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To Conclude: Keep In ation Low and, in Principle, Eliminate It

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The U.S. economy is doing exceptionally well this year, with low inflation and an average unemployment rate of only 5 percent. Economic growth continues to be robust in this seventh year of the current expansion, which started in April 1991. Since that time, the economy has created 14 million new jobs, and inflation has been comparatively low and stable. In the first nine months of 1997, inflation in the Consumer Price Index was running at an annual rate of only 1.8 percent, which is as close to a stable price environment as we have seen in decades. Private-sector forecasts, however, indicate that inflation, as measured by the CPI, is expected to return to its trend level of roughly 3 percent in the next year.

High employment today means that many workers are acquiring skills and experience that will yield benefits for the rest of their careers. But the best thing about the current economic good news is that it has not been created by artificial demands stemming from excessive money creation. On the contrary, the low money growth and low inflation of the current expansion mean that long-term prospects are not being jeopardized for the sake of today's prosperity.

In response to such good news, some observers—especially those prone to hyperbole—have proclaimed a "new economic paradigm" in which the U.S. economy has become both recession-proof and inflation-proof. In this view, policymakers need not worry about demand or inflation because markets will keep growth strong and inflation in check. However, history suggests caution with respect to such Panglossian notions that "all is for the best in this best of all possible worlds."

We must not ignore the lessons of the past by adopting inflationary policies that have consistently culminated in slowed growth and higher unemployment. The fact is that, throughout history, efforts to use expansionary monetary policy to squeeze more real growth out of the economy than can be sustained have always led to increases in the misery index. What is the misery index? It is the sum of the inflation, unemployment, and long-term interest rates. This index was at an all-time high in the early 1980s, when each of these three rates soared into the double digits. By comparison, the index is very low today, registering less than half the "misery" of the early 1980s.

The purpose of this article is to address the following issues: why low and stable inflation has been good for economic growth, how inflation uncertainty hurts our economy, and what steps the Fed can take to make its price stability policies credible. The appropriate monetary policy response to today's environment of comparatively low inflation, low unemployment, and low interest rates is to nurture it with a credible commitment to price stability—an inflation rate so close to zero that it ceases to be a significant factor in long-term planning. Only in this way can the Fed reconcile its potentially conflicting statutory objectives of "maximum employment, stable prices, and moderate long-term interest rates" and realize its ultimate goal of a rising U.S. standard of living. Let me begin by considering the first issue I posed earlier.

WHY HAS LOW INFLATION BEEN GOOD FOR THE ECONOMY?

Under the successful disinflation policies of the past 15 years, the U.S. economy has enjoyed its most cyclically stable period ever. Since 1982, the economy has had positive growth in all but three quarters out of 59. By comparison, between 1969 and 1982, when inflation was trending upward, there were 20 recessionary quarters out of 56. The current stable growth experience is the best evidence that the Fed's choice to fight the double-digit inflation of the late 1970s and early 1980s has been good for the economy. Even though we have not yet achieved price stability as I've defined it, the current 3 percent inflation trend is the best record we've had since the early 1960s.

Let me briefly review the basic arguments as to why low inflation is good for the economy. First, a stable price backdrop enables the price system to work more efficiently than it would with high and variable inflation. By "working efficiently," I mean that the economy is not wasting resources. When the general level of prices is comparatively stable, decision makers can interpret changes in dollar prices as accurate signals on which to base decisions. In free economies, clear, reliable signals from prices help people make the choices that are best for them. Interest rates, for example, represent one of the most fundamental prices in the economy—the rental price of capital—and the real interest rate is a central factor in savings and investment decisions. But market interest rates transmit fuzzier signals about the required real rate of interest in an inflationary climate, because observed nominal interest rates also respond to shifts in inflation expectations.[1] Accordingly, the decisions of savers and investors are distorted in an inflationary monetary regime.

Thus, the best way to keep price signals clear is to keep inflation low and, in principle, eliminate it.

Second, inflation distorts decisions because it is a hidden tax on the private sector borne by holders of money and government securities. Even at today's 3 percent inflation trend, the real value of a dollar is cut in half in less than 25 years. Although the government admittedly has to collect taxes, the inflation tax generates incentives for wasteful efforts to reduce money holdings, like currency, which depreciate through inflation. Inflation also distorts decisions to save and invest, since inflation-compensating interest payments and inflation-induced capital gains are counted as taxable income. The tax on the portion of interest payments that is intended to adjust for inflation inadvertently enlarges the wedge between the value of the interest paid by the borrower and the after-tax value of interest received by the lender.[2] In the case of capital gains, significant tax burdens can fall on transactions that have not generated any real income—for example, when an asset is sold at a price that has increased only at the rate of inflation. These inflation-induced tax distortions decrease planned savings and interfere with capital formation.

The best way to attenuate the inflation tax is to keep inflation low and, in principle, eliminate it.

Third, recent business-cycle research suggests that a stable, non-inflationary environment, rather than one in which monetary policy is directed at fine-tuning real growth, may be the best contribution monetary policy can make toward sustaining real growth. Behind the premise of fine-tuning lies the notion of a trade-off between inflation variability and output variability—the idea that higher inflation can buy more real growth in the short run. Contemporary thinking, however, says that inflationary variability *threatens*, rather than prolongs, economic expansions. Recessions are often the product of particular inflationary imbalances, instead of expansions that have simply "run out of steam."[3] An example of an inflationary imbalance from the mid-1980s is the excessive investment in commercial real estate that eventually depressed the market, taking years to unwind.

[1] The U.S. Treasury's issuance of inflation-indexed bonds, which began in January 1997, is intended in part to help distinguish changes in real interest rates from changes in expected inflation, but substantial imprecision persists. Campbell and Shiller (1996) provide an international appraisal of indexed bonds in practice.

[2] See Dewald (1986) and Feldstein (1996) for discussion of how inflation distorts saving and investment.

[3] Diebold, Rudebusch, and Sichel (1993) evaluate evidence that the age of an expansion does not significantly influence the probability of the onset of recession.

Because inflation has been shown to be more volatile at higher levels, the best way to reduce its variability is to keep inflation low and, in principle, eliminate it.

In general, U.S. monetary policy has succeeded in capturing many of these benefits of low inflation during the past 15 years. I would further argue that this success has not been an accident but, instead, a deliberate policy choice. The policy shift since the early 1980s to a low-inflation regime has required a commensurate reduction in the rate of monetary expansion. Growth in the M2 aggregate averaged more than 9 percent from 1968 to 1983, but less than half as much—4.4 percent—from 1984 to 1997. This experience demonstrates that the Federal Reserve can restrain excessive money growth and bring down the inflation rate. Inflation control is undeniably the Fed's responsibility because it alone has the tools to determine the long-run rate of monetary expansion needed to keep inflation low. Even though the inflation rate so far this year is running at less than a 2 percent rate, there remains a good deal of uncertainty as to whether inflation is down for the count. Until price stability becomes the explicit, publicly recognized, and sole objective of monetary policy, a degree of inflation uncertainty is bound to persist. Let me now turn to the second of my three questions.

WHY IS INFLATION UNCERTAINTY BAD FOR THE ECONOMY?

In addition to expected inflation, inflation *uncertainty* increases nominal interest rates because lenders demand compensation for the risk they take that inflation might end up higher than expected.[4] The inflation-risk premium, which effectively raises real borrowing costs, arises in policy regimes where credibility is imperfect. What happens is that lenders judge that future inflation will almost certainly not be much less than expected, but could quite possibly be considerably *more* than expected. This asymmetry often results when inflation has fallen to a low level at which lenders and borrowers agree that inflation has a greater likelihood of a substantial increase than decrease. In such an environment, market interest rates adjust to compensate lenders for facing these asymmetric risks. As a market response to uncertainty, the inflation-risk premium resembles other risk premiums that help people hedge against risk. Whereas other risk premiums respond to risks that are intrinsic to the nature of the investment, the inflation-risk premium hedges against an unnecessary risk uncertainty surrounding the value of the money that will be used to repay the debt. Only a non-inflationary monetary regime can eradicate this unnecessary inflation risk and thereby deliver the lowest sustainable real borrowing costs to stimulate capital formation and foster future growth.

International evidence suggests that investors often require substantial inflation-risk premiums. After they have been burned by inflation once, investors typically need to see years of consistently low inflation to convince them that the risk of inflation has subsided. For the past several years, almost all major industrial countries have had inflation rates well below 5 percent. Yet the real borrowing costs on government securities differ widely across countries because of the substantial inflation-risk premiums in countries that have a long history of inflation. Indeed, the prospect of reducing the inflation-risk premium in their interest rates strongly motivates Italy, Portugal, and Spain, for example, to join the European Monetary Union.

Much of the inflation-risk premium in interest rates stems from the experience that once inflation is unleashed, the process of bringing it back down is long and painful. As a consequence, it is even more important for the Fed to convince the public of its intentions to contain inflation. Reductions in the inflation-risk premium are possible if the Fed follows a disciplined and credible policy to move inflation lower and keep it that way. This brings me to the last of my three questions.

[4] Kandel, Ofer, and Sarig (1996) and Chan (1994) find evidence of an inflation-risk premium in interest rates.

HOW CAN THE FED MAKE PRICE STABILITY POLICIES CREDIBLE?

The persistence of inflation-risk premiums in nominal interest rates—even with inflation as low as it has been in recent years—is an indication of imperfect inflation credibility. A policy is credible when it can be counted on. And a credible non-inflationary monetary policy is one that can be counted on to keep inflation low. Credibility is an essential element of a price stability policy for the simple reason that only when people have faith in price stability can the full range of benefits begin to accrue. Otherwise, interest rates will remain elevated by an inflation-risk premium.

New Zealand is one country that had a history of high inflation in which the central bank appears to have rapidly acquired credibility for its new, low-inflation policies.[5] There, a legislative mandate calling for price stability through inflation targets has convinced investors that the country's imperfect past inflation record is not likely to recur. Without this newly created credibility—even with low current inflation—long-term interest rates in New Zealand could easily be 3 or 4 percentage points higher than they are. By achieving a degree of credibility through inflation targets and a legislative mandate that makes price stability the monetary policy objective, New Zealand has been able to reduce real borrowing costs substantially.

I am concerned, however, that in the United States, 3 percent inflation has become too entrenched in people's expectations. One argument against a move to lower inflation is that, because of these entrenched expectations, the transition would be too disruptive. Indeed, a surprise attack on inflation could well lead to a regrettable loss in output. A sound way to change these entrenched expectations would be to adopt an approach similar to that of New Zealand and several other countries. This approach involves setting a precise inflation goal and a timetable for achieving it. At the semiannual congressional hearings on monetary policy, the Fed could announce a set of multiyear inflation targets, which would then define a course by which inflation could gradually be reduced. Correspondingly, policy actions would be geared both to place inflation within that year's target range and to set the stage for the following year's target. In short, when inflation is too high—and I think even 3 percent is too high—a specific inflation target and stated timetable would make it easy to see if policymakers were in fact carrying out their responsibilities.

I would argue that announced policy objectives in the form of inflation targets would enhance the Fed's credibility, because its policy actions would be easier to interpret. In such an environment, preemptive policy actions against inflationary pressures could be readily understood for what they are. If, on the one hand, people believed that the Fed were merely acting at an early stage to head off inflationary imbalances, they would understand that the economy was not in immediate danger of either a recession or a burst of inflation. If, on the other hand, the Fed had poor credibility and poorly understood reasons for acting, the public might believe that the Fed acts only when panicked, and they might therefore interpret any Fed action as cause for alarm.

CONCLUSION

I have emphasized that "price stability" is a state that must be sustained, and considered sustainable, over time. Although CPI inflation has been running at just 1.8 percent so far this year, longer-term expectations are for roughly 3 percent a year, and there is always a risk that inflation could run higher. What really matters is not merely the absence of inflation at any given point in time, but the widespread presence of public expectations that prices will remain stable in the *future*. I believe the best way for the Fed to achieve price stability is to announce multiyear inflation targets, paving the way for private plans, contracts, and Fed policies to reinforce each other. In this way, price stability represents a compact with the American

[5] Walsh (1996) discusses recent monetary policy practice in New Zealand.

people that, if upheld, could achieve lower interest rates, eliminate the deadweight costs of inflation, and remove inflationary imbalances as a cause of economic downturns. For its part, the Federal Reserve can best contribute to this compact by confirming that it is following a price stability policy by announcing specific inflation targets and a timetable for meeting them. A legislative mandate along these lines would further strengthen the compact.

I do not think the excellent performance of the U.S. economy during the current economic expansion is just a chance occurrence. The low-inflation environment has been an important contributing factor, and the public should give monetary policies that have restrained excessive money growth their due credit for contributing to current economic good times. The public should also recognize that the Fed's single-minded pursuit of price stability is the best way it can contribute to an economic environment of sustained growth and a rising standard of living.

Indeed, my conclusion is that the best policy for economic growth is to keep inflation low and, in principle, eliminate it.

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