IRET Congressional Advisory

INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

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November 7, 2005 **Advisory No. 195**

MONETARY POLICY IN THE MONTHS AHEAD

President Bush has nominated noted economist Ben Bernanke to succeed Alan Greenspan as Chairman of the Board of Governors of the Federal Reserve System. Dr. Bernanke has served as Chairman of the President's Council of Economic Advisers since June 2005. He was a member of the Fed board from 2002 to 2005, and was formerly professor of economics at Princeton University. Dr. Bernanke is an expert on monetary policy. He is a longtime advocate of "inflation targeting," opposing both price inflation and deflation.

Inflation targeting is the idea that the Federal Reserve should be charged with and held accountable for keeping inflation within some specified low range, for example, 1% to 1.5% annually. If inflation exceeds that rate, monetary policy would be tightened. If inflation falls to zero or less (deflation), policy would be eased.

It is important that the Fed leadership focus primarily on maintaining a sound currency. Inflation is anti-growth, and depresses investment, productivity, wages, and employment. Inflation increases the taxation of income from capital. Capital consumption allowances (depreciation allowances) are strung out over many years and are not adjusted for inflation. When prices rise, the cost of capital is understated in real terms, business taxable income is overstated, and effective tax rates rise. Investment falters, dragging down employment and wages.

Inflation, particularly at a variable and unpredictable rate, also creates uncertainty and risk, reducing the incentive to invest. It reduces the usefulness of the currency as a stable store of value and medium of exchange. In the case of the dollar, it would reduce the use of the currency in world trade, depriving the United States of the considerable advantages of creating the world's money and reducing the market for U.S. securities (in addition to raising interest rates on U.S. government debt).

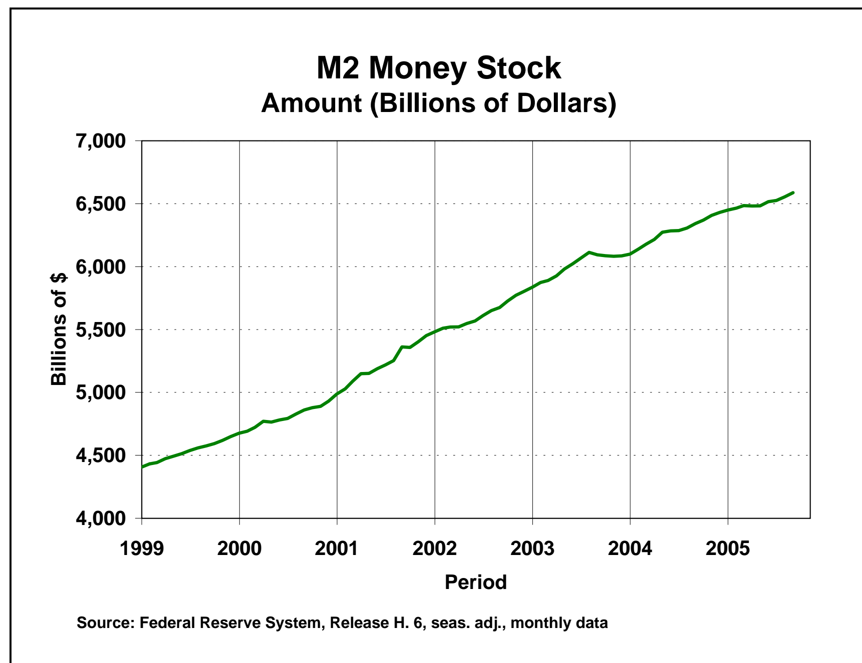
This view of the real anti-growth effects of inflation is contrary to the old "Phillips curve" view, which held that a little inflation could boost employment by tricking workers into accepting a lower real wage. Of course, the workers soon catch on, and they demand wages that keep up with prices. The presumed employment gains are wiped out, and are in fact offset by the damage done to investment and the demand for labor.

While price stability should indeed be the principal goal of the Central Bank, it must be noted that hitting an inflation target is necessarily a somewhat long-term objective. Some flexibility is called for. Inflation numbers vary monthly. The core rate of inflation might be a better measure than more volatile alternatives. It may be several months before a trend in inflation becomes clear. The policy instruments that the Fed has at its disposal to curb inflation or offset deflation take time to work, and the economy responds to the available policy instruments in different degrees in different circumstances. Consequently, it is inherently difficult to know in the present what policy is needed to keep inflation tame in the future.

There are several market signals that the Federal Reserve can watch to gain insight into where inflation may be heading. The current inflation rate is one sign, but it is the result of past Fed actions as well as recent economic factors.

Commodity prices, particularly as displayed in the futures markets, can be an early warning sign of general price swings. However, they can also be affected by technological changes and demand swings related to real growth. Commodity prices have generally risen less rapidly than finished goods prices over the last two decades (recent energy price spikes notwithstanding). Also, specific commodity prices may move relative to prices of other commodities and finished goods. Therefore, although commodity prices can provide signals to the Fed that it needs to tighten or ease, these signals must be read in context.

Forward exchange rates of the dollar versus other currencies can also give a signal as to whether the supply of dollars is in line with the demand for the dollar. A dollar that is falling or rising against other currencies is usually associated, over time, with inflation that is higher or lower than abroad. However, if other currencies are inflating or deflating, matching their movements will not give long-term price stability. Again, the indicators can give the Fed important guidance, but must be used with caution.



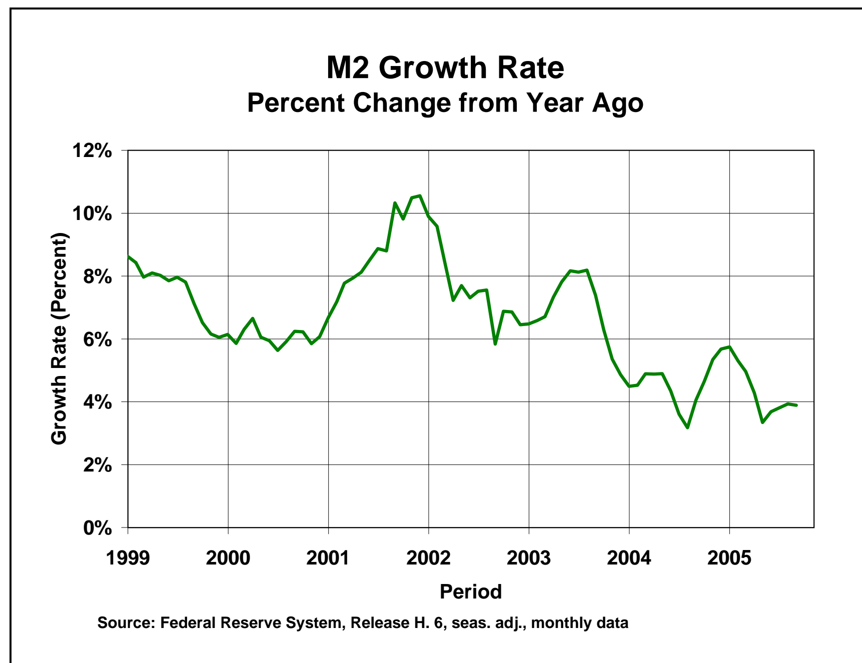
Long-term interest rates and the term structure of rates (differences in interest rates on short, medium, and long term securities) are other indicators. Rising long term rates can be a signal that the public is expecting higher inflation down the road. However, they can also be a signal that new technologies or lower tax rates on investment have raised the returns to physical capital, which are then reflected in returns on financial instruments. The higher interest rates are then a means of attracting additional funds for a more rapid pace of investment, which may boost capacity and reduce prices in the affected industries.

The Fed has on occasion tried to discern inflation pressures by looking at the growth rate of real output (GDP), assuming that too fast a rate of growth would press on capacity. That assumes the Fed knows what capacity is, and that excessive money growth is the cause of the real growth and the price pressures. That is an outmoded view. Growth per se is not inflationary. Just as a bumper crop of wheat lowers the price of wheat, a pick-up in output relative to past trends may reduce prices if the added output is associated with additions to capacity, resources, productivity gains, and new efficiencies. Lower unemployment is not a sign of price pressure if higher productivity or lower tax rates on labor make additional hiring economical and additional labor force participation more rewarding. There is no fixed rate of "non-accelerating inflation rate of unemployment" (NAIRU). Inflation should be a concern, and monetary stimulation should be considered excessive, only if the real growth is accompanied by other indicators suggesting a broad increase in prices. Again, the signals must be read in context.

An added complication is that trying to stabilize price swings in the short-term with frequent changes in monetary policy is impossible because of how monetary policy acts on the economy. Monetary policy does not act directly on the price level. Monetary policy works through its influence on the rate of growth of the monetary base (bank reserves and currency), which affects the money supply, which

in turn affects the price level. The Fed's immediate policy instrument is the short-term Federal funds rate, which may rise or fall as it conducts its open market operations (sales or purchase of Treasury securities) that restrict or expand the monetary base. Changes in the discount rate also affect the willingness of banks to borrow additional reserves directly from the Fed. How much reserve growth and money supply expansion are associated with any given federal funds rate depends on the economic situation.

The supply of money is not the only factor in determining the price level or rate of inflation. How much money growth is non-inflationary depends also on the rate of growth of demand for money. Money demand, including the demand for dollars here and abroad, is affected by the rate of growth of real output, the rate of return on competing assets, the fear or lack of fear of inflation, and by technology and financial innovation.



Monetary policy only acts with a lag. The money supply rises after changes in the monetary base, and the effects are felt on the general price level and real output anywhere from about nine months to two years later. Exchange rates, commodity prices, and long term interest rates may react more rapidly, especially in the forward markets. Because of these lags, the Fed must be cautious how far it pushes its policy changes, waiting to see what each bit of change will do before proceeding further. If it continues a policy shift until it sees the effect on the general price level, it will usually overshoot, risking boom or crash, inflation or deflation, instead of a "soft landing". For all these reasons, monetary policy must not twist and turn with each change in the price index, but aim for broadly measured price stability over time.

This brings us to recent and current monetary policy. The Fed created an abnormal surge in reserves in 1999, fearing a banking crisis related to the Y2K computer problem, which never materialized. The Fed then took back the excess reserve growth in 2000 to avert an inflation blip, but overshot the mark, contributing to the 2000-2001 recession. The Federal Reserve then created a bulge in the growth rate of bank reserves in 2001 to fight the recession and sluggish recovery. The resulting bulge in money growth has been part of the reason for the increase in the rate of inflation over the past few quarters, from a range of about 1% to 2% to nearly 4%. (Some of the rise is obviously due to the energy supply disruptions from the hurricanes, and will be reversed as supplies come back on line.)

The Fed has since been slowing the rate at which it has added to bank reserves. Money growth was already slowing before the Fed began raising short-term interest rates last year. Money growth rates stepped down in 2002, though they were still high by historical standards. They rose a bit in 2003. The Fed began a series of 0.25% increases in the federal funds rate in June 2004, guiding itself to a further gradual slowing of the rate of growth of the monetary aggregates, which stepped down again in 2004-2005. The 2004 slowing of money growth is probably just

beginning to be felt today. The effects of the further tightening done this year will not be felt and will not be known until mid-2006.

Two key questions are: Have the Fed's recent actions been enough to slow the growth rate of money to a path consistent with stable prices over the long-term, or does it need to do more? Should the Fed pause in its push for slower money growth, waiting to see what the tightening done to date will do? If inflation still remains too high going forward, further tightening could be undertaken.

The alternative is to take a few more steps now to slow money growth further in the months ahead. Money growth this year may still have been a bit above the growth rates consistent with near-zero inflation the mid-1990s. Further tightening of reserves this fall may be needed to bring money growth and inflation down in 2006 and 2007. However, this runs a risk of overshooting and slowing the real economy, as in 2001. In our view, the Fed should pause here, or very soon, and await further developments.

The Fed has sometimes viewed short-term interest rates as the actual policy target, rather than a means to an end (and some Fed officials may still think that way). The short rates are often described as "stimulative", "neutral", or "restrictive" if they are low, medium, or high relative to long-term rates, or to historical norms, or to the growth of real GDP, or whatever other indicator they have chosen to guide policy. Doing so may confuse restraint with stimulus by failing to note the role of inflation, or the rate of return on investment in plant and equipment, to great ill effect.

For example, high interest rates may be a sign of too much money creation in previous quarters, rather than too little current money growth, if the past money growth has raised inflation and interest rates. If, in those circumstances, the Fed were to speed money creation to drive the short rates down, it would in all likelihood raise future inflation, and drive long rates up in anticipation. At the opposite extreme, in the Great Depression, short-term interest rates were nearly zero, and the Fed thought it was being easy. In fact, it was being horrendously tight, with the money supply and prices falling at more than 10% a year, meaning that real interest rates were in double digits.

Descriptions in the media of Fed manipulation of interest rates to manage the economy are a throwback to less enlightened times. We look askance at predictions that "the Fed will raise the federal funds target a quarter percent for two more months, until it is 4.5%, which will be neutral, that is, neither stimulative nor restrictive." The Fed may do so if it is thinking in terms of "neutral vs. stimulative" rates, but it would be better advised to do so only if it thinks slower reserve growth is needed to keep money growth and inflation in check. As mentioned above, the Fed should not be targeting the growth of real output, since growth per se should not be viewed as inflationary.

In monetary policy, it is best to move slowly and to keep one's eye on the long-term objective of price stability. Ben Bernanke's instincts in that regard are entirely sound.

Stephen J. Entin
President and Executive Director

Note: Nothing here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before the Congress.