INFLATION TARGETING

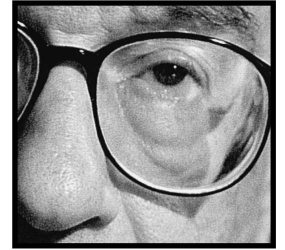
Fed Policy after Greenspan

By Ben S. Bernanke, Frederic S. Mishkin & Adam S. Posen

How to diet without a lock on the refrigerator door.

The Federal Reserve's performance under Chairman Alan Greenspan has been nothing short of miraculous. During his tenure, inflation has almost been eliminated, economic growth has been rapid and unemployment has fallen to levels not seen since the 1960's. This stellar record has led the media to elevate Greenspan to something approaching movie-star status. The financial markets apparently cannot imagine anyone else at the helm of the Fed, and several presidential candidates have already come out in favor of his reappointment – even though the Chairman's term does not expire until next year.

But Alan Greenspan will not always lead the Fed – he is in his 70's, after all – and current technology is not up to cloning him. More important, just as the biggest box-office star turns out the occasional bomb that goes straight to video, even the best central bankers make mistakes. That is why movie studios bet on their production systems rather than on their stars – and why the Federal Reserve should be thinking through its approach to monetary policy A.G. (after Greenspan).



Is there anything (beyond burning incense and singing hymns) that can be done to increase the chances that U.S. monetary policy will stay on track without the input of another Greenspan? We think the answer lies in a strategy known as inflation targeting that has been employed with great success by several countries, including Canada, New Zealand, Australia, Sweden and the United Kingdom. Inflation targeting not only offers hope of consolidating the gains of the Greenspan years, but would also make monetary policy more transparent and accountable to the public. And that's a good thing for both the financial markets and the democratic political system.

RIGHT: ROBERT C. BURKE; TOP: GEORGE DE KEERLE/BOTH LIAISON INTERNATIONAL

CURRENT FED PRACTICE: JUST DO IT

Unlike many central banks, the Fed is relatively opaque and secretive in its policy-making. It has never clearly articulated precise policy goals to Congress or to the public. Nor does it lay out, even in the most general terms, the contingencies that would cause it to contemplate changing its stance on monetary policy. Less obvious, but no less important, the Fed does not provide a nominal anchor for the economy – an explicit target for, say, the growth of the money supply, the exchange rate or, as we will advocate,

for the rate of inflation, on which people can base their expectations about future price levels.

This is not to say that the success of U.S. monetary policy in the 1990's was an accident. The Fed has communicated the benefits of stable prices with sufficient conviction to give it the political breathing room to fight inflation. And fight it has: After bringing down the rate of inflation, the Fed has carefully monitored the economy for signs of incipient price pressure and undertaken periodic preemptive strikes in the form of interest rate hikes.

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For example, from February 1994 to February 1995 the Fed tightened credit by doubling the rate at which banks could borrow money overnight (from 3 percent to 6 percent) even though inflation showed no overt signs of stirring. This preemptive action must be judged a success, since inflation has remained low even as the economic expansion continued. And in recent months the Fed has again been raising interest rates in an attempt to strangle the inflation monster before it comes out of its lair.

The long lag between monetary-policy actions and their effects dictates the need to alter course before prices accelerate. If a central bank were to wait for inflation to rise, the opportunity to maintain stable prices with only modest interest rate hikes would be lost. For once inflation has been allowed to gather momentum, higher inflation expectations become ingrained in a variety of long-term business agreements ranging from union wage pacts to contracts with suppliers. And that makes inflation both more difficult and more costly to eradicate.

In the past, the Fed often made the mistake of waiting to respond to inflationary pressures. But Greenspan took the academic research on the importance of expectations and preemptive policy-making to heart, and the Greenspan Fed has consistently tightened credit before inflation reared its noxious head. Earlier action has meant less severe action, allowing the Fed to avoid the nasty recessions associated with inflation fighting in the 1970's and 1980's.

While the combination of a commitment to price stability and a strategy of preemptive strikes has yielded good results, it is not clear that we should be satisfied. We call the Greenspan Fed's strategy the "just-do-it" approach, because it lacks an explicit, publicly articulated goal and a coherent framework.

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IF IT AIN'T BROKE, WHY FIX IT?

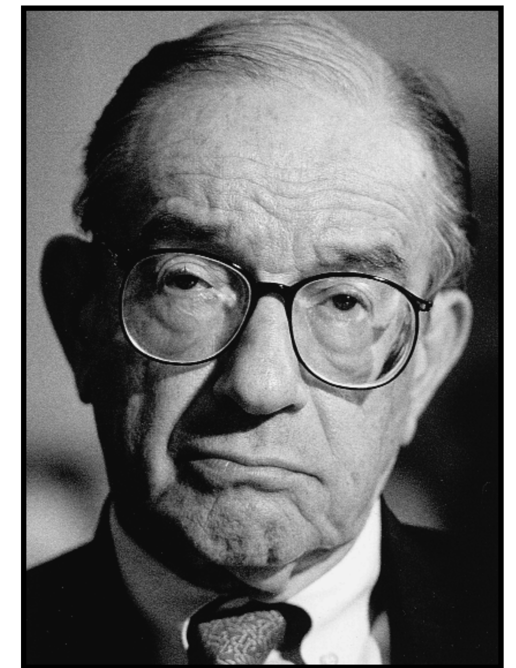
In light of the success of the just-do-it strategy, it's only natural to ask why the Fed should consider alternatives. The answer is that just-do-it has some disadvantages that will likely cause it to work less well in the future. Indeed, the lack of a clear policy framework is already being felt in subtle ways.

One limitation of policy-as-usual is its lack of transparency: The fact that the Fed remains unwilling to share its thinking with the public. The endless guessing games about Fed intentions engendered by its close-mouthed approach increases volatility in financial markets and generates unnecessary uncertainty about the future of the economy.

What's more, the secrecy is hardly conducive to making the Federal Reserve accountable to Congress and the public, since it leaves no explicit criteria for judging the Fed's performance. Perversely, the absence of explicit performance benchmarks may create leeway for opportunist politicians to pressure the Fed to pursue short-term objectives (e.g., a temporary and unsustainable burst in job creation) at the expense of long-term ones (e.g., price stability). There is no reason to think that increasing transparency would come at the cost of macroeconomic performance. In fact, evidence from other countries suggests that transparency actually improves the performance of monetary policy.

The lack of an explicit nominal anchor is also a problem in the context of a just-do-it approach. For example, under its current practices, the Fed risks unnecessary exposure to inflation scares – those occasional, seemingly spontaneous increases in inflation expectations that drive up interest rates on bonds and mortgages. In addition, the lack of a nominal anchor makes it harder for the Fed to contain the effects of adverse supply shocks, like a jump in the price of oil. For with nothing to tie them down, inflation expectations are more sensitive to transitory increases in prices.

Probably the most serious problem with just-do-it, however, is its strong dependence on the preferences and skills of central bankers – not to mention the faith of the public in fallible policy makers. In the United States, Greenspan and other Fed officials have



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emphasized inflation control through forward-looking policies. The Fed's prestige and credibility with the public have risen in tandem with the great success of these policies to date. But the Fed's leadership will eventually change, and there is no guarantee that the next team will be committed to the same goals or forward-looking tactics – or that the new policy makers will be as skillful at it.

By the same token, there is no guarantee that the relatively good working relationship between the Fed and the executive branch will continue. Nor is there any assurance that the public would support the Fed's commitment to price stability, should economic times turn tougher. In short, a just-do-it policy does not build sustainable credibility.

In fact, in a different economic or political environment, a less-than-transparent Fed might face strong pressure to engage in over-expansionary policies. There are historical examples – notably, in the late 1960's and the 1970's – of the Fed abandoning successful

low-inflation policies in favor of expansionist inflationary policies. And without an explicit policy anchor, that could happen again.

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WHAT IS INFLATION TARGETING? AND WHY IS IT A GOOD IDEA?

There is a well-tested alternative to a just-do-it policy directed by a strong Fed chairman. "Inflation targeting" commits the central bank to forward-looking pursuit of low inflation – the source of the Fed's current success – and also enhances the central bank's accountability and transparency. As we noted, inflation targeting has been adopted by a number of major industrialized countries and, more recently, by emerging-market economies, including Chile, Israel, Mexico and Brazil. The strategy has been associated with the maintenance of historically low levels of inflation and, as important, strong public support for policies aimed at stabilizing prices.

The basic premise of inflation targeting is that the central bank and the government must make a public commitment to an explicit target level for inflation, to be achieved over some medium-term horizon. Further, the central bank must provide markets and the public with enough information to judge its performance and to understand the logic behind its tactics. The very public goal-setting and reporting inherent in inflation targeting makes the central bank accountable with a minimum risk of political interference. Political pressure is channeled into healthy interest in the central bank's effectiveness in meeting its stated inflation goal, as well as into debate about the appropriate level for the inflation target itself.

More explicitly, inflation-targeting consists of the following elements:

- Public announcement and definition of a numerical target for inflation (usually around 2 percent a year) and a time frame (usually between one and two years) over which the target is to be attained.
- An explicit commitment, by both the central bank and elected officials, to price stability as the primary long-run goal of monetary policy.
- Use of a broad range of relevant information in making monetary policy, rather than a focus on a single variable, such as the growth of the money supply.
- Publication of inflation forecasts, with a description of the circumstances under which policy would change.
- Expanded communication about the plans and objectives of monetary policy-makers through regular, comprehensive and clearly written publications.
- Increased accountability of the central bank for attaining its inflation objectives.

Experience in other countries shows that inflation targeting provides a good balance of transparency and flexibility. And we think it would serve to institutionalize, and thus to perpetuate, many of the positive features of current practice by the Greenspan-dominated Fed. After all, this Federal Reserve Board stands for low, stable inflation and it has taken a forward-looking approach in its preemptive strikes on inflation.

Adoption of inflation targeting by the Federal Reserve would have several major advantages over "policy making as usual". First, it would depersonalize U.S. monetary policy. This is not to deny that Chairman Greenspan and the current Federal Open Market Committee (consisting of the Fed Board of Governors and a smaller group of regional Fed bank presidents) have served us well. But there is a reason why Americans generally prefer to be ruled by laws than by men, and the mistakes of the Fed in the 1930's and the 1970's reinforce the point.

Second, inflation targeting would be an improvement over current practice in that it would increase the transparency of policy-making. It would build on a number of recent steps taken by the Fed, notably the shortening of the time before minutes of Federal Open Market Committee meetings are released, the decision to announce whether the interest rate target has been changed immediately after the committee's meeting, and the announcement of the direction of bias – up, down or neutral – of future interest-rate policy. Yet there is no reason to be so cautious in expanding transparency. A wide-open door would promote better public understanding of Fed policy-making, leading to a more informed public debate – and, we are convinced, to better policy outcomes.

Why better outcomes? Inflation targeting encourages both politicians and the public to focus on what monetary policy can do (namely, maintain long-run price stability), rather than on what it cannot (create permanent increases in growth through expansionary policies). Easy credit has too often been seen as a quick fix for the economy because it creates output and jobs in the short run. However, both experience and extensive research shows that turning on the money spigot cannot sustain such increases for long. On the contrary, it leads to higher inflation, with harmful consequences for the economy in the long run.

Inflation-targeting frameworks in other industrialized countries have nudged the political debate toward a more realistic, longer-run perspective. An excellent example occurred in Canada in 1996, when the president of the Canadian Economic Association criticized the Bank of Canada for pursuing what he claimed was an excessively contractionary monetary policy.

His speech sparked a widespread public debate. In countries not pursuing inflation targeting, such debates often degenerate into

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calls for immediate easing of monetary policy, with little reference to the long-run consequences.

In the Canadian case, however, the inflation-targeting framework pushed the debate into a substantive discussion of what the target for inflation should be and how quickly it should be attained. Both the Bank and its critics were obliged to make their assumptions explicit and to estimate the costs and benefits of different levels of inflation. In the end, the Bank of Canada's openness and responsiveness led to increased support for the Bank's policies, with the result that criticism of the Bank's tough anti-inflationary measures did not have much impact on the 1997 elections – as it had in 1993.

Increased transparency would also reduce financial and economic uncertainty. More

information from the Fed about its objectives and plans could reduce the costs incurred by financial market players, who now spend too much of their business lives guessing about what the Fed will do next. Greater transparency would also make it easier for businesses and consumers to plan for the future – i.e. whether to commit to long-term contracts, when to refinance a home mortgage.

Third, an inflation-targeting framework is more consistent with democratic principles than other approaches. There are good reasons to grant central banks some degree of independence – notably, insulation from short-term political pressures. Indeed, there is strong evidence that countries with independent central banks enjoy lower rates of inflation than countries without them, with no greater volatility in employment or output. Yet the practical economic arguments for central bank independence co-exist uneasily with the presumption that government policies should be made democratically. Indeed, criticism of the Federal Reserve may in part be prompted by the impression that the Fed and its Chairman have become too powerful.

Since policy objectives in a democracy must ultimately reflect the popular will, they should be set by elected officials. Consequently, the central bank should not lay down the objectives of monetary policy. However, because the central bank has the best information and expertise on how to achieve policy objectives, it should be free to choose the means for getting the job done.

Inflation targeting is consistent with – and, indeed, promotes – this way of organizing responsibility. In the framework used by most countries, the central bank is fully accountable to elected officials, who have the primary responsibility for setting the goals for monetary policy and monitoring the outcomes. At the same time, the targeting framework ensures that the objectives set by the government are feasible and that they fit into a consistent long-run perspective. For example, this requires the government to choose goals for inflation (which is controllable by the central bank) rather than for, say, the long-run unemployment rate (which is not). Finally, under inflation targeting as it has generally been practiced, short-term operational decisions belong solely to the central bank.

Changes in the system for setting monetary policy in Great Britain offer an example of how inflation targeting reduces the tensions between central bank independence and democratic policy making. Prior to 1997, monetary policy decisions in the United Kingdom were made by the executive branch, in the person of the Chancellor of the Exchequer. However, on May 6, 1997 the new Chancellor of the Exchequer, Gordon Brown, granted independence to the Bank of England by giving it the power to set the overnight interest rate.

Brown made it clear that his action had been made possible by the earlier adoption of an inflation-targeting regime, which had increased the transparency of policy and the accountability of the Bank. He also pointed out that inflation targeting would enable the elected Government to continue to set the goals of monetary policy – as is appropriate in a democratic society – but at the same time would ensure that the Bank has adequate discretion in meeting the goals.

Fourth, the evidence suggests that the adoption of inflation targeting would make it easier for the Fed to deal with adverse economic shocks. For example, the Bank of Canada has emphasized that inflation targets have improved its ability to deal with contractionary shocks to demand. Because a decline in demand also leads to lower expected

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inflation, the Bank has been able to respond with a monetary easing without causing the public (or the financial markets) to question its anti-inflationary resolve.

Inflation targeting is particularly good insurance against the threat of deflation, or falling prices. Deflation poses grave risks for the economy. Indeed, deflation has been associated with deep recessions or even depressions, as in the 1930's. And the recent bout of deflation in Japan has dogged efforts to repair that country's financial system and economy. Targeting inflation rates at levels a couple of percent above zero, as all inflation targeters have done, makes periods of deflation less likely. The evidence from both surveys and the behavior of interest rates suggests that maintaining a target for inflation above (but not too far above) zero does not lead to instability in inflation expectations or to a decline in the central bank's credibility.

Fifth, it seems likely that having inflation targets in place would give the central bank more flexibility to react to potential financial crises. For example, in the wake of the failure of a large financial institution that rattles financial markets, the Federal Reserve would be able to inject needed liquidity into the financial system with the knowledge that its medium-term targets will help to anchor

inflation expectations.

The financial markets' reaction to Fed policy in the early 1990's is an example of what can happen when explicit inflation targets are not in place. In response to problems in the banking sector and credit markets, the Fed kept short-term interest rates fixed at the extremely low level of 3 percent (or about zero, in real terms) for more than a year. To rationalize this policy, Chairman Greenspan referred to the financial "headwinds" that were holding back the recovery.

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Nevertheless, Wall Street expressed concern that the Fed was losing its anti-inflationary resolve – a concern that manifested itself in substantial increases in long-term bond rates when the Fed began raising short-term rates in February 1994. This response might well have been moderated had a credible inflation-targeting regime been in place.

Similarly, explicit inflation targets would have reduced the inflationary risks associated with the otherwise well-justified 75 basis point drop in short-term rates in fall 1998 – the Federal Reserve's policy response to the exchange-rate crisis in Russia and the near-collapse of Long-Term Capital Management.

WHY NOW?

We have argued that U.S. monetary policy, despite its excellent performance in the Greenspan years, would be likely to perform even better if the Fed formally adopted inflation targeting. But why now?

The reasons are largely political. Countries that have adopted inflation targeting have typically done so not when inflation is rising, but after they have already achieved some success in taming prices. That timing makes sense because it increases the likelihood the new regime will endure, as the central bank builds on its established credibility as an inflation fighter. Moreover, the public seems more willing to accept inflation targeting once it recognizes that low inflation can indeed be achieved, that it provides tangible economic benefits, and that additional short-run costs (in terms of lost output and employment) to bring down inflation may not be necessary.

The current situation in the United States thus seems highly propitious for the adoption of inflation targeting. Inflation has been low and stable for well over five years. The economy has been remarkably healthy, enjoying a balanced, long-lived expansion. The benefits of a low-inflation environment have become clear to the American public. And last but not least, the success of inflation targeting in other industrialized countries is becoming increasingly apparent.

Thus the United States has a window of opportunity in which a new monetary policy framework could be readily adopted. With luck, the new framework would be firmly established by the time the next difficult policy decisions have to be made, ensuring that they are likely to be the right ones – whether or not the Fed has Alan Greenspan at the helm.