CONGRESS OF THE UNITED STATES

JOINT ECONOMIC COMMITTEE

VICE CHAIRMAN JIM SAXTON

PRESS RELEASE

For Immediate Release
June 17, 1999

Press Release #106-36
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STATEMENT OF VICE CHAIRMAN JIM SAXTON
MONETARY POLICY AND THE ECONOMIC OUTLOOK

WASHINGTON, D.C – I am pleased to welcome Federal Reserve Board Chairman Alan Greenspan before the Joint Economic Committee once again. This hearing is one in a series of periodic hearings on monetary policy and the economic outlook.

The performance of the economy in recent years has been very strong, and monetary policy has played an important role in fostering and sustaining this expansion. During the expansion, the Federal Reserve's policy of gradually moving to price stability has resulted in declines in inflation, interest rates, and unemployment all at the same time. This is a remarkable achievement, and Chairman Greenspan deserves much credit for his leadership in monetary policy.

The healthy economic performance also has generated higher-than-expected revenues to the Federal government that have erased the deficit and pushed the budget into surplus. State and local governments have also enjoyed a fiscal bonus from the combination of positive economic trends.

The benefits of U.S. economic growth also were seen outside our country. The health of the U.S. economy has helped offset the effects of the financial and economic problems in the emerging market economies. The positive impact of the U.S. economic expansion on the international economy was complemented by a series of deft reductions in interest rates by the Federal Reserve last fall to stem deflation fears and stabilize the international financial markets.

All of this, including the role of Chairman Greenspan, is more or less well recognized by most Americans. What is less well known is the specific policy framework the Federal Reserve has used to achieve the positive results in the domestic economy. Chairman Greenspan's exceptional leadership of the Federal Reserve is associated with a framework for policymaking known as inflation targeting. As the Chairman and I have discussed at previous JEC hearings, the Federal Reserve has essentially adopted an informal policy of inflation targeting and used it to gradually reduce inflation and unemployment at the same time.

A serious discussion of this policy is useful to explain what the Fed under Chairman Greenspan has done and how it has fostered the extraordinary economic expansion we enjoy today. Personal judgement and wisdom have played an important role, but the framework for policymaking is also critically important. The success of Federal Reserve policy is a combination of several factors, but more understanding is needed about the basis of the policy framework itself.

Inflation targets are a narrow range of permissible increases in a broad price index expressed as annual percentage increases. For example, an inflation target could be defined as an increase in a retail price index of between zero and, say, 2 percent per year. Explicit official inflation targeting can be established as is the case in many countries, or implicit informal inflation targeting can be used as in other countries such as the United States. Inflation targeting as an approach to achieving price stability has proven particularly effective.

Price stability improves the operation of the price system and promotes economic efficiency and growth. Inflation targeting is an approach to achieving price stability through gradual reductions in inflation that minimize economic disruptions in the short run. As noted previously, during this expansion, inflation has been reduced, but unemployment has fallen as well. Only a few years ago many economists would have regarded this outcome as improbable if not impossible. Nonetheless, the Fed's informal approach to inflation targeting shows that gradual reductions in inflation can be associated with strong economic and employment growth leading to lower unemployment rates.

In addition to its successful monetary policy, recently the Federal Reserve has also made further strides towards increased transparency. The Fed has improved transparency in recent years by announcing interest rate changes as they occur, and also notifying the public about changes in the bias of the policy directive even when rate changes are not made. The Fed is to be commended for these steps towards greater transparency in monetary policy. Greater transparency improves the quality of information available to market participants and thus limits the potential for unexpected surprises to unsettle financial markets. Explicit inflation targeting would be a further move toward transparency that would also foster increased accountability.

Chairman Greenspan, your testimony this morning is especially welcome at this critical juncture in monetary policy. We look forward to your testimony.

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