For release on delivery
5:00 p.m., E.S.T.
January 26, 1989

# HOW TO ACHIEVE ZERO INFLATION: GOING ON A MONETARY DIET

W. Lee Hoskins, President
The Federal Reserve Bank of Cleveland



San Francisco Association of Business Economists
San Francisco, California
January 26, 1989

# How to Achieve Zero Inflation: Going on a Monetary Diet

## Introduction

I would like to talk with you today about why we as a nation should adopt a goal of eliminating inflation completely. The benefits of reducing inflation to zero would be substantial, perhaps as substantial as those we have already enjoyed in reducing inflation from 12 percent to 4 percent. I believe that a pre-announced program to eliminate inflation gradually over a 4 to 5 year period would further enhance economic performance. The Federal Reserve alone has the ability to control the inflation rate. I would like to recommend several changes in the policy process that would make this goal easier to achieve.

My remarks today should not be interpreted in the context of today's or tomorrow's monetary policy. As you know, the Federal Reserve, confronted with a step-up in inflationary pressures last year, moved gradually on several occasions toward a more restrictive monetary policy. Over the past year short-term interest rates have risen by 2 1/2 to 3 percentage points, and the growth of each of the principal monetary aggregates which we watch has slowed significantly.

Changes in recent years in the relationships between policy instruments and ultimate objectives as well as the long and variable lags between monetary policy actions and inflation mean that we cannot be sure of the effects of last year's monetary actions. In similar fashion, we cannot make or modify monetary policy today without exercising large elements of judgment. Although we will not know the ultimate outcome for some time, our actions last year may have prevented a further acceleration in the inflation rate. But I am still inclined to doubt that we have made much progress toward an inflation-free environment.

Inflation, as I have argued for some time, is too high. Although we seek to eliminate inflation, we do not seek to do so abruptly. Nevertheless, reducing inflation is such an important goal that policymakers should be willing to err on the side of overly-restrictive policies, until it becomes clear that progress toward that goal is being made.

## A Monetary Diet

Few would disagree that price stability is good policy. Unfortunately, zero inflation is easier to advocate than achieve. Why is it so hard to end inflation? Consider for a moment an analogy between a monetary policy to eliminate inflation and a personal program to eliminate excess weight. In both cases giving advice is easy. It is easy to say eat less and you will lose weight. Likewise, it is easy to recognize that the Federal Reserve has the ability to end inflation and must slow money growth to do so.

Anyone who has tried to lose weight knows that good intentions do not guarantee the desired outcome. Once a weight-loss program is begun there will always be temptations to abandon it. If a particular meal is just too good to pass up, the dieter promises that he will make it up tomorrow.

The market is full of quick-fix programs that promise easy, overnight weight-loss, yet rarely deliver on such promises. Weight-loss programs that don't work are probably worse than none at all. The health advantages come from a permanent reduction in weight. Programs that reduce too quickly, only temporarily, or fail to provide adequate nutrition are health hazards and ought to be avoided.

Successful weight-loss programs share some common elements. They begin by setting realistic goals which are well-defined and measurable. A good diet plan begins with an explicit goal, a long-term desired weight level, and a time frame for reaching the goal. The successful plan connects a program for daily behavior to the long-term goal. The program also includes a daily menu, supplying the nutrients needed to keep the body healthy, but limiting the daily intake of calories. A good program will also include some exercise and health monitoring. The successful program outlines what you should do today, right now, and in every period until the goal is achieved.

In many ways, our desire to end inflation is like an individual's desire to lose weight. As of today, there is no outside authority that will make us commit to long-run price stability. Once the program for ending inflation has begun, we may quit at any time and return to an inflationary policy. No one will believe that our disinflation policy will really lead to zero inflation unless we state well-defined objectives and allow people to see that our daily actions are consistent with our long-term goals.

## Choosing an Objective of Zero Inflation

Many ask why we should seek zero inflation. I think the diet analogy is a good one. Just as excess body fat reduces mental and physical performance and leads to other health problems, inflation reduces the efficiency of markets and leads to other economic problems.

Others question whether zero inflation is a realistic or politically feasible goal. Quite frankly, I'm not sure, but part of my responsibility as a central banker is to participate in establishing policies that are considered feasible and realistic. Other countries have succeeded. Two of our major trading partners, West Germany and Japan, are prospering under policies of price stability. Furthermore, I think the improvement in the U.S. economic performance during the last six years owes much to the lower inflation environment. We do not have stable prices yet, but like a dieter who has begun to lose weight, we are already performing at a higher level.

Several factors seem to stand in the way of an explicit commitment to end inflation. First, there is the mistaken idea that we know the actual level of full employment or the maximum feasible noninflationary growth path for the real economy. Second, there is the mistaken idea that the Fed can engineer an increase in real output if the economy begins to fall below the trend growth rate. If there are short-term benefits from such a policy, and I do not think there are, they will be temporary and will surely be followed by longer-term costs disproportionate to the gains. Think about the drought in 1988 for a moment. Could the Fed have replaced the lost food by manipulating interest rates or inflation?

Certainly, I do not believe that we can make people better off by manipulating the inflation rate in an attempt to smooth real GNP growth. We are not better off if suppliers misread an inflationary policy for a real increase in demand. To the extent that business cycles spring from real shocks and imbalances in the economy, we will have downturns that are not the fault of monetary policy. If the Federal Reserve takes responsibility for the business cycle rather than inflation, a commitment to an inflation-free environment will not be credible. While there may be temporary adjustment costs to ending inflation, these costs can be reduced. Moreover, there are permanent losses in welfare from an inflationary environment.

If inflation is allowed to continue, the potential of the economy will be reduced. It is important to recognize that the disruption to real output from moving to end inflation will be greater if we allow inflation to rise or if we lose credibility.

There is another objection to a zero inflation policy. Many who would otherwise agree to a policy of price stability argue that a little inflation is good because economic efficiency requires flexibility in real wages and nominal wages are rigid downward. Workers are psychologically adverse to declines in nominal wages. The argument is that inflation lubricates the wage adjustment process by allowing real wages to be adjusted downward in response to industry-wide shocks without confronting workers with the need for explicit cuts in pay. Inflation diffuses the blame, and somehow workers don't mind as much.

I don't like this argument because it assumes workers are ignorant or irrational. Economists make this argument based, not on theoretical considerations, but on how they think the real world differs from their theories. They fail to understand that this behavior is due to ongoing inflation. Rather than help lubricate the wage adjustment process, I think inflation complicates and bogs down the process. Workers often feel cheated by inflation. They know they need wage increases just to maintain a given standard of living. But the economy performs less efficiently with inflation and workers are less productive, often through no fault of their own.

In a world of zero inflation, workers would not have to look through the veil of inflation to see how they were being compensated. Workers could more easily see that wage increases were rewards for permanent increases in productivity.

## Choosing a Gradual Path

The ultimate goal is an inflation free environment, but the policy to get there should be gradual. A person who is 50 pounds overweight should not try to lose 50 pounds immediately. When an economy has experienced inflation for some time people develop institutions and behavior patterns that help them cope with inflation. We get used to high nominal interest rates. We come to expect inflation to reduce real debt burdens. Expectations of inflation become embedded in asset prices. The "dieting" economy should not attempt to eliminate inflation immediately.

Policymakers have long worried that if they try to stop inflation, they might start a process of decline and deflation that cannot be stopped. We have had experiences in which disinflation led to severe declines. The worst of these instances occurred because of contractions in the volume of money and credit. Certainly, we can be encouraged by the way the Federal Reserve maintained liquidity in the economy following the October 1987 stock market crash, without abandoning longer-term policy goals.

In any case, I think we induce unnecessary costs in the economy if we try to eliminate inflation too quickly. Any time the inflation rate turns out to be different than expected there are arbitrary redistributions of income. Imagine what would happen if the Fed went to zero inflation immediately. The people who had purchased Treasury debt in recent years would reap a windfall as market rates fell with lower inflation expectations. The taxpayer would bear the real burden. The average maturity on Treasury debt is just a few years, so it makes sense to take a few years to eliminate inflation.

Each of the reasons why we might go faster or slower should be the subject of more research. While I have suggested one percentage point per year, perhaps other paths would be preferable. I am not so concerned about the exact timing of disinflation as I am about committing to a specific path so that the "weight-watchers" -- "Fed-watchers" in this case -- can monitor our progress and feel confident that the policy is sound.

Recent events in the financial markets certainly suggest growing confidence in the commitment of the Federal Reserve to a less inflationary future. But it is worth remembering that a central bank that loses credibility may not have the luxury of adopting a gradual policy. This is most obvious in cases of hyperinflation where the entire monetary system must be reformed overnight. In moderate inflations as we have in the United States today, I think a gradual policy will work.

## Choosing a Specific Index

Another practical problem is deciding which price index should be used as the official target of policy. Should we use an index of products consumed, like the Consumer Price Index, an index of goods produced, like the Producer Price Index, a subset of these, or a general index like the GNP deflator. Again, there may be many reasons to choose one index or another. Over the longer run, I don't think it matters as long as we choose a general price index which would tend to reflect the price of things produced and purchased using U.S. dollars.

However, once we decide to implement such a policy, we would prefer a target that has some desirable short-run properties. It should not be too sensitive in the near term to supply shocks and foreign events. An index, like the Consumer Price Index, often deviates from its underlying trend for as much as a year or two because of changes in the price of imports, or because of a supply shock like the drought we had last summer. On the other hand, if the CPI was chosen as the target, there is no reason why the Fed could not allow deviations from the target path if there was a clear reason for doing so.

Many people have argued that current price indexes overstate the true inflation rate by 1 to 2 percent because the price indexes do not capture the quality increases in new products. This is a technical issue and like a dieter who has an inaccurate scale, I would either get a new one or make allowances for the inaccuracy.

## Making the Policy Work

Over the past several years the Federal Reserve has gradually reduced the growth of the various measures of the money supply. It seems to me that the disinflation process will require further gradual reductions in the growth of the money supply and the monetary base. The growth of the base has been reduced from almost 10 percent in 1986 to 7 percent last year. From time to time some have criticized the unevenness of the reduction; but continued progress toward zero inflation, requires a continued gradual reduction in the growth of the base and the other monetary aggregates.

## Providing Information

The increased uncertainty about velocity and the relationships between the monetary aggregates and economic activity in the 1980s has reduced the usefulness of the information available to the public about monetary policy. To monitor policy now, people must rely on reports of inflation which are influenced by non-monetary factors and may lag well behind policy changes. No one knows for sure the connection between policy actions and inflation. Like the dieter, we can only begin a program, use our best judgment, and make adjustments as we go along.

As long as we have to use judgment, there will be some skepticism. The best way to overcome this doubt is to provide the most complete picture of policy to the public. Currently, under the Full Employment and Balanced Growth Act of 1978 (Humphrey-Hawkins), the Federal Reserve is required to regularly and publicly discuss its view of current economic conditions and its predictions for economic growth, inflation and unemployment. Moreover, the Federal Reserve is required to report its objectives for various monetary aggregates. The basic purpose of this law is to clarify policy actions and ensure that they are consistent with longer-run goals.

Aside from Humphrey-Hawkins testimonies, the Federal Reserve regularly releases some information (Policy Directives) about each FOMC meeting six or seven weeks after the meeting. The Policy Directive contains a brief discussion of how the FOMC has voted to change policy in some way. The votes of individual committee members are provided.

What is missing is a clear message relating these short-term policy actions to an inflation goal. I am interested in providing more complete information. The Policy Directive may inform the public that the Federal Reserve has chosen to tighten or loosen, but the public cannot tell by how much, for how long, or to what end. Under current procedures, the Federal Reserve announces discount rate changes immediately, and it usually gives a brief discussion of why the change was made. A similar procedure for all policy actions would seem desirable.

**Conclusion**

If I were overweight and had promised my doctor for years that I would lose weight, he would be understandably skeptical about announcements of a new diet plan. However, if I told him that I had restricted my diet to 2,000 calories per day for the last month and had lost four pounds, that I felt better than ever, and that I intended to continue until I lost 50 pounds, then he might believe me. If he had a large stake in my future health, however, he would continue to monitor my weight to make sure I was staying on the plan.

Likewise, we could adopt a program to end inflation that would be credible if people saw it working. The plan should involve a steady diet, not bouts of starvation followed by binges. While it might not be painless in the beginning, the cost would be reduced if we let people see how we planned our menus and if we let them watch us eat our meals. Furthermore, once an inflation-free environment is achieved, maintaining it will not require sacrifice on the part of the public. On the contrary, I think much of the recent pleasant surprise in our economic performance is due to recent success in lowering inflation. Like the successful dieter, the economy would perform even better if we were to achieve an inflation-free environment.