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THE IMPORTANCE OF COMMITTING TO A ZERO INFLATION POLICY

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The Importance of Committing to a Zero Inflation Policy

It is a pleasure to have the opportunity to speak to the Pittsburgh Association for Financial Planning.

Charlie Parker, the famous jazz musician, once said, "Romance without finance ain't got no chance." Although Charlie's statement is insightful in its own right, I think that there is also some insight if we apply the statement to our current economic situation.

We have had a business romance for the past seven years -- a lengthy economic recovery by some standards. What is responsible for the longevity? Good fortune has played a part. Factors such as a relatively stable political climate and a stable supply of natural resources has encouraged longevity and strength. Many of these forces are considered beyond the control of policy makers. Nonetheless, I believe that the Federal Reserve is responsible for part of the successful romance. An environment of price stability has allowed people like you -- participants in the financial markets -- to perform effectively and facilitate the important resource allocation process.

Recently, some have argued that the Federal Reserve's adherence to a policy of price stability will eventually end the recovery, or cause a recession. I think that this is a fallacy. Ultimately, inflation itself causes recession and inflation results in less than optimum economic performance. In the long run, there is no trade-off between inflation and recession.

A Fallacious Tradeoff: Inflation For Recession

Unfortunately, over the years we have come to believe that we can prolong expansion, or avoid the pain of recession, with more inflation. A look at recent history reminds us that there is no tradeoff between inflation and recession. Although we don't understand recessions completely, we have seen that they can be caused by monetary policy actions as well as by nonmonetary factors.

In the early 1980s we had recessions caused by monetary policy mistakes. The policy mistakes were the excessive monetary growth rates of the 1970s, which allowed accelerating inflation and rising interest rates and ultimately led to the need for disinflationary monetary policies. The disinflationary policies were necessary to get our economies back on acceptable real growth trends. Yet even today, we are apt to blame the policies which reduced inflation for the recession instead of blaming those which created the inflation to begin with.

Why is it that inflationary policies cause recessions? As managers in the financial services industry, you face a great many sources of uncertainty surrounding any investment decision. First, you must know your market and offer a product that people want. Next, you have to monitor costs and build in the highest possible quality. Implicit in this task is a whole host of decisions that require guessing future rates of interest and inflation. Generally, high and variable rates of inflation cause mistakes in these decisions, mistakes which may lead to incorrect investments or products.

For some, costs due to inflation and interest rates may not seem critical; for example, those with low fixed costs and those that are able to adjust wages and prices for inflation. For most, though, inflation and interest rates will be critical. Otherwise capable managers who made investments in the late 1970s in inflation sensitive areas -- farming, timberland, oil, real estate -- fell into bankruptcy when high inflation rates failed to continue into the next decade. However, the people who made this bet in the 1960s became very wealthy. The history of the business cycle is a history of gyrations in money and prices.

Nonmonetary "surprises" also can cause disruptions in resource use that may be widespread enough to be a recession. These surprises have many sources. They include technological innovations such as we have seen in computers, information processing, and management techniques. They also come from economic disturbances like droughts, strikes, wars, cartel actions, and political change. For example, political reforms in countries like Poland and China may produce recession because people have to learn how to reorganize and develop institutions that use the market. Recessions can also emanate from the combined effects of many particular disturbances to individuals, firms, and industries.

Even if we could eliminate all the influences from monetary policy, there would still be recessions and expansions because of these surprises. Changes are occurring in the economy that economists and policymakers do not completely understand -- for example, technology and the changing tastes of consumers and investors. Other changes occur which are considered to be uncontrollable -- like droughts and oil spills. If we let market forces operate, these changes will be accommodated or corrected in a natural and gradual fashion. Market forces work best in a stable policy environment. Without a doubt, there will always be short-term difficulties, but it is to our long-term advantage to allow the world to experience fundamental change.

Let me emphasize, I am not in favor of recessions. On the contrary, I believe that variable and uncertain monetary policies exacerbate the business cycle. We must remember that recessions will occur even under an ideal monetary policy, but they will not be as frequent or as severe. Under an ideal policy we would not have recessions induced by inflation and the persistent need to eliminate it.

Nonmonetary Surprises: Why Don't We Use Policy to Thwart Them?

There is a bit of irony in the idea of forecasting recessions; that is, if we could forecast recessions, we probably wouldn't have to worry about a policy to eliminate them. A recession is one kind of economic fluctuation. Consider another kind of fluctuation -- seasonal fluctuations due to weather, tax laws, and cultural events like holidays. There is a fundamental difference in the way we treat seasonal and business cycle fluctuations. Seasonal downturns can be larger than cyclical downturns, yet the government adjusts the data to account for seasonal downturns. Seasonality can be adjusted because seasonal fluctuations are predictable based on past experience. People can anticipate and prepare for seasonal downturns.

People have developed a variety of ways to deal with seasonal variations in employment and output. Farmers know that a single fall's harvest has to feed the family for a whole year. Construction workers know that their relatively high incomes during the summer must carry them through the winter months. Successful retailers know that nearly one-third of their sales come in the winter holiday season. Consequently, their budget plans and banking relationships reflect this cash flow problem.

People survive business cycles in many of the same ways that they survive seasonal cycles. Firms build up a reserve of profits in good times to survive the bad times. Households save during good times -- and postpone large purchases in bad times. Government programs like unemployment insurance and the graduated income tax operate automatically to even out or stabilize spending over the business cycle.

The point is that if business cycles were predictable -- a necessary condition to justify a stabilization policy -- adjustments by people would make such a policy unnecessary.

Even if we thought that eliminating the business cycle was a desirable and healthy long-term goal, I believe it is impossible to do so. There are several reasons that prevent us from using monetary policy to offset nonmonetary surprises. First, we cannot predict recessions. Second, policy does not work immediately or predictably; it works with a lag. The effects of monetary policy on the economy are highly variable and poorly understood.

<u>The Crystal Ball Syndrome</u>: The limitations of economic forecasting are well-known. Analysis of forecast errors has shown that we often don't know when a recession has begun until it is well underway. At any point in time there is such a wide band of uncertainty around economists' forecasts that the plausible outcome ranges from expansion to recession.

The people who make forecasts and those who use them often get a false sense of confidence because forecast errors are not distributed evenly over the business cycle. When the economy is doing well, forecasts that prosperity will continue are usually correct. And when the economy is performing poorly, forecasts that the slump will continue are also usually correct. The problem lies in predicting the turning points. However, the turning points are the things we must forecast to prevent recessions.

<u>Monetary Policy's Long and Variable Lags</u>: Even if we could predict recessions and wanted to vary monetary policy to alleviate them, we still face an almost insurmountable problem -- monetary policy operates with a lag. Moreover, the length of the lag varies over time, depending upon conditions in the economy and the public's perception of the policy process. The effect of

today's monetary policy actions will probably not be felt for at least six to nine months, with the main influence perhaps two to three years in the future. The act of trying to prevent a recession may not only fail, but it may also create a recession where there was not going to be one.

The other reason for a lag is that you, as the operators of businesses, do not act in a vacuum. You understand the political forces operating on a central bank. You know that a return to inflation is always a possibility. Uncertainty about future policy makes you cautious about future investments. Uncertainty about future inflation will raise real interest rates, drive investors away from long-term markets, and delay the very investments needed to end the recession. The more certain people are about the stability of future monetary policy, the more easily and quickly inflation can be reduced and the economy recover.

We don't know exactly how a particular policy action will affect the economy. The effects of monetary policy is the topic of great debate underway among economists today. Macroeconomic ideas about monetary policy and its effect on real output have changed profoundly in the last decade. We have learned that the effect of monetary policy depends on peoples' expectations about policy.

Lessons We Should Have Learned

If we have learned anything about economic policymaking in the last twenty years, we ought to have learned to think about policy as a dynamic process. To claim that, "in order to reduce inflation, we must have a recession," is a wrongheaded notion that completely ignores the ability of humans to adapt their expectations as the environment changes.

People do their best to forecast economic policies when they make decisions. If the central bank has a record of expanding the money supply in attempts to prevent recessions, people will come to anticipate the policy, setting off an acceleration of inflation and misallocation of resources that will lead to the need for a correction -- a recession. Suppose for a moment that the recession followed a period of excessive monetary expansion -- a common occurrence in the United States over the last three decades. An economy often goes into recession following an unexpected burst of inflation because people have made decisions that were based on an incorrect view of the course of asset prices and economic activity. The central bank can do little to cure the situation except to provide a stable price environment. This will be the optimal setting in which you can adjust your business plans to work off inventories and bad debts generated during the inflationary expansion. How long this takes depends on many factors, some of which are outside the control of the central bank.

A Zero Inflation Policy Is a Pro-Growth Policy

The U.S., and many other western countries are experiencing extraordinarily long expansions. It is no coincidence that these expansions have proceeded in the presence of reduced inflation. I think it is because of, not in spite of, restrictive monetary policies that we have done so well. The combination of prolonged growth and relatively low, stable inflation will make it easier for central banks to continue fighting inflation. It is very important that we not return to the inflationary policies of the past. Doing so will almost certainly cause a repeat of the terrible recessions we suffered in the early 1980s.

We know that the U.S. economy is currently operating well below levels that could be achieved if we eliminate inflation. Zero inflation would make our monetary system more efficient, contribute to better decisions, and result in more efficient use of our resources. Achieving zero inflation will allow the economy to perform at a higher level.

Inflation adds risk to decisions and retards long-term investments. It changes the nature of the economic environment so that random inflation outcomes overwhelm otherwise prudent managers. Inflation causes people to start up businesses and use costly accounting methods that have the sole purpose of hedging against inflation. In the absence of inflation, the resources working in these areas could be devoted to producing more goods and services. Inflation interacts with the tax structure to stifle incentives and limit investment. Inflation undermines peoples' trust in government. Why do we allow this sand to clog the wheels of our economy?

Primary Goal of Monetary Policy Should Be Price Stability

In my view, monetary policy has only one goal -- price stability. Price stability over the long run is the major contribution that monetary policy can make to the attainment of sustainable prosperity. Price stability would eliminate the distortions that inflation induces in the economic decisions of households, businesses, and workers. It would reduce the dampening influences of unnecessary risk and uncertainty on longer-term planning and investment. These benefits, though difficult to measure, are likely to be substantial over time. And, although it is necessary to think about the short-term costs of eliminating inflation, it is also important to recognize the accumulation of costs associated with the current inflation trend.

If the United States is to achieve price stability and enjoy its benefits, the Fed must have price stability as its monetary policy goal. The Fed's control of money creation gives it the power to control the price level over time. No other agency of government is equipped to do that.

Some argue that the nation and government have other objectives such as high employment, rapid economic growth, and a stable foreign exchange rate. During the past two decades, we learned that if the Fed compromises its goal of price stability in pursuit of these other goals, the result is not high employment, rapid economic growth, and a stable exchange rate; the result is high inflation. I believe that achieving price stability is the greatest contribution the Fed can make to achieving these other important national economic goals.

Arguments are also made for the need to coordinate monetary and fiscal policies. I believe that the experience of the past two decades has also taught us that monetary policy cannot correct the failures of fiscal policies. A bad monetary policy won't produce better fiscal policies. I am not suggesting that fiscal policy is unimportant for monetary policy. The accumulation of large amounts of government debt could create an incentive for adopting inflationary monetary policies.

Central Bank Credibility

The success of a monetary policy that strives for price stability lies in the public's assessment of its credibility. In the final analysis, credibility accrues to those who visibly make choices in support of their announced goals. Congressman Stephen Neal has introduced a joint resolution (House Joint Resolution 409) mandating the Federal Reserve to adopt and pursue monetary policies leading to, and then maintaining, zero inflation. I support H.J. Res. 409 and believe that it is valuable in two ways. First, it explicitly mandates the Federal Reserve to pursue a single objective -- price stability. Second, it establishes a five year time frame for eliminating inflation gradually.

"Price stability," as I have been referring to it and as it is referred to in Representative Neal's resolution, is an inflation rate which is not a factor in economic decision making. It would be undesirable, even impossible to achieve exactly zero inflation each and every year. Central banks cannot control the price level over short time horizons such as one quarter or even one year. No matter how much people may wish otherwise, there will always be temporary and unforeseen factors that will cause the price level to deviate from the desired policy target of no change in the price level. It would be a mistake to try to keep some inflation index on target each and every quarter, or even each and every year. A firm commitment to price stability would anchor the price level or create a world where people expect the average long-run inflation rate to be zero.

Achieving price stability will require a transition period in which we eliminate inflation gradually. H.J. Res. 409 mandates that inflation be reduced gradually in order to eliminate inflation by not later than five years from the date of enactment of the legislation. I believe the five year time period is appropriate. Some people believe that achieving price stability within five years would involve quite slow economic activity and employment growth for an extended period. The costs of achieving price stability are a matter of substantial debate. I personally do not believe the costs are large. Whatever the costs might be, we do know that the costs will be less if we begin the process of achieving price stability when inflation is low. The costs will be less if the Federal Reserve has a high degree of credibility, and the costs will be less if the Federal Reserve makes a commitment to achieving price stability. H.J. Res. 409 would enhance the credibility of monetary policy even further and reduce the costs of eliminating inflation.

Conclusion

Monetary policy is being tested today. Although we have enjoyed high levels of economic growth, recent slowing in economic activity in the U.S. has prompted calls for easier monetary policy -- lower interest rates and more rapid monetary growth. Yet, such a policy would not only support the current inflation rate, but would also lay the foundation for accelerating inflation. The result would be an economy operating even further below its long-run potential, with growing vulnerability to frequent and severe recessions. A monetary policy that leads to zero inflation, even if it risks a recession, is our best opportunity for long-term growth.

Fears of recession create an apparently insurmountable barrier to price stability. This is unfortunate. The perceived trade-off between inflation and recession is an illusion. In the end, inflation itself is the cause of most recessions. In the end, continued inflation will reduce economic growth. To achieve maximum sustainable growth in the economy in the 1990s, central banks around the world should commit today to achieving zero inflation.