

ECONOMIC COMMENTARY

Federal Reserve Bank of Cleveland

Skepticism about the Direction of Inflation: Causes, Costs, and Cures

by Jerry L. Jordan

Bumper stickers sometimes convey important ideas. In the 1980s, a familiar one on America's highways read "VISUALIZE WORLD PEACE." The underlying idea was that visualizing helps people behave in ways that tend to bring the vision to reality.

In the 1990s, I would like to see a bumper sticker that says "VISUALIZE PRICE STABILITY." If everyone today acted on the belief that the dollar's purchasing power would remain constant, households and businesses would make decisions quite differently, with overwhelmingly beneficial effects for the economy. But many Americans are skeptical about the government's ability — as well as its resolve — to keep the price level stable, and this skepticism is hampering the nation's economic performance.

■ The Current Situation

During the 1992 presidential campaign, the performance of the economy was the No. 1 issue. With the election over and a new administration soon to be in place, White House efforts to foster more rapid economic growth than seen in the last few years will undoubtedly receive top priority.

A number of factors, including the glut of commercial office space, the reduction in national defense spending, and the adaptation of business practices to information processing technology, have certainly contributed to the economy's sluggishness. Adjusting to

such fundamental changes will require time, patience, and an economic environment in which households and firms can make sensible long-run decisions about consumption, savings, and investment.

Inflation currently is low, but unfortunately, the public does not expect that to be the case in the years ahead. This skepticism is evidenced by the disparity between what people *see* and what they *foresee*. Over the last several years, inflation has been trending down (now hovering around 3 percent), and there is evidence that it is likely to stay low for the next year or two. Furthermore, the avowed intent of the Federal Reserve's key policymaking body, the Federal Open Market Committee (FOMC), is to keep a tight rein on prices. Domestic policy directives issued by the FOMC in recent years all state that the Committee seeks monetary and financial conditions that will foster price stability.

Nevertheless, the public continues to expect inflation to heat up. Long-term interest rates have remained stubbornly high — the yield curve is the steepest in history — and people seem to believe that when the curve flattens, it will be the result of short rates rising rather than long rates falling. Surveys show that consumers are anticipating inflation of about 4 percent over the next 12 months and 5 percent on average over the next five to ten years. The consensus Blue Chip forecast is

Even though the Federal Reserve has been successful in keeping inflation in check over the last several years, and despite its avowal to continue targeting price-level stability as its top priority, most Americans are still making financial decisions conditioned on the belief that inflation is likely to be higher in the future than it is today. Here, Cleveland Federal Reserve Bank President Jerry L. Jordan discusses the reasons for this public skepticism about price stability, the real economic costs entailed, and the ways in which Congress, the Federal Reserve, and the new administration can help.

for the 30-year Treasury bond rate to hit 7.5 percent next year and 7.7 percent in 1997. Such rates would be extremely high in a stable price environment. Furthermore, consumers have been refinancing their mortgages and corporations have been borrowing long-term money in record volumes at fixed interest rates that are quite high, unless one believes inflation will once again reach the 4 to 5 percent range.

Such behavior by millions of Americans reflects a general skepticism about the prospects for achieving and maintaining price stability. In view of what caused the skepticism, it may be justified, but the result entails substantial real economic costs. Fortunately, cures are available for the Federal Reserve, the Administration, and the Congress to pursue.

■ The Causes of Skepticism

There are several reasons why Americans are so skeptical about the future course of inflation and monetary policy. Once one has lived through a period of ever-rising prices, it is not unreasonable to question policymakers' determination to avoid a repeat. The Federal Reserve lost much of its credibility as a champion of price stability when it allowed inflation to accelerate out of control in the 1970s. Although it regained some ground in the early 1980s, assertions of a price stability goal again began to ring hollow as inflation was allowed to remain in the 4 to 5 percent range throughout most of the decade. At 5 percent inflation, the price level doubles in about 15 years.

Another factor contributing to the prevailing skepticism is that many people believe (incorrectly, in my view) that a long-run trade-off exists between unemployment and inflation. As they see it, monetary policymakers will choose — or be forced to adopt — an inflationary policy aimed at reducing the jobless rate.

It has also been argued (again, I think, incorrectly) that a little inflation is good for the economy. Indeed, several recent articles in *Business Week*, *The New York Times*, and *Investors Business Daily* draw on both this belief and the unemployment/inflation trade-off argument to suggest that the Federal Reserve should again forsake price stability in order to get the economy moving at a faster pace in the near term.

Unfortunately, the timing of the Fed's actions over the past two years has falsely led some observers to conclude that the central bank is already targeting real growth at the expense of inflation. By cutting interest rates immediately following reports of a weak labor market on numerous occasions, the Federal Reserve has fostered the impression that its primary concern is near-term employment growth, not price stability. This interpretation is incorrect. In fact, policymakers know that the only sustainable pro-growth monetary policy is one that achieves and maintains price stability. Federal Reserve policy during the past decade has been based on recognition of this tenet.

Another reason for Americans' skepticism is the lack of support for price stability from Congress and the Bush Administration. Congress was unreceptive to the proposed Neal Resolution mandating price-level stability as the Federal Reserve's primary responsibility, while the Administration did little to promote either that goal or Federal Reserve System independence. Indeed, Treasury Secretary Brady frequently criticized the Fed for keeping the reins of policy too tight.

Finally, despite the huge budget deficit, neither the Administration nor Congress has demonstrated the political will necessary to constrain the growth of government spending. This failure is important in light of the widespread belief that, in the long run in a democratic society, the same political forces

that produced the fiscal deficits will ultimately force the Federal Reserve to monetize the government's debt, resulting in inflation. To the extent that financial market participants believe in this long-run "fiscal dominance" theory, large budget deficits will prevent long-term interest rates from falling.

Skepticism about the outlook for price stability is a reasonable response to past experience. In the post-World War II period, inflation has fallen during recessions or periods of slow growth, only to accelerate to even higher levels as subsequent expansions have gained momentum. Such experience apparently has caused many people to believe that growth *per se* causes inflation, while in fact it is inflation that necessitates the policies that bring growth to a temporary halt.

■ The Costs of Skepticism

The economy pays dearly for Americans' skepticism about Washington's willingness to hold the line on inflation. Since taxes are based on nominal rather than real income, long-term investment is discouraged: High expected inflation means high effective taxes on real capital income. Long-term investment is also reduced as managers, incorporating an inflation risk premium into their bottom-line calculations, establish higher hurdle rates for proposed projects. The result is that shorter-lived, "quick payback" projects are favored over long-lived additions to the nation's capital stock.

What's more, many projects that would be viable in a low-inflation environment are not undertaken at all. Among other things, reduced investment slows the structural adjustments necessary to foster economic growth, such as the conversion of defense industry plants and workers to peacetime pursuits.

Expectations of higher inflation also cause valuable resources to be expended in designing, marketing, and seeking out financial instruments to serve as inflation hedges. In addition, some physical assets are used to protect against inflation, leading to overinvestment in such things as inventories and houses, at the expense of investment in other physical assets that would be more productive for the economy.

Expecting inflation to be higher than what actually occurs can result in nominal wages and other contractual costs rising faster than business revenues, in turn lowering profits and prompting managers to slash costs by cutting payrolls. That is, if inflation turns out to be lower than was anticipated when wage contracts were signed and other costs were agreed to, companies will end up paying more than they bargained for in real terms. This puts pressure on managers to pare their work forces and to reduce other production costs.

Finally, when borrowers and lenders act on the belief that inflation will be higher than what emerges, *ex post* real interest rates rise and wealth is transferred from debtors to creditors. For businesses, the higher real debt-servicing burden (and lower profits) increases the probability of default, dampens credit demand, and reduces confidence about the future. For households, the same debt-servicing burden cuts into the amount of discretionary income available for consumption spending. It is unlikely that the prosperity-lowering responses of businesses and households to their losses will be fully offset by creditors' responses to their windfall gains.

■ The Possible Cures for Skepticism

There are several actions that the Federal Reserve, the Clinton Administration, and the new Congress could take to instill confidence in the future course of inflation and monetary policy. The United States could adopt a specific multiyear target for the price level that reflects a gradual slowing and then a cessation of inflation. The credibility of such a program would be enhanced by placing monetary policy actions firmly within a longer-term perspective pointed exclusively at achieving price stability. Obviously, such a program requires judgment, but it is important that judgment be exercised in the context of the longer-term price stability objective.

Monitoring the growth rates of monetary aggregates that have a long history of consistency with movements of the price level would be an important part of such a program. As policymakers, we know that producing money faster than people want to add to their money balances creates an excess supply that results in a rising price level. But from time to time, as in the past few years, these relationships may be disturbed temporarily. On such occasions, the necessary monetary policy judgments and adjustments should be made within the longer-term framework. Doing so would be reassuring to financial market participants who closely monitor central bank actions.

The Fed could also improve the timing of its actions. By associating policy actions with the monetary aggregates instead of with labor market data, monetary authorities would avoid the implication that they are shifting their focus away from inflation and toward the attainment of some particular employment or output level that they cannot systematically control anyway.

The Federal Reserve's credibility would also be enhanced — and skepticism reduced — if it were to announce a target path for the price level and then clearly articulate to the public its plans for achieving that goal. In addition, until the central bank's credibility is secure, it would also be helpful to promptly and

fully explain any tactical changes in policy implementation necessary to keep policy consistent with the price-level objective. To some extent, this is now being done in February and July of each year, when target ranges for certain monetary aggregates are set and are announced to Congress by the Federal Reserve Board Chairman in his mandatory Humphrey-Hawkins testimony. However, that process does not include a specific timetable for achieving price-level stability, nor does it require specification and explanation of FOMC actions, judgments, and responses when monetary policy actions do not appear to be consistent with the longer-term goal of price stability.

There are several important contributions the new administration could make as well. First, it could declare its support for price-level stability and then endorse the schedule adopted to reach that goal. Publicly supporting the Neal Resolution would be a clear sign of the executive branch's intent.

Second, to demonstrate its conviction, the White House could use the Federal Reserve's targeted price-level objectives (inflation rates) in its own budget calculations. By law, the Administration is required to project expenditures and receipts for five years, based on inflation and other assumptions. Avoiding the use of inflation forecasts that are higher than targeted by the Fed would add credibility to such objectives.

And finally, it is critically important that the Administration work with Congress to keep the growth of government spending in line with that of tax revenues so that budget policy will not appear to be on a collision course with monetary policy. The public always worries that politicians will resort to an unlegislated inflation tax when current expenditures are not covered by explicit taxes.

Congress likewise has a role to play in allaying inflation fears. First and foremost, it must work with the Administration to get federal finances under control. Second, legislators should resurrect and pass the Neal Resolution. And third, the Fed should be held accountable for achieving its targeted price-level trajectory.

By helping to reduce long-run inflation expectations, these steps by the Fed, Congress, and the Administration would immediately reduce long-term nominal interest rates. This in turn would raise investment, thus speeding economic expansion in the short term and contributing to long-run growth.

■ Conclusion

At current rates of inflation and monetary growth, the adjustments that would be required to achieve price stability are quite small. There is no time like the present to consolidate hard-earned gains.

In principle, the Federal Reserve can achieve price stability regardless of the fiscal policies hammered out on Capitol Hill. But it is by no means certain that a government permanently wedded to massive budget deficits will refrain from trying to change the Federal Reserve Act in ways that would force the central bank to assist in financing Washington's fiscal follies. Governments are always tempted to use monetary policy to achieve short-run employment objectives, believing that any inflation by-product can be dealt with at some later date.

Instead of relying on luck, as some administrations have, the Clinton White House should take a lesson from history. Tolerance of inflation creates costs and complications. When the pressure to try a little inflation builds, as surely it will, we would all be wise to remember a popular bumper sticker of several years ago: JUST SAY NO.

This Economic Commentary is based on a speech presented by President Jordan to the Association of Bank Holding Companies in Tucson, Arizona, on November 5, 1992.

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