EMBARGOED UNTIL 10:15 a.m. CST
Tuesday, December 12, 1995

The Inflation Outlook: Could It Be Better?

Remarks by
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Northeast Mississippi Economic Forecast Conference
Tupelo, Mississippi

December 12, 1995

Thank you for inviting me to speak to you today. The Community Development Foundation of Tupelo is widely known for its accomplishments in fostering economic growth in northeastern Mississippi, and it is heartening to know that the Eighth Federal Reserve District includes such vibrant communities. Some of you might recall that I spoke to you in 1989. I am gratified to receive an invitation for a return engagement, particularly when the topic involves the economic outlook. I must not have steered you too far wrong six years ago!

Since we last spoke, the national economy has gone through a recession and a recovery. Recessions are never desirable, but they sometimes foster innovation and change, setting the stage for renewed vigor. I believe this to be true of our recent experience. Although the recovery phase of the current business cycle disappointed some in its relatively modest rate of growth, the expansion has matured nicely. Unlike some expansion phases in which excesses develop, recent economic performance has been characterized by balanced, investment-led growth. This growth has been particularly notable in the Eighth Federal Reserve District. As detailed in a recent issue of the St. Louis Fed publication, *The Regional Economist*, income in the seven states that make up our district has been growing more rapidly than the national average over the past two years.

At the same time, U.S. inflation has been remarkably stable--and remarkably low. Over the past four years, the annual rate of CPI inflation has remained at 3% or lower, and it appears that it will again be in that vicinity in 1995. I believe these trends are related: The recent period of low, stable inflation has been conducive to the business restructuring and investment that is driving the current expansion. This is in sharp contrast to the 1970s, when variable and rising inflation contributed to an environment of uncertainty and speculative behavior that made it difficult to maintain long-run growth.

When I spoke here in 1989, I pointed out that the 1980s had been a period of considerable, but uneven success in bringing the rate of inflation down. Since then, we have made some progress and solidified our gains. It is disturbing, however, to hear some say that inflation is dead and gone, and that the Fed should move onto other battles.

As we contemplate the outlook, it is clear that few people expect further improvement in inflation trends. One widely followed consensus forecast--that of the Blue Chip economists--foresees 3% inflation in 1996. The National Association of Business Economists projects a rate of 3.1%. Surveys of consumers reveal an even more pessimistic outlook. Over the longer term, there appears to be little optimism that inflation will recede further. In the recent budget negotiations between the Administration and Congress, one economic assumption *not* in dispute is the prediction that inflation will average above 3% into the next century.

We should not allow ourselves to become complacent about an inflation rate that remains stubbornly high at 3%. Having made such an assessment in the past, I am aware that it is sometimes met with bemusement. To those of us who remember the disastrous inflation record of the 1970s, recent trends might indeed seem innocuous by comparison. But inflation--even at low levels--erodes the purchasing power of the dollar over time. At the current trend inflation rate of 3%, the purchasing power of the dollar declines to 75 cents after only 10 years. It is halved in merely a generation. To paraphrase the noted inflation expert and grammarian, Yogi Berra, our children will be telling us that "A dime ain't worth a nickel anymore."

Some of you might also recall that the inflation rate was only about 4% when wage and price controls were imposed in 1971--a step that was taken in an atmosphere of crisis. A generation ago, modest single-digit inflation was understood to be unnecessary and undesirable. We should be no more sanguine today about the dangers of inflation than we were then.

The lessons of the past are clear. Experience both in this country and in the rest of the world has demonstrated that inflation can do significant harm to economic performance, and that price stability helps provide an environment conducive to economic growth. The principal contribution that the Federal Reserve can make to our nation's economic well being is in providing such an environment--and we can do better at that than we have been.

I'd like to elaborate on that theme further, organizing my remarks around the following questions:

- Why focus on inflation?

- What are the benefits of price stability? and
- How can we make price stability a lasting legacy?

Let me begin with, "Why focus on inflation?" Inflation is costly because it distorts decision-making. It fosters an environment of uncertainty about the nature of contracts, particularly those extending over a long period. This is especially true in regard to decisions about saving and investing. Confidence in the future value of the dollar is crucial when it comes to making sound and efficient judgments about such long-term matters. Economic growth prospects can be improved only by providing households and businesses with an environment in which uncertainty about future price levels is minimized.

Over 80 years ago, the economist Irving Fisher made the following observation: *"We have standardized every other unit in commerce except the most important and universal unit of all, the unit of purchasing power. What businessman would consent for a moment to make a contract in terms of yards of cloth or tons of coal, and leave the size of the yard or the ton to chance?"* Coincidentally, Fisher made that remark in the year that the Federal Reserve System was founded. His insights into the problems of inflation, and the way to stabilize the purchasing power of the dollar, remain as true today as they were then. Through sound monetary policy, price stability is feasible.

Unfortunately, the current mandate given to the Federal Reserve lists multiple objectives for the U.S. economy, including maximum growth, low unemployment and stable prices. These objectives are typically cast in somewhat vague language, leaving the Fed with no clear ranking of priorities. This state of affairs makes it far too likely that, in addressing short-run concerns, we risk losing control of the long-run trend in inflation. In hindsight, this was our error in the 1970s.

The Federal Reserve did not intentionally allow inflation to reach double-digit levels in the 1970s. But, in trying to buffer the economy from the effects of temporary shocks, we lost sight of our long-run mission. Eventually, a painful readjustment was necessary in order to reverse the trend of accelerating inflation. We are still suffering the consequences of that era in the form of uncertainty about the future and complacency about the seemingly "low" inflation we are currently experiencing.

The institutional structure of the Federal Reserve and the operating procedures governing monetary policy have changed very little since the 1970s. It is not at all inconceivable that the errors of that time might someday be repeated--and participants in financial markets know it. Yet there is increasing pressure on the Fed to lessen its vigilance against inflation, and to turn its attention to other matters.

In reality, the Federal Reserve cannot successfully pursue multiple objectives. Ultimately, the only variable under the Fed's direct influence is the supply of money. And the evidence that longer-term trends in the growth rate of the money supply and inflation are closely linked suggests that controlling inflation should be the proper focus of Federal Reserve policy. Simply put, inflation is the result of allowing too much money to circulate for a given level of economic activity.

Though it is difficult to identify a tight link between any measure of the money supply and the rate of change in prices over very short time periods, the relationship between inflation and money appears clearly over the span of decades. This relationship is also apparent when we compare the inflation performance of different countries around the world. Those countries that experience rapid inflation also show high rates of money growth, and those with low inflation are those whose central banks maintain moderate monetary expansion.

This is particularly clear in the extreme cases of hyperinflation, where rates of price increase can cause a total breakdown in the exchange mechanism of an economy. Among all the historical episodes of hyperinflation, where inflation reaches double or triple digit rates per month, we have consistently witnessed correspondingly high rates of growth in monetary aggregates. Moreover, we have never seen a hyperinflation that was *not* accompanied by rapid money growth.

Episodes of hyperinflation also provide clear examples of the destructive power of inflationary forces: In such environments, individuals and businesses devote vast resources to protecting their asset positions from the ravages of inflation. These resources must necessarily be drawn from more productive uses, depressing economic growth. In a recent economic conference sponsored by the St. Louis Fed, evidence was presented which showed that high inflations reduce output growth significantly. More relevant to our current situation, research also showed that even moderate inflation is detrimental. Eliminating inflation would be no panacea, but the potential gains to our standard of living can be quite appreciable when even small increases in GDP growth rates are compounded over a number of years.

Some argue that the Fed should retain multiple objectives--that we should attempt to balance the goals of low inflation and low unemployment. This position is based on the notion that there is a stable trade-off between these two objectives--in other words, that we could somehow lower unemployment by accepting a higher rate of inflation. But we now know this relationship to be ephemeral. The fact is, the Fed's long-run ability to directly influence output and employment trends is negligible. Real output growth depends largely on population and technology growth, the skill and education levels of the work force, and the accumulation of capital. Monetary policies that create excess demand and inflation simply don't have any lasting positive effect on the quantity of goods and services produced in the economy. However, such policies can impede the economy from reaching its full potential. Accordingly, monetary policy should aim at creating an environment conducive to growth, one in which relative price signals are clear and markets are not distorted by high and variable inflation.

Now let me turn to our second question, "What are the benefits of price stability?" Happily, the advantages of an environment of price stability--credibly achieved and maintained--are many. Fundamentally, inflation distorts the crucial mechanism by which relative prices serve to allocate resources in a market economy. When households and businesses are uncertain whether a particular price change reflects a true re-valuation, or simply is part of an overall price-level shift, bad decisions will undoubtedly be made. A production manager who observes an increase in the market price of his or her company's product might be inclined to plan for higher output if the price increase is interpreted as reflecting strong demand. That decision would be ill-founded, however, if the price rise simply reflected a surge in inflation. Uncertainty about the source of observed price changes makes it likely that the planner will err in either case.

When uncertainty about the value of dollar-denominated assets prevails, individuals and firms are understandably reluctant to engage in productive long-term saving and investment. Once a commitment to price stability has been made, and its credibility fully established, decision-makers will be more likely to engage in efficient long-term planning.

Credible long-run price stability, and the consequent willingness to engage in productive long-run investment, would also be reflected in lower interest rates. The best way for the Fed to facilitate low interest rates is to achieve stable prices. Interest rates include a premium to compensate lenders for the expected erosion of purchasing power over time which inflation engenders. They also include a premium to compensate for the risk associated with uncertainty over future price level changes. If this uncertainty were eliminated, interest rates could be permanently lowered, further enhancing investment and growth.

We can observe this phenomenon by comparing countries with different inflation records. For example, the Bundesbank, Germany's equivalent of the Federal Reserve, has long had a reputation for being diligent in fighting inflation, and that record is reflected in interest rates. Borrowing costs in Germany are nearly 3/4 of a percentage point lower than in France, despite the fact that inflation is running at nearly the same rate in the two countries. Germany enjoys the benefits of having a longer record of low and stable inflation.

Another important benefit of low inflation involves the interaction between inflation and the tax code. Currently, some elements of the tax structure are indexed, but individuals and businesses pay taxes on some capital gains that are purely inflationary. In addition, the taxation of interest income and taxes on certain types of inventory valuation provide additional channels whereby inflation becomes a back-door path to higher taxes. In a noninflationary environment, our nation's tax structure would be more transparent, more equitable and subject to clearer political discussion. Recently, Undersecretary of the Treasury Lawrence Summers pointed out that declines in inflation during the 1980s contributed to reducing the burden of corporate taxes by at least one-third. Lowering inflation from its current trend would lessen tax burdens even further.

All of these factors contribute to the benefits of price stability. An environment in which interest rates reflect the expectation of stable prices into the foreseeable future--one in which inflation no longer distorts price signals or tax burdens--is clearly conducive to long-term investment and enhanced growth prospects.

Finally, I'd like to address the question, "How can we make price stability a lasting legacy?" As I've tried to indicate, the importance of monetary policy for inflationary trends, the clear benefits of low inflation, and the illusory nature of the short-term trade-offs between growth and inflation all lead me to conclude that monetary policy should be conducted with a single objective in mind: price stability.

Credibility in this endeavor begins with a clear commitment. The full measure of benefits from an environment of stable prices can only be reaped when the general public is confident that inflation will not re-emerge to erode the value of their money or their assets. Consequently, it is crucial that the Federal Reserve establish credibility in its pursuit of price stability.

The recent experiences of several countries, including Canada, New Zealand, Sweden and Britain, suggest that credibility can be achieved by making a public commitment to the single objective of price stability. Particularly in New

Zealand, where the officials of the central bank are held personally accountable for maintaining low inflation, the public seems to have accepted the proposition that high inflation is a thing of the past. New Zealand now appears to have lower interest rates than other nations with similar records on inflation, presumably because it has gained credibility through its public commitment to price stability.

In the United States, legislation has been introduced in Congress to make price stability the sole objective of monetary policy. In principle, I support this initiative. I believe that once the Fed has such a mandate, price stability is a realistic, attainable goal. Of course, the establishment of a clear price-stability objective need not be imposed from outside the Federal Reserve System, however preferable that may be in terms of credibility. Within its current mandate, the Federal Open Market Committee could, I believe, explicitly recognize the overriding importance of price stability among its various objectives.

Once we establish a clear commitment, implementing a policy of price stability is a matter of applying tried and true management techniques: establishing objectives, monitoring performance and maintaining accountability. As any effective manager knows, the way to unlock the full potential of an individual or of an organization is to establish clear, attainable objectives and insist upon accountability in meeting those objectives. Evaluating performance is a much more ambiguous and malleable process when objectives are unclear or perhaps even conflict with one another. I am convinced that a more formal structure of accountability would improve the policy process, providing greater focus and structure to the deliberations of the Federal Open Market Committee.

The first operational issue that confronts us in implementing a policy of price stability is to define precisely what we mean by that term. Conceptually, price stability describes an environment in which inflation is no longer a consideration in the decision-making processes of households and businesses. Arguably, this could best be achieved by maintaining a particular price level over time--that is keeping the inflation rate at zero. But there are no perfect inflation measures. So we might choose a price index like the CPI that has broad coverage and is widely recognized by the public. Keeping changes in it close to zero would be a practical operational objective of monetary policy, at least until a better measure is created.

The transition to price stability would then require that we select a target path for achieving our objective, one that moves us toward price stability within a clearly stated period of time. Some economists argue that reducing inflation is costly, but most agree that those costs can be minimized, if not eliminated, by reducing public uncertainty about the process. This benefit can only be accomplished by having a fully articulated policy.

There will, of course, be occasional deviations of the price level from its objective. In fact, there are circumstances under which transitory deviations might be acceptable or even desirable. For example, if we were to observe an increase in the price of agricultural commodities that was due to a severe drought, it would be inappropriate to try to offset that transitory price rise, even though it would likely show up as an increase in the overall price level. This type of temporary, *relative* price change carries precisely the type of signal that prices are supposed to convey in a market economy. What we need to avoid are policy responses that allow temporary price level changes to become permanent through monetary accommodation.

Likewise, I am not suggesting that the Federal Reserve abandon its responsibility for stepping in to provide temporary liquidity during financial crises. Accommodating such special needs is perfectly consistent with maintaining price stability, as long as the transient nature of a liquidity crisis is recognized.

In summary, over the past few years we have experienced a remarkable concurrence of positive economic conditions: Strong investment; moderate, balanced growth; and low, steady inflation. I do not want to detract from that record, but neither do I want to be complacent about our potential in the United States to do even better. As the nation's central bank, the Federal Reserve can contribute to that realizing potential by convincingly committing to an objective of price stability. The current policy setting, characterized by multiple objectives, makes it all too easy to lose sight of our single-most important role in economic policymaking.

There is no magic formula for making price stability a lasting legacy. Rather, we need to rely on sound management principles in the conduct of policy. We must clearly state our objective, monitor our performance, and accept accountability for achieving our goal. If we fail to clearly specify our objective, we will never achieve full credibility, and hence will fall short of enjoying the full benefits of a low-inflation environment. The recent record on inflation is good, and the outlook is far from dismal--but it *could* be even better.