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MONETARY POLICY AND THE STATE OF THE ECONOMY, PART I

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BEFORE THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

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MONETARY POLICY AND THE STATE OF THE ECONOMY, PART I

Tuesday, July 17, 2007

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The committee met, pursuant to notice, at 10 a.m., in room 2128, Rayburn House Office Building, Hon. Barney Frank [chairman of the committee] presiding.

Present: Representatives Frank, Waters, Maloney, Watt, Scott, Green, Cleaver, Ellison, Klein, Wilson, Perlmutter; Castle, Paul, Manzullo, Garrett, Neugebauer, Bachmann, and Marchant.

The CHAIRMAN. The hearing will come to order. As we made clear, we have a statutory requirement under the Humphrey-Hawkins Act for the Chairman of the Federal Reserve to come twice a year to each of the relevant committees in the House and the Senate to make a report. That has previously been considered to be a unique, if not sacred occasion, in which the Chairman is invited to pronounce with due deference on the part of the listeners. We intend to continue to be polite and receptive to what the Chairman has to say, but we have decided in the current Congress that we are going to make clear that there are other views that are relevant, and that the responsibility the Federal Reserve has under the Humphrey-Hawkins Act is one that is important enough to get a range of comments on the issue, so that is what we are going to be doing today.

The ranking member of the subcommittee—although this is a full committee hearing—has also been one of those who over the years has argued that it is legitimate to have full and vigorous debate over whether what the Federal Reserve does is right or wrong. And so we look forward to today, leading to a very serious discussion tomorrow.

We are seeing a change to some extent in the economics profession that the New York Times talks about. I'm glad we have three very distinguished economists here today, none of whom have ever felt constrained by academic convention. And I think that affects one of the key issues that the Federal Reserve is dealing with. There has been a lot of conversation about inflation targeting, about the theory that the Federal Reserve, in pursuit of its obligations under the Humphrey-Hawkins Act, should focus on a maximum inflation amount and very explicitly conduct its policy with the goal of keeping inflation under that number.

The Federal Reserve, of course, under the Humphrey-Hawkins Act has a dual mandate—to restrain inflation, but also to promote

full employment. Many of us are concerned about that approach because we believe it would lead to an undervaluing of the employment issue. The Chairman believes, and he will talk more about this, that he can in fact serve both goals by the way in which he is approaching the inflation issue, and we will hear a lot about the anchoring of inflation expectations as the philosophy that the Federal Reserve is increasingly adopting, both the Chairman and Governor Mishkin in particular have spoken about this.

What I want to talk about, though, is the real economic situation we find ourselves in today, which I think has an impact on this inflation unemployment incipient rivalry, which is what's there, whether people acknowledge it or not, at least in the emphasis, and here's the issue that I'm really sort of trying out in my own head, and I will talk some today and a little bit more tomorrow, and the issue is this:

What we have in the Federal Reserve is the argument that, from the standpoint of overall economic progress, it is important implicitly to focus on inflation and that if you can keep inflation low and keep inflation expectations anchored at a fairly low level, that will allow them to conduct monetary policy in a way that will promote the fullest possible employment in any given set of circumstances. And it's an emphasis that says from the overall economic standpoint, inflation is really the key driver. Some deference is paid to employment, but it does seem to me that the emphasis goes the other way.

But we have, I think, a new recognition. We had a hearing on it last week. The New York Times has written about it a couple of times, and it's this: We're at a situation in America today where the distribution of wealth that is generated has become a very significant economic issue. And implicitly, the view that I've been discussing downgrades that. It asserts essentially that the focus has to be on the overall rate of growth in the country. And the assumption is that if you keep inflation down, you can promote an appropriate rate of growth and therefore all will benefit.

Increasingly, it is clear as we look at the events of the past couple of decades, especially the past 6 years, the increasing concentration of wealth in the country has now become a significant issue. A couple of weeks ago, the immigration bill blew up very noisily in the Senate. Of somewhat equal significance from this perspective, trade promotion expansion died without either a bang or even a whimper. It just died. People didn't even notice.

I say that because there are many who argue for increased integration of the United States into the global economy, taking full advantage of technology and trade as wealth generators, who were very regretful of that, and they have been talking about, "How do we resuscitate the immigration bill? How do we get back trade promotion authority?"

I think it's very clear. The problems that led to the demise of both of those are extrinsic to both issues. You are not going to solve either the immigration issue for those who want, as I do, an immigration bill along the general lines that went down, or get back into the trade business simply by changing the terms of those two policies. There is a deep unhappiness within the American electorate over the maldistribution of income.

The recent report put out by the Financial Services Forum—which is headed by Don Evans, a close friend of the President, and the first Secretary of Commerce in this Administration—a three-member panel which consists of: Matthew Slaughter, an immediate past member of the Council of Economic Advisors, whom Mr. Bernanke says he selected for that job; Grant Aldonis, who is a high-ranking Commerce Department official with trade responsibilities in this Administration; and Robert Lawrence of Harvard. What they put out is a report which documents the extraordinary maldistribution of income recently.

The fact under their—the most striking chart was the one that shows, since 2000 I believe was the period they picked, if you look at segments of the economy, real income rose for 3.8 percent of the economy, of the people, and was either stagnant or eroded for 96.2 percent. The political effects of that are serious. Professor Friedman has written about inequality and the impact of it.

And we are now seeing, in very vigorous form, that the connection between the two is this: If we do not address this problem of the excessive inequality—obviously, inequality is essential to a capitalist system. No one's trying to get rid of it, at least no one rational. But it can reach a point where it becomes clearly politically distorting, and it may also become economically distorting in terms of consumption, in terms of the savings rate.

But if we are not able to alleviate the understandable anger that Americans feel at the real maldistribution of income and the fact that as wealth has increased, they get little of it, then people should understand that we will not be making progress in some of these other areas. It makes no sense to tell people that trade and other economic policies will help promote national wealth if the overwhelming majority of citizens don't think that they benefit when the national wealth increases.

And that is why—and that seems to become a constraint on the Federal Reserve. That gets to the tradeoff of inflation and unemployment to the extent that there is one. It does mean that the social and eventually the economic cost of increased unemployment is even greater than it may have been in people's minds. The anger that will be generated if the Federal Reserve were to decide that because of excessive inflation, and that it's slowed down the economy with the resulting increase in unemployment and the obvious further retardation of real wage growth, then the economic consequences and political consequences become worse.

So I think we are in a somewhat new era in this regard in which this—it is no longer sufficient to look at the overall economic performance. Distribution questions have become prime questions for the future of the economy, and they've become more than just distribution questions because they control whether or not the economy can in fact continue to grow in ways that people would find satisfactory.

I now recognize the gentleman from Texas.

Dr. PAUL. Thank you, Mr. Chairman. I appreciate very much you holding these hearings because, like you, I've had an intense interest in monetary policy and think it's very significant.

It's interesting to note that over the years since we've been holding these Humphrey-Hawkins hearings, money supply had been in

the past emphasized to a large degree, and yet recently, it's been deemphasized to the point where in these reports they've barely even referred to money supply. Likewise, a year ago, they even stopped reporting M3, as if it were totally unimportant. But the definition of certain words, I think, is very important. Most people talk about inflation, but almost everybody wants others to think that inflation is measured by prices as recorded in the CPI or the PPI. And yet for others, inflation is merely the increase in the supply of money and credit, it's the excess of credit that is inflated, which leads to higher prices in certain categories.

So often what is neglected today with current understanding of monetary policy is that as long as we can bring about a government statistic that claims that the prices are relatively stable or rising at a lower level than that which would cause worry, then everything is okay. What is ignored is the fact that even if prices are stable as measured by the CPI, you still have other conditions to be concerned about such as malinvestment, excessive debt, and bubble formations.

And indeed, this is the case in recent years where inflation of prices seem to be relatively stable, and yet we still had NASDAQ bubbles developing, housing bubbles develop, and various areas of the economy where prices go up excessively. The one thing characteristic about monetary inflation is that price inflation is not even. It's never even, and it's never fair, and I think this should help explain the concerns that the chairman has regarding the maldistribution of wealth. I'm deeply concerned about that, too, but I see it so often as a monetary phenomenon because the characteristics of a fiat currency, the characteristics of a devaluation of money, mean that the middle class and the poor hurt the most, and there are certain categories that benefit the most, the people who get to use the money first; the politicians, the government, and the military-industrial complex. These individuals benefit. When that money circulates, somebody else gets hit with a high inflation rate.

Quite frankly, if we were measuring the CPI today the way we used to measure the CPI, it's rising at over 10 percent, so it becomes convenient for governments to change their calculation and make it sound like we are controlling prices and everybody is supposed to be satisfied with this.

But what has happened, I believe, over these many years, especially since 1971, is that we have deferred to the central bank to be the central economic planners, that they are in charge of the economy and they can achieve this merely by manipulating interest rates. So there's a large consensus of people and groups that like low interest rates. The stock market likes low interest rates. The banks like low interest rates. Everybody seems to like low interest rates, and people call for low interest rates. Consumers, when they're borrowing money, like low interest rates. But it just happens to injure a lot of other people. Some individuals still believe that saving is worthwhile, and yet the interest that they earn is below market rate, and it hurts them. People on fixed incomes suffer from this.

But this whole notion that a central bank somehow has the wisdom to know what interest rates should be is to me rather bizarre, and also the source of so much mischief that has gone on. If our

goal is to have stable prices to a degree, if you look at monetary history, you will find out that if you have an asset-backed currency, prices will remain pretty stable for 100 or 200 years as long as you have an asset-backed currency.

It's only when there's nothing behind that currency, and banks, the central banks that inflate the currency that you have this radical increase in prices, and all you have to do is study the price increases since 1971, and it's a disastrous record for that.

I believe also the idea that ought to be challenged is the notion that somehow or another if we just increase the money supply, which is the inflation, that we will increase employment, and yet this was virtually disproven and to a degree rejected in the 1970's, because it did eventually lead to stagflation. And today, I believe we are facing the very same conditions. This is the first time in over 30 years that every currency is going down in value in terms of traditional money, which is gold. And in the 1970's, it led to very bad times for us, and I think we should beware of this.

But ultimately, monetary policy is key. Most economists will accept the notion that inflation, when they think of inflation, of course, prices, is a monetary phenomenon. At the same time, they falsely assume that if we can hide the inflation, change the way we record it, don't look at inflation for one group versus another, that we have nothing to worry about. That was virtually the major error they made in the 1920's, believing there was no inflation, no malinvestment; but there was, and there had to be a correction.

So the malinvestment and the misdirected economy and the excessive debt comes from the excessive credit created by the Federal Reserve Bank. Unless we address that and really hold their feet to the fire so that we have more transparency, the fact now that we get less transparency, although they talk about more transparency, means to me that they're trying to hide the ill effects of what's happening with the monetary system.

So once again, I want to thank the chairman for these particular hearings that we're having, the extra effort to try to emphasize the importance of the Federal Reserve. But I will argue strongly that we need more transparency. The Congress needs to assume more responsibility for the very important issue of maintaining the value of the currency. And I yield back.

The CHAIRMAN. The gentlewoman from New York is recognized for 5 minutes.

Mrs. MALONEY. Thank you, Chairman Frank, and I want to welcome our distinguished panel of experts and thank them for testifying today.

These next 2 days of hearings come at an important time, because monetary policy remains at a critical juncture. Risks in the housing market have not yet subsided, and rising mortgage delinquencies on subprime home loans could level a serious blow to the overall economy. Personal bankruptcies will undoubtedly rise as the many families who have fallen prey to these risky mortgages run out of options, and the ability of American consumers to keep spending may be flagging with the cooling housing market.

Last month retail sales experienced the sharpest decline in nearly 2 years, with housing-related sales contributing to the fall. Meanwhile, core inflation has tended to be higher than the Fed is

comfortable with over the long term, which seems to have contributed to the Fed maintaining an anti-inflation tilt.

Dr. Galbraith's testimony challenges the Fed's view that the relatively low unemployment we currently have poses an inflation risk. Even more compelling is the evidence he presents that earnings inequality is, "A direct product of monetary policy choices." How American families are faring should be an important part of the Fed's policymaking decisions, because most workers have not shared in the gains from the economic growth we have seen so far.

Setting the right course for monetary policy is further complicated by our huge budget deficits, our record debt, and international trade imbalances. Our challenge is to return to the legacy of fiscal discipline that President Bush inherited but squandered over the past 6 years. Democrats in Congress have a realistic budget plan that adheres to the PAYGO principles for controlling the deficit and bringing revenues into line with what we need to spend to defend our country and take care of our citizens.

I thank the chairman for holding these hearings, and I look forward to the discussion and the testimony from our distinguished panel.

Thank you. I yield back my time.

The CHAIRMAN. The gentleman from Texas had a unanimous consent request.

Dr. PAUL. Thank you, Mr. Chairman. I'd ask unanimous consent to insert a printed statement into the record.

The CHAIRMAN. Is there any objection?

There being none, it will be put in the record.

And we will now proceed to the witnesses. We appreciate your coming. This is a procedural innovation which we think people will be building on, so we thank you for participating. Professor Friedman, let's begin with you.

STATEMENT OF DR. BENJAMIN M. FRIEDMAN, WILLIAM JOSEPH MAIER PROFESSOR OF ECONOMICS, DEPARTMENT OF ECONOMICS, HARVARD UNIVERSITY

Mr. FRIEDMAN. Thank you, Mr. Chairman. I'm delighted to be here this morning to address this distinguished committee. As you mentioned, I do indeed have views on the role of inequality in our economy today, and I also have views on the issues that Congressman Paul raised in his earlier remarks. The remarks in my prepared statement focus on two issues. The first is the dual mandate and the second is inflation targeting. What I'll do, with your permission, and in the interest of time, is to only present parts of my prepared remarks.

The CHAIRMAN. Without objection, all of the written material that any of the witnesses wish to present will be made part of the record.

Mr. FRIEDMAN. Thank you. I appreciate that. Our country's central bank is unusual today in two respects. First, under the prevailing legislation, Congress has instructed the Federal Reserve to conduct monetary policy so as to promote both maximum employment and stable prices. This dual mandate, as it's often called, stands in contrast to the charge given to many other countries' cen-

tral 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 monetary policy around the pursuit of a specific publicly announced rate of inflation, what's commonly called inflation targeting.

I believe our country 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 harmful for the Federal Reserve to organize its monetary policy within an inflation-targeting rubric. I will address both of these issues.

First, the dual mandate: The purpose of any nation's economic policy is clearly to advance its economic wellbeing, meaning the prosperity of its citizens and the vitality of the institutions through which they participate in economic activity.

Whether working men and women are able to make a living, whether the businesses that they own and at which they work and earn a profit and invest for future growth, and whether the banks and other financial institutions on which they rely can survive, are all fundamental aspects of that wellbeing. Individual citizens are, and they have a right to be, concerned with many facets of the economic environment in which they live; their incomes, their employment prospects, their ability to start a business, or to borrow to purchase a new home, just to name a few.

Experience shows that rising prices, or for that matter, 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. We value it not for itself but for how it enhances the economy's capacity to achieve those goals that, even if they are not genuinely primary from the perspective of basic human concerns, at least instrumental on a higher level.

The idea that economic policy should pursue price stability as a means of promoting more fundamental economic wellbeing, either currently or in the future, is not grounds for pursuing price stability at the expense, much less to the exclusion, of that more fundamental wellbeing.

I go on, in my prepared remarks, to contemplate an imaginary situation in which the economy is in deep depression, banks are failing, corporations are in bankruptcy, home mortgage foreclosures are accelerating, and then to imagine that the Chairman of the Board of Governors of the Federal Reserve System were to appear at the equivalent of tomorrow morning's hearing and greet you, ladies and gentlemen, by saying, "I'm pleased to report that during the past year, U.S. monetary policy has been outstandingly successful. Overall inflation has again been just 1 percent, and prices other than for food and energy have risen by .9 percent. My colleagues are here to accept your congratulations."

Now, such a situation is of course unthinkable. But the relevant question for this committee is what makes it unthinkable. The Federal Reserve System is a part of our Federal Government, to which the Congress has—importantly, 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.

I turn now to inflation targeting.

The CHAIRMAN. I'm going to—we'll do 7 minutes for each of the witnesses, so, please keep going.

Mr. FRIEDMAN. Thank you, Mr. Chairman. Advocates of inflation targeting, both within central banks and elsewhere, frequently ground the argument in favor of this way of conducting monetary policy on considerations of transparency, which Mr. Paul mentioned in his remarks, though in a very different way, 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, makes clear what policymakers are trying to achieve. When the objective is low and stable inflation, transparency also helps to anchor the public's expectations. Furthermore, accountability of policymakers for the efficacy of their actions is plainly part of what constitutes effective democracy.

I believe, however, that under circumstances like those under which our Federal Reserve System operates, the argument for the transparency of inflation targeting fails, and with it the argument for the resulting greater accountability. Describing the intended trajectory of monetary policy in terms of inflation alone need not imply that policymakers have no objectives apart from inflation, but nor does it preclude their having such a single goal for monetary policy. The essential question is whether policymakers have objectives for output and employment or not. If they do, then inflation targeting is more likely to undermine the transparency of their policy than to promote it. The chief reason is that under inflation targeting, policymakers reveal to the public only one aspect of their multiple objectives. They have a numerically specific and publicly announced target for inflation, but not for the real component.

Indeed, many inflation targeting central banks—and I give some examples in my prepared remarks—appear to go to some effort not to reveal targets that they have, or even objectives that they have, for the real aspects of the economy. In light of the favorable effect on short-run output—inflation tradeoffs that some people argue 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 outcomes is of course clear enough. But their doing so hardly contributes to the transparency of their policy, nor does it contribute to making their policy accountable.

Indeed, one interpretation of the movement toward inflation targeting among so many of the world's central banks, 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 18th century Scottish philosopher and economist David Hume, writing about the central political issue in the Britain of his day, which was monarchy

versus republic, observed that, and here I quote Dr. Hume, "The Tories"—that is, the pro-monarchy party—"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 a numerical target for only the inflation objective, when in fact policymakers are charged by the Congress to have objectives for inflation as well as for output and employment, biases the relative importance that policymakers 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 specified in the Congress's instruction to the Federal Reserve, would simply devolve into a rhetorical fiction.

The United States is today 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. Thank you, Mr. Chairman.

[The prepared statement of Dr. Friedman can be found on page 41 of the appendix.]

The CHAIRMAN. Thank you, Mr. Friedman.

Mr. Galbraith.

STATEMENT OF DR. JAMES K. GALBRAITH, LLOYD M. BENTSEN, JURISDICTION CHAIR IN GOVERNMENT/BUSINESS RELATIONS, LYNDON B. JOHNSON SCHOOL OF PUBLIC AFFAIRS, THE UNIVERSITY OF TEXAS AT AUSTIN

Mr. GALBRAITH. Thank you, Mr. Chairman, Congressman Paul, and members of the committee. It is a particular honor for me to be here today, as someone who worked for this committee from 1976 until the early 1980's, and who helped—with Congressman Hawkins, and under the leadership of Chairman Reuss—to draft what became the Full Employment and Balanced Growth Act, under which these hearings are being held, and who worked on these hearings for the first 5 or 6 years of their existence. So I am delighted and honored and very privileged to be back.

As this 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.

Like Professor Friedman, I strongly subscribe to the wisdom that Congress showed in specifying multiple goals for our Nation's Central Bank. The question I would like to address today is, has the Federal Reserve particularly over the last several decades, observed that mandate?

I would like to make a number of closely related points, some of them about the condition of the economy and some of them about the actual conduct of monetary policy.

It is widely believed in the economics profession that the dual mandate is inconsistent: that low unemployment and particularly

full employment is, per se, an inflation risk. If you read, for example, "The Wall Street Journal" of just this past June 21st, you find the headline, "Fed policy makers are likely to continue to highlight risks that low unemployment could push inflation higher when they meet next week."

The study that I and my co-authors have done, and that we present to this committee, contradicts the connection between inflation and unemployment for the period after 1983. And especially the natural rate or NAIRU hypothesis that was first formulated back in 1968, and which has been accepted as a matter of faith by a great many economists ever since.

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 simply no evidence that violating this supposed threshold produces rising inflation.

A perfect example of that came in the late 1990's when those thresholds were violated persistently for a period of 3 years or more with sustained full employment. Contrary to the fears of many, inflation simply did not rise. It was a very good time and a lesson in the wisdom of the Congress in having specified that both full employment and reasonable price stability could and should be policy goals.

A second point that is often made is that inequality lies outside the scope of monetary policy. In testimony before this committee in 1997, Chairman Greenspan said he was uncomfortable with inequality but, "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."

Chairman Bernanke holds a similar view. He gave a speech recently in Omaha where he discussed inequality with concern, but didn't mention the role of monetary policy.

This belief is incorrect. We find that inequality—specifically in pay or earnings, that is to say the inequality in the labor market, experienced by working people—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. What we show is that it is also in part a direct product of monetary policy choices.

I should say, having said that in the good period that I just referred to in the late 1990's, inequality of this type declined. And so I believe the Federal Reserve's relatively permissive monetary policy in that period should get some of the credit.

Let me turn to the conduct of monetary policy. It is, of course, widely believed and often stated that monetary policy in recent years has been aimed at fighting inflation. And for an earlier period, 1969 to 1983, there is some evidence of that. But that evidence has as a statistical matter largely disappeared in the period since.

Part of the reason may be that since 1983, the economy has transmitted very few clear signals of high or even rising inflation to the Federal Reserve. And with no inflation, logically there can be no reaction to inflation. But this raises two questions. Why did inflation so largely disappear? And why did the Federal Reserve

undertake numerous periods of tighter policy in spite of the absence of rising inflation?

Now there is an argument that the Federal Reserve was engaged in the management of inflation expectations, but I would suggest that there is very little direct evidence of what those expectations are. And it is a very nebulous kind of argument.

Our belief on the contrary is that the economy really did change in the early 1980's as a result of the high dollar de-industrialization and, frankly, globalization. And that inflation was permanently or for the long term reduced as a result of the changed position of the United States in the world economy. Since then, fighting inflation has been a relatively easy task because there has been virtually no inflation and certainly no wage inflation to combat.

The second claim is that the Federal Reserve does respect the dual mandate. But we find that over the period from 1984 through 2006, the Federal Reserve has not in practice generally accepted the strictures of the Full Employment Act. Instead, it has behaved as if it believed that unemployment rates below a range between 5 and 6 percent are dangerous in and of themselves. It has behaved as if it believed that low unemployment poses high risks of inflation, although the evidence that I have just mentioned refutes that view. It is perhaps not surprising since, as I said before, a large number of economists hold this belief, but it is contrary to the evidence. 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 the mandate of the Congress.

A final point about monetary policy—and here I tread on somewhat delicate territory—has to do with the question of whether the Federal Reserve has stood entirely apart from politics over this period.

The Federal Reserve has a reputation of being an apolitical agency. Still scholars have raised the question: Does there exist a presidential election cycle in monetary policy? And we thought it reasonable to examine that possibility. We find, and in the paper which the committee was presented, rather strong evidence that such a cycle has existed.

We find that in the year before presidential elections, the term structure of interest rates, a measure of monetary stance, deviates sharply from what was otherwise normal. Moreover, the direction of variation depends on who is on power. The Federal Reserve has had a tendency to ease in election cycles when Republican Administrations are in office, and a tendency to tighten in election cycles when Democratic Administrations are in office.

These are historical findings that 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 elections.

I would like very briefly to second what Professor Friedman just said about an inflation target. 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. And if the latter, you run the risk of compounding supply shocks with demand shocks adding interest rate insult to oil price injury.

These are technical issues with no easy answers. And that suggests that in some situations, constructive ambiguity may be preferable to complete clarity. This is something that, of course, Chairman Greenspan was famous for knowing.

And, if I am right, finally, that inflation was in fact killed by the opening of the economy in the early 1980's, then setting an inflation target is a little bit like putting up a cross over the grave. It is 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 1970's died out in the 1980's does not mean that we face no inflation risks. Inflation accompanies war. The Iraq War had some inflationary impact mainly through its affect on the price of oil. Inflation may also recur if the international monetary system enters a crisis causing a further fall in the value of the dollar. That is the risk of any unipolar currency system. It's a great privilege to issue the world's reserve currency but only so long as it lasts. These are issues for the future. They are issues, however, that the Federal Reserve will not be able to handle on its own. They require a broader perspective than one that would simply be served by an inflation target.

Mr. Chairman, in conclusion, my research has pointed to several somewhat disturbing patterns in the actual conduct of monetary policy over the past quarter century. We have, in particular, the evidence 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.

On these and other matters, I believe Chairman Bernanke should be asked to provide assurances that these patterns will not be repeated. He should be asked, I think, to reexamine any models which tie predicted inflation to the unemployment rate and to report in detail on that review and to examine in particular the evidence that the world did change as much as 25 years ago, breaking previous linkages between inflation and unemployment.

He should be asked to reexamine the view that the Federal Reserve does not have any effect on inequality and he should be asked, of course, to assure Congress that interest rates will not be cut or raised solely in anticipation of an election.

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

[The prepared statement of Dr. Galbraith can be found on page 52 of the appendix.]

The CHAIRMAN. And now, Professor Meltzer.

STATEMENT OF DR. ALLAN H. MELTZER, THE ALLAN H. MELTZER UNIVERSITY PROFESSOR OF POLITICAL ECONOMY, TEPPER SCHOOL OF BUSINESS, CARNEGIE MELLON UNIVERSITY

Mr. MELTZER. Thank you, Mr. Chairman.

I am going to start by responding to the comments that you, Congressman Paul and Congresswoman Maloney, made at the beginning. It is a pleasure to be here again, yet again, before this committee.

I would like to say on the issue of distribution, one may think that the issue of distribution is very important or think that the poverty problem is very important and the distribution of income is something that should be left. But if the public thinks the distribution of income is important then for the Congress it becomes important. But what is the problem?

First, we should note that the problem arises not just in the United States and Canada; it arises pretty much generally around the world. That is, it is happening in China, perhaps even more extreme than here. It is happening in the U.K. It is really a reflection of something which is very basic and going on all over the world, and that is productivity change.

As the great Frederick Hayek pointed out, the first effects of productivity change are going to be felt by those who are able to master it, and their incomes go up relative to other people.

Our failure, to the extent that we have a failure on the problem, lies in the poverty of the educational system that we have for those people who are most victims of the distribution of income that you are concerned with. Congress, along with various Administrations have been discussing that problem since the 1960's without making significant progress. It is really seriously time to look at why that is, and to ask the question, why is it that we cannot train a large fraction of the population to do the jobs and have the skills that are necessary?

In my experience as a corporate director, if you go to a factory, it is hard to see a job of any major importance to a company, including line jobs, where the worker does not have to be literate and numerate. He has to be able to read the computer and take his instructions from the computer and transfer that into an action on his line. And if we do not train people do that, we cannot expect them to get jobs that require that.

Second, to Mr. Paul, I think one of the great advantages of Humphrey Hawkins has been that it eventually led to greater transparency for the Federal Reserve. And this committee by scheduling regular hearings, even though they are not always successful, they at least require the Chairman to answer your questions and to be responsive. It is a long distance from the 1930's when the Federal Reserve said, "We do what we want and it is none of your business." That just does not fly in the present system.

On the inflation target, I think the discussion so far has been incorrect. We have an inflation target. It is a loose inflation target. We go to the marketplace and ask anybody, what is the Fed's objective, and they will tell you to get the inflation rate, the core inflation rate, down to 1 to 2 percent. They say it all the time. It is published in the newspapers. It is a generally agreed upon thing.

Now, does that violate the dual mandate? Of course not. If the unemployment rate were 8 percent now, instead of somewhere around 4.5 percent, the Fed would be behaving differently. It would be responding as it is required to do under the dual mandate.

So the issue about the inflation target is, how specific are we going to be, how transparent is the Fed going to be, how clear is the announcement going to be? Are we going to leave it at the sort of vague 1 to 2 percent or are we going to tighten it?

I think if we tighten it, we have to go in the direction of making sure that we are clear about exactly what the Federal Reserve is going to do. I am going to talk about that a little bit more.

To Congresswoman Maloney, I have to say that I agree broadly with what the Fed has been doing. The unemployment rate is relatively low and they are concentrating on inflation. If the unemployment rate was higher, as I said before, they would be doing things a little bit differently.

Now is a good opportunity. They have had the benefit of going through a period where they were able to lower the measured inflation rate without having unemployment rise, and I think that certainly has influenced them in their decisions.

So I agree broadly with the aims that they have been generating and the direction in which they have been going. I think the problems remain, and many of the problems that you have talked about do remain, but they are not primarily monetary problems. Monetary policy is a powerful instrument but it is not all that powerful: it cannot do much about the saving rate; it cannot do much about the distribution of income; and it cannot do much about the budget deficit. Those are problems which, for better or worse, Congress has to work on, and the Administration has to work on, but not the Fed.

Let me turn to my written remarks. They are brief. In the past 25 years, central banking has been transformed in all developed countries. Several announce inflation targets and make serious and generally successful efforts to achieve the targets.

The European Central Bank uses judgment about current or recent data supplemented by concern about money growth, the so-called second pillar of the strategy. The Federal Reserve continues its discretionary policy, but as I have said, a discretionary policy aiming at a loose inflation target.

All of these techniques have been much more successful than previous policies or methods of operation. Although they differ in their approach, current operations have two common features. First, central banks are more independent of politics and government than in the past. This is obvious in Britain and New Zealand where the meaning of central bank independence and its limits are set out explicitly in an agreement between the government and the central bank. Second, central banks now give much more weight to avoiding inflation than in the past.

In the 1960's and the 1970's, the mantra preached by central banks all over the world and certainly here told the public that inflation would start to rise before the economy reached full employment. Price and wage guidelines were a necessary policy tool to achieve full employment with price stability and low inflation. That

is the essence of the argument of James Tobin in the landmark 1962 Report of the Council of Economic Advisors.

Instead of getting low unemployment and low inflation, major countries, Britain and the United States especially, had higher inflation and rising unemployment. Even the politicians noticed the failure because the public noticed the failure. More importantly the voters noticed that countries like Germany and Switzerland put more effort into controlling inflation and did not suffer higher average unemployment at the time.

Governments and central banks discarded the old mantra. Guideposts and wage controls went into the dust bin where they belonged. In their place was a new mantra preaching a very different point of view. The new claim was that sustained low inflation or price stability is a necessary condition for sustained full employment. Free markets work better than controls. The approximately 25 recent years of low inflation have strengthened this belief. With floating exchange rates and low inflation, Britain and the United States have had long expansions and relatively mild recessions. The United States is now in a third long expansion. The three longest peacetime, if I may use that word, peacetime expansions in the United States are the three most recent expansions. That is a very good record.

If we do not worry so much about what has happened in the last few months, but we go back and look what has happened over the 20 years since we have changed to a less inflationary policy, we can see quite a remarkable increase in living standards in the United States.

Maintaining low inflation has worked extremely well in Britain and the United States but less well in European countries that joined the European Central Bank. Within the European Central Bank, the experience of countries like Ireland with pro-growth policies differs markedly from countries like Germany and Italy that tax and regulate excessively. The voters have noticed that and there seems to be some change happening.

Virtually everyone recognizes that for Germany, France, and Italy, the required solutions to current problems are real, not monetary, and more generally political, not economic.

Central banks in Britain and the United States should not rest on the achievements of past reforms, as important as they are. Both now claim to value transparency and clear communication, a break from the past secrecy that central bankers once prized. It took many decades for central bankers to recognize that just as financial markets depend on them, they depend on financial markets. In principle, interdependence has become accepted.

Central banks have not explained an ever present part of the uncertainty that accompanies all economic changes. The duration of any change is often in doubt. A change may be temporary or persistent. Changes may alter the level or the growth rate. It usually takes time to decide the type of change that has occurred and how long it will persist.

Inflation occurs when the central bank lets money grow persistently above the growth rate of real output on a sustained basis. The price level rises and continues to rise as long as the central bank remains on this course.

Contrast this inflation with the rise in the price level that continues for a few months or a year, something like the shock that we have had recently. Money growth is not expansive. The rise in the price level can be the result of an oil shock, an increase in excise taxes, devaluation of the currency, and many other one-time changes. As the change spreads through the economy, the price level rises. The rise is typically spread over time so the rate of price increase will at first look very similar to a monetary inflation just discussed. But it is important to keep them apart.

The Fed is in the money business. It can do something about the monetary inflation without any harm to the economy. It cannot do much about most of those other price rises without harming the economy. If it tries to roll back the domestic prices to offset the oil price we will have more unemployment.

The difference is that the one-time increase does not persist. Oil prices do not rise from $35 to $70 a barrel this year into $140 a barrel next year and $280 the following year. Central banks must learn to distinguish these one-time increases from the sustained inflation that they and only they can cause.

A great part of the dispute, I believe, in the economics profession about what to do about inflation has to do with the fact that some of us define inflation the way I do, sustained increases in the price level continuing over time, and others define it as any increase in the price level. Those are two different things and it is useful whatever names are applied to them, it is useful to keep them separate.

Some make the distinction, or appear to, when they describe their role as preventing a surge in oil prices from increasing the expected rate of inflation. Many market watchers do not make the distinction and some official statements are misleading. Central banks should clarify their role and their view.

Separating one-time changes and persistent changes is a major problem. Decades ago, in 1948, the late distinguished economist, Jacob Viner, wrote to the President of the New York Federal Reserve to caution him about over-responding to temporary transitory changes.

Viner wrote, "You certainly have the advantage over me of being closer to the market." But it may not be an unmixed advantage. The ticker may loom too large in your perspective and what from the point of view of the national economy are molehills may appear to you as mighty mountains. Mistaking one-time price changes for inflation can be costly. An oil price increase is a tax on consumers and producers whether it comes as a restriction of supply as in the 1970's or mainly an increase in demand as currently, it is not a monetary event. Reducing money growth to roll back the effect of the oil price increase is costly. The first effect is to reduce output over its growth rate. Further, letting the price level rise but holding the maintained rate of inflation unchanged is a low-cost way of reducing real income. A reduction that must be made to pay the oil producers for the real increase in the cost of their product.

Central bankers and markets must be much more, must become more familiar to the duration of changes, whether the change is permanent or temporary. They cannot do that if they adjustment policy fully to new information at each meeting.

I am writing the history of the Federal Reserve. I have read more Federal Reserve minutes than any living person would ever want to do and I can tell you that most of the discussion, most of the discussion at the meetings has to do with very near-term events. Trying to interpret whether the inventory increase is going to persist, whether the unemployment increase reported this month is going to persist, whether the big surge in prices this month is going to persist. The answer is they do not know. They cannot know. So they should direct their policy at a longer-term target. They must hold to medium term strategies. One reason the economy's performance has been better in recent years is that to a large extent they have done that. Central banks should announce and follow a policy rule that seeks stability over the medium term. Thank you.

[The prepared statement of Dr. Meltzer can be found on page 60 of the appendix.]

The CHAIRMAN. Thank you, Mr. Meltzer.

Professor Galbraith, the point about inflation—we have that paper that you mentioned on that, and I—many people in America have felt, in addition to the overall growth pattern, some of the negative impacts of globalization, it does seem to be—you're telling us that there are some benefits for them they haven't been able to reap either, namely that—well, we are told reduction in prices, advantages for consumers, that that's one of the results of globalization and trade. You're kind of generalizing that and saying that there is a basis for taking that into account in policy.

So let's—what is the policy implication of your view that inflation has been substantially—the possibility of inflation is substantially diminished by economic trends for the context specifically of monetary policy. What should that mean to the Fed?

Mr. GALBRAITH. Well, globalization came very abruptly and roughly to the United States in the early 1980's. A great many industries were downsized and offshored, and a great many workers lost their jobs. The system of wage setting that we had up to that time greatly diminished in importance, largely disappeared.

We also got afterwards a rising tide of imported goods, low-cost imported goods from oversees. Those two things had a sustained, permanent effect on the previously inflationary structure of the economy. That's the basic point.

What that meant was when we got to the 1990's, we, in fact, were able to pursue a full employment monetary policy, and inflation didn't return. What we got instead when we got to full employment was sustained increases in productivity. Productivity turned out to be dependent on, endogenous to, the state of the economy. It improved when labor became scarce.

So the implication I would draw from this for the present is that we can have a full employment policy in this country. It does not by itself pose a risk of higher inflation, and that is the key point which I don't think—the evidence does not suggest that the Federal Reserve has taken that point on board. The evidence suggests that they are still very wary of low rates of unemployment and that they tend to regard those low rates of unemployment as intrinsically risky. But I would suggest that they aren't.

Inflation could return, but if it does return, it will return as a result of the deterioration of our international position rather than as a result of an eruption of wage pressures in the domestic economy. And it seems to me that's a different set of problems and one that can't be easily addressed simply by manipulations of the interest rate.

So the Federal Reserve ought to be supportive of a full employment policy.

The CHAIRMAN. When you say the danger of inflation is deteriorating internationally, is this a dumping of American debt that people hold?

Mr. GALBRAITH. Precisely. We do supply the reserve currency to the world. We greatly benefit from the willingness of foreign central banks and institutions to hold American dollar assets. If they decided that they would prefer euro in large quantities we would have a very serious problem and that would include inflationary consequences.

That's an issue which we may have to deal with in the future, but it's not a question that can be dealt with by short-term monetary policy decisions.

The CHAIRMAN. Professor Meltzer, you're eager to say something.

Mr. MELTZER. Yes. I don't think that's factually correct.

The CHAIRMAN. Which part?

Mr. MELTZER. The part of what he just said about the reason inflation has come down. Productivity growth did not begin, did not rise until 1990. Inflation was cut, more than cut in half in the 1980's. It was 1982 when Paul Volcker and the Fed gave up the attempt—gave up the anti-inflation, the strict anti-inflation—under pressure both from the Congress and from events abroad, gave it up. But growth rate of productivity does not increase for at least another decade, so it's hard to put it.

Second, how much can the growth rate of productivity, which is where globalization is going to mainly affect the economy, how much can it affect the inflation rate? I mean the growth rate of productivity is 1 percent, 1½ percent during part of this period higher. The inflation rate is substantially lower by much more than 1½ percent.

So it has to do with something else. That something else is the much better monetary policy that we've had.

Mr. GALBRAITH. Just to clarify, I think we don't have a disagreement of facts. What I was saying was that the rise in productivity which occurred in the late 1990's—in the timeframe that Allan is referring to—was what happened instead of a rise of inflation that many predicted when unemployment fell very low.

It turned out that we got a great deal of productivity growth at precisely that period.

The CHAIRMAN. Let me ask—Professor Friedman, I think by the way, is very clear on it. Alan Greenspan is seen by many as a great conservative. In fact, during the 1990's, he was arguing that we could sustain a lower unemployment rate without a risk of inflation. He was in fact acting on that premise, contrary to what—a lot of conventional liberals.

I mean the New York Times—I remember one great event—reporting a story in the New York Times financial page which said

that if unemployment had remained below the level that would cause inflation for 11 quarters without causing inflation and therefore we should just wait for the inflation rather than thinking that maybe that equation they had was not accurate. I think that was a very important time.

Let me just close my time with Professor Friedman. You've been, to my mind, very persuasively critical of the notion of inflation targeting. How should the Fed balance the dual mandate? Is there a big conflict, and if there is, how do they balance it?

Mr. FRIEDMAN. Mr. Chairman, on the balancing of the two parts of the dual mandate, I think the word is, precisely, balanced. What is wrong with inflation targeting is not that the Federal Reserve would suddenly have some objective for inflation that they do not already have.

Allan Meltzer is exactly right in this regard. Everybody in the market has a reasonably good understanding today, and many people in the general public too, that what the Federal Reserve would like to see is somewhere between 1 and 2 percent for some appropriately defined inflation rate.

The issue is that if the Federal Reserve were to announce publicly a specified numerical inflation rate without simultaneously having some kind of a numerical description of what unemployment rate or rate of economic growth it were pursuing then we would be back in a situation like, for example, when the Federal Reserve was pursuing monetary targets.

Many of us remember well what it was like on Thursday afternoons when the Federal Reserve had a monetary target. If you happened to have been standing on the trading floor of any brokerage firm or any bank at approximately 3:15 in the afternoon, every trade would stop. The room would fall into a hush as everyone would wait to see what number the Federal Reserve announced at 3:30 for the previous week's money supply, as if there were any information of any serious economic content in one week's money supply movement.

Now why is this the case? The reason is clearly that once a central bank or for that matter any other economic policymaker states a clear numerical objective, then the public wants to hold the policymaker accountable for that objective.

If the Federal Reserve felt in a position to be evenhanded, and have a numerical target for inflation and a numerical target for the growth rate or the unemployment rate, then the problems of undoing the dual mandate that I was describing would go away. But the Federal Reserve has been very articulate, I think, about why they do not want or are not able to announce a clear numerical target for growth or for unemployment. And in that context, I think it would be a mistake for all of the reasons that I described to have one for inflation.

Now what should they do? At a hearing like this, I suppose it's always somewhat awkward to say that current practice is pretty good, but I think if one reads carefully the statements that the Federal Reserve Chairman makes when appearing before this committee and its Senate counterpart, I think one sees the thought process of trying to steer one's way between the tensions that inevitably arise in the short and medium run between wanting to have

unemployment as low as possible, and growth as rapid as possible, and yet not wanting to ignite either inflation or inflationary expectations.

Now no doubt these reports can be made better, and I agree with what both Allan Meltzer and Jamie Galbraith said about the role of this committee and its Senate counterpart in causing these reports to be written and questioning the Federal Reserve Chairman when he appears, but I think the process of talking through and thinking through and questioning through what the conflicts and tensions are is exactly right.

Let me finally offer if I may—

The CHAIRMAN. Quickly.

Mr. FRIEDMAN.—just one comment on the exchange that you and Jamie and Allan were just having.

A key way to understand how international influences have affected our economy in the last 20 years is to ask whether, 20 years ago, any of us would have believed that the United States, in the context of a falling dollar and huge increase in oil prices, would be able to have 2 percent inflation and an unemployment rate in which the digit in front of the decimal point is a four?

That was exactly the achievement that Alan Greenspan delivered when he was the Chairman of the Federal Reserve. In September of 1994, the unemployment rate first dropped below 6 percent. A widespread view announced in the Wall Street Journal, the New York Times, and elsewhere, and widely shared among economists, was that this would be inflationary, and therefore, the Federal Reserve had better tighten monetary policy.

But Alan Greenspan was explicit that he saw a combination of increasing productivity and, importantly, international pressures that would prevent firms from having pricing power and therefore avoid the need to tighten policy, and therefore, he didn't.

Three years later, in September of 1997, the unemployment rate for the first time in a very long time—

The CHAIRMAN. We have to move quickly.

Mr. FRIEDMAN. —dropped below 5 percent, and once again everybody expected this to be inflationary and Greenspan again didn't tighten. I think this was a tremendous achievement, but it was based on recognizing both the role of productivity and the importance of international competition.

The CHAIRMAN. I would say that there was reference to the role of this committee and greater transparency, and I have to, I think, give deference to Henry Gonzalez whose picture is up there. During my time in this committee, he was a consistent advocate of greater openness. He was told by people at the Fed that what he was pushing for would be destructive.

When I got here, they didn't announce what they did. The FOMC didn't announce for 6 weeks what it had done. They denied that there were minutes. Meltzer would have had to find another topic because they used to deny they even had the minutes until we found them.

And Henry Gonzalez was a very effective advocate for that. The other thing I would notice, and it just has occurred to me, is we talked about this at—particularly what Professor Friedman said. There was this substantial absence of expected inflation and it

doesn't seem to me that an anchoring of inflation expectations was a major factor in that in the 1990's.

Mr. Paul.

Dr. PAUL. Thank you, Mr. Chairman. Adding to the case for transparency, I would like to see the day that the Fed returns to at least reporting M3 unless they've decided money supply has no value, but I want to deal a little bit with inflationary expectations and the future of the dollar on international exchange markets.

We talk about inflationary expectations, and I think we have to recognize that expectations are very subjectively motivated, and I think it's very important. But in reality, it has to be in relationship to the money supply. But inflationary expectations are really the reverse side of the value of the dollar, and we can't ignore that.

Today the dollar is having a bit of a problem on the international exchange market, and I'm just wondering what the future will bring. My question, as I conclude this short statement, is what will the future of the dollar be in the short run in the next 1 or 2 years?

Already we have some evidence that there has been an attack on the dollar. As far as the euro goes, it has lost more than 9 percent in the past year. It has lost more than 10 percent against the pound. And lo and behold the Indian rupee, if you had been in Indian rupees, you would have made 13 percent, so that doesn't say a whole lot for a sound currency.

As a matter of fact, if you had just gone north and invested in Canadian dollars, in 6 months, you could have made 11 percent. So it seems to me that if you want sound money and stable prices you have to deal with that, you can't ignore it and resort to saying, well, the CPI is going up at 2 percent. The CPI, if you use the old CPI calculation, which I see no problem with, it's going up over 10 percent.

And besides, poor people and the middle class have a higher inflation rate than other people. If you have to pay for medical care and food and fuel, you might have an inflation rate of 15 percent, for all we know. So it ultimately is the value of the dollar.

Dr. Galbraith mentioned that the dollar, you know, is—inflation and the dollar can be weakened in times of war. And certainly the 1970's rushed it in after we had the guns-and-butter attitude of the 1960's, and it is true, it isn't the war that causes the inflation, it's the spending, and it's the monetizing of the debt that causes inflation. And we can well expect to see a lot more inflation coming because of this tremendously excessive spending today as well as no attempt to cut back on entitlements.

But the dollar, up until recently, may well have been much stronger than it really deserved. There was a false trust. It's a reserve currency, and there's a fair amount of trust. And I think I sense from Dr. Galbraith that there is a concern; maybe attitudes will change.

And the characteristics of so many currencies over history is that the confidence in currencies can gradually decrease and then they can collapse because there's a subjective element to it. And this is my great concern, what will the future bring for the dollar because if the dollar goes down, you have inflation.

Already we have Kuwait asking for euros, and we have the Iranians not taking dollars. This to me seems to be a very, very seri-

ous problem if the dollar is to be rejected. Of course, the Chinese aren't going to attack the dollar, but they themselves indicated that they might buy a few more currencies other than just dollars.

And we had a serious attack on the dollar in 1979 and 1980. It was rescued with 21 percent interest rates. So my question is, are we moving into a new era? Will the IMF be able to bail us out? How serious is this? Or should we forget about it and just say, well, CPI is not going up, and unemployment is high, and nobody seems to be suffering? Or should we really be concerned about some of these indicators now that show that our dollar is under attack?

I'd like to see if I can get comments from you about what you expect in the next 1 to 2 years, with regard to the dollar.

Mr. FRIEDMAN. Well, Congressman, I'm happy to address the dollar, although I have to say that if what you're really interested in is the outlook for currencies over something like a 1-year horizon, the last group of people in the world whom you should ask is professional economists. Certainly that would include all three of us sitting before you today.

But if you're interested also in the longer run perspective, say a half-a-decade or a decade, I think the fears that you express are quite well-founded, but in a slightly different way than you express them. The way I would put it is that today the United States is paying for what we buy from abroad, over and above what we receive from what we sell to people abroad, an amount equal to approximately 6½ percent of our national income.

If any country other than the United States were to do this, this would be unanimously recognized as irresponsible. Now as Jamie Galbraith mentioned, we have the privilege at the moment of issuing the world's reserve currency, and therefore people don't normally use the word irresponsible to refer to us in this way. But it is irresponsible, nonetheless. And the further question is whether it is sustainable. The answer there is clearly no, and so what will happen as a result?

One thing that could happen is that we would find a variety of ways of increasing our country's competitiveness, increasing what we save, and reducing what the government borrows. And putting all of those together, we would be able to reduce the size of our international imbalance in such a way that we would avoid a major decline in the dollar.

Failing those steps then, I think it's clear that the dollar will have to move toward a lower exchange value compared to the currencies of the other countries with whom we trade. And then the crucial question from the perspective of your inquiry is whether that would happen abruptly and in a disorderly way—you point entirely correctly to the events of 1979 and 1980—or whether it would happen over a longer period and in a much more orderly way.

The United States currency has declined enormously over the past 40 years compared to, for example, the Japanese yen and the Swiss franc. But nobody looks at this as a disaster. This is just the ordinary working of differential competitiveness and differential inflation rates, and there's no reason to think that would be harmful to the economy now.

The key issue is whether we move in a timely fashion on a whole variety of fronts—saving, government borrowing, competitiveness, and education—in a way that makes our workforce more productive. All of these ways that would allow us to narrow our trade deficit by at least, let us say, half, or whether we continue to borrow from abroad in a way that really is irresponsible, in which case then we certainly will risk the kind of eventuality that you're concerned with.

Mr. GALBRAITH. I would take—well, agreeing with many things that Professor Friedman just said, I would take a somewhat more sanguine view of the stability of the system, at least in the short term.

We issue the world's reserve currency. Other countries hold it because we provide a very liquid and very safe financial asset, more liquid even now than the euro is. And they have their reasons. The Chinese have their reasons in particular for accumulating the reserves that they accumulate. They are engaged in managing a massive project of urbanization, massive growth of exports, and the accumulation of dollars is an artifact of that.

So they're not inclined to destabilize the system, and there are only a few players who are large enough that their actions would be decisive. I think it's possible that this system could go on for a while. As long as the world economy is growing, the corresponding demand for reserves will be there, and the corresponding current account deficit will be there for the United States.

The problem, as I see it, is that the system, like all monetary systems, is inherently precarious. It is subject to a shock, a crisis, a panic, a collapse down the road. The form of that, I think, is very difficult to predict. It could be incident to a political crisis of some kind.

We should be thinking strategically about how to deal with that should it occur. And that's the issue, it seems to me, that we ought to be focusing on.

Mr. MELTZER. I think you've raised an appropriate long run question. As Professor Friedman said, not just economists, no one knows what's going to happen with the dollar over any short period.

The great economist Keynes is alleged to have said that if you owe your banker $100 and can't pay, then you have a problem, but if you owe your banker $1 million and can't pay, then he has a problem. So with the Chinese, they have $1.2, $1.3 trillion dollars. There's not much that they can do to get out of that position without hurting themselves along with us and many other people, and they show every evidence of collecting more no matter what they say as they follow the Golden Rule of Paul Samuelson, never give the forecast and the date in the same sentence. So they say, we are going to revalue our currency, but they never quite say when.

But the long-term problem is a serious problem. That is, if you said over the long term what will happen with the dollar you have to believe that over the long term the dollar is going to decline in value. Why is that? Basically because we invest more than we save; we save too little.

Look at the political campaigns that are now well underway. What are we hearing? We hear a lot about the need for more more

money spent on health care. That may be a very desirable thing to do and say, but very little is said about how we're going to pay for the additional health care or even for the present heath care programs.

The unfunded liability in health care is something in the order of $60 trillion. Nobody has a good idea. Nobody even wants to discuss how we're going to get $60 trillion to pay for that. So if you add that to the Social Security program, which is small compared to the health care program, and the health care programs are getting bigger, it's hard not to believe that we're going to continue to spend at a faster rate than we save. That cannot be resolved with a strong dollar.

So finally I'd like to say we always have to make a choice between whether we want domestic price stability or foreign exchange stability. We can't do both with the same instruments. We've chosen to have domestic price stability, so the Federal Reserve's policy, the government's policy, and the Congress's policy is to live in hope, as Jamie Galbraith said, that the dollar will decline gradually.

They have no policy to make sure that's going to happen. They just hope that's what's going to happen.

The CHAIRMAN. The gentlewoman from California.

Ms. WATERS. Thank you very much, Mr. Chairman and members.

I'd like to thank our guests for being here today. And I would like to go back to some of the discussion that was afforded us by Dr. James Galbraith about income equality and monetary policy.

Mr. Bernanke was here, I don't know, several months ago, and I complimented him on several speeches that he had made on income equality. However, I was basically jeered by one of my colleagues who said something to the effect of, well how could you possibly be that passionate about a speech by Mr. Bernanke on income equality. But I was, because I had not heard that issue coming from a Chairman since I'd been here.

I had been here since Mr. Greenspan was here, and I interacted with him a lot; but, I don't believe that he saw the relationship between the conduct of monetary policy and income equality. I think Chairman Bernanke does. And I would like you—even though you did so, I think, in your presentation, and there may have been some additional discussion—to explain why there is such a debate about the role of monetary policy and the problem of income equality? What can you tell us about the divergent perspectives on this issue?

Are you suggesting, or have you said to us, that there certainly is a relationship, some correlation between the conduct of monetary policy and income equality? If there is such a correlation, what might the Fed do to address inequality and income over the long term which appears to have grown in the past several years?

Mr. GALBRAITH. A great deal of this discussion—and Professor Meltzer alluded to it in his remarks—is couched in terms of the functioning of the labor market, the capacity of workers to meet the demands of employers to have the appropriate sets of skills.

We found in looking very carefully at the way in which the inequality in structures of pay actually received by workers behaves

over time—and we've measured it very precisely going back as far as 1947, that a large part of the movement of inequality is very closely related to the overall performance of the economy.

That is to say, when times are bad, it is low wage workers—who work variable hours, who work at hourly rates, who have overtime or don't have overtime—who suffer the most. And they suffer more than higher paid workers, workers in more stable industries, workers with regular salaries.

When times are good on the other hand, as they were in the late 1990's, it's the low paid workers—whether they're skilled or unskilled—the workers at the bottom of the scale who gained the most rapidly.

Ms. WATERS. May I interrupt you for just a moment because I want you to include in your discussion some of my concerns about the exportation of jobs to third world countries for cheap labor?

When I first got elected to office, the Goodyear plant closed down in my district, and those were well-paid workers who had been there for years. They sent their children to college, they bought homes. What I have not seen in that community is the kind of jobs and incomes tied to Goodyear since that time.

Mr. GALBRAITH. Certainly that has happened, and certainly a great many high quality blue collar jobs have been lost over the past couple of decades. But what happened in the late 1990's, in particular, was that we had, as Ben Friedman referred to, a sustained period of very low unemployment. It was correspondingly a good period for relatively low wage workers. They gained ground.

They worked a lot of hours. They had overtime. They had continuous employment. And that then enabled poverty rates, particularly for minority populations, to fall to levels they had not seen before.

So it's possible for a well-functioning economy in other words that pursues and reaches the objective of full employment to greatly reduce the inequality which is experienced in the labor market. That is to say, inequality between the wages paid to low wage workers and those paid to higher paid salaried and managerial employees.

There are other aspects to inequality. Inequality that emerges from stock market incomes is an entirely different phenomenon. I don't want to address that. But just focusing on what happens in the labor market because that is where one hears all the talk about the need for education and skill development, it turns out that one can have a very material effect in the short run by pursuing a high employment strategy.

These two things are in fact not distinct. They are connected, and that's something that makes it relevant to monetary policy.

Ms. WATERS. Thank you very much. I yield back.

The CHAIRMAN. The gentleman from Delaware.

Mr. CASTLE. Thank you very much, Mr. Chairman. Dr. Galbraith, I'm struck by your comment, which has been repeated in the questions too, in your written testimony, and in your oral testimony, about inflation being permanently defeated in the early 1980's.

I guess it's in the eyes of the beholder to a degree because certain things come to mind, particularly higher education, in which a lot

of you are involved, which has had tremendous inflationary aspects to it, medical insurance and the health assurance that's attended to it, as you can imagine, the cost of housing, which has had tremendous inflation as well.

And I would agree with you that in the case of many goods, the quality has improved and the cost has stayed roughly the same. But in those instances, the quality arguably is roughly the same as it was, and the cost has gone up tremendously.

One key element in all of these is that there has been government involvement, as we know, with health care obviously, Medicare, Medicaid and other programs, lending on higher education and the same thing with housing, mostly through this committee. What does this suggest about the wisdom of expanding government's role in the economy, or is that unrelated to the three areas which happen to have had real inflationary growth?

Mr. GALBRAITH. Well, I think, Congressman, that you're entirely right, that these are areas in which economic activity and to some degree pricing power has been sustained in part because these are areas where you have a public-private system in which the backstopping influence of the government is there. And as a result we have had, in part—that's part of the reason why we've had a rising share of GDP devoted to health care, a very high share by comparative standards devoted to higher education and a very high proportion of the population who owns their own homes compared to other advanced countries.

I tend to regard these things as strengths of the American economy, actually, areas in which we perform quite well in terms of delivering high quality services to at least part of the population. Obviously health care has at least major problems with the part of the population that isn't insured, with the costs of certain services and with the costs of the insurance system that many who are privately insured have to bear. But it is a dynamic and technologically advanced sector that delivers a lot of services to the population.

So one has to balance these things. And I think that the question—if your question is, could one have done better by leaving these sectors entirely to the private market, my answer would be, I don't think so. I think that one would have run the risk of not having the services and not being able to sustain the quality that we've seen. And so I would see the problem of controlling costs as something that has to be addressed in each of these sectors. It essentially can't be evaded. It's part of the public policy issue that the system that we have presents.

Mr. CASTLE. Dr. Meltzer.

Mr. MELTZER. Can I just add a little bit? If you look at the research, and there's tons of it, on education and what makes a big difference, the answer that pops out at you everywhere is family structure. If you're a middle class family, you're helping the kids do their homework. That's not true of the whole population, and that's the biggest single problem that we have to solve, and it's not an easy one to solve.

We can substitute in the public sector for that by having things like early childhood education. There seems to be some evidence that early childhood education, if it's maintained, not if you start

it in the first grade, if you start it well before the first grade, that in fact it has some effect that doesn't wear out.

A lot of these programs, they have an initial effect, they raise the standards for the children, but then by the time they get to the fifth grade or the eighth grade, it's gone. There seems to be some evidence now that if we start it early and maintain it that maybe we get somewhere. In effect we replace the family with doing the discipline and the training.

Mr. CASTLE. Let me ask you this question, or maybe to anybody who would like to answer, and that is the relationship of education to employment and to wages. I mean this is something that's a given. We've all talked about it. We've all seen the statistics that if you graduate from college you earn this much more, and college that much more, or whatever.

From an economics point of view, is all of that rhetoric that generally we talk about, and others talk about, a given or is there any inaccuracy to it in terms of employment for this country? Should we be looking to education to advance employment as far as the future is concerned?

Mr. FRIEDMAN. I'll speak to that, Congressman.

Mr. MELTZER. Let me just say it not only is true what you said, that you get a big jump because of college education, but you get a bigger jump now than you did earlier.

Mr. FRIEDMAN. Yes, Congressman what you say is absolutely true. And importantly, the origin of much of the wage inequality that we've been talking about this morning has been the widening of these wage differentials. The amount by which a college educated person in the United States earns more than a high school educated person has doubled over the past generation, and so the incentive both for an individual to go to college and also for the public policy process to provide opportunities for people to go to college is much greater than it was before.

The same thing is true also for the kind of early education policy that Allan Meltzer was just describing. Many years ago, Project Head Start, for example, got a very bad rap because all we had to go on in evaluating it was questions like, does it increase students' test scores. If you think about how you would evaluate a program after 2 or 3 years, of course, that's all you can measure.

But now we've been at Head Start for 30 years and we can address questions like, does it affect who graduates from high school 12 years later, does it affect who goes on to college, and does it affect who has a stable job by age 23? We can even address pathology questions like, does it affect who gets in trouble with the law while in high school, or does it affect which of the girls get pregnant while in high school?

In every case, the answer to that question is "yes." Yes, the incentive both for individuals to get educated is much greater today, but we shouldn't just stop there. There is also an important incentive and signal for what the education process, which is mostly a public institution in the United States as you point out ought to be doing.

Ms. WATERS. [presiding] Thank you very much.

The gentlelady from New York, Mrs. Maloney.

Mrs. MALONEY. Thank you. Dr. Galbraith, in your testimony you raise the charge that there is a presidential election cycle for monetary policy. Monetary policy is more restrictive when a Democratic Administration is in office but more permissive when a Republican Administration is in office. Does that mean that you expect monetary policy to be less restrictive heading into 2008?

Mr. GALBRAITH. It is a statistical finding and it relates to the year before a presidential election, compared to other periods, after controlling for the position of inflation and unemployment. And it's a remarkably stable finding. So it does suggest that there has been, going back to 1969, a pattern in which this variance in monetary policy has occurred in the year before presidential election.

I would make no prediction about what Chairman Bernanke and his colleagues may do in the next year as we approach the presidential election. I would hope that this pattern would not persist—that if I ran the study 2 years from now, I would find that this cycle was an exception.

I think it's worthwhile, though, for this committee to be aware that this pattern does exist in the data. The committee should be wary of interest movements in future presidential election cycles that are otherwise difficult to explain. You should be prepared to ask questions so that a more stable policy can, in fact, emerge going forward.

Mrs. MALONEY. Professors Meltzer and Friedman, would you care to comment on the theory that there is a presidential election cycle to monetary policy?

Mr. MELTZER. Yes, as I said earlier, I have been writing the history of the Federal Reserve, and I would be glad to share with you 1,100 pages of manuscript covering just the period from 1951 to 1986. It is certainly true that in 1968, President Johnson decided that he had to raise the tax rate and tighten policy in December of 1968, after the election; he didn't do anything before the election.

The CHAIRMAN. We should note that he wasn't a candidate, so that made it a little easier for him.

Mr. MELTZER. No, but his vice president was a candidate. It may have had some effect, it may not.

In 1971, 1972, what happened? Well, President Nixon put on price controls, all right, following out what was then the belief that you couldn't stop the inflation by other means without having serious loss of unemployment.

In 1975, 1976, Republican Administration, President Ford was in office. President Ford was an anti-inflationist and the Federal Reserve tightened in 1975 in preparation for the 1976 election. And many people believe that's one of the reasons that President Ford lost the election.

The next case is Jimmy Carter. This is one I'm very familiar with. I had a meeting with Bert Lance right after the Carter Administration came in. I told him that they were doing an expansive policy at that time. They were going to pay for it later very likely by having high inflation when they wanted to run for reelection and not to do that.

And he said to me, "Well, Walter Heller was just in here and he said the opposite of what you just said. What would you say to Walter Heller?"

And I said, my answer to Walter Heller would be that if you follow my proposal, you can always expand before the election, but if you follow his, you are going to have to contract. And of course, we did get a big inflation, partly because of the oil shock, partly because of poor Federal Reserve policy.

So I won't go through all the others—1984 we now have the Volcker disinflation, right? It was more expansive in 1983 and 1984 because the disinflation was over.

So we can go through those. I just don't think—the Fed is in Washington. It is, of course, aware of politics. How can you not be? How can you live in Washington and not be aware of politics, but it mostly does a reasonable job of trying not to play politics because it knows that if it plays that game, it is going to lose. You're not going to let them play that game and you're certainly not going to let them play the game that Jamie Galbraith is talking about.

So there may be statistical evidence that comes true. I just don't believe if you look at them one by one, that you see a pattern there which says that they're systematically trying to do things. And I can tell you that very rarely at a Federal Reserve meeting does anyone ever mention political facts. The only person I can remember doing it regularly was Preston Martin, and he didn't stay very long.

Mrs. MALONEY. My time has expired. Dr. Friedman.

Mr. FRIEDMAN. There have been a few episodes that clearly meet this test. The most obvious one involved Arthur Burns in 1972, and it has been widely reported in the press because of various leaks by people who were present.

But the key thing to remember is that it's not necessarily the case that the majority of the people who are serving as members of the open market committee are appointed by, or even sympathetic to, any particular person who is running for President at the moment. The Federal Reserve Bank Presidents tend to stay in office for a very long time. Members of the Federal Reserve Board don't necessarily stay for their full 14-year terms, but typically it has been the case that a person who is running for President, even if it's an incumbent running for reelection, can look at only a small number of members of the open market committee as people to whom he would have some connection. I would, therefore, find it surprising as well if this were a very strong regularity.

The CHAIRMAN. The gentleman from Missouri.

Mr. CLEAVER. Thank you, Mr. Chairman. It is an honor to have the opportunity to have some dialogue with the three of the best brains in our country and I'm going to ask two questions in one just to reduce the time, since you probably are interested in having lunch.

I'm very much concerned over the fact that we have probably less than another $800 billion to spend before we reach the debt ceiling. And with us borrowing a considerable amount each month for the war in Iraq, we're borrowing probably close to $14 billion, certainly more than $10 billion each month, so I think it is like $600,000 a minute.

Pretty soon we're going—this is the question. Do you believe that in a short period of time, certainly within the next 2 years, the support of the war is going to require a vote of Congress to raise the

debt ceiling beyond $9 trillion. And if so, how does that speak to the world, considering that China and Japan are buying a lot of our debt?

The second part of it, which has some impact on it, I believe, and that is—since the Great Depression, we have not had a minus savings rate in this country. I think in the Depression it was like –0.5 percent. The second part of the question is do you think—we hear the words that the economy is going fine, everything is good, everybody should be happy, and if that is so what is happening with the savings rate considering that the Asians are close to 20 percent? And because we have no savings rate in this country, the domestic borrowing by the government is almost nonexistent; is this dangerous for our capacity to defend this Nation as well?

Dr. FRIEDMAN. Congressman, I'll address primarily your first question but also the second because the two are clearly related. The answer to your first question is very simply, "yes." If we continue with the current levels of government spending and government taxing, then within some quite finite period, Congress will be called upon once again to raise the debt ceiling.

Now some people think that this ritual of having to raise the debt ceiling is pointless. I disagree. I think that it serves a useful function of focusing people's attention on the extent to which the government is borrowing as a result of spending more than it takes in.

At the moment, a large part of that excess spending is going for Iraq, but the same would be true if it were spending for something else. The real issue is the balance of the spending and the taxing.

But, the government's debt today, while large in absolute dollars, is actually smaller than it was some time ago. At the end of World War II, the government owed more than a dollar of debt for every dollar of our national income. Over a period of years, by running only small deficits, the government got the debt ratio down to only 26 cents on the dollar of GDP. It then went up dramatically between 1980 and 1993. Then it came down again during the Clinton Administration, and now under the Bush Administration, it's going back up again, but not as dramatically as it had been rising earlier.

In a world in which the Baby Boom generation is going to retire very soon, we have this liability that Allan Meltzer associated with keeping the Medicare system going. Nobody knows how we're going to manage to do that. We also have borrowing from abroad that's equal to 6½ percent of our national income. We should be running a surplus now, not running a deficit. The useful purpose of the debt ceiling ritual, I think, is to focus people's attention on exactly that problem.

Mr. CLEAVER. Dr. Friedman. Before you move on to Dr. Galbraith, when you were saying that the debt today is probably smaller than it was in World War II, I'm not sure what the loan guarantees were then, but the loan guarantees that we have today are not even included in this $8.3, $8.4 trillion debt that we have.

Mr. FRIEDMAN. That's exactly right, Congressman. My reason for focusing on the actual secured indebtedness, the part that you were describing, was that's what is involved in the debt ceiling. When Congress votes to raise the debt ceiling, it isn't about all of the unfunded liabilities, nor the credit guarantees. What that's about is

the debt securities that the U.S. Treasury issues. To the extent that we also have $60 trillion of unfunded Medicare liabilities, they are completely separate from the amount included in the debt ceiling that you will inevitably be asked to raise within the next short period of time.

Mr. GALBRAITH. Here Ben Friedman and I do have something of a difference of view.

I would be very wary of measures that tried to move directly back toward a budget surplus in the present environment because those measures would tend to slow economic activity, and they would tend to put people out of work. It would either be by raising taxes or by cutting expenditures on public programs. They would tend to cause direct harm.

And the benefit is at least somewhat uncertain, perhaps even very uncertain. So given the choice between a strong economy and public deficits which, while large in dollar terms are not historically very large in relation to GDP, and as Ben said, a debt burden which is not historically out of line—it's lower than it was in the 1940's and through much of the 1950's—I would be careful about making radical changes in fiscal policy just because the deficit is high, and the debt is going up.

I would say, since you mentioned the war, and since talking earlier about the degree to which our position depends upon the confidence that the world has in our economic dynamism of viability and prosperity, that the war is very troubling in this respect. It raises questions about the extent to which the United States really can anchor the global security system on its own.

And to the extent that those uncertainties and anxieties exist in the world, you're going to see other governments and foreign players, financial players, diversifying, hedging their bets. I would like to see us consider the global security situation as part and parcel of our global financial stability.

These issues tend to be considered entirely apart, but they are not entirely unrelated. And we could find that if we make serious errors in one area, that it comes back to be very costly in the other.

The CHAIRMAN. Oh, I'm sorry. Go ahead, Professor Meltzer, did you want to—

Mr. MELTZER. I just want to add briefly, I agree with most of what Ben Friedman said. I would only disagree that when you raise the debt ceiling, nothing happens. I mean people have forecast pretty well that you're going to have to do that, you forecast that you're going to have to do it. It's not going to be a secret when it comes, so it will be a hassle in the Congress. Because Congress doesn't like to increase the debt ceiling, the public misinterprets it, but the fact is that it won't have any economic effect.

The CHAIRMAN. Let me restate that, as there is an important principle here. The Minority is always strictly opposed to raising the debt ceiling, whomever is in the Minority. The gentleman from Minnesota.

Mr. ELLISON. Mr. Chairman, thank you very much for holding this hearing. It is a shame sometimes but there are so many things going on because I really wanted to hear the bulk of the testimony. I apologize for not being here.

And, Mr. Chairman, I wonder if I could ask some questions about debt, personal debt that Americans are facing. I know that is not exactly on the subject, but I would be very grateful for your view on the subject.

You know, Americans on average have a negative savings rate. Could you talk about what that means for the overall functioning of our economy, what it means in terms of what the implications are for individuals, and for our consumer sector? Could you talk about that a little bit?

Mr. FRIEDMAN. I am guessing that is probably closer to my interests than either Jamie Galbraith's or Allan Meltzer's.

I think we have to be very careful to distinguish different parts of the population, Congressman. There are some families who have very large debts but also have very large amounts of assets behind those debts. Some of those assets are stable in value but others aren't. People who keep taking out larger and larger mortgages because their houses keep rising in value, for example, are exposed in a particular way, namely, what happens if the value of their house drops significantly?

Then a much larger part of the population is borrowing not against assets, but in an unsecured way on credit cards, borrowing to buy washing machines, refrigerators, or to take vacations. These are typically smaller amounts of debt and they are exposed less to that kind of asset risk than to the risk that a person is going to lose his or her job. Hence, there is a part of the population that is exposed to asset value risk, and there is another part of the population that is exposed to employment risk.

For many years, at least the last 10 years that I can recall, economists have been concerned that the rising consumer debt burden would cause consumer spending to drop back to be more in step with the increase in personal incomes, and this has not really happened yet.

Clearly borrowing more than one earns cannot go on forever unless one is the government. But the question then is, when does something stop that we know is unsustainable? Economists have been predicting for a long time that rising debt levels would cause consumers to pull back. This might cause the economy to slow, perhaps even go into recession. But it just has not happened yet. Perhaps this means that the American consumer is becoming used to higher debt levels. Perhaps it means that our lending institutions are more capable of finding efficient ways to lend to consumers, although the collapse of the subprime mortgage market certainly suggests that these institutions do not work as well as the lenders would like to believe.

Mr. ELLISON. Excuse me, Doctor. I was going to say that example you just mentioned on the prime, you know, we do have a lot of people whose housing prices were increasing, they were refinancing their houses, and then the housing market flattened out. And now some of them are what they call upside down, and then they are in foreclosure, and they lose their houses, which has implications throughout the economy.

Is that an example of sort of this, the end of the consumer debt gravy train? Sort of the chickens coming home to roost situation?

Mr. FRIEDMAN. It may be, Congressman. But even apart from the subprime market, it could be simply that the cessation of increase in house prices would mean that all sorts of middle class families who were not in the subprime market at all will have to stop borrowing more simply because their house—against which they have been borrowing—is no longer going up in value.

Mr. ELLISON. Right.

Mr. FRIEDMAN. So there are many, many reasons to believe that at some stage, the ability of the American consumer to keep increasing spending more rapidly than family incomes are going up is going to come to a halt. But it has not happened yet and, therefore, expecting it to happen this year or next year or the year after is simply a speculation.

Mr. ELLISON. Okay. Let me ask you this, Doctor. What about the fact that people are living on credit cards nowadays? I mean, if we have a 1 percent negative savings rate, does that mean that, you know, you have an average number of working families who run out of money by Wednesday, but don't get paid until Friday? Is that a way to understand the negative savings rate situation in which we find ourselves?

Mr. FRIEDMAN. I think it is both that and the borrowing against houses, Congressman. Both pieces are quantitatively very important.

Mr. ELLISON. What do you think about individual development accounts to help poor people save money?

Mr. FRIEDMAN. I think it is a terrific idea. Indeed, there are all sorts of such devices. If we had been having this conversation 20 years ago, I think every one of us at this table would have bemoaned the country's low savings rate and then gone on to say that we know very little about how to use public policy to encourage saving. It turns out that all of these tax-favored saving plans were very disappointing in their effect.

But today all sorts of new research has suggested new ideas like the ones that you suggest. One of my own colleagues at Harvard, for example, has come up with a terrific idea that the Congress, I think, has been moving forward with, to change the default option on 401(k) plans. It turns out that merely such a small thing as changing the default option—which is not forcing anybody to do anything, it is just what happens if you do not check any of the boxes on the form—even that device turns out to have a significant impact on what people save. So I think the state of play in terms of what public policy can contribute to the low saving problem is very different than it was 2 decades ago, and I am pleased to see Congress moving forward in some of these respects and I think there are plenty of others, too.

Mr. MELTZER. May I just say—

The CHAIRMAN. We are running out of time, I am afraid. If you are real quick—

Mr. MELTZER. Very quick.

That is a very poor number, the saving rate, the personal saving rate, for the reasons that he just outlined. I mean mortgages, capital gains, things like that are just not in there. So a better number of what the society is doing is to look at the overall saving rate

which includes businesses and so on. We do not save enough but that number is misleading.

The CHAIRMAN. Is the second number better or worse? Better?

Mr. MELTZER. Better.

The CHAIRMAN. The gentleman from Colorado.

Mr. PERLMUTTER. Thanks, Mr. Chairman. Just a couple of questions on the auto industry. We have this CAFE standards bill coming up and I have been getting besieged by both sides as to the need to really increase mileage beyond 35 miles per gallon in the next 10 or 15 years. And the other side is saying, "Gee, let the SUVs and the pick-ups kind of go their own direction and we can do this with cars, otherwise the entire industry is going to be gone."

I guess my question to you, gentlemen, is where do you see the auto industry going?

The CHAIRMAN. In fairness to the witnesses, they can answer if they want to, but we did have a hearing on this specific set of subjects, and they were not asked to come with any particular reference to either the auto industry or energy efficiency or any others. If they wish to answer it, okay, but in fairness, we do like to have some kind of notice of what people are going to be asking.

Mr. PERLMUTTER. So now that I have been slightly chastised, I still am going to ask my question. If you cannot answer it, it is okay. It is what is on my mind and, if not, then I do not have any questions, Mr. Chairman.

Mr. MELTZER. Let me give you an answer which is not a direct answer to your question, which is highly relevant. We are unwilling to do things to raise the price of gasoline and cut down on the amount of oil. So we are giving money, sending money to our adversaries. To the Iranians, to the Saudi Arabians, even to minor adversaries like the Venezuelans. We are going to pay in defense because of our unwillingness to pay for the energy.

If we would cut down on our importation of energy and the price were lower, they would have less money. That is a really important in my opinion national security issue which affects our economy.

I do not know much about the automobile industry, but I do think that is an area where we are going to spend for defense because we are unwilling to tell the consumers they have to pay more for oil and we have to do things to get rid of oil imports.

Mr. GALBRAITH. I have to say I agree with Allan on that. I would add that if we do now what is necessary to move to the front of the technological curves in these areas then we may have a competitive industry which we may lose if we do not. It is inevitable that we are going to have to transform the way we do transportation in this country in order to meet, among other things, the challenge of climate change, the challenge of energy security. We should be taking on that assignment with real intensity at this point or it will quite soon too late.

Mr. FRIEDMAN. I agree with what both Allan Meltzer and Jamie Galbraith said, but I would add one more point that I think is pertinent to your question, Congressman.

The history of American business in the post-World War II period is full of examples of things that public policy has asked business to do and that business has resisted on the ground that it

would be destructive of the industry. But many have turned out not only not to be destructive of the industry, but to be stimulative in ways that nobody imagined.

The most obvious example is putting stack scrubbers in utility plants. I am old enough to remember that debate after the Clean Air Act was passed and the question was whether it was conceivable that the American public utility industry could afford to put stack scrubbers in the utility plants or whether this was going to lead to the collapse of industry or the price of electricity becoming too expensive for middle class families to pay.

Not only did neither of those outcomes take place, but after a very short interval, it dawned on people that there was going to be a business in which somebody had to make the stack scrubbers, somebody had to install the stack scrubbers, and somebody had to maintain the stack scrubbers. This was all about profits and jobs that nobody had ever imagined.

I am very optimistic about the capacity of American industry to meet the requirements that are placed on it. Today the story is that it would be impossibly expensive and either the automakers would go out of business or consumers would never buy the cars if they had to meet some higher CAFE standards. My guess is that the technology will not only be doable for the industry, but turn out to be a further source of jobs and profits for whoever is smart enough to be able to make it and install it and maintain it.

Mr. PERLMUTTER. Thank you very much. Thanks, Mr. Chairman.

The CHAIRMAN. I am going to ask one final question. We have a vote.

On the role of the bank, there was a quote, I think from Professor Galbraith, from the current and previous Chairman of the Federal Reserve about how monetary policy is irrelevant to the issue of inequality and they accept that it is a factor.

It does seem to me that—I disagree with that and the monetary policy in fact has had an effect on inequality. Let me put it this way. First, Professor Meltzer, you did note correctly that there is a worldwide phenomenon now of the erosion of real wages, but it is not uniform. It does appear that there are institutional mechanisms that can have an impact, particularly on strong labor market mechanisms.

And they do not have to be bad ones. The Scandinavians do better than the Chinese or us and so—and that is all in the sense—here is the problem we now have. It was still the view on the part of, I think, the establishment, all three of you in various ways dissent to that and that is why we were glad to have you here, that it is important for the central bank occasionally to crack down on overall growth to keep inflation from getting out of hand. And that despite the previous experience with the NAIRU and it seemed to me that during the 1990's the NAIRU was a lagging indicator of unemployment. As unemployment went down, the NAIRU to economists. It was always about a half-a-point more than the reality. But it clearly got discredited.

There are still people who see that trade-off, that Phillips Curve. The problem with that is that it does affect inequality. The one recent period when we have had a halt in the excessive trend—the trend towards excessive inequality was the late 1990's when a very

tight labor market and it seems to me we had a very good situation there. We had a very tight labor market which helped wages go up but not to the point where they caused inflationary pressures. To his credit, Bernanke has acknowledged as long as wages significantly are lagging productivity increases the fact that they are going up should not be—is not inflationary.

So here is the situation that we run into. The erosion of labor market institutional factors in the United States has been a problem. And we now have the point where there is still this tendency on the part of some, it would seem to be the Federal Reserve and Governor Mishkin talks about this and says, "Well, we have reduced the pain that will come in the employment area if we raise interest rates and slow down the economy, but it is still going to be there."

What is the response to those who say that it is still going to be necessary from time to time to combat inflation by reducing overall growth, by raising interest rates in the most blunt way to raise unemployment, and that to some extent, it is still important for the Fed to be willing to see unemployment rise as a way of checking inflation.

Let me ask each of you, because that still clearly is, I think, a received opinion. Let me start with Professor Galbraith.

Mr. GALBRAITH. Well, I would say as the gentleman from Missouri might say, "Show me." Wait until the evidence is in and as the gentleman from Massachusetts might say, "Don't shoot until you see the whites of their eyes."

The CHAIRMAN. But, of course, they will tell us that once that happens, then inflation will be out of control and it will be too late.

Mr. GALBRAITH. Well, what they still need to have is evidence for their point of view. And that evidence has been singularly lacking. If the evidence is clear, it is presented that their case, that there is a run-away wage inflation such as we have not seen in this country in a generation, then one would have to consider the evidence.

But as Allan Meltzer said earlier, you would not want to mistake a one-time increase in the oil price for a sustained rise in the inflation rate, and you will not know the difference until substantial time has elapsed.

And as Ben Friedman just said, if you impose standards on the auto companies, they will adapt and innovate. The same insight underlay the Scandinavian model that you just referred to in the labor market. What the Scandinavians did was to say, we are going to have a relatively egalitarian structure of wages with strong union representation. Firms will have to adjust and become more productive. And that underlay the rise of Scandinavian productivity from the middle of Europe to the top at the present time. So it is a strategy for a stronger and more competitive America.

The CHAIRMAN. I cannot be more inclined to—you cited the Massachusetts response from Bunker Hill, but I did go up into the New York area, and I think my response would be more likely to be "Forget about it."

Professor Meltzer?

Mr. MELTZER. Unfortunately, if we get a big inflation, there is no way we are going to end it without more unemployment. I mean that is just a fact.

The CHAIRMAN. Right. But is it—I guess I phrased it unartfully. Do we have to anticipate the problem by being very tough on the interest rate if the unemployment rate starts trickling down?

Mr. MELTZER. Look at the record of the last three expansions. Now, we did not end up with a high inflation. We did not end up with big unemployment. We pursued a moderate policy through that period and in 2001, 2002, we had a slight rise in unemployment, but, boy, I have never seen a recession in which consumer spending went up and up dramatically. Home buying. Home building. Businesses were the ones that took the heat in the 2001 and 2002 recession. They pursued, I would say, a really strong countercyclical policy.

Talk about the dual mandate in operation. The dual mandate was certainly uppermost in Greenspan's mind in 2001 and 2002.

The CHAIRMAN. Oh, yes, that is very important. You say that clearly in 2001 and 2002, they took very seriously both aspects of the mandate and the results were benign.

Mr. MELTZER. They were good.

The CHAIRMAN. Good.

Mr. MELTZER. Good. Hard on corporate profits, hard on investment, you know, but we took the burden off the consumers. We had a housing boom and an automobile boom. We sold 17 million cars in a recession year.

The CHAIRMAN. Professor Friedman, let's finish up.

Mr. FRIEDMAN. Two points, Mr. Chairman. First, the fact that inequality tends to be abated during a strong economy is yet another reason why the Federal Reserve should take seriously the real part of its dual mandate, but the underlying point is that they should be doing that anyway.

It is not as if they need the connection to inequality to think that low unemployment, all else being equal, is better, and more rapid growth, all else being equal, is better. It is very useful to have the connection to inequality, to the extent that it is there, and I look forward to reading Jamie Galbraith's paper. But it should not be the case that the Federal Reserve needs that argument to think that a low unemployment is better than a high unemployment rate. They should be doing that anyway.

Second, is it going to be necessary from time to time to arrest the growth of the economy in order to keep inflation in check? Well, yes, of course it is. But the real issue is the extent to which the Federal Reserve is willing to press forward on both sides of the dual mandate. In the same way that when inflation is beginning to get out of hand then what they are supposed to do, by Congress' instruction, is to take steps to arrest it, similarly when inflation is not getting out of hand, what they are supposed to do also by Congress' instruction is to press forward to achieve maximum employment. That is what the Act says: maximum employment. It is terrific if maximum employment means impeding the widening increase in wage inequalities, but they should be doing that anyway.

The CHAIRMAN. Thank you. I appreciate that. We are going to have to break. We are going to go vote. I thank the panel for showing up.

I will just say, Professor Meltzer, we will be awaiting the book. And if the book becomes a movie, some of us will be thinking about who should play us in the history of the Federal Reserve.

This has been very useful to us and we really appreciate the thoughtfulness of today.

The hearing is adjourned.

[Whereupon, at 12:20 p.m., the hearing was adjourned.]

A P P E N D I X

July 17, 2007

Statement of Congressman Ron Paul before the Financial Services Committee
Humphrey Hawkins Prequel Hearing
7/17/07

During the 30th year of the Humphrey-Hawkins hearings, it would be helpful for Congress to reassess the usefulness of the Humphrey-Hawkins mandate. The dual mandate calls for full employment and stable prices. Humphrey-Hawkins assumes that the Federal Reserve has unique insights into the United States economy that no one else possesses, that the Federal Reserve knows what prices should be and how much unemployment there should be. Full employment which is brought about through rising inflation will eventually lead to a stagnant economy which will lead to more unemployment. 30+ years after the stagflation era, I would hope that Phillips curves are one of those barbarous relics of the past that have been sent to their graves, along with wage and price controls and bans on the private ownership of gold.

But what I wish to highlight the most is the most pernicious part of the Humphrey-Hawkins mandate is the mandate for price stability. This objective overlooks the natural tendency of prices to fall over time. As new production technologies are brought on line, factories gear up, economies of scale are reached, and the prices of goods will decrease.

Goods which originally are affordable only by the very rich, over the course of time and because of the fall in prices will become available to the poor and the middle class, raising the standard of living of all Americans. 100 years ago a rich person might have driven a car and a poor person would have walked barefoot. Today a rich person might drive a Lexus, while a poor person drives a Kia, but they both have cars, and shoes.

Price stability attempts to disadvantage consumers by keeping prices stable, rather than allowing them to take their natural course of decline. This policy comes from two misguided notions: that lower prices lead to lower profits, and that lower prices lead to deflation. In its effort to ensure price stability, the Federal Reserve resorts to inflation targeting, using the federal funds rate and open market operations to increase the money supply at an ostensible low rate, introducing a subtle but pernicious inflation into the monetary system. Inflation benefits the government and the well-off, the first users of the new money, but harms those who receive the new money last, those who are predominantly poor and middle class.

But prices do not just apply to goods, they also apply to the price of labor, or wages. Wage raises are often indexed to government CPI figures, which are notoriously prone to manipulation. While official government figures show a CPI under 3%, according to the methods used when CPI was first calculated the current rate of inflation is over 10%. What this means is that while wages will remain stable in real terms, the price of goods and services will increase at a faster rate, leading to a decrease in the real standard of living. The Fed's loose money policy then leads to the lure of easy credit, which will hook more and more families, who will find themselves falling deeper and deeper into debt to finance their lifestyles.

Until the Congress realizes that the economy cannot be managed by a group of economists, no matter how large or how brilliant the group may be, the result will be the same. Inflation will continue to rise, and the American people will continue to grow poorer. We would be far better off if the Congress were to reassert its Constitutional authority over the monetary system, establish a sound currency, and eliminate its meddling in the free market.

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.

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[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.

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 disappear? And second, if the Federal Reserve never reacted to inflation, how come it 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 responsible for the quiet behavior of inflation in fact. Some scholars have even credited these hearings with contributing to more effective monetary policy. I should perhaps 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 a sign of economic irrationality if there were. Certainly 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 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 no inflation, and certainly 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.

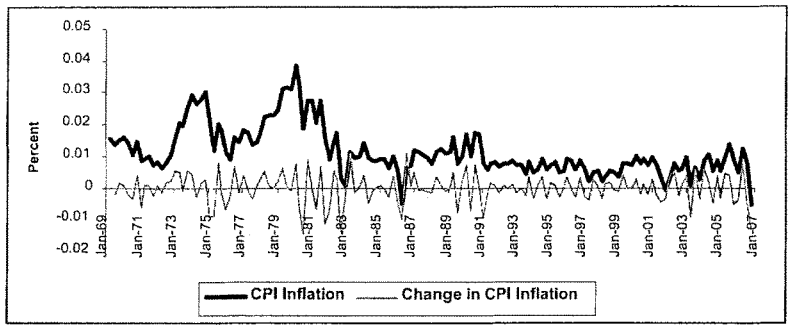


Figure 2. Close Relations: Wage Inequality and Unemployment, 1949 - 2002

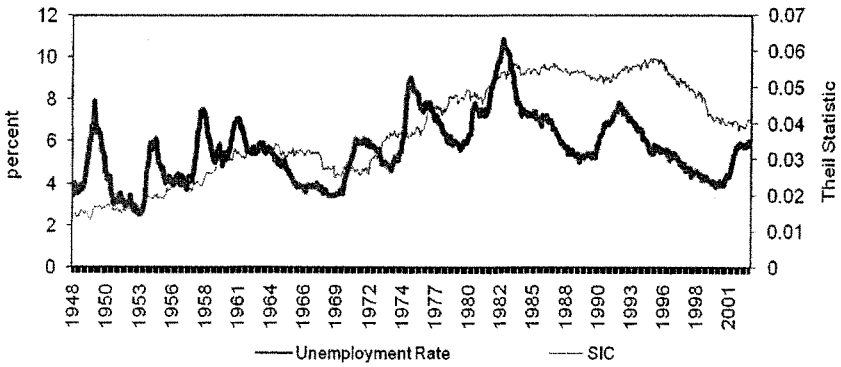
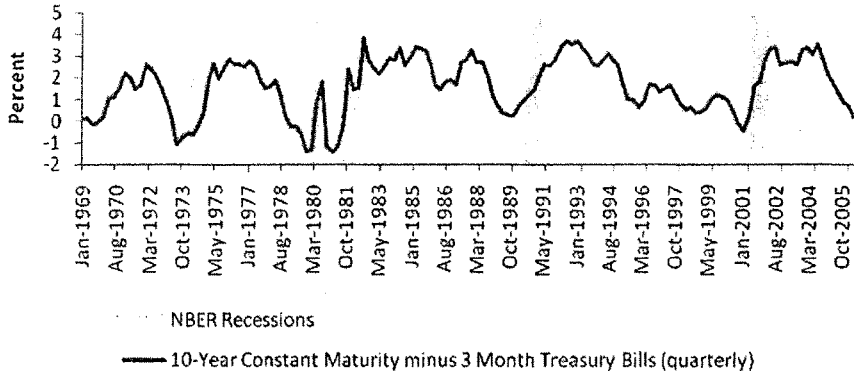


Figure 3. Monetary Stance: The Term Structure of Interest Rates, 1969-2006



Reforming Central Banks

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To the

House Committee on Financial Services

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Reforming Central Banks

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In the past twenty-five years, central banking has been transformed in all developed countries. Several announce inflation targets and make serious and generally successful efforts to achieve the targets. The ECB uses judgment about current or recent data, supplemented by concern about money growth, the "second pillar" of its strategy. The Federal Reserve continues a discretionary policy.

All of the techniques have been much more successful than previous policies or methods of operation. Although they differ in their approach, current operations have two common features. First, central banks are more independent of politics and government than in the past. This is obvious in Britain or New Zealand where the meaning of central bank independence and its limits are set out explicitly in an agreement between the government and the central bank. Second, central banks now give much more weight to avoiding inflation than in the past.

In the 1960s and 1970s, the mantra preached by central banks told the public that inflation would start to rise before the economy reached full employment. Price and wage guidelines were a necessary policy tool to achieve full employment with price stability or low inflation. Instead of getting lower unemployment and lower inflation, major countries--Britain and the United States especially—had higher inflation and rising unemployment.

Even the politicians noticed the failure. More importantly, the voters noticed that countries like Germany and Switzerland put more effort into controlling inflation and did not suffer higher average unemployment.

Governments and central banks discarded the old mantra. Guideposts and wage controls went into the dustbin where they belong. In their place was a new mantra preaching a very different view.

The new claim is that sustained low inflation or price stability is a necessary condition for sustained full employment. Free markets work better than controls. The approximately twenty-five recent years of low inflation have strengthened this belief. With floating exchange rates and low inflation, Britain and the United States have had long expansions and relatively mild recessions. The United States is now in a third long expansion. Aided by more rapid productivity growth, living standards have soared.

Maintaining low inflation has worked extremely well in Britain and the United States but less well in the European countries that joined the European Central Bank. Within the ECB the experience of countries like Ireland with pro-growth policies differs markedly from countries like Germany or Italy that tax and regulate excessively. Virtually everyone recognizes that in Germany, France, and Italy the required solutions to current problems are real not monetary and more generally political, not economic.

Central banks in Britain and the United States should not rest on the achievements of past reforms, important as they are. Both now claim to value transparency and clear communication, a break from the past secrecy that central bankers once prized. It took many decades for central bankers to recognize that just as financial markets depend on them, they depend on financial markets. In principle, interdependence has become accepted.

Central bankers have not explained an ever present part of the uncertainty that accompanies all economic change. The duration of any change is often in doubt. A change may be temporary or persistent. Changes may alter the level or the growth rates. Usually it takes time to decide the type of change that has occurred.

Inflation occurs when the central bank lets money grow persistently above the growth rate of real output. The price level rises steadily and continues to rise as long as the central bank remains on this course. Contrast this inflation with a rise in the price level that continues for a few months or a year. Money growth is unchanged. The rise in the price level can be the result of an oil shock, an increase in excise taxes, devaluation of the currency, and many other one-time changes. As the change spreads through the economy, the price level rises. The rise is typically spread over time so that the rate of price increase at first looks very similar to the monetary inflation just discussed. The difference is that the one-time increase does not persist. Oil prices do not rise from $35

to $70 a barrel this year and to $140 a barrel next year. Central banks must learn to distinguish these one-time increases from the sustained inflation that they, and only they, can cause.

Some make the distinction, or appear to, when they describe their role as preventing the surge in oil prices from increasing the expected rate of inflation. Many market watchers do not make the distinction, and some official statements are misleading. Central banks should clarify their role.

Separating one-time changes from persistent changes is a major problem. Decades ago, in 1948, the late, distinguished economist Jacob Viner wrote to the President of the New York Federal Reserve to caution him about over-responding to transitory changes. Viner wrote:

> "You certainly have the advantage over me of being closer to the market, but it may not be an unmixed advantage. The ticker may loom too large in your perspective and what from the point of view of the national economy are molehills may ... appear to you as mighty mountains."

Mistaking one-time price changes for inflation can be costly. An oil price increase is a tax on consumers and producers. Whether it comes as a restriction of supply as in the 1970s or mainly an increase in demand, as currently, it is a non-monetary event. Reducing money growth to role back the effect of the oil price increase is costly. The first effect is to reduce output or its growth rate. Further, letting the price level rise but holding the maintained rate of inflation unchanged is a low cost way of reducing real incomes, a reduction that must be made to pay the oil producers for the real increase in the cost of their product.

Central bankers and markets must become more familiar with the duration of changes—whether the change is permanent or temporary. They can not do that if they adjust policy fully to new information at each meeting.

Central banks must develop and hold to medium-term strategies. One reason that use of inflation targets has improved policy outcomes is that they encourage attention to the medium term. Central bank directors have to look ahead and give less attention to transitory, often random movements.

In recent years, we have had expansions that are longer than average. It is not chance or accident. It results from better decisions and better policies with more attention to the medium-term.

Central banks should announce and follow a policy rule that seeks stability over the medium-term.

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