The Role of Inflation in Current Economic Performance

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I'd like to begin today with the best news you could hear from any speaker on a Saturday morning: I intend to be brief. I've been allotted 45 minutes, but I shouldn't take up much more than half that time. I'll be happy to take a few related questions in the time remaining. Also, because your businesses and mine depend on the same economic information, I'll be interested to hear your perspective on the economy.

We are now well into the eighth year of an economic expansion that began back in April of 1991, soon after the end of the Persian Gulf War. This extended run in growth of real gross domestic product—GDP—is impressive but not unprecedented. In fact, there have been two lengthier economic expansions since the end of World War II: the longest was from February 1961 to December 1969, and the second-longest was from November 1982 to July 1990. By the end of the year, however, the present expansion will rank as the second-longest in the post-World War II era.

Still, if the current economic growth streak isn't yet unprecedented, the accompanying low unemployment and inflation truly are, at least in the postwar era. Consider this: the unemployment rate has been below 6 percent for more than three years, and hit a 28-year low in April. Inflation as measured by the consumer price index has been at 3 percent or lower for more than six years. We have not seen this combination of sustained growth, low inflation and low unemployment in a generation. And just about every economic forecaster is predicting the same for the remainder of 1998 and throughout 1999.

Next to, What's going to happen to interest rates? (which I'm never able to answer), the question I'm asked most often these days is, Why have things been so good? That, I think, is the right question. As business people and policymakers, it is essential that we begin to glean some lessons from the current expansion so that we can take advantage of them in the future.

Like so many things in business and economics, there is no simple explanation for why we are enjoying the best economic performance in our lifetime. This morning, however, I want to identify several contributing factors and then explore in more depth what I think is the single most important element in the economy's performance: low inflation.

To begin with, we've benefited from some old-fashioned good luck. Most notably, a series of positive oil shocks has helped keep prices low throughout the economy. This is simply the reverse of the 1970s negative oil shocks: Lower oil prices have given businesses and consumers more money to spend on other things, raising our standard of living. The globalization of markets has also helped: Increasing competition for goods helps keep import and import-competing prices low. Technology is a third factor. While I do not believe that traditional supply constraints have been repealed, it is clear to me that computers, data processing and communications technologies have improved productivity somewhat, and in doing so have very likely raised the rate at which our economy can grow.

Without question, all of these things have helped expand output. But they are secondary in order and importance to the economic policies—fiscal and monetary—that produced the low inflationary economic environment. On the fiscal side, Congress and the Bush and Clinton Administrations deserve enormous credit for balancing the Federal government's budget; this has been, without a doubt, among the most important factors in bringing interest rates down with inflation. And on the monetary side, Fed policy has given great weight to achieving and maintaining a low inflationary environment.

Throughout the Southeast, individuals and business leaders tell me that low and stable inflation is extremely important and that they are counting on the Fed to make sure it stays low. But people often have a difficult time explaining why low inflation matters. Today, I'd like to share my view of the dividends provided by low inflation.

Inflation is commonly defined as a decline in the purchasing power of money caused by a persistent increase in the general level of prices. Inflation distorts economic incentives and diverts resources—financial, labor and capital—away from their most efficient uses. It encourages immediate consumption and discourages saving and investment. It creates uncertainty and risk. It reallocates otherwise productive resources to inflation avoidance activities.

These "efficiency costs," as economists call them, are most obvious during periods of hyperinflation. In 1920s Germany, for example, when inflation exceeded 2 billion percent, a reichsmark note that would buy a house at the beginning of the decade would barely buy a loaf of bread a few years later. This is hyperinflation in the extreme, and its symptoms include weakening faith in the national currency, a return to barter and avoidance of payments in currency, hoarding of real assets such as gold, depleted savings, plummeting investment, increasing demand for "escalator clauses" in contracts (despite their ineffectiveness), and the eventual breakdown of trade and exchange. When prices double every day, week or month, conjecture and speculation consume expectations and information. Efficiency costs become insurmountable and all meaningful economic activity grinds to a halt. Unfortunately, history also provides us with several recent examples of hyperinflation and the ruin it brings: Brazil, Argentina and Peru in the 1980s and Russia in the mid-1990s.

It is significant that this has not been the American experience. (It's also significant that in many countries where hyperinflation has existed, the U.S. dollar has become the de facto currency.) It ought to serve as a reminder that this country's long-standing concern about low inflation is well founded, not as an end in and of itself, but as a means of providing the best environment for the market economy to operate efficiently.

We need not look far into our own history for a reminder of what can happen when we let down our guard. From 1973 to 1982, inflation in the United States ranged from a low of 5.8 percent to a high of 13.5 percent; in four of those years, it actually exceeded 10 percent. Now, compared to some of the hyperinflationary periods I just mentioned, the American inflation experience of the 1970s seems pretty trivial. But it did exact significant efficiency costs throughout the economy.

Consider inventories, for example. In an inflationary period, a producer who expects input prices to increase in the future is induced to build inventories on the theory that what she pays now is less than what she will pay later. This diverts financial resources and working capital away from future production, diminishing the producer's ability to respond to future market developments and increasing her exposure should demand weaken.

Labor contracts are another example of efficiency costs. Notwithstanding the certainty that prices will increase, uncertainty prevails in an inflationary period. Workers respond by, among other things, demanding shorter labor contracts—one year instead of three, for example. But this comes at a cost. By regularly diverting resources from efficient production to the much more basic question of staffing, substantial costs are imposed on companies.

Inventory building and labor contract shifting are just two examples of inflation avoidance activities. Others include annual cost of living adjustments (COLAs), index pricing, adjustable rate mortgages and inflation gaming, which is probably best described as speculation based solely on the movement of prices, rather than the actual production of goods and services. To be sure, each of these produces a few winners. As with gambling, the right combination of guessing and dumb luck can occasionally produce a jackpot in an inflationary period. Also as with gambling, however, luck always and inevitably comes to an end, creating far more losers than winners.

Was the inflation of the 1970s simply an extended run of bad luck? Or was something else involved? In fact, monetary policymakers did get a very bad break in the form of sharp OPEC production cuts in 1973. But it wasn't the oil price shocks that triggered inflation. Consider this: in the five years following the oil price shocks, inflation in Germany fell from around 7 percent to below 5 percent; inflation in Japan declined from around 30 percent to below 5 percent. And each of these economies imported a much larger share of oil than the United States did.

The difference was the monetary policy response. Price shocks—positive or negative—do not give consumers more or less money. Instead, they give consumers more or less money to spend on other things. The Fed's response to the oil shocks of the 1970s was to ease monetary policy. This easing, it was thought, would mitigate the effect of having so much less to spend on other things. It is clear that the Fed's policy did, in fact, cushion the economy in part; the recession would have been much deeper otherwise, as it was in Germany and Japan. The inflation that resulted was the inevitable consequence of that policy choice and should have been no surprise.

But if monetary policies triggered the high inflation of the 1970s, they also would be an essential first step toward its ultimate cessation. Beginning in the late 1970s, new monetary policies were implemented by the FOMC under the leadership of Chairman Paul Volcker. The results were not immediately favorable.

Inflation institutionalizes price increases and expectations. They feed each other in a sort of vicious cycle that becomes very, very difficult to break. By the time the Fed began to take action against inflation, expectations of inflation had long since been hardwired into the economy. The Fed could not change those expectations overnight. However, the Fed could tighten monetary policies, which is an essential first step toward bringing money and credit growth back in line with output growth. What happened, of course, was that inflation decelerated gradually, the legacy of misguided, accommodative monetary policies, while economic growth slowed immediately. It initially produced some of the worst economic performance in our modern history: rising unemployment and relatively high inflation.

But even after the demise of stagflation, after inflation was tamed and growth resumed, a stubborn and nontrivial level of inflation expectations remained. Well into the 1980s, for example, long-term interest rates remained high. This so-called inflation premium indicated that considerable doubt remained about the Fed's long-term commitment to low inflation.

Today we're winning the battle against inflation expectations. The University of Michigan's Survey of Consumers found for the first time last year that long-term inflation expectations—predicted inflation over the next 5-10 years—actually fell below 3 percent. Consumers have been joined by the pros: in April, 29 private forecasters surveyed by the Federal Reserve Bank of Philadelphia indicated that they expect inflation to increase an average of 2.5 percent a year for the next decade. And as I've indicated, nearly everyone I encounter in our Southeast region expects inflation to remain low.

Perhaps there are even some Fed-watchers who have become "believers." Maybe a few would credit the current low inflationary environment to a series of shrewd and well-timed policy moves by the FOMC. Obviously, I believe our policies have the central role in producing the current inflation environment, and the Fed is happy to take some credit for it. But what has this brought us? For the vast majority of people, the businesses and consumers who are borrowing, investing, selling and buying, the most compelling case for low inflation is the economy's current performance.

The current expansion has been characterized by a sustained and substantial increase in business investment and consumer spending. Put another way, aggregate supply and demand have grown at about the same rate with very little distortion of output or prices. One of the factors that has made this growth possible is the general absence of efficiency costs. Workers don't have to guess what their wages will be worth next year; businesses don't have to guess what the cost of production will be; investors don't have to subtract the cost of inflation from expected returns; consumers don't have to spend now before prices go up. And so on. I realize that I'm calling your attention to a negative, to something that doesn't currently exist, and that says a lot about why inflation is so pernicious: we tend not to take notice of it until it's much too late. But in any case, it's the general absence of inflation and its associated efficiency costs that has contributed to the strength and persistence of the current expansion.

I and those I share policymaking responsibilities with remain committed to the proposition that low inflation allows for the most efficient allocation of scarce resources; that low inflation is the essential first condition—the sine qua non—for healthy economic growth; and that low inflation is an ongoing means to new job creation and to a variety of other desirable economic and social ends. For more than a decade, we've had our economic policy priorities just about right. And with a little bit of luck, they've returned the best economic performance in a generation.

As I suggested earlier, this period of sustained economic prosperity provides a unique opportunity to stand back and reflect on what's brought us here. I hope I have made a reasonable case this morning that low inflation has been the central feature of our recent economic good fortune, and that it should be embraced by policymakers, business leaders and individual consumers as the cornerstone of our economic future.

Thank you again for the invitation to be with you today and for this chance to share my views.

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