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Three Percent Inflation Is Not "Price Stability"

Remarks by
Thomas C. Melzer
President, Federal Reserve Bank of St. Louis

Jonesboro Rotary Club
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I would like to thank the Jonesboro Rotary Club for giving me the opportunity to speak with you this afternoon. I'm happy to be here for two reasons. First, it allows me to tell people about the Federal Reserve and its role as the central bank of the United States. Second, it gives me a chance to express my views about the appropriate objective of Federal Reserve monetary policy, namely the pursuit of price stability.

In Arkansas, the economic news is very good: Arkansas' unemployment rate has been consistently below the U.S. average for the past four years, and, as detailed in a recent issue of the St. Louis Fed publication, *The Regional Economist*, income has been growing more rapidly than the national average. Nationwide, employment growth has been solid, unemployment is low, and the expansion has been sustained for 60 months, well above the historical average.

Although this news on the real economy is heartening, monetary policymakers sometimes pay too much attention to monthly gyrations in the real economy rather than on providing the kind of stable price environment within which the real economy can function best. Our focus should be on keeping inflation low in the long run, not stimulating short-run real growth. Real growth cannot be increased in any lasting sense by monetary policy. The Federal Reserve's influence over economic activity in the short run is both extremely limited and highly unpredictable, but monetary policy has long-run and lasting effects on inflation.

I think it is fair to say that the Fed has performed reasonably well with respect to inflation during the recent expansion. Last year's inflation performance was the best in nearly a decade, and 1995 marked the fourth consecutive year that inflation has been below 3 percent. The recent period of low, stable inflation has been strongly conducive to the business restructuring and investment that is driving the current expansion. It is also the primary reason why long-term interest rates—those crucial to farmers, homeowners, and businessmen and women—are much lower today than they were in the late 1970s and early 1980s. Then, inflation was at double digit rates and widely expected to stay high.

Today's economic landscape is in sharp contrast to that period, when the rising inflation trend contributed to a corrosive environment of uncertainty and speculative behavior. While we have made progress and solidified much of our gains, the inflation train has not yet been derailed. Look at the forecasts of the Blue Chip survey of economists, the Congressional Budget Office, and the Office of Management and Budget—all continue to project inflation of about 3 percent for this year. Surveys of consumers reveal an even more pessimistic outlook. Disturbingly, there appears to be little optimism that inflation will recede over the next several years. In the recent budget negotiations between the administration and Congress, one economic assumption *not* in dispute was the prediction that inflation will average above 3 percent over the next seven years.

Despite such a consensus, we should not be satisfied with an inflation rate that remains entrenched at 3 percent. At that rate, the purchasing power of the

dollar declines to 75 cents after only 10 years and by half in a generation. Three percent inflation is indeed not price stability. In the brief time I have today, I'd like to organize my remarks around the following issues: What monetary policy can and cannot achieve; what the benefits of price stability are; and how we can lock in those benefits.

Monetary policy is not an elixir that cures all ills, but it does play a significant role in providing an environment within which a market economy can function efficiently. Specifically, monetary policy actions determine the monetary base, which is the amount of currency held by the public and the amount of reserves held by banks. The monetary base is given that name because it is the ultimate standard for settling obligations between individuals, businesses and financial institutions. Monetary policy decisions, by influencing the reserve holdings of financial institutions, also affect the amount of deposits that the public uses to make payments.

When there is an excess supply of money, demand for output grows relative to capacity to produce, and prices rise. That simple explanation says it all: Excess money can't add to the number of workers, it can't add to technological know-how, and it can't increase the stock of capital goods used in production. Therefore, it can't increase output in the long run. But it can increase aggregate demand, or total spending, and thereby increase the price level.

Although few relationships in economics are ironclad, the evidence is overwhelming that longer-term trends in the growth rate of the money supply and

inflation are closely linked, not just for the United States but for every other country, too. In retrospect, losing sight of monetary policy's long-run impact on inflation was a crucial error in the 1970s. The Federal Reserve did not intentionally allow inflation to reach double-digit levels during this time. Rather, it was the consequence of a good-intentioned attempt to buffer the economy from the effects of temporary shocks, like the quadrupling of oil prices and rising unemployment rates. Too much money was created, and its value was severely depreciated. In spite of the inflationary monetary policy, real output grew far slower in the 1970s than in the 1960s, when inflation was much lower.

That excessive monetary growth causes inflation is clear, but so what? Is inflation really such a bad thing? Let me list some of the costs of inflation before discussing the benefits of price stability. Inflation fosters an environment of uncertainty about the nature of contracts—particularly those extending over a long period. High inflation rates are always associated with high variability in individual prices, which means that markets get fooled about how much to produce, how much to pay for inputs, and how much to charge for products. Such misallocations can be extremely costly with regard to capital investments that have long pay-out periods and credit markets that finance capital formation. As Irving Fisher, one of the great economists of the 20th century, said: "We have standardized every other unit in commerce except the most important and universal unit of all, the unit of purchasing power." Inflation—even at 3 percent—is a shifting standard.

Another cost is that inflation in this country not only disturbs our markets, but markets around the world as well. The United States is by far the largest international trading nation, and the dollar remains the international standard for making payments. Our pre-eminence as an international financial center is jeopardized by inflation.

Diversion of resources from production to protect against inflation is another cost. In hyperinflation, declines in the purchasing power of money reach double or triple digit rates per month. Every such case, consistent with what I said earlier, is linked to comparable increases in the money supply, including those in parts of the former Soviet Union today. These episodes provide unambiguous examples of the destructive power of inflation: In such environments, individuals and businesses devote vast resources to protecting their asset positions from the ravages of inflation. Because scarce resources are drawn from more productive uses, economic growth and living standards are depressed, as well. Yet, it is not only hyperinflation that causes harm. Even moderate inflation is detrimental—as the 1970s and early 1980s proved in the United States. Fast monetary growth did not create more economic growth, only more inflation.

Finally, inflation distorts taxes. In fact, the big net beneficiary of inflation is government, which profits from the depreciation of its outstanding debts and increases in taxes on purely inflationary income returns, including capital gains. Such inflation-induced distortions are costly to the private sector.

Price stability, by avoiding the costs of inflation, can enhance the economy's performance. The price mechanism is the fundamental way in which a market economy distributes resources. Your salary, which is the price of your labor, goes a long way in determining how you employ your skills and abilities. Likewise, the supply of corn gets allocated based on its value as an input to the production of various goods. When the price of corn rises, as it has been recently because of dwindling supplies, those buyers who value corn the most bid up its price. This is how the price mechanism should work: rationing the supply of corn or your time to its most valued use.

Inflation, much like sand in a gearbox, wears away and distorts this mechanism. For example, production managers who observe an increase in the market price of their company's product might be inclined to plan for higher output if the price increase is interpreted as reflecting strong demand for the product. But if the price rise simply reflects a surge in inflation, then uncertainty about the source of observed price changes increases the probability of an error. The idea that an environment of price stability would allow the economy to reach its full potential isn't some abstract concept. Rather, once a commitment to price stability has been made, and its credibility fully established, business decisionmakers will be better able to engage in efficient long-term planning.

A credible monetary policy with an objective of long-run price stability would also translate into lower interest rates. The way for the Federal Reserve to facilitate low interest rates is not to turn on the monetary spigots, but rather to

achieve stable prices. There is a good reason why interest rates are two to three percentage points higher today than they were in the 1950s. Inflation was two to three percentage points lower at that time. Thus, even 3 percent inflation is reflected in market interest rates. All of us who have experienced the inflation cycle of the last 20 years know that interest rates include an "inflation" premium to compensate lenders for the expected corrosion of their purchasing power over time. Interest rates also include a premium to compensate for the risk associated with uncertainty over future price level changes. If price stability were achieved and inflation uncertainty eliminated, interest rates could be permanently lowered, further enhancing investment and growth.

We can readily observe how inflation and interest rates are related by comparing countries with different inflation records. For example, Germany enjoys the benefits of having a long record of low and stable inflation, with low borrowing costs. The reason for this, most economists agree, is that the German Bundesbank, their version of our Federal Reserve, is strongly committed to achieving such an outcome. Compare German inflation and interest rates with those of Italy, Israel and Mexico—countries with much higher inflation historically and much higher interest rates today.

I've gone through the arguments as to what sound monetary policy can achieve and how price level stability would benefit the economy. But if the benefits are so clear-cut, why doesn't the Federal Reserve "just do it?" Unfortunately, the current mandate given to the Fed doesn't go far enough in

allowing us to attain this goal. The reason is that, besides stable prices, the Federal Reserve has other objectives, such as maximum growth and low unemployment. Further complicating matters, these objectives are 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—an outcome we can do something about.

Nevertheless, some still argue that the Fed should always strive to balance the goals of low inflation and low unemployment. When all is said and done, we are left with the reality that there is *no* reliable tradeoff between unemployment and inflation. That is, inflationary policies won't create jobs and output, but only inflation. The acceleration in monetary growth and inflation that occurred from the mid 1960s thru the early 1980s was not associated with a decrease in the unemployment rate, but an increase. Likewise, it was not associated with an increase in real output growth, but a decrease.

Making price stability a lasting legacy begins by committing the Federal Reserve to price stability as its primary objective. 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. But public confidence first requires credibility—and credibility is much easier kept than recovered. Nonetheless, the recent experiences of several countries, including Canada, New Zealand, Sweden and Britain, suggest that some

credibility might be gained by making a public commitment to the single objective of price stability. These comparatively new initiatives seem to be working out well.

Similar legislation has been introduced in the U.S. Congress to make price stability the sole objective of monetary policy. I support the principle of this initiative because once the Fed has such a mandate, price stability is a realistic, attainable goal. Within its current mandate, the Federal Open Market Committee could explicitly recognize the overriding importance of price stability among its various objectives. But this outcome is a second-best solution. The reason is that, at various times in the past, the Fed has shown wide latitude in ranking its objectives—often changing them to fit the prevailing climate of economic opinion. It is not enough for today's policymakers to say that price stability is first, sustainable long-term growth second, low unemployment third, and so forth. As the damage of the 1970s showed, a future Fed is not hemmed in by a current Fed's preferences.

In summary, over the past few years we have experienced a remarkable confluence of positive economic conditions: Strong investment; moderate, balanced growth; and low, steady inflation. I do not want to denigrate that record, but neither do I want to be complacent about our potential to do even better. As the nation's central bank, the Federal Reserve can contribute to that potential by being committed to an objective of price stability. The current policy setting,

characterized by multiple objectives and unpredictable outcomes, 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. The Federal Reserve must have a clear objective, its performance must be monitored, and it must be held accountable for attaining its goal. If this is not done in a convincing fashion, we will never achieve full credibility, and the nation will fall short of enjoying the full benefits of a stable price level environment.

As the markets constantly remind us, curbing inflation expectations is always a work in progress. Three percent inflation is the best record in 30 years. That's not bad, and the outlook is far from dismal. Nonetheless, I hope you agree that 3 percent inflation is not price stability. We can do even better. And, to allow our free market system to function at its maximum potential, we should.

Thank you.