

## **ZERO INFLATION: FINISH THE JOB**

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Last month marked the eleventh year of the Greenspan Fed. During this period, the Fed has achieved low inflation rates not seen since the decade before the Vietnam War. This relatively stable and low inflation environment enabled the economy to expand and unemployment rates to decline, with only a short and shallow recession marring the performance. How different this period is relative to the decade of the 70's, which started with both single digit inflation and unemployment rates but ended with double digits for both. Much of the success for improved economic performance must be assigned to monetary policy and its increasing focus on price stability or zero inflation as a policy objective.

However, there are not assurances that the pursuit of zero inflation and the benefits that it confers on the operation of the economy will be the primary objectives of a future chairman and FOMC. Preventing the monetary policy mistakes of the 70's and preserving the policy process that permits the economy to achieve its maximum performance needs to become part of the Federal Reserve as an institution, independent of the views of people who temporarily occupy policy making positions. Now, while the benefits of a zero inflation objective for monetary policy are clear for all to see, is a good time to finish the job and make the necessary institutional change at the Fed.

### **AVOIDING PAST MISTAKES**

Price stability or zero inflation seems to be within reach, with the U.S. inflation rate at less than 2.0 percent for the past year. The issue now is once price stability is achieved, how do we secure it for the future.

It has been a long march from the double-digit inflation rate of 1980 to the low rate enjoyed today. Along the way there were certainly many opportunities to repeat the policy mistakes of the 1970's. The international debt problem, the Crash of 87, the savings and loan disaster, the Gulf war, and a recession all posed potential pitfalls for

monetary policy makers. None of these events prompted the Fed to engage in bouts of rapid money growth sufficient to cause inflation to accelerate significantly.

In the early 80's we had recessions caused by monetary policy mistakes. These mistakes were rapid money growth rates during the previous decade, which required accelerating inflation and rising interest rates and ultimately led to the need for disinflationary monetary policy. The disinflation policies were necessary to get the economy back to acceptable levels of real economic activity. Many observers and perhaps some Fed officials are apt to blame the recessions on the policies that reduced inflation instead of blaming the policies that created the inflation in the first place. With price stability, the economy would not suffer recessions induced by inflation and the subsequent need to eliminate it.

If we have learned anything about monetary policy in the last 20 years, we ought to have learned to think about policy as a dynamic process. To claim that in order to reduce inflation, we must have a recession is a wrong-headed notion that ignores the ability of people to adapt their expectations as the environment changes. For the past decade and a half the Fed has emphasized price stability or zero inflation as an objective of policy both in its public pronouncements and in its policy actions in terms of money growth rates. Inflation has come down, unemployment rates are at record lows and the economy has expanded but for one short and shallow recession in 1990.

The lesson of this period is that a credible policy of price stability promotes an environment conducive to achieving the highest standard of living that our endowment of real resources and human capital will permit. From this long-term vantage point of maximum sustainable economic growth, monetary policy cannot be used to fine-tune the performance of the economy over the business cycle.

## **INSURING PRICE STABILITY FOR THE FUTURE**

Moving to near zero inflation is a significant accomplishment. Making the institutional changes necessary to insure price stability in the future would be even more of an accomplishment. Members of the Federal Open Market Committee come and go and circumstances in the economy can and do change as do the political winds that blow up and down Pennsylvania Avenue. Perhaps the current members of the FOMC have

learned the value of price stability as the dominant objective of monetary policy but what about future members? Will a deep recession with sharply rising unemployment and concomitant political pressure on the Fed “to do something” dampen the resolve for price stability? Will the FOMC repeat the failed policies of the past?

There is nothing in the charter of the Fed that requires it to make price stability the overriding objective. There is nothing in the monetary policy process either by tradition or practice that locks in price stability as the primary objective. Indeed, the traditional analysis in the policy process focuses on current economic data and models that imply an exploitable tradeoff between inflation and unemployment.

For the Fed to lay the ground work for a credible policy of price stability for the future it needs to make some fundamental changes in the policy a process now so as to build a tradition, practice and culture of price stability that becomes imbedded in the walls at 21<sup>st</sup> and C. First, the FOMC needs to approve a multi-year price stability objective with a time frame for achieving it. Second, it needs to impose a rule on itself, tying policy actions to an intermediate target such as the monetary base. These changes would shift the policy process away from the focus on the federal funds rate, current economic data and models with ephemeral tradeoffs between inflation and unemployment. An alternative approach would be for the FOMC to specify that the ultimate goal—price stability—is the rule, using discretion in choosing actions to achieve that goal.

With either approach, credibility would have to be earned through consistent and predictable actions to achieve the price stability goal. While not directly binding a future FOMC to this goal, the current FOMC would be establishing a tradition and practice within the institution that over time would be hard to dislodge. Of course, the most effective way to bind a future FOMC to a price stability goal is to alter its charter through legislation. Several countries have adopted this approach of their central banks with good results. In this country, such bills have been proposed but have failed to pass. There are also risks attached to the legislative approach. Congress has in the past sought to remove Fed presidents from voting on the FOMC since it does not get to approve their appointments. Despite the difficulties and risk in legislative approach, it is worth trying this route again. Senator Connie Mack (R-Florida) would be an appropriate champion for

such a legislative mandate given his public statements about the importance of a sole objective of price stability for the Fed.

The ultimate goal of monetary policy must be to provide a credible and predictable commitment to price stability required for peak performance of the economy. The Greenspan Fed has made much progress towards price stability. It is now time to finish the job and secure the benefits of price stability for tomorrow's economy.