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The Road to Price Stability

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The Road to Price Stability

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Abstract

Nearly a quarter-century after Paul Volcker's declaration of war on inflation on October 6, 1979, Alan Greenspan declared that the goal had been achieved. Drawing on the extensive historical record, I examine the views of Chairmen Volcker and Greenspan on some aspects of the evolving monetary policy debate and explore some of the distinguishing characteristics of the disinflation.

KEYWORDS: Price stability, monetary policy, Paul Volcker, Alan Greenspan.

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Nearly a quarter-century after Paul Volcker's declaration of war on inflation on October 6, 1979, Alan Greenspan, his successor at the helm of the Federal Reserve, declared that the goal had been achieved: "Our goal of price stability was achieved by most analysts' definition by mid-2003. Unstinting and largely preemptive efforts over two decades had finally paid off." (2004, p. 35.)

The policies of the Federal Open Market Committee (FOMC) under the leadership of Chairmen Volcker and Greenspan not only successfully reestablished an environment of price stability but also contributed to a remarkable period of economic stability and prosperity. Following an initial phase of dislocation and rapid disinflation, inflation stabilized—first near four percent and, over the past dozen or so years, closer to two percent—as measured by the core CPI and PCE indexes (Figure 1).[1] Also, the volatility of economic activity declined markedly and over the past decade productivity accelerated.

It is too early to separate the role of monetary policy from other factors that may have contributed to this incredible overall improvement of the macroeconomic fortunes of the United States during the Volcker-Greenspan era. However, the policies leading to the restoration of price stability undoubtedly had a significant, positive role, a conclusion as inescapable as recognition of the deleterious effect of policy on macroeconomic performance during the Great Inflation that preceded the disinflation.

Exploring distinguishing characteristics of the policy strategy pursued by the Volcker-Greenspan-led FOMC helps put the disinflation experience in historical perspective. The extensive historical record—including the transcripts of FOMC meetings, speeches and congressional testimony—offers a clear picture of the views of Chairmen Volcker and Greenspan on numerous aspects of the evolving monetary policy debate. Drawing on this record, I examine selected issues that, in my view, are particularly important for comparing and contrasting the policies of the Committee

[1]Inflation indexes in Figures 1 and 2 reflect inflation over four-quarters, in percent, with data available in January 2006.

under their watch to alternative policy approaches. A caveat is that members of the FOMC hold diverse views, and consequently the views of the Chairman do not necessarily reflect the consensus of the Committee. Nonetheless, subject to this limitation, tracing the expressed views of the Chairman and their possible policy implications is informative.

I. The Primacy of Price Stability

The Federal Reserve Act (as amended in 1977) directs the Federal Reserve to pursue policies promoting "maximum employment, stable prices, and moderate long-term interest rates." Federal Reserve policymakers have operated in a manner consistent with these or similarly worded objectives for many decades (see Orphanides, 2003, for earlier statements and interpretations of objectives). The operational meaning of these objectives has evolved over time, partly because of evolving perceptions regarding how short- or long-run tradeoffs might complicate efforts to attain them simultaneously.

One of the most significant improvements in monetary policy since 1979 can be identified with the reaffirmation of the unique role of price stability as an operational objective for monetary policy. Chairman Volcker's beliefs and their significance for understanding the policy reform of October 1979 are reviewed in David Lindsey et al (2005). Along similar lines, Chairman Greenspan repeatedly expressed the view that price stability is a prerequisite for attaining maximum sustainable growth in the economy, pointing to its primacy as a monetary policy objective. Indeed, on October 19, 1989, during congressional hearings regarding the zero-inflation resolution, Chairman Greenspan expressed his support for clarification of the Federal Reserve's objectives along these lines:

> "The Zero-Inflation Resolution represents a constructive effort to provide congressional guidance to the Federal Reserve. . . . Legislative direction

> as to the appropriate goals for macroeconomic policy in general and monetary policy in particular have been provided before. Unfortunately, the instructions have defined multiple objectives for policy, which have not always been entirely consistent–at least over the near term.
>
> The current resolution is laudable, in part because it directs monetary policy toward a single goal, price stability, that monetary policy is uniquely suited to pursue. . . . [O]ver the long run, price stability is a precondition to the economy turning in its best possible performance. It is for this reason that the Federal Reserve remains determined to reach this goal."

Chairman Greenspan's views go beyond the traditional theoretical arguments of superneutrality, which profess that the economy's maximum sustainable growth is invariant to inflation. Rather, he points to price stability as a precondition for attaining maximum growth. Thus, as he articulated on May 24, 2001, "a central bank's vigilance against inflation is more than a monetary policy cliche, it is, of course, the way we fulfill our ultimate mandate to promote maximum sustainable growth."

II. Defining Price Stability

Despite its central role as a guiding principle during the Volcker-Greenspan era, neither Chairman proposed an explicit quantitative definition of price stability. To the contrary, Chairman Greenspan stressed that available indexes are insufficiently precise for this purpose: "By price stability, however, I do not refer to a single number as measured by a particular price index. In fact, it has become increasingly difficult to pin down the notion of what constitutes a stable general price level. . . . [A] specific numerical inflation target would represent an unhelpful and false precision." Instead, he suggested a qualitative metric: "Rather, price stability is best thought of as an environment in which inflation is so low and stable over time that it does not materially enter into the decisions of households and firms" (2002, p. 6).

The limitations of measuring the general price level with any one specific index can be highlighted by examining the differences in alternative inflation measures (Fig-

ure 2). Especially near price stability, reliance on any specific measure for guidance could be problematic. The difficulty of selecting just one imperfect measure, among many plausible alternatives, may also explain why the FOMC has multiple times switched the index employed to communicate its inflation outlook (Figure 3-A).

By espousing a qualitative definition, Chairman Greenspan also reaffirmed continuity with Chairman Volcker, who remarked:

> "A workable definition of reasonable 'price stability' would seem to me to be a situation in which expectations of generally rising (or falling) prices over a considerable period are not a pervasive influence on economic and financial behavior. Stated more positively, 'stability' would imply that decision-making should be able to proceed on the basis that 'real' and 'nominal' values are substantially the same over the planning horizon–and that planning horizons should be suitably long." (December 28, 1983.)

III. Policy Implementation

Chairmen Volcker and Greenspan identified inflation expectations and their stability as critical not only for defining price stability but, more broadly, as a crucial input for guiding monetary policy and gauging its success. Close monitoring of the evolution of inflation expectations has been a critical aspect of policy throughout the Volcker-Greenspan era. Reflecting on the policy reform of 1979, Chairman Volcker recently reiterated the high costs of failing to keep expectations well contained: "I have one lesson indelible in my brain: don't let inflation get ingrained. Once that happens, there's too much agony in stopping the momentum." (Letter to William Poole, May 26, 2004.)

Both Chairmen also identified the value of preempting destabilizing forces, when possible. However, they often questioned the reliability of forecasts that are necessary for implementing preemptive policy and expressed doubts about the utility of econometric models for policy advice.

In light of their prevalence in theoretical discussions of the policy process, particularly notable has been Chairman Greenspan's rejection of the operational usefulness of various natural rate concepts and associated gaps as policy guides (e.g. the output gap, the unemployment gap and the interest-rate gap). Responding to a question regarding "the so-called 'natural rate' of unemployment" on June 22, 1994, Chairman Greenspan pointed out that "[w]hile the idea of a national 'threshold' at which short-term inflation rises or falls is statistically appealing, it is very difficult in practice to arrive at useful estimates that would identify such a natural rate." He concluded: "In light of these uncertainties, I do not think that any one estimate of the natural rate is useful in the formulation of monetary policy."

Similarly, responding to questions regarding the "neutral" rate of interest, he replied: "Although the concept of a 'neutral interest rate' is a useful theoretical construct, difficulties in implementing it in practice limit its usefulness as a framework for monetary policymaking. For one thing, a variety of definitions of a neutral real interest rate are possible. For another, quantitative estimates of the level of such a rate are subject to considerable uncertainty." (Letter to Rep. Jim Saxton, November 28, 2005.)

Since theoretical formulations of the monetary policy problem typically abstract from the multitude of uncertainties surrounding concepts and measures employed to profess policy advice, it is unsurprising that the Volcker-Greenspan era has not been straightforward to characterize in terms of simple models. Typical optimal control exercises based on simple models, for instance, may suggest that policy decisions should be guided by balancing output gaps and inflation gaps over some forecast horizon, or, alternatively, by Taylor rules responding to such gaps. Such strategies, however, are antithetical to a framework that properly acknowledges the limitations of policymakers' knowledge and, as such, inconsistent with the views of the two Chairmen. Indeed, the outcomes of the 1970s, when monetary policy more closely

matched such policy prescriptions, serve as a reminder of their risks.

An unconventional aspect of the 1979-2003 disinflation was its episodic nature. While incipient increases in inflation were actively resisted throughout the period, the pursuit of persistent economic weakness implied by conventional disinflation approaches was avoided once inflation stabilized near four percent. Further progress toward price stability appears more consistent with the opportunistic approach to disinflation, which may also help explain its modest cost (Orphanides and Wilcox, 2002). Progress could be attributed to the 1990 and 2001 recessions, and, during the 1990s, to the unexpected acceleration in productivity, which kept both inflation and unemployment systematically on the low side of FOMC projections (Figure 3).

IV. Concluding Remarks

The remarkable quarter-century-long journey to price stability defies characterization in terms of the simple models typically employed for theoretical treatments of monetary policy. This has been interpreted as evidence of a considerable discretionary element in policy decisions. Nonetheless, the policies of the Volcker-Greenspan-led FOMC reversed the legacy of distortions and instabilities associated with the Great Inflation and avoided repeating the policy errors that led to it. Ultimately, monetary policy in the Volcker-Greenspan era has been remarkably systematic, and it succeeded by focusing on "maximizing the probabilities of achieving our goals of price stability and the maximum sustainable economic growth that we associate with it." (Greenspan, 2004, p. 37)

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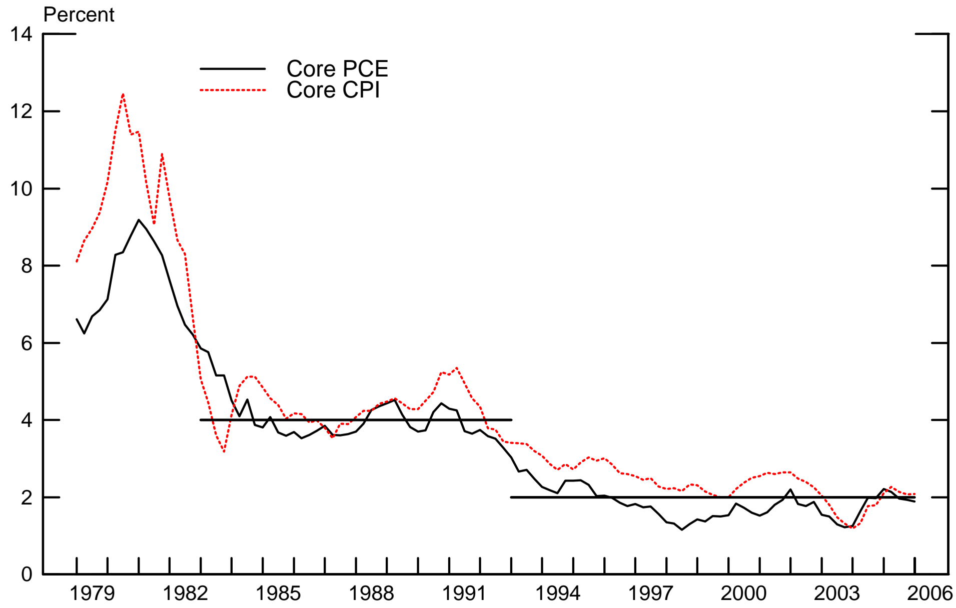


FIGURE 1: INFLATION SINCE 1979.

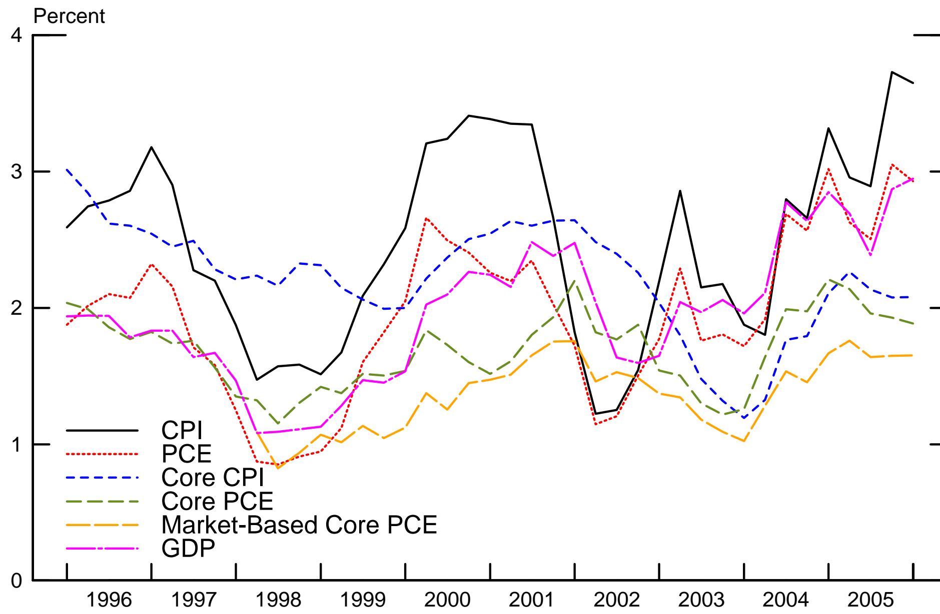
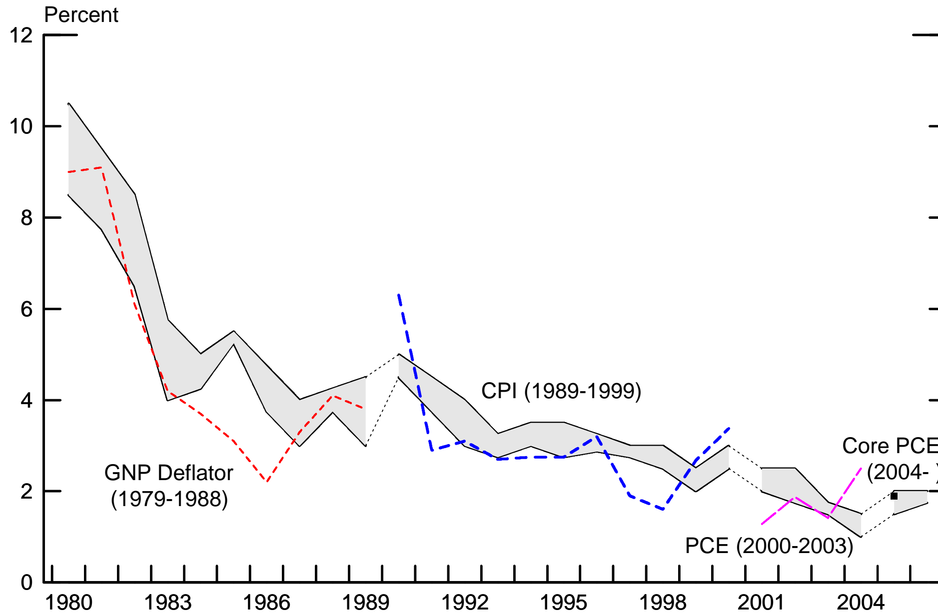


FIGURE 2: ALTERNATIVE MEASURES OF INFLATION.

A. Central Tendency of Inflation Projections and Outcomes



B. Central Tendency of Unemployment Projections and Outcomes

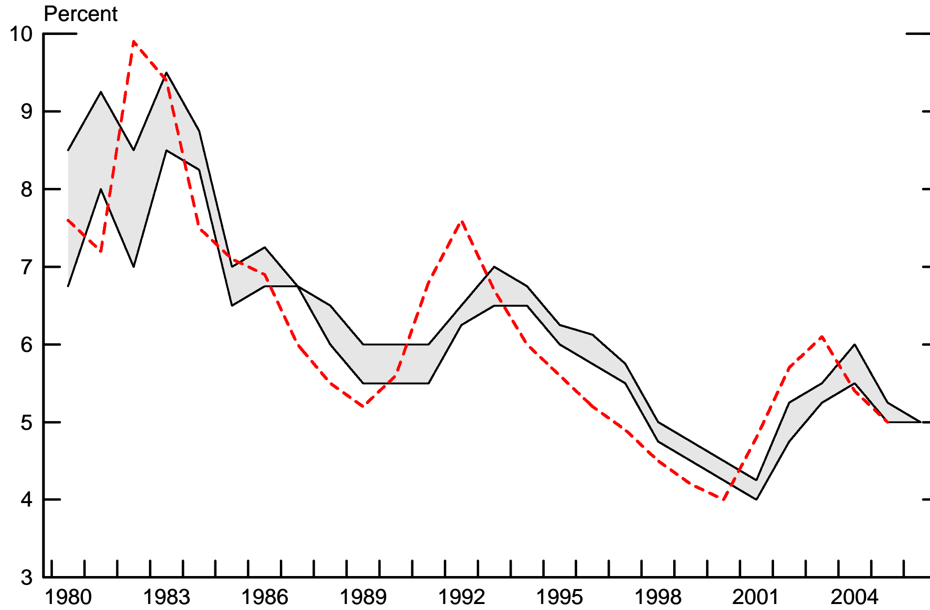


Figure 3: FOMC Projections and Subsequent Outcomes.

Notes: The central tendency of projections shown for year t (shaded area) are from the Monetary Policy Report prepared in July of year $t-1$. Unemployment refers to the average level in the fourth quarter of the year and inflation to the four-quarter-average ending in that quarter. Outcomes (dashed lines) are as published at the beginning of year $t+1$.