

Testimony of James K. Galbraith, Lloyd M. Bentsen, jr. Chair in Government/Business Relations, Lyndon B. Johnson School of Public Affairs, The University of Texas at Austin, and Senior Scholar, Levy Economics Institute, before the House Committee on Financial Services, Hearings on the Conduct of Monetary Policy under the Humphrey-Hawkins Full Employment and Balanced Growth Act, Washington, DC, July 17, 2007.

Mr. Chairman and Members of the Committee. It is a rare privilege for me to return to this room today. I first came to work here in the early summer of 1975, just in time for the first regular hearings on the Conduct of Monetary Policy, under the Chairmanship of Henry S. Reuss and by authority of House Concurrent Resolution 133. With my fellow staff economists Robert Auerbach and Robert Weintraub, and under the supervision of the staff director, Paul Nelson, I worked on those hearings almost continuously for the following six years.

In 1976, alongside Leon Keyserling, Bertram Gross and others, I participated in the drafting of H.R. 50, the Hawkins-Reuss bill, which became the Humphrey-Hawkins Full Employment and Balanced Growth Act of 1978. Some of those meetings occurred in the office of Congressman Augustus F. Hawkins, and it is an honor for me to salute that great American today, as he approaches his centennial. To his law, I contributed a very small thing: language governing the form and content of these hearings. No one then expected that they would become the major enduring legacy of the Full Employment Act, but so they have.

A major purpose of these hearings was to establish the formal and practical authority of the Congress, as provided for in the Constitution, over the Federal Reserve. These hearings remind us that, unlike some central banks, the Federal Reserve is not wholly independent. It is a “creature of Congress,” subject to oversight and to economic goals and objectives specified by law. Congress wisely grants to the Federal Reserve broad discretion in the conduct of monetary policy. But these hearings provide a forum whereby that conduct may be reviewed, questioned, criticized, and held to account.

As its title suggests, the Full Employment and Balanced Growth Act set into law goals for the economic policy of the United States, including for the Federal Reserve. Those goals included *full* employment and *reasonable* price stability - a precise statement of what is now often called the “dual mandate.” The question I raise today is: has the Federal Reserve observed that mandate? I report the results of a study recently completed on this topic, with the help of two co-authors, one of whom, Dr. Olivier Giovannoni, is present today.

Let me summarize our major findings. These relate first to two widely-held beliefs about the economy: that low unemployment is an inflation risk, and that economic inequality is unrelated to monetary policy. Second, they relate to common claims about the conduct of monetary policy, in particular that monetary policy reacts to inflation, that it respects the dual mandate, and that it has held itself rigorously outside of politics in modern times.

Claim: Low unemployment is an inflation risk.

I call your attention to the headline in the Wall Street Journal, On-line Edition, June 21, 2007:

“FED POLICY MAKERS ARE likely to continue to highlight risks that low unemployment could push inflation higher when they meet next week.”

Contrary to the anxiety expressed in this headline, we find that since 1983 there is no evidence that low unemployment rates foster higher inflation. The perfect example is that of the late 1990s, when we saw steadily decreasing joblessness, up to the point of sustained full employment for three years. Inflation did not rise. More broadly, the evidence is consistent with the view that demand-side inflation was driven out of the system by the mid-1980s, by the destruction of the previous pattern of wage bargaining, and by the effects of a high dollar on import prices and quantities, especially. Globalization, in other words, ended inflation. (See Figure 1). It also therefore lifted the constraint that inflation had previously placed in the path toward full employment.

Our results contradict the connection between inflation and unemployment, and especially the natural rate or NAIRU hypothesis first formulated in 1968 and accepted as a matter of faith by most economists for nearly forty years. This alleged connection has been proffered to justify persistently high unemployment rates, and to rationalize raising interest rates when unemployment falls "too low." But since 1983, let me repeat, there is no evidence that violating the supposed threshold produces rising inflation.

Claim: Inequality is outside the scope of monetary policy.

In testimony before this Committee on March 5, 1997, Chairman Greenspan stated as follows:

Second, however, there has been, as we know and discussed over the years, a significant opening up of income spreads, largely as a function of technology and of education with the increased premium of college education over high school, and high school over high school dropouts becoming stronger. The whole spread goes right through the basic system. It is a development which I feel uncomfortable with. There is nothing monetary policy can do to address that, and it is outside the scope, so far as I am concerned, of the issues with which we deal.

On February 6 of this year, Chairman Bernanke gave a lengthy speech to the Greater Omaha Chamber of Commerce on the problem of wage inequality. He did not mention the role of monetary policy or the Federal Reserve. One may infer that he shares Chairman Greenspan's belief, that monetary policy and inequality are unrelated.

This belief is incorrect. We find that inequality in pay or earnings – especially in manufacturing – does react to the rate-setting decisions of the Federal Reserve. Inequality has always been the

"recipient of shocks," among them the effects of unemployment and inflation. But here we show that inequality is also a direct product of monetary policy choices. In the statistical sense, monetary policy causes inequality.

Having said that, in the late 1990s this type of economic inequality-- in pay – *declined*. (See Figure 2.) This was a good result, reflective of the move toward full employment in those years. The Federal Reserve's permissive policy during this period should get part of the credit.

Let's turn to the conduct of monetary policy. Our approach is inspired by the famous "Taylor Rule," which holds that the Federal Reserve's behavior follows a "reaction function," based on the deviation of inflation and unemployment from their targets. Numerous studies have shown that the Taylor Rule provides useful prediction of the path of short-term interest rates.

As our measure of monetary policy stance, we use the term structure of interest rates, measured as *the difference between* a 90 day Treasury bill rate and the ten-year bond rate (Figure 3). This is a very stable, reliable way to measure the effect of monetary policy on the economy. It is better than the short-term interest rate taken alone – since it measures short rates *in relation to* the state of inflation expectations, which are reflected in long-term interest rates. Further, as is well-known, a flat or inverted yield curve is a good indicator of impending slowdowns.

Claim: Monetary policy has aimed at "fighting inflation."

This is what everyone says. And there is some evidence, for the period 1969 to 1983, that the Federal Reserve did fight inflation: the term structure became flatter when inflation was high. But after 1983, this effect disappears, unless low unemployment is also giving the same signal.

Part of the reason may be, that since 1983 the economy has transmitted few clear signals of high or even rising inflation to the Federal Reserve. With no inflation, logically there can be no reaction to inflation. But this raises two questions. First, why did inflation so largely disappear? And second, with so little inflation to react to, how come the Fed raised interest rates, and flattened the term structure, on numerous occasions, notably in 1988, 1996, 2000, and 2005?

Federal Reserve officials argue that they engage in the management of *inflation expectations*, and that their success is responsible for the quiet behavior of inflation in fact. Some scholars have credited these hearings with contributing to more effective monetary policy. I should be happy about that, yet I'm skeptical on two grounds. First, there is no *direct* evidence of a purely psychological effect of monetary policy on expectations. Second, it would be a sign of economic irrationality if there were. Surely, no oil company has ever foregone a higher price for gas, simply because someone else might end up paying a higher interest rate later on.

Our conclusion is that inflation was defeated *permanently* in the early 1980s, mainly by globalization. Here we have a quasi-permanent cause, an elastic supply of low-cost goods, leading to a quasi-permanent effect. Since then, fighting inflation has been an easy task, for there has been virtually no inflation, and practically no wage inflation, to combat.

Claim: The Federal Reserve respects the dual mandate.

The Humphrey-Hawkins Act called on the Federal Reserve to pursue full employment. We find that it has generally not done so. To the contrary, we find that the Federal Reserve tends to raise interest rates when unemployment falls below a certain range, which we believe to be between five and six percent. In extreme conditions, when unemployment is high and rising, the Federal Reserve also lowers interest rates. But this effect is less reliable.

Together, these findings tell a simple tale. The Federal Reserve, over the period from 1984 through 2006, has not generally accepted the Full Employment Act. Instead, it has behaved *as if* it believed that unemployment rates below the five-to-six percent range are dangerous in and of themselves. It has behaved *as if* it believed that low unemployment poses high risks of inflation, even though our evidence refutes that view. This is perhaps not surprising, since the mainstream of the economics profession has held this theory for forty years. But it is contrary to fact. It is contrary to what one should expect in an open economy, which the United States has become, where prices are largely set globally and not in the home labor market. And in addition to that, it is contrary to law.

Claim: The Federal Reserve has been apolitical.

Finally – if I may tread on even more delicate territory – the Federal Reserve has a reputation for standing apart from politics. This reputation has been maintained, notwithstanding the fact that three modern chairs of the Federal Reserve Board were previously Chair of the Council of Economic Advisers in Republican administrations. No Federal Reserve Chair has held a similarly high previous political appointment under a Democratic president.

Some scholars have raised the question: does there exist a presidential election cycle in monetary policy? We thought it reasonable to examine the possibility. We find surprisingly strong evidence that such a cycle exists. Specifically, we find that in the year before presidential elections, the term structure deviates sharply from otherwise-normal values. Moreover, the direction of variation depends on who is in power.

When a Republican administration is in office, the term structure in the pre-election year tends to be steeper, by values estimated at up to 150 basis points. Monetary policy is accordingly more permissive. When a Democratic administration is in office, the term structure tends to be flatter, by values also estimated at up to 150 basis points. Monetary policy is more restrictive.

These findings control for changes in interest rates due to inflation and unemployment. They are robust across model specifications and also across time. Taken together, they do suggest the presence of a serious, persistent partisan bias, at the heart of the Federal Reserve's policymaking process. These findings are, of course, historical. They do not necessarily predict the conduct of policy under Chairman Bernanke. But they raise an issue, in our view, that this Committee would be well advised to take into consideration as we approach future election cycles.

Brief comments on inflation targeting and the dollar exchange rate

Going beyond the scope of our paper, I would like to comment briefly on two current questions: First, there is the debate over whether the Federal Reserve should adopt an inflation target, and if so, of what type. Second, there the question of the future of the dollar, and in particular the potential consequences for monetary policy of pressure on China to revalue the RMB.

It is well-known that Chairman Bernanke favors an explicit, numerical target for the inflation rate. I have no difficulty with explicit targets as such: interim targets of four percent unemployment and three percent inflation were written into the Humphrey-Hawkins Act. They helped to clarify what Congress intended.

But an inflation target alone would indicate that the Federal Reserve gives priority to price stability over full employment. Congress should not accept that.

Further, the more one examines the making of an inflation target, the more technical difficulties appear. Should one target core or headline inflation? If the former, you run the risk that non-core inflation will become ingrained before any reaction occurs. If the latter, you run the risk of compounding supply shocks with demand shocks, adding interest-rate insult to oil-price injury. These technical issues have no easy answers. And that suggests that in some situations constructive ambiguity may be better than clarity (as Chairman Greenspan knew).

Finally, if I am right that inflation was killed by globalization, then setting an inflation target is like putting up a cross over the grave. It's perhaps not a bad thing. It may make us feel better. But one would not be justified in crediting the cross for keeping the ghost in the ground.

The fact that the inflation of the 1970s died in the 1980s does not mean that we face no inflation risks. Inflation accompanies war, and the Iraq War has had some inflationary impact, mainly through the extraordinary rise in the price of oil. Inflation may also recur, if the international monetary system enters a crisis, causing a sharp further fall in the value of the dollar. That is a risk of any unipolar currency system: it is a great privilege to issue the world's reserve currency, but only for so long as it lasts.

In this connection, I realize that many favor placing strong pressure on China, to sharply revalue its currency. Let me urge caution. Such a step could risk destabilizing the "nominal anchor" that has kept dollar prices reasonably stable in the world economy. And the benefits to American workers are fairly remote. The world is full of countries to which the employers of low-cost labor could turn if it became too expensive to continue operations in China. The clear winners from a sharp Chinese revaluation, on the other hand, would be those now speculating on the Shanghai real estate and stock markets.

In short, if the international dollar reserve system must eventually be changed, we should not try to do it with *ad hoc* measures. Rather, we should begin to design a new system capable, if possible, of greater enduring stability than the present one.

Conclusion

Mr. Chairman, my paper has pointed to several disturbing patterns in the actual conduct of monetary policy over the past quarter-century. In particular, the evidence suggests that the Federal Reserve has a habit of reacting adversely to low unemployment, even though full employment does not, by itself, pose an inflation risk.

I believe Chairman Bernanke should be asked to provide guarantees that this pattern will not be repeated. He should be asked to assure Congress that interest rates will not be raised *solely* on the evidence of low or falling unemployment. He should be asked to re-examine any models which tie predicted inflation to the unemployment rate, and to report in detail on that review. He should be asked to examine the evidence that the world did change in the early 1980s, breaking the previous linkages between inflation and unemployment.

He should be asked to take account of evidence that Federal Reserve policy directly influences not only unemployment, but also inequality.

Finally, Chairman Bernanke should be asked to assure Congress that interest rates will not be cut or raised *solely* in anticipation of an election. The Federal Reserve would then be on notice that Congress is conscious of the evidence pointing to a political cycle in past behavior. It will become aware, as it should be, that future actions following these same lines will not escape examination by this Committee.

Mr. Chairman, thank you for your time and again for this opportunity. I look forward to answering any questions you may have.

Figure 1. Is Inflation Dead? Inflation and Changes in Inflation, 1969-2007.

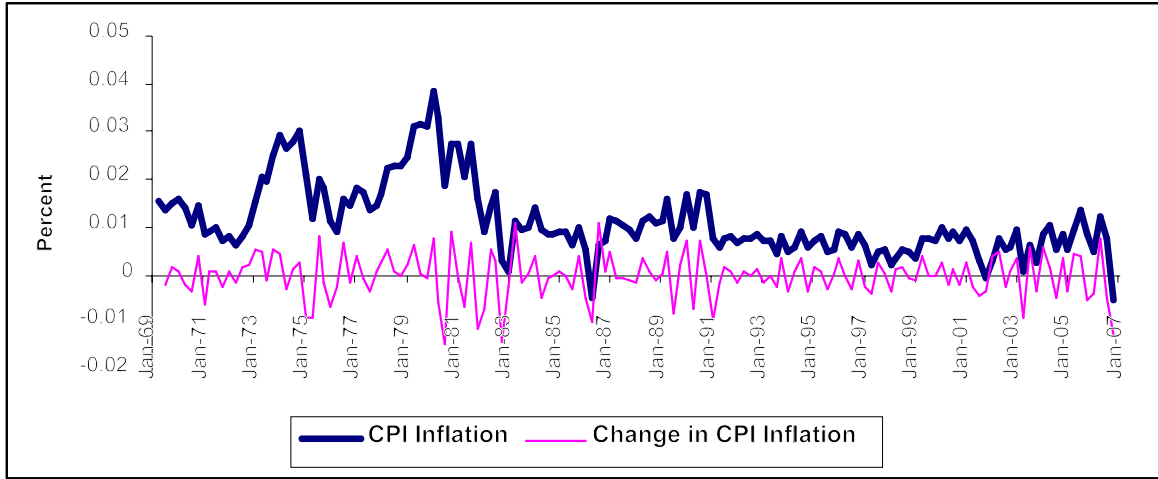


Figure 2. Close Relations: Wage Inequality and Unemployment, 1949 - 2002

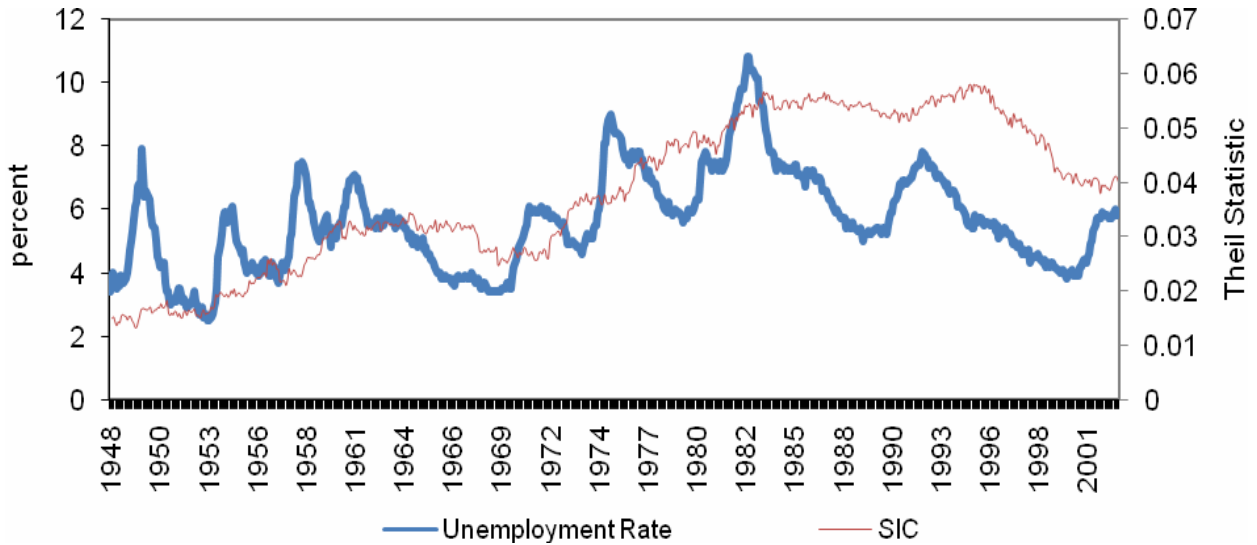


Figure 3. Monetary Stance: The Term Structure of Interest Rates, 1969-2006

