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Anti-Inflation Monetary Policy is Pro-Growth

Jerry L. Jordan
President and Chief Executive Officer
Federal Reserve Bank of Cleveland

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I. Introduction

- A. Acknowledge the introduction.
- B. My topic is the relationships between growth and inflation.
 - 1. Title of speech could very well be: "Growth and Inflation: Siamese Twins or Odd Couple?"
 - 2. Siamese twins are always together, which is how some people think of growth and inflation.
 - 3. In my view, growth and inflation are an odd couple. Sometimes they are seen together, but generally they go their separate ways, and indeed are pretty much incompatible.

II. Two Basics: Inflation Hampers Prosperity, and the Fed Fights

Inflation

- A. Inflation hampers prosperity in four ways:
 - 1. It interacts with the tax code to discourage saving and investment.
 - 2. It diverts resources to hedging activities.
 - 3. It shrinks an important unit of measure, wasting resources by making measurement more complicated.
 - 4. It pushes interest rates up, reducing investment and shifting it toward shorter-lived investments.
 - a. This does *not* mean that an interest premium for expected

inflation, which increases *nominal* but not *real* interest rates, always reduces investment. Normally, investors are concerned with real rates, not nominal rates. However, there are two ways that inflation expectations *do* reduce investment.

- b. First, an increase in nominal interest rates can restrict investment by businesses and households that are liquidity-constrained.
- c. Second, uncertainty about the *amount* of inflation causes lenders to add a *real* premium to interest rates to compensate for the uncertainty, which will reduce investment.

B. The Fed fights inflation:

1. The FOMC's domestic policy directive says "The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output."
2. Alan Greenspan has told Congress that the mission of the FOMC is to "ensure maximum sustainable growth by pursuing and ultimately achieving a stable price level." (7/22/94)
3. Greenspan has told Congress "When it comes to inflation expectations, the nearer zero, the better." (Humphrey-Hawkins testimony, 2/22/94)
4. Greenspan also said (2/22/94), "We will be at price stability when households and businesses need not factor expectations of changes in the average level of prices into their decisions."
5. Inflation has been brought down by more than 10 percentage points since

1979. [The CPI rose 13.3% in 1979 (Dec to Dec) and about 2.7% in 1994 (Dec to Dec)]

III. Silly Ideas

- A. John Mueller, Retreat from Doomsday: Obsolescence of Major War
 - 1. “Silly Ideas” -- Pentagon developing contingency plans to defend against invasion by Canada or Mexico.
 - 2. Holland, Sweden, Portugal -- Germany, Japan.
- B. Two silly ideas of 19th century: dueling and slavery.
- C. From the future perspective of the next millennium:
 - 1. Imagine looking back at the 20th century and trying to explain to your grandchildren some of the ideas in the economic arena that prevailed in this century.
 - 2. Government regulation of:
 - a. What is produced.
 - b. Where it is produced.
 - c. Lines of business -- segmentation/fragmentation.
 - d. Prices of products/services.
 - e. Interest rates paid/received (usury laws/reg. Q ceilings).
 - f. Wages paid/received.
 - 3. Prohibiting ownership of gold.

4. Prohibiting deposits denominated in foreign currency.
 5. Taxing ownership and use of productive capital.
 6. Controlling foreign exchange.
 7. Controlling international capital flows.
- D. Silly ideas about macroeconomic “stabilization policies.”
1. Increasing both government spending and taxation by same amount expands the economy (so-called balanced budget multiplier).
 2. Deficit spending multiplier.
 3. Governments create jobs.
 4. Governments create wealth.
 5. Governments cause growth.
- E. Two particularly silly ideas that are relevant to this speech:
1. Eroding the purchasing power of money increases employment.
 2. More people working and producing goods and services reduces the value of money.

IV. Inflation and Real Economic Growth: The Long and the Short of It

- A. The Fed does restrain *nominal* growth but not *real* growth.
1. Distinguish between nominal economic growth and real economic growth.
 2. Obviously, when nominal growth exceeds real growth, the price level is

rising.

3. It is then merely a tautology to say that the Fed must restrain nominal growth to restrain inflation.
4. But nominal growth is of little consequence compared to real growth.
5. The important question is, does the Fed, in restraining inflation, restrain *real* growth? In the most important sense, the answer is "no."

B. The long and the short of it is that inflation and real growth can be *directly* correlated over the course of a business cycle even though they are *inversely* correlated over the long run. Let me elaborate:

1. The real growth rate can be directly correlated with the inflation rate over a business cycle.
 - a. At some stage in an expansion, prices may rise faster than normal as demand growth outpaces supply growth.
 - b. At some stage in an economic slowdown, prices may fall (or rise at a slower-than-normal pace) if demand growth weakens relative to supply growth. [This wouldn't happen if the contraction were caused by a supply shock.]
 - c. On average, however, price rises that are faster than normal will be offset by those that are slower than normal.
2. However, the correlation in the *short run* does not tell us anything about the *long-run* impact of the *average* inflation rate on real economic growth and standards of living.

- a. The positive correlation over the business cycle does not prevent higher average inflation from being associated with lower average growth, or with lower standards of living, in the long run.
- C. Real growth is harmed by inflation over the longer run.
- 1. Refer to the arguments in section II.A.
 - 2. Some but not all empirical evidence supports those assertions.
 - a. One difficulty with empirical investigations is that all output is considered equally valuable, even if it is activity intended to hedge against inflation or to correct for problems caused by inflation, rather than activity that contributes to improved standards of living.

V. Is Bringing the Inflation Rate Further Down Good Policy?

- A. The inflation rate is already quite low. Should policies strive to bring it down even further?
- B. One practical problem for policymakers could be measurement accuracy.
 - 1. This was not important when the inflation rate was high.
 - 2. Now, when the measured inflation rate is low, accuracy becomes an issue if our target is zero.
 - 3. Analogy: Suppose you are sailing north on Lake Erie but want to avoid

crossing the Canadian border. Not knowing your exact location is *not* a problem when you are near the Ohio shore, but it *is* a problem when you are far out on the lake.

- C. The key issue is net present value of costs and benefits from lowering the inflation rate.
1. Costs of reducing inflation are hard to estimate.
 2. Benefits of lower inflation are hard to estimate.
 3. However, to argue that there is a net *loss* from *lowering* the inflation rate is the same as arguing that there would be a net *gain* from *raising* the inflation rate, unless you also argue that the effects of changing the inflation rate are not symmetrical.
 - a. It is absurd to believe that there are net gains from raising the inflation rate. Countries that have experienced hyperinflation did not experience golden ages of prosperity.
 - b. I have not yet heard an argument that convinces me that the results of lowering the inflation rate would not be the opposite of the results of raising the inflation rate.

VI. Conclusions

- A. The Fed opposes inflation, not growth.
- B. Restraining inflation is beneficial, not harmful.
- C. Inflation and growth may be Siamese twins within a business cycle, but they are an odd couple in the long run.
- D. Further reduction in inflation is desirable.