

ECONOMIC COMMENTARY

Federal Reserve Bank of Cleveland

Stable Inflation Fosters Sound Economic Decisions

by James G. Hoehn

Monetary policy has traditionally sought the attainment of several economic conditions, including high employment, steady capacity growth, a stable dollar, and low inflation. The ultimate goal is enhancement of the general welfare.

The question is, how can monetary policy successfully meet concerns about output, employment, and inflation simultaneously? This *Economic Commentary* argues that monetary policy can serve the general welfare by keeping inflation stable. Under such a policy, people can make sound economic decisions about work, production, and consumption free of unnecessary distortions caused by variable inflation.

Considerable reliance should be placed on inflation and inflationary pressures as indicators of the success of policy rather than on the outlook for output and employment. Output and employment concerns will be largely met if the Federal Reserve pursues its commitment to keep inflation stable.

■ The Inability of Monetary Policy to Control Output

The all-embracing public policy objective of enhanced general welfare does not directly translate into a particular policy objective for the Federal Reserve System. The design of monetary policy therefore is thought to reflect the judicious weighing of several criteria, including levels of inflation, output, and employment.

This notion, however, must take into account that the Federal Reserve can ultimately control only current-dollar economic variables such as the money stock, the general level of prices, or the rates of change in prices. The Federal Reserve regulates these current-dollar, or nominal, quantities by changing the amount of securities it holds in its portfolio.

The problem is that the public welfare depends not on these nominal variables under the control of the Federal Reserve, but on physical quantities of consumption goods available,

How should monetary policy use its control over money and prices to influence employment and output? Under a policy to stabilize inflation, people can more easily make sound production and consumption decisions, and economic activity will tend to vary appropriately with changes in productive opportunities.

or output, which the Federal Reserve cannot control. Although policy can influence output in the short run, achievement of an arbitrary target for output is not possible because output depends largely on factors over which monetary policy has very little influence, such as technology and the availability of productive resources such as land, labor, and machines.

The challenge for monetary policy is how to use control over money and prices to keep output close to an appropriate level. The problem is complicated by the lack of adequate knowledge about the factors that determine appropriate output at any given time: available resources, technology, and personal preferences for consumption versus leisure.

■ Variable Inflation Can Distort Production and Consumption Decisions

If people are fully informed about prices, and if prices are free to adjust to pressures emanating from the decisions of buyers and sellers, then people are able to make sound resource decisions. As a result, the output level will be ideal in a textbook sense. If the world were so ideal, monetary policy would not have the important influence that it has on output.

Consider first that people do not have all the information they might like to have when making buying and selling decisions. In order to know how much of his income to spend on beef, for example, a person would ideally want to know the value of his dollars in all kinds of alternative purchases, from pork to sports cars.

A person also would like to know the purchasing power of his dollar this year, next year, and even further into the future in order to make prudent choices. (Generally, a dollar has a value inversely proportional to the overall price index, such as the Consumer Price Index.) To the extent that a person is uncertain about the value of a dollar, he cannot make sound economic decisions. Some uncertainty is inherent in a market system in which changing prices reflect changing conditions.

Still, monetary policy influences this uncertainty by its impact on the variability of the price level. If the overall price level is relatively stable, as it has been in the United States in recent years, then people will be able to attribute changes in the dollar price of beef to a real increase in the cost of beef relative to other alternatives. But if the purchasing power of money is unstable, as it is in some Latin American nations, then people cannot be sure to what extent a rise in the dollar price of beef is an increase in the relative costliness of beef as opposed to a general inflation.

This confusion between the overall price level and changes in relative prices will arise unless people observe all of the prices in their potential shopping basket. Collecting all of that information is too costly. People do shop to determine alternative spending opportunities, but this search is limited by the time and effort it costs.

According to one theory of how unexpected inflation can influence output, a general increase in prices can temporarily deceive suppliers into thinking that the reward for producing their product has increased. Suppliers initially think that the relative price of their product has risen, and respond to the apparent improvement in incentives by increasing employment and production. This decision to expand is a mistake, albeit a reasonable one. Unexpected inflation, by fooling suppliers into increasing production, may even result in the building of plants and acquisition of equipment that later are discovered to be unneeded.

A related explanation of how inflation can distort private choices involves sticky prices and wages—those that are not bid up or down instantaneously by buying and selling pressures. For example, labor contracts give employers considerable discretion over employment at a fixed-dollar wage rate (or, at least, at a wage rate that is not fully and continuously adjusted for inflation). If the general level of prices rises, employers find their profit margins increased and find it advantageous to expand production and employment. The expansion of activity is inappropriate, however, because it arises from decisions that have been distorted by inflation, rather than representing an appropriate response to economic fundamentals.

The importance of fluctuations in inflation in accounting for fluctuations in U.S. output is in dispute. But the effects are potentially important enough for people to try to protect themselves against them. In order to reduce such mistakes, people entering into agreements to buy and sell labor or goods try to guess the rate of inflation. If they think prices generally will rise, they tend to inflate dollar payments by the same proportion.

However, it is not always a simple matter for people to fully adjust their business dealings to expected inflation. Changes in prices and wages are infrequent and limited in many industries. Pricing conventions are not easy to rationalize, but probably reduce decision-making and bargaining costs and foster good relations between buyers and sellers. In any case, contracts already signed cannot ordinarily be altered to reflect a revised inflation forecast.

Considering the difficulties people have in dealing with a variable rate of inflation—the costs of forecasting and adapting business dealings plus the errors in decisions that inevitably occur despite the best of efforts—the public welfare tends to be enhanced by policies that promote easily predictable levels of inflation. Easiest of all for people to adapt to is a constant price level, which removes inflation from economic decisions altogether.

■ Price Stability and Output Concerns

The Federal Reserve System has placed great importance on obtaining price stability. In the early 1980s, a money-targeting policy was successfully used to reduce high and accelerating inflation. In more recent years, the money stock has been allowed to vary considerably, but this policy has been justified as necessary to stabilize inflation in the face of historically large changes in the relation between money and prices. Inflation has been moderate and stable relative to that of the 1970s and early 1980s.

Concern with stabilizing inflation has not, however, meant that the Federal Reserve has abandoned concern about output. By stabilizing inflation, monetary policy provides an environment in which people can make sound output decisions, undistorted by inflation. Output will then tend to vary more or less appropriately in response to changes in economic fundamentals.

Consider how a policy of price-level stabilization works when the demand for goods and services increases. Initially, prices will tend to rise and suppliers will tend to respond by increasing output. This increased production is inappropriate because it arises from the distortions of inflation. Under a policy of stabilizing the price level, the Federal Reserve

would contract the money supply until the inflationary pressure was removed. Then, the inappropriate stimulation of output would also be removed. So far as fluctuations in the economy arise from changes in the demand for goods and services, stabilizing inflation would at the same time stabilize output.

A policy of stabilizing prices would also promote desirable results if the supply of goods expands because of improved technology or increased productive resources. Better productive opportunities, such as discovery of new oil fields or new techniques of recovering oil from old fields, lead people to increase output, in this case, output of oil and of things made using oil. The increased supplies would tend initially to create deflationary or disinflationary pressures. This deflation is unwanted because it restrains the economy from taking full advantage of the greater productive opportunities.

If technology or available resources change, then stabilizing output is not the best policy. In this case, price and output stability could appear to be in conflict, but this is mostly because the ideal output level has changed. Hence, the conflict between price and output objectives is less serious than it first appears.

Monetary policy can do little about another kind of event: improved technology and other fundamental changes can create abrupt and uneven growth rates among various industries. The growth of new industries and the decline of mature ones require that capital and labor be reasigned, a process that takes time and that typically involves unemployment in the disfavored industries. For example, increasingly sophisticated machinery in farms and factories has displaced much of the labor force to the growing service and high-technology industries.

Important technological changes in the economy are widespread at times, and help account for periods of high general unemployment. But to use monetary policy to attempt to solve structural imbalances is ill-advised. Workers need to be moved from the sectors with high unemployment into the growing industries; inflation cannot help get the needed movement or ease its costs.

Stabilizing inflation would not stabilize output in the highest possible degree, but it would not necessarily lead to larger fluctuations in output. Indeed, closer control of inflation would reduce the historical tendency of inflation to accelerate during expansions and decelerate during contractions—a tendency that inappropriately magnifies the expansion and contraction of output growth.

■ Conclusion

Monetary policy can largely meet legitimate concerns about output and employment in an indirect way by paying greatest attention to inflation and inflationary pressures. At any given moment, output and inflation concerns may appear inconsistent, because output can be increased by raising inflation. Higher inflation does not permanently raise output, however; nor is higher output necessarily desirable if purchased with harder work. Furthermore, consideration of how people's economic decisions are distorted by variable inflation argues for a policy that tends to target a stable rate of inflation.

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