July 17, 2007

HOUSE FINANCIAL SERVICES COMMITTEE TESTIMONY

Benjamin M. Friedman
William Joseph Maier Professor of Political Economy
Harvard University

Mr. Chairman:

I am pleased to have the opportunity to present my views to this distinguished committee. It should go without saying (although the point is often overlooked) that a nation's central bank is part of its government. In the United States our Constitution assigns the power "to coin money [and] regulate the value thereof" – in modern parlance, the authority to conduct monetary policy – to the Congress. For nearly a century now, the Congress has delegated that power, subject to ongoing oversight, to the Federal Reserve System. The oversight that this committee and its Senate counterpart exercise over the Federal Reserve's conduct of monetary policy is an integral part of how our democratic system of government works.

Our country's central bank is unusual today in two key respects. First, under the prevailing legislation by which the Congress has delegated this important policymaking power to the Federal Reserve, Congress has instructed the central bank to conduct monetary policy so as to promote *both* maximum employment *and* stable prices. This "dual mandate," as it is often called, stands in contrast to the charge given to many other countries' central banks to focus primarily or even exclusively on maintaining stable prices. Second, the Federal Reserve System

has stood apart from the movement among many other central banks to organize their formulation and implementation of monetary policy around the pursuit of a specific publicly announced rate of price inflation – what is commonly called “inflation targeting.”

I believe the United States is well served by both of these differences: The Congress is right to assign the Federal Reserve a dual mandate, and given that dual mandate it would be a mistake for the Federal Reserve to organize its monetary policy within an inflation targeting rubric. In my remarks this morning I shall address each of these issues in turn.

A Dual Mandate? YES

The purpose of any nation’s economic policy is to advance its economic well-being, meaning the prosperity of its citizens and the vitality of the institutions through which they participate in economic activity, both in the present and for the future. Whether working men and women are able to make a living, whether the businesses that they own and at which they work can earn a profit and invest adequately for future growth, and whether the banks and other financial institutions on which both individuals and businesses rely can survive in the face of the risk-taking that is central to their reason for existing, are all fundamental aspects of that well-being.

Individual citizens are, and have a right to be, concerned with many facets of the economic environment in which they live: their incomes, their employments prospects, their ability to start a business or borrow to purchase a new home, just to name a few. From an aggregate perspective, yet further aspects of an economy’s actual and prospective situation are plausibly of concern to public policymakers: the levels of production and employment in relation

to "full employment" benchmarks, the economy's international balances, its investment rate, among others.

Monetary policymakers in particular also have both practical and historical reasons for seeking to maintain the vitality of financial institutions and the functioning of financial markets. The Federal Reserve System was created as a direct response to a series of banking crises (in 1901, 1907 and 1913, and before that in the nineteenth century also) that not only shut down much of the nation's financial system but spilled over to impair the nonfinancial economy as well. The visible sign of that motivation was the new central bank's charge, in the original Federal Reserve Act, to "provide an elastic currency." The collapse of the nation's savings and loan industry in the late 1980s once again showed how the impairment of a country's banking system can interrupt the credit creation process, destroy asset values, and otherwise impede the ability of households and firms to carry out their ordinary economic affairs.

Experience shows that rising (or falling) prices can and sometimes do undermine the efficient functioning of economic activity, so that price stability is a key desideratum in all of these regards. But price stability is instrumental, valued not for itself but for how it enhances an economy's capacity to achieve those goals that, even if they are not genuinely primary from the perspective of basic human concerns, are at least instrumental at a higher level. The idea that economic policy should pursue price stability as a means of promoting more fundamental economic well-being, either currently or in the future, is not ground for pursuing price stability at the expense, much less to the exclusion, of that more fundamental economic well-being.

There are two circumstances under which instructing a central bank to look out only for price stability would make sense. One would be that some other instrument of public policy

were also capable of serving the same purpose with respect to output and employment, and the differential economic effects of the two policy tools at the government's disposal were such as to warrant assigning responsibility for price stability to one (in this case monetary policy) and for maintaining maximum sustainable employment to the other. Early in the post World War II period many economists and other participants in the economic policymaking process held out just this hope for the flexible use of fiscal policy. But since then both experience and developments in economic thinking have belied that hope. Today no other such policy tool is visible. Hence the importance attached to monetary policy, in practically every quarter, with respect to both the economy's inflation rate and its level of output and employment.

Alternatively, if monetary policy were unable to exert influence over output and employment in any more direct way than via the evolution of prices, then – from the perspective of how to conduct monetary policy, though not more generally – promoting fundamental economic well-being and pursuing price stability would amount to the same objective. But today few economists, and certainly few business people, market investors, or even ordinary citizens who concern themselves with economic affairs, believe that actions taken by the central bank have no impact on output or employment, or real economic outcomes more generally. Nor is it the case that over short- to medium-run horizons the monetary policy actions that are best for achieving price stability are always best for achieving maximum sustainable output and employment. That correspondence may or may not hold in the long run, but not over the time frame with which citizens, investors and policymakers are also rightly concerned.

It is not legitimate, therefore, to duck the question of whether and how monetary policy *should* seek to affect real economic outcomes by subsuming that question within the prior one of

whether monetary policy *can* do so. Both theory and evidence indicate that in an economy like that of the United States monetary policy can affect not just prices but also output, employment and other important aspects of nonfinancial economic activity, and can affect them over at least some significant period of time. The relevant question is in what way it should seek to do so.

Perhaps the easiest way to illustrate the argument that the Congress ought to charge our country's central bank to bear responsibility not just for price stability but for output and employment as well, not to mention aspects of financial stability, is – only briefly – to take seriously the opposite prospect. Imagine that this committee were welcoming the chairman of the Board of Governors of the Federal Reserve System for his or her semi-annual report on monetary policy. Suppose that the economy had been spiraling downward for nearly a year, the unemployment rate were in double digits, industrial production were down by, say, one-fifth from the previous peak, corporate bankruptcies and home mortgage foreclosures were accelerating, and banks were beginning to fail in large numbers. And now suppose that, in the midst of this economic disaster, the Federal Reserve chairman were to begin his or her testimony as follows: "I am pleased to report that during the past year U.S. monetary policy has been outstandingly successful. Overall inflation has again been just 1.0%, and prices other than for food and energy have risen by just 0.9%. My colleagues and I are here to accept this committee's congratulations and those of the American people."

Such a situation is, of course, unthinkable. But the relevant question for this committee is what makes it so. The Federal Reserve System is a part of our nation's government, to which the Congress has – under instruction, and with oversight – delegated its Constitutional power to

make monetary policy. The substantive content of that instruction is essential, and the existing dual mandate is a crucial component of it.

Inflation Targeting? NO

Under a dual mandate like ours in the United States, therefore, over short- to medium-run time horizons monetary policy has two objectives, price stability and maximum sustainable employment (three if financial stability constitutes an independent objective). But the central bank has only one instrument with which to seek to achieve these objectives: typically, in modern times, setting a short-term interest rate like the federal funds rate. Even apart from the inability to predict future economic developments in a setting in which the influence of its policy takes time, therefore, the central cannot be expected to achieve desired paths for both prices and real outcomes. Barring some special coincidence, the best that a policy with only one instrument can achieve is to keep the economy on the path that represents the best possible compromise between the two objectives. Considerations of uncertainty only make matters more difficult.

In recent years many central banks have addressed this tension between multiple objectives and their single monetary policy instrument by resort to "inflation targeting." In current usage of the term, the two essential components of an inflation targeting strategy for conducting monetary policy are (1) the clear public statement of what rate of price increase policymakers are seeking to achieve over some medium- to long-run horizon, in practice typically stated in terms of a target range, and (2) the formulation, in internal central bank discussion as well as statements to the public, of the economic trajectory intended to follow from the chosen monetary policy in terms of the implied path for inflation.

In principle, as many advocates of inflation targeting have emphasized, inflation targeting need not imply that the chosen inflation rate is policymakers' sole objective, and so in principle an inflation targeting regime would be consistent with a dual mandate like that which Congress has assigned to the Federal Reserve System. Their argument is that with only one instrument (again, usually a short-term interest rate) it is possible for monetary policymakers to describe their intended economic trajectory in terms of only one variable. The appeal of doing so in terms of inflation, rather than output or employment, rests on the presumption that in the long run monetary policy cannot affect those real outcomes, which instead ultimately depend only on factors such as endowments, preferences and technologies. Hence by choosing inflation for this purpose, policymakers are focusing on a variable that monetary policy can influence not just over the medium horizon but in the long run as well.

Advocates of inflation targeting, both within central banks and among academic researchers, frequently ground the argument in favor of this way of conducting monetary policy on considerations of transparency and accountability: Telling the public which single variable to associate with monetary policy, and also the numerical target at which the central bank is aiming for that variable, makes clear what policymakers are trying to achieve. When the aim of policy is well known and the results straightforward to monitor, it is also possible for both higher authorities and the public to hold policymakers accountable for their success or failure. Transparency of the central bank's policy is presumably helpful in that it reduces the uncertainty that financial market participants, as well as households and firms more generally, face in carrying out their respective economic plans, thereby making the economy as a whole more efficient. Further, especially when the objective is low and stable inflation, transparency of that

particular objective also helps to anchor the public's inflation expectations, thereby reducing the real economic costs associated with combating any unexpected increase when price-setting behavior depends not only on real economic activity relative to full-employment benchmarks but also on expectations of future inflation. Accountability of policymakers for the efficacy of their decisions and actions is plainly part of what constitutes effective democracy.

The argument for the greater transparency of the inflation targeting strategy fails, however – and with it the argument for the greater resulting accountability of monetary policy – when policymakers have objectives for real economic outcomes, as under the Federal Reserve's dual mandate. Describing the intended economic trajectory in terms of inflation alone need not imply that policymakers have no objectives apart from that for inflation, but nor does it preclude their having such a single-goal objective. The essential question is whether monetary policymakers have objectives for output and employment, or not.

If they do, then inflation targeting is more likely to undermine transparency of monetary policy than to promote it. The chief reason is that under inflation targeting policymakers normally reveal to the public only one of their multiple objectives: that for inflation. If outsiders knew (and were able to use) the economic model on which policymakers rely in evaluating potential actions, the public could infer what path for output or employment, or any other variable of interest, would be expected to accompany the targeted inflation trajectory. (They could also back out the central bank's intended path for interest rates.) But few central banks operate with such a single economic model, and even if they do few disclose this information anyway. Nor do inflation targeting central banks quantify for the public – or, normally, even for

themselves – the relative importance that they attach to their objectives for inflation and for real economic outcomes.

To the contrary, many inflation targeting central banks at least appear to go to some effort *not* to reveal such aspects of their policymaking to the public. An increasingly common practice, for example, following the initial lead of the Bank of England, is to issue at regular intervals a detailed monetary policy report, but to call it an "Inflation Report" – as if inflation were the only aspect of economic activity of concern to monetary policy. Similarly, many inflation targeting central banks, in the public explanation that they provide of the rationale underlying their monetary policy strategy, avoid any reference to the possibility of tension, even in the short run, between their inflation objective and any real outcome.[1] In light of the favorable effect on short-run inflation-output trade-offs that ensues from keeping expectations of future inflation anchored at a low level, the incentive for policymakers to downplay or even conceal their objectives for real economic outcomes is clear enough. But their doing so hardly contributes to the transparency of their policy.

The same considerations undermine the argument for inflation targeting on grounds of promoting the accountability of monetary policy. If policymakers have objectives for both inflation and real outcomes, but disclose only their inflation objective, then Congress as well as the general body politic can hold them accountable in an explicit way at most for their success or failure in meeting their inflation objective; the rest must rely on inference and guesswork.

---

[1]A good example is the Bank of Canada, which until recently stated the rationale for its inflation targeting policy as follows: "Inflation control is not an end to itself; it is the means by which monetary policy contributes to solid economic performance. Low inflation allows the economy to function more effectively. This contributes to better economic growth over time and works to moderate cyclical fluctuations in output and employment."

The other possibility, of course, is that policymakers may not actually have objectives for output and employment, but instead may direct their policy solely toward the achievement of the stated rate of inflation. If so, then an inflation targeting policy is fully transparent, and the consequences argued for accountability follow as well. In this situation, however, monetary policymakers would be abdicating their responsibility for seeking, within the capacities of the instrument at their disposal, to achieve economic conditions in the interests of the public whom they supposedly serve, including individuals, businesses and financial firms. If they were operating under a dual mandate, they would obviously be violating it.

Indeed, one interpretation of the movement toward inflation targeting among so many of the world's central banks (and, perhaps even more so, among academic researchers who advocate this policy rubric) is that this is precisely the state of policymaking that inflation targeting is intended to bring about over time. A plausible consequence of constraining the discussion of monetary policy to be carried out entirely in terms of a specified numerical inflation trajectory is that, in time, objectives for output and employment will atrophy, or even disappear from policymakers' purview altogether.

This eventuality would ensue in part simply because the language and analytical framework within which discussion takes place inevitably shapes what is discussed. The eighteenth century Scottish philosopher and economist David Hume, writing about the central political issue in the Britain of his day (monarchy versus republic), observed that "The Tories have been obliged for so long to talk in the republican style that they ... have at length embraced the sentiments as well as the language of their adversaries." We are all familiar with instances of the same phenomenon in our own day.

In addition, exactly as the argument for accountability implies, policymakers inevitably take more seriously those aspects of their responsibilities for which they expect to be held accountable. Disclosing only the inflation objective, when in fact policymakers have objectives for inflation as well as for output and employment – as Federal Reserve policymakers do under a dual mandate – biases the relative importance that they will attach to these respective objectives by fostering their accountability for inflation and not for real outcomes. In time, the objectives for output and employment will devolve into a rhetorical fiction.

The United States is well served by the dual mandate that the Congress has assigned to our nation's central bank. It is worth preserving. Inflation targeting would instead undermine it.