain subdued, stimulative policies that are a surprise have a larger economy-boosting impact. In short, as inflation is reduced, incentives increase for policy-makers to unexpectedly stimulate the economy. Pre-commitments to explicit price targets reduce these perverse incentives.[14]

- **Govern by rules rather than by men**: While the Federal Reserve has performed admirably under the regimes of Chairmen Volcker and Greenspan, there is no guarantee that it will continue to perform so well in the future under different management. Institutionalizing the goal of price stability will help ensure that Federal Reserve performance depends more on a transparent system of rules rather than upon the vagaries of individuals and is less prone to political manipulation or pressure. Adopting such rules would provide a political buffer, preventing future administrations from manipulating monetary policy when there are incentives to do so.

- **Prevent the use of inflation as a source of government revenue**: Continued pressures on fiscal policy to balance the budget, resolve entitlement problems, and limit taxation will induce government policy-makers to look for alternative revenue sources. Inflation, after all, can serve as a mechanism to finance government spending and reduce real government debt. Adopting explicit rules for price stability would prevent the use of monetary policy for such purposes.

ALLOWANCE FOR FLEXIBILITY

One of the key criticisms of adopting inflation targets is that such a strategy would remove monetary policy's flexibility. With fiscal policy constrained so that it cannot be used for stabilization policy, it is argued that monetary policy is the only tool left for this purpose and therefore should remain relatively unencumbered.

This criticism seems misplaced for several reasons. Certainly the international experience with inflation targeting provides ample evidence that, in practice, inflation targets leave room for a good deal of flexibility. In particular, inflation targets normally consist of bands rather than point estimates. They are usually multi-year in nature. The relevant targeted inflation index often is adjusted for volatile (supply-side) components. And even after such adjustment, some countries (e.g., New Zealand) allow for further exceptions to specified targets. All of these considerations allow for considerable flexibility, yet maintain a focus on long-term price stability.

[14]In economic jargon, this is referred to as the "time inconsistency" problem.

Furthermore, if unanticipated shocks are "demand-side" in nature, inflation targets automatically direct appropriate monetary policy responses that work to stabilize the economy. Finally, by adopting inflation rather than price level targets, some accommodation of unanticipated one-time supply-side shocks are allowed for (i.e., inflation targets do not require offsetting deflation and hence associated economic disruption as do price level targets). [15] In sum, inflation targets retain a good deal of flexibility for monetary policy.

LEGISLATIVE HISTORY

In the United States, legislation mandating price stability for monetary policy is not new. As ably documented by Irving Fisher, a series of bills to stabilize the purchasing power of money or the general price level were introduced and re-introduced during the 1920s and 1930s.[16] The most prominent sponsors of these bills were T. Alan Goldsborough (MD) and James A. Strong (KS). Congressional hearings were held on several of these price stabilization bills and during these hearings, the idea of price stabilization received significant support from academics, businessmen, and farmers. Opposition came from various officials of the Federal Reserve System.[17]

The Goldsborough Bill mandating price stability passed the House of Representatives on May 2, 1932 by an overwhelming vote of 289-60. [18] The Bill, however, was blocked in the Senate principally by Senator Carter Glass (Federal Reserve officials testified in opposition to the Bill).

Price stability, of course, has been identified as one of several economic objectives mandated to the Federal Reserve as embodied in the Employment Act of 1946 and the Full Employment and Balanced Growth Act of 1978 (Humphrey-Hawkins Act). The need to focus primarily on price stability, however, re-emerged as a legislative priority in the Neal

[15]Because offsetting deflation is not required by inflation targets, these targets embody "base drift" (an ever-increasing price level). In other words, inflation targets imply that the price level becomes "non-stationary"; once disturbed, the price level does not return to its previous level. Because of this characteristic, inflation targets are associated with greater long-term variance and uncertainty of prices. Nonetheless, because inflation targets enhance policy flexibility, they are viewed as more realistic politically.

[16]See Irving Fisher, *Stable Money: A History of the Movement*, Adelphi Co., New York, 1934 (see chapters V and VI).

[17]Governors Strong, Harrison, and Norris as well as Board members Meyer, Miller, and Young voiced opposition to the idea. Director of Research Goldenweiser also opposed the idea during such hearings. See Fisher, pp. 150-206.

[18]This bill mandated price stability and additionally gave the Federal Reserve the power to raise or lower the price of gold when necessary. See Fisher pp. 186-7.

Resolution. This congressional Resolution instructed the Federal Reserve to gradually eliminate inflation within five years and then to maintain price stability. The initiative, however, remained in committee.

CURRENT PRICE STABILITY LEGISLATION

The Mack-Saxton Bill was introduced during the 104th Congress in September 1995 and reintroduced during the 105th Congress in April 1997. The Bill includes the following features:

- Establishes long-term price stability as the primary goal of Federal Reserve monetary policy.

- Repeals the Full Employment and Balanced Growth Act of 1978 (Humphrey-Hawkins Act) and the multiple policy goals mandated by this Act; amends portions of the Employment Act of 1946.

- Places responsibility on the Federal Reserve to numerically define price stability and set the time table for achieving it.

- Requires the Federal Reserve to report to Congress semi-annually and provide information on the numerical progress toward achieving the price stability goal.

- Requires the Federal Reserve to describe variables used to gauge its own progress toward price stability and to report to Congress when it changes methods for measuring its own progress.

As these features suggest, the Bill is a significant step forward in moving to make long-run price stability a reality. But the legislation may not be the final word on this issue. Continued progress on this front, for example, might include additional ingredients to:

- Allow for significantly improving the transparency of monetary policy; specifically, requiring that Federal Reserve reporting and disclosure be more timely, frequent, thorough and detailed as well as more accessible to the public. This might involve, for example, requiring an explicit "inflation report" detailing the inflation outlook to be presented at more regularly scheduled congressional oversight hearings.

- Promote the transparency of Federal Reserve and Treasury exchange rate policy and clarify the relationship of this policy to mandated Federal Reserve inflation goals. Such clarification would involve identifying the precedence of inflation objectives vis-a-vis exchange rate policy as well as simplifying and clarifying related decisionmaking processes.

- Require the Federal Reserve to identify before the fact what remedial action will be undertaken should price stability goals not be achieved.

IMPLICATIONS FOR CURRENT MONETARY POLICY

Regardless of the success of price stability legislation in the United States Congress, the Federal Reserve should move forward on several fronts unilaterally to adopt these features fostering price stability and enhanced transparency. Doing so will not only promote the credibility of monetary policy but will also help to remove uncertainties spawning unnecessary market volatility. These actions will enable market prices to serve as more reliable sources of information and policy indicators and furthermore will foster improved market discipline on monetary policy.

SUMMARY AND CONCLUSIONS

Currently, our fiat money system has no reliable price anchor or standard of value. At the same time, Congress has the legal authority and oversight responsibility for regulating the value of money and providing for such an anchor. There are many reasons for and benefits from adopting price stability as the primary goal of monetary policy. This objective has been endorsed not only by many of the world's most esteemed monetary economists but also by many Federal Reserve officials. Both historical and contemporary evidence demonstrates that such a strategy works quite well. Furthermore, the approach allows for ample monetary policy flexibility; there are many reasons why this approach should be adopted now.

The time has come to introduce price stability as a legislative goal. Current price stability legislation is not the first to advocate stable money, but it offers much of what was the best in earlier initiatives. Such legislation deserves the support of both Houses.

Robert E. Keleher
Chief Macroeconomist