Is Inflation Too Low?

You spent a day in a shopping mall armed with a clipboard and asked shoppers the question "Do you think inflation should be low?" most likely you’d get the unanimous answer "Yes." On the other hand, if you asked "How low should the inflation rate be?" responses would probably vary. Not only are there contrasting views among the general public regarding this question, economists also hold different views regarding ideal inflation rates. Some economists believe that the economy will likely work better with a moderate inflation rate of, say, 2 or 3 percent per year. William Poole, President and CEO of the Federal Reserve Bank of St. Louis, argues that zero inflation should be the paramount objective of monetary policy.

Two primary arguments exist for moderate inflation. The first holds that inflation facilitates the smooth operation of labor markets and thereby promotes maximum employment in the face of nominal wage rigidity. This argument is based on the contention that downward nominal wage adjustments occur too infrequently to be consistent with flexible real wages. Simply put, employers are hesitant to lower workers' nominal wages. In an environment of inflation, however, holding wages constant is a way for firms to lower real wages without lowering the face amount of employees’ paychecks. Secondly, some contend that inflation keeps nominal interest rates from falling too close to zero and thereby gives the Fed sufficient room to ease monetary policy—that is, to cut rates—should a recession appear imminent.

Alan Greenspan, Chairman of the Federal Reserve Board of Governors, has pointed out that our economy's fine performance since the early 1990s has been accompanied by low and stable inflation. Clearly, the U.S. experience of the last five years casts doubt on the conventional thinking that falling inflation inevitably will bring slower real growth or a higher rate of unemployment. If monetary policymakers are committed to zero inflation, then one source of interference with the efficient working of markets—uncertainty about expected inflation—would be reduced. Inflation uncertainty makes it difficult for individuals and firms to distinguish changes in relative prices of goods and services from changes in the overall price level. Mistakes in the allocation of resources are more likely to occur because of this uncertainty, with real growth consequently less than it could be.

One could argue that uncertainty about inflation could be eliminated if monetary policymakers simply selected a specific inflation rate. Specifying the rate would satisfy the uncertainty about inflation so that rate would not have to be zero. Poole argues in favor of a zero target for two reasons. First, maintaining a steady but positive inflation rate would probably be harder politically than maintaining a steady zero inflation. In a world where both politicians and economists often believe that just a little more inflation would generate economic gains, policymakers could be tempted to increase the inflation target over time, say, from 2 percent to 2.5 percent.

A second argument for zero inflation concerns the distortions caused by the interaction of inflation with the tax code. Nominal interest income and nominal capital gains are subject to tax. For example, if an investor sold a stock for a $2,000 gain, and if 20 percent of that gain over the years were due to inflation, then $400 of the gain would be subject to taxation even though that $400 was not real—that is, the $400 would not have
existed without inflation. Examples such as this point out why inflation has been called taxation without representation.

But what about the argument regarding the inflexibility of nominal wages as an argument for some positive inflation to enable real wage reductions when nominal wages are steady during periods of inflation? Poole suggests that in the face of zero inflation, nominal wage rigidity would give way to wage flexibility because competitive forces would force wage flexibility just as competition forces price flexibility. Furthermore, typically compensation is set by a firm for at least a year. Part of compensation budgeting is based on the firm’s expectation regarding the rate of inflation. Obviously, a commitment to zero inflation would reduce potential errors in inflation forecasting by the firms.

Turning to the second argument for modest inflation, does zero inflation cause special problems for monetary policy because nominal interest rates cannot be less than zero? Put another way, with moderate ongoing inflation, monetary policymakers have room to push the real rate of interest below zero, which they cannot do when the steady inflation rate is zero. Although the Fed implements short-term policy by targeting the nominal federal funds rate, monetary policy is reflected fundamentally in the growth of the money stock. Liquidity—that is, providing the economy with enough money and credit to meet demand—can always be injected into the economy, regardless of the level of nominal interest rates. Furthermore, it is reasonable to expect that any given interest rate change would have a larger impact when interest rates are low than when they are high.

To summarize, it seems that logic and evidence suggest that the appropriate goal for monetary policy is a long-run inflation rate of approximately zero. In our current economic environment of a low and comparatively stable rate of inflation, it’s easy to forget the costs of even modest inflation. Inflation makes planning more difficult for individuals and firms, it interferes with the efficient operation of markets, and it interacts with the tax code to discourage saving and investment. Moreover, inflation’s effects are felt most acutely by members of society who are economically the most vulnerable. In arguing for a positive rate of inflation, therefore, the burden of proof should rest with those who contend that our economy would perform better with inflation than without it.

This article was adapted from "Is Inflation Too Low?" which was written by William Poole and appeared in the July/August 1999 issue of Review, a St. Louis Fed publication. It also is reprinted through the permission of the Cato Institute, which originally published this article.

Endnotes

1. A zero-inflation target ignores measurement questions, such as a possible bias in the relevant price index. As a practical matter, policy is probably best specified in terms of a measured inflation range that accounts for our best estimate of measurement errors. [back to text]
Q & A

How long is the current economic expansion?

At the end of November 1999, the current economic expansion in the U.S. was 104 months old. It began April 1991, and we have experienced no negative quarters in real GDP (gross domestic product) growth since then.

Is this the longest expansion in U.S. history?

If real growth continues through the first quarter of 2000—and all indications are that it will—the current boom will surpass that of the 1960s and become the longest expansion in U.S. history.

Is the business cycle gone forever?

Probably not. Historical evidence clearly indicates that market economies have suffered business cycle fluctuations and that periods of good times, or expansions, are interspersed with periods of recessions—sometimes mild, sometimes severe.

What has caused the current economic boom?

The productivity of our nation's workers has grown faster during the last few years than it had for more than the two previous decades. Meanwhile, the end of the Cold War has permitted the U.S. government to redeploy its expenditures away from defense and toward other productive ventures. In the process, we've shifted from a budget deficit to a budget surplus, releasing resources into the private sector. Finally, good monetary policy, measured by an inflation rate that has been both low and stable by historical standards, has contributed to an economic environment that allows markets to work efficiently.

Having experienced such a long expansion, should we expect recession around the corner?

If you're asking "Do economic expansions die of old age?" the statistical evidence on this question is "no." Suppose you flip a coin five times, and it comes up heads each time. What is the probability of flipping heads on the sixth try? The answer is 50 percent—the first five heads have no influence on the current coin toss. Similarly, the fact that our economy has expanded for several years in a row does not increase the odds that we will enter a recession next year. Careful statistical analysis shows that economic fortunes do not depend on the length or timing of past expansions. They depend instead on stable prices and low inflation.

The content for Q & A was adapted from "How Long Can the Expansion Continue?" by William Poole, President and CEO of the Federal Reserve Bank of St. Louis, and appeared in the October 1999 issue of The Regional Economist, a St. Louis Fed publication.
Economic Snapshot

3rd Quarter 1999

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*Preliminary

Is the Median CPI a good predictor of future CPI inflation?

Consumer price indexes that exclude the food and energy sectors commonly are reported as core inflation. Food and energy sectors are particularly susceptible to large supply shocks that sometimes cause the overall price index to reflect these shocks rather than the underlying monetary inflation rate. An alternative to the core CPI is the Median CPI. The difference is that the median removes all items with inflation rates above or below the one in the middle. The Median CPI has been a relatively good predictor of future CPI inflation, especially in periods when the trend rate of inflation was changing slowly, if at all.

William T. Gavin, vice president of the Research Department of the Federal Reserve Bank of St. Louis, warns us that the Median CPI was a good predictor of future inflation during this episode.

Once again, in 1997 and 1998, falling oil prices contributed to the decline of all-items CPI, whereas the Median CPI remained substantially higher. This time, however, monetary policymakers indicated their...
determination to bring about a reduction in the trend rate of inflation. Consequently, the Median CPI proved to be an overstatement of subsequent inflation.

The lesson, Gavin suggests, is that the forecasters need to pay attention to the intentions and actions of policymakers, as well as to measure of the prevailing trend rate of inflation.