FRBSF Weekly Letter

February 8, 1991

Controlling Inflation

People generally agree that uncertainty about the future level of prices is undesirable since it leads to a less efficient allocation of resources. For instance, the more uncertain people are about future inflation, the less willing they will be to write long-term contracts or to make long-term investments. In principle, the monetary authority can minimize such uncertainty by controlling inflation. However, what this means for the actual conduct of policy is subject to considerable debate. Some argue that for inflation control to be effective, monetary policy should be aimed at bringing the inflation rate down to zero. Others argue that certainty about future prices can be achieved merely by keeping the inflation rate steady at its prevailing level. With steady inflation, prices would rise, but the overall level of prices still would be easy to predict.

This *Letter* discusses these two alternative approaches to controlling inflation in the context of the monetary authority's need to convince the public that it is committed to that goal. This need arises because policymakers generally have multiple, and sometimes conflicting, objectives for policy. Thus, the public cannot always be sure which goal has top priority, since economic circumstances, and therefore the priorities attached to different goals, can change over time. This is a critical issue since individuals' perceptions of policy bear heavily on their economic decisions. Therefore, the monetary authority must not only strive for price stability (predictability), but also find effective ways to let the public know that it places a high weight on achieving that goal.

Multiple policy goals and the inflation rate

In most countries, controlling the inflation rate is not the only goal of the monetary authority. In the U.S., for instance, the Congress has mandated that the Federal Reserve conduct policy to achieve such goals as high levels of employment and economic growth, along with stable prices.

Having multiple goals necessarily limits how much policymakers can do to reduce price uncertainty, because achieving one objective often requires compromise on another. For example, suppose the monetary authority reacts to a supply shock, like a rise in the price of oil, by following a more stimulative monetary policy, in an attempt to offset any slowdown in the economy. If the stimulative policy continues long enough, it will raise the rate of inflation. However, since monetary policy cannot influence the level of output in the long run, output will eventually return to the level that would have prevailed without such a policy. Thus, in a world where the monetary authority is known to attach a high weight to stabilizing output, random shocks can move the inflation rate around; this makes predicting inflation, and, thus, the future price level, more difficult.

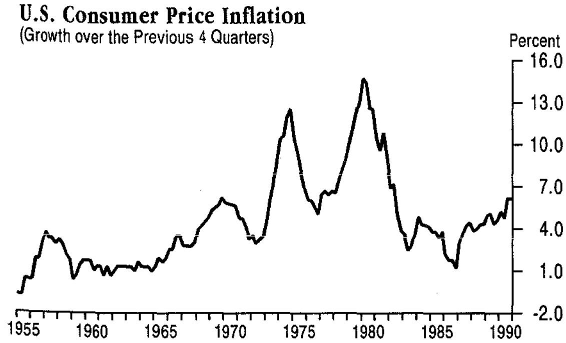
With multiple policy goals, then, the predictability of future prices depends upon the priority attached to inflation *versus* other objectives. In addition, if a high priority on price predictability is to be reflected fully in private economic decisions, individuals must be sure about how much weight is being given to controlling inflation relative to other objectives. Individuals also need to determine how much the priority placed upon controlling inflation might change as, say, the economy moves into a recession.

Historical patterns

Data for the post World War II period provide ample evidence of how policy priorities can change. Chart 1 shows that while inflation was relatively low and stable from the mid-1950s to the mid-1960s, it has been much higher and more variable since then. Indeed, statistical tests indicate that from the mid-1960s through the early 1980s there was no tendency for inflation to return to some level or even to a trend. Such behavior makes it extremely difficult to predict what the price level will be in the future.

In part, the apparent difference in price uncertainty in the two periods may be due to the nature of the nonmonetary shocks to the economy, such as the oil price shocks in the 1970s. Nevertheless, we do have some evidence suggesting that progressively higher levels of inflation were tolerated after the mid-1960s in order to keep unemployment rates low. For instance, the behavior of the federal funds rate (adjusted for inflation) over this period has generally been seen as providing information about the stance of monetary policy, with a low funds rate indicating easier policy. It turns out that the inflation-adjusted federal funds rate was noticeably low during much of the 1970s, and was actually negative for several quarters both in the middle and towards the end of the decade.

Chart 1
U.S. Consumer Price Inflation
(Growth over the Previous 4 Quarters)



This pattern in priorities apparently was reversed in the beginning of the 1980s. At that time, the unemployment rate rose sharply and output contracted, which led to a drop in the inflation rate noticeably below the levels that prevailed in the 1970s. While the rate of inflation has varied since then, so far it has not displayed a sustained upward trend.

Retaining credibility

The lowering of inflation rates in recent years probably has convinced the market that policymakers place more weight on controlling inflation now than in the late 1970s. Consequently, we should have less price uncertainty today than, say, ten years ago.

But, as economic circumstances change, the public cannot be sure that the priority attached to controlling inflation will not change. Thus, while the market may believe that policy will be less likely to allow inflation to approach the peak levels observed in the early 1980s, there still may be considerable uncertainty about the range over which the inflation rate could vary. The fact that the rate of inflation has been gradually creeping up over the last few years also may be contributing to this uncertainty.

Under these circumstances, how does the Federal Reserve retain credibility as an inflation fighter?

Zero inflation. . .

One answer is embodied in a House Resolution proposed over a year ago by Congressman Stephen L. Neal, and supported by many analysts and policymakers, including the Chairman of the Federal Reserve Board Alan Greenspan and the President of the Federal Reserve Bank of San Francisco Robert Parry (see *Weekly Letter* March 2, 1990). This resolution calls upon the Federal Reserve to conduct policy with a view to bringing the inflation rate down effectively to zero over a five-year horizon, and to maintaining price stability thereafter.

Passage of such a resolution would give Congressional endorsement to a policy of trading off some real growth in the economy in the near term for lower inflation in the long run. Effective implementation of the Neal Resolution would virtually eliminate uncertainty about future prices. Recent evidence to support this assertion is available, for example, in work by economists Lawrence Ball and Stephen Cecchetti. They point out that statistical tests on U.S. data reveal a positive correlation between the level of inflation and the degree of price uncertainty. Such a correlation suggests that commitments by a monetary authority to control inflation should be more believable the lower it keeps the rate of inflation. The Federal Reserve's support for the Neal resolution last year, then, can be seen as a way of emphasizing that it does not intend to let inflation get out of control.

. . . Or stable inflation?

What if the monetary authority aimed at an alternative policy prescription—stabilizing inflation at its current level? Part of the argument in favor of this option rests on the principle that the degree of price predictability need not be related to the level of inflation. If inflation stays at about the same rate, people can be confident about the future level of prices in making long-run contracts.

In that case, many argue, it does not make sense for the U.S. to incur the risk of the high economic costs, in terms of higher unemployment and lost output, required to bring the inflation rate down toward, say, zero. This argument has some appeal, especially because there is little evidence to show that the relatively modest levels of inflation that have prevailed in the U.S. over the past few years impose significant costs on the economy.

Is the commitment convincing?

The problem with a policy based on the premise that "it is too costly to reduce inflation today" is that it provides individuals little reason to believe that policymakers' would act on their commitment to control inflation in the future. Individuals have no way of knowing if policymakers will ever be willing to incur the costs of reducing inflation: if it is too costly to reduce inflation today, it will be too costly to reduce inflation tomorrow as well. In other words, the logic behind accepting today's rate of inflation would support accepting any future rate of inflation. Thus, such a policy cannot ordinarily be distinguished from one that would do nothing to control inflation.

Consequently, it seems unlikely that merely pledging to maintain the current rate of inflation would be very convincing to the market. This is particularly true given the likely political pressures that would tend to emphasize short-run output and employment considerations over longer-run price stability. The historical record, which we have already examined, lends some support for such skepticism. The steady increase in inflation over the late 1960s and the 1970s appears consistent with an acceptance of the prevailing rate of inflation and an aversion to imposing short-term costs on the economy in order to obtain the long-term benefits of a lower, more predictable inflation rate.

The oil shock and the war

Under normal circumstances, it is difficult to counter skepticism that a policy to hold inflation at its current level is really a do-nothing policy. If policymakers are not seen as making hard choices, it is not easy to convince the public that policymakers remain committed to controlling inflation. However, it is possible to distinguish the two policies under some conditions; for instance, inflationary shocks will call forth a vigorous response from a monetary authority committed to stabilizing inflation.

Circumstances are obviously far from normal right now. The price of oil has risen substantially since Iraq's invasion of Kuwait (even though it has fluctuated wildly of late). The recession-induced increase in the unemployment rate brings with it the possibility that (as in the 1970s) policymakers will switch objectives and temporarily de-emphasize inflation control. Finally, and perhaps most important, there is the uncertainty created by the beginning of the war with Iraq. These events have created the potential for an increase in inflation. Containing inflation in the near future may turn out to be a difficult task, depending upon factors such as the price of oil and the duration of the war in the Middle East. Keeping inflation in check in the face of such pressures will have the effect of making the Fed's commitment to inflation control more convincing.

Conclusions

We have argued that uncertainty about future inflation will remain in check if the monetary authority is seen as placing a relatively high weight on controlling inflation. Under normal circumstances, a policy pledged to reducing the rate of inflation should be more persuasive than a policy of maintaining the current inflation rate, since the latter cannot be distinguished from a policy that would do nothing to control inflation.

At this time, however, there is some risk that inflation will accelerate. Thus, stabilizing inflation in the current economic environment could enhance the Federal Reserve's credibility. Even so, any gain in credibility is unlikely to be permanent; sooner or later, when economic circumstances are more normal, the issue of retaining credibility will have to be faced anew.

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