For Release on Delivery
6:30 P.M. E.S.T.
February 15, 1990

THE CASE FOR PRICE STABILITY

remarks by

Wayne D. Angell
Member, Board of Governors of the Federal Reserve System

before

Forex USA Inc.
New York, New York

Thursday, February 15, 1990

THE CASE FOR PRICE STABILITY

I speak today amid an inflationary climate. By this, I don't just mean that broad measures of prices have been rising at around a 4-1/2 percent rate for some years. Nor am I merely refering to the recent bulge in monthly figures for energy and food prices in the wake of the December cold snap. Instead, I mean today's climate of opinion about inflation.

Attitudes reflecting an acceptance of inflation as a normal fixture of economic life have become pervasive. Surveys indicate that the markets expect recent inflation rates to persist. The consensus forecast of private economists embodies the same view. Without doubt, the climate of opinion has adapted, unfortunately, to perpetual inflation. It's time to change that.

Too many observers believe that, given the price experience of recent years, the Federal Reserve is satisfied with stabilizing the inflation rate at around 4-1/2 percent. That view draws the wrong conclusion from the experience of the 1980s. The Federal Reserve's war on inflation since 1979 is really a multi-step process. In the first stage, the Federal Reserve orchestrated a deceleration of inflation from double digits down to 4 percent by restraining monetary growth. During the mid-1980s, however, progress appeared to stall. Our ability to approach price stability was limited at that time by several factors, including importantly the very large depreciation of the dollar from its high in early 1985. The dollar adjustment caused imported goods to become more expensive, at the same time that it stimulated U.S. exports.

The dollar's decline added a temporary upward bias to inflation, particularly as measured by the CPI. On the other hand, monetary policy succeeded in containing the overall price effects of dollar depreciation as well as drought-related commodity price and energy price readjustments. The time has come to move on, however. Conditions now allow us to further disinflate in an atmosphere of near-equilibrium foreign exchange rates and energy price levels. If markets recognized this, they would not count on inflation to persist at around a 4-1/2 percent rate.

The current climate of opinion about inflation is just plain wrong--and on several counts. It's wrong ethically to sanction inflation, which is like licensing cheating and the mistrust it breeds. It's wrong economically to dismiss inflation's inefficiencies and human costs, which hamper and threaten economic stability and long-term economic growth. And it's risky financially to bet on continuing inflation, because it has to be stopped. I'd like to elaborate on these three points.

From an ethical perspective, inflation introduces a fundamental element of dishonesty into social relations. With inflation, a dollar tomorrow will not be as valuable as a dollar today. In this case, the economy's standard of value and unit of account is worth less and less over time in terms of its command over goods and services. True, people recognize this depreciating value and make adjustments. Market interest rates rise to compensate lenders for the expected reduction in the future purchasing power of their principal, and borrowers pay the higher interest knowing their loans will be repaid later in depreciated dollars.

While credit markets do adjust to inflation, the adjustment is imperfect because inflation forecasts are imperfect. An element of uncertainty and risk is thus inevitably introduced into borrowing and lending activities that would be absent if the parties could instead depend on stable prices. With inflation, the parties can't count with certainty on how much the legal tender will be worth in the future. The situation is akin to the added uncertainty faced by buyers if sellers typically could be expected to lie about the quality of their products. Buyers would adjust, all right, offering to pay lower prices than they would if sellers were always truthful. But the buyers wouldn't know exactly how much of a discount would be appropriate, since they wouldn't know exactly how untruthful sellers were. An underlying sense of suspicion and insecurity would creep into transactions for goods and services.

It's not really so different for financial transactions in a climate of inflation--just consider the wide variety of credit market transactions that households and businesses have to rely on to protect and augment their financial wealth. A basic sense of distrust and insecurity is fostered in an inflationary atmosphere, and it would hardly surprise me if such unwelcome attitudes did not stay confined to credit transactions but began to permeate other social interactions as well.

Let's retreat a bit to the sphere of political economy and the related issue of trust between the citizenry and its government. If the government, as represented by the monetary authority, has committed itself to price stability, its credibility is on the line, as with any stated inflation goal. But why would a stable price goal be more credible than another inflation goal? That is, why would a central bank be viewed as more inclined to stand by a commitment to price stability, or to restoring price stability in the event of temporary shocks away from it, than a commitment to maintain or restore a 4-1/2 percent inflation rate? Put another way, why would the public's uncertainty about actual price deviations from the announced objective be smaller if the objective is price stability than if it is 4-1/2 percent inflation?

I believe the answer is obvious. A stable price level goal has an inherent plausibility--the tie to a stable purchasing power for the legal tender--that is lacking for any other inflation goal. A central bank's announcement and attainment of a stable price level objective would resonate with the citizenry in a way that no other goal could. To me, a stable price goal is the only inflation goal a central bank can adopt that can itself contribute to the people's sense of trust in the government and in its commitment to a stable economic environment.

Worth noting at this point is the role played by the credibility of the monetary authority in keeping the actual rate of inflation near the target in the face of transitory shocks. Central bank credibility also is crucial in minimizing the transitional economic costs in terms of the output and employment losses of restoring inflation to target in the wake of upside deviations. Thus, the greater credibility of a price stability target means that it can be more readily attained over time than any other inflation objective.

In my view, maximum productivity, efficiency, and economic growth can be achieved only in a climate of price stability. The welfare costs of inflation are readily identified, though I admit less easily quantified. I see several major sources of economic benefit from achieving price stability--lower long-term as well as short-term interest rates, a redirection of resources away from speculative and toward productive activities, more long-term contracting, an improved price mechanism, better information about firm profitability, fewer tax code distortions, and more stable economic activity around a higher level.

First, long-term interest rates would no longer embody premia reflecting both inflation expectations and the uncertainty surrounding the accuracy of those expectations. As a result, price stability would enable investors to focus more on long-term projects rather than being obsessed with pursuing short-term gains. Also, with more certainty about future trends in the overall price level, our saving rate would tend to be higher. Households would be more inclined to invest in long-term projects if they felt more secure about the future purchasing power of their savings.

Second and furthermore, stable prices would make people less inclined to invest in speculative holdings rather than in long-term securities as a way to protect the real value of their wealth. In addition, more effort would be directed at productive investments and innovations. Currently, too much attention is placed on <u>how</u> to finance activities rather than on <u>what</u> activities to finance. One has to wonder how much lower rates of inflation have benefited Japan and West Germany in these respects and how much our own inflation experience by contrast has encouraged short-sightedness.

Third, certainty about the long-run purchasing power of a dollar would promote a lengthening of contracting to a more optimal extent in labor and goods markets, as well as in financial markets. By their nature, contracts reduce uncertainty about the future, and allow buyers and sellers to weigh more heavily the long-term benefits of their actions. Given that private contracts cannot be indexed perfectly, inflation makes entering into long-term contracts riskier. Because it discourages such contracting, inflation robs our economy of long-term relationships between people based on their mutual interest. Eliminating the fear of unexpected price movements over the long haul would foster the long-run planning that facilitates investment and economic growth.

Fourth, price stability also would reduce the uncertainty that buyers face in detecting the true equilibrium prices of goods. With stable prices, buyers would be better able to sort out relative from general price movements, as the latter would be eliminated in the long-run. By distorting the signals that prices send to buyers and sellers, inflation leads to serious inefficiencies in the allocation of resources. Some may say that as long as inflation is anticipated, the signalling function performed by prices is unimpaired. But even an anticipated inflation creates confusion, because price increases across and within industries would not be simultaneous.

Fifth, inflation also introduces uncertainty about whether profits reported by firms accurately indicate economic profits. One tangible example is that under permissible accounting practices inflation can affect reported profits depending upon the accounting treatment of inventories and depreciation. To some extent our capital markets can decipher economic from reported profits by employing a large number of investment analysts. Nevertheless, an element of uncertainty and added costs persists about assessments of economic profits.

I believe that because inflation introduces a source of uncertainty regarding how well markets can assess firm profitability it hurts our economy in two big ways. First, uncertainty about true profits can breed worker mistrust of profit-sharing and other flexible wage arrangements that offer potentially large efficiency gains to our economy. By hindering the application of better compensation systems and labor management relations, inflation denies us of the benefits of more flexible wages for stabilizing economic growth in the short run and of improvements in productivity in the long run.

Furthermore, the inflation distortions to profit accounting can hide evidence of poor management from shareholders and lenders. This not only may allow inefficient managers to continue running companies into the ground, but also may cause investors to misallocate resources because they lack good information about the true profitability of some firms and the capability of their management. It also encourages investors to demand higher returns from investing in businesses, especially less well-known ones, as compensation for added uncertainty about true profits. For these reasons, price stability would enable our financial markets to function better in allocating capital.

A sixth major benefit of price level stability is that it would eliminate the distortions that inflation creates through the tax code. Two prime examples, perhaps the most important ones, are the effects on long-term investment and on how corporations finance their activities. Under the current tax code, any capital gains that simply compensate investors for inflation are subject to taxes. Hence, inflation increases the share of real capital gains that are taxable, and thereby artificially lowers the real return on capital gains. Also, in this way, inflation encourages Americans to be short-sighted. Price stability would eliminate this distortion and encourage markets to assess short-term versus long-term investments in accordance with their true economic benefits.

Inflation also artificially encourages debt over equity financing. Because interest payments on debt are tax deductible under present tax laws, any inflation premia built into interest rates are tax deductible. However, any inflation embedded into the nominal capital gains to shareholders is not deductible. Since investors focus on after-tax returns, shareholders require greater before-tax returns from firms to provide long-term finance than do debt holders. For this reason, inflation artificially lowers the cost of debt financing relative to that of equity financing under our tax structure. By contrast, price stability would encourage firms to use the mix of debt and equity financing that best reflects fundamental economic considerations, rather than the flaws of our tax code.

Of course the Congress could alternatively rewrite the tax code to correct these and other problems. But given the vagaries of the legislative process--especially when it comes to tinkering with the tax code--I think prospects are better for stabilizing prices.

Finally, long-run price stability would promote more stable economic growth for two reasons not yet mentioned. First, it would eliminate one source of uncertainty about the foreign exchange value of the dollar. By undertaking an explicit and credible policy of stabilizing the price level, the Federal Reserve would ensure that the U.S. economy avoids the destabilizing effects of vicious cycles that can occur when inflationary expectations and exchange rate depreciation interact. With price expectations firmly anchored, monetary policy would more efficiently cushion price shocks from outside or inside the U.S. economy without destabilizing foreign exchange, domestic financial expectations, or economic activity.

Second, price stability precludes stop-and-go monetary policies that work to synchronize business cycles across sectors. As a result, overall economic growth would be steadier, with resources shifting away from contracting and toward expanding sectors in a more orderly way. Consequently, swings in unemployment and the incidence of production bottlenecks would be minimized.

I believe that the best overall course of action that we can take is to fulfill our commitment to attain price level stability within four years. A four-year horizon is short enough that the public would see progress against inflation every year, and it is long enough to enable the policy to gain credibility, which would reduce any temporary costs of attaining price stability.

Now, some may object that the short-term consequences of stabilizing the price level are not worth the ultimate benefits. But I think that many people fail to see the potential benefits enumerated above of price stability to our long-run economic health.

I also think that some people overstate the short-term costs because they overlook the likelihood that during the transition period, the Federal Reserve will gain credibility by demonstrating progress toward price stability. By further reducing trend M2 growth over time and thereby upward pressures on prices, the Federal Reserve indirectly can reduce any temporary adjustment costs in terms of lost output and employment. Commodity prices, which the Federal Reserve staff has found to have a stable relationship with final goods prices in the long-run, can continue to be an important indicator in implementing this strategy. One reason that such a strategy would work is that the Federal Reserve would be better able to anticipate correctly and to offset price pressures. In addition, market prices for commodities, which are forward-looking, would stabilize faster under this strategy and thereby help stabilize the cost structure of producing final goods and services. This in turn will further enhance the credibility of attaining price-level stability and result in workers pressing for smaller cost of living adjustments as they see faster progress toward stable prices.

I am optimistic about the prospects for achieving price stability for several reasons. First, over the past three years, the Federal Reserve has slowed the growth of M2 to a 4-1/2 percent average, and I believe we are now beginning to see a reduction in inflationary pressures. A good indicator of underlying inflation trends is the CPI less its volatile food and energy components, which react sharply to temporary supply disruptions. We have seen a decline in the rate at which this key index has increased--from 4-3/4 percent in 1988 to 4-1/4 percent last year. I expect that we will see continued progress in the prices of goods in 1990 and then somewhat later in the prices of services.

In addition, I think that our ability to eliminate inflation in a shorter period of time and with smaller transitional costs has improved because our wage and price system has become more flexible over the 1980s. One only has to look at the spread of profit-sharing and performance-based compensation systems and the greater use of variable interest rate contracts to see this. These innovations allow the prices of labor and capital to respond more readily to economic conditions, thereby minimizing underutilization of production factors when nominal shocks occur. Another indication of increased wage and price flexibility was our own experience in the early 1980s, when the inflation rate was brought down more quickly and with less temporary unemployment than the experience of the 1970s and 1960s would have suggested.

A final reason for optimism is the growing number of policy-makers inside and outside the Federal Reserve System that have seen the wisdom of pursuing price stability. Many are recognizing that an independent Federal Reserve with price stability as its essential goal would, as I have suggested, foster the long-run health of our economy and would also help restore a sense of confidence in our financial system--a system which has been buffeted by the S&L crisis, scandals on

Wall Street, and a nearly intractable federal deficit. Many people are also realizing, as I have, that the stability of our economy is at too great a risk if we do not pursue price stability.

To summarize, the economic losses and risks of doing nothing more about inflation are large enough that complacency is not a viable alternative. The longer we wait to attain price stability, the longer we deny our society its benefits. It is now time that we begin completing the process of disinflation. Price stability promises lasting gains that would dwarf any transitional costs. The Federal Reserve should conduct a clearly enunciated, credible anti-inflation policy, reaching its goal of price stability in four years. This achievement would transform the climate of inflation to one of price stability, thereby lifting the cloud of mistrust and uncertainty that hangs over our nation's future. We must attain price stability, for it is the moral and economic imperative of a central bank.