

A SYMPOSIUM OF VIEWS

Is a Little Bit of Inflation OK?

In recent issues of The International Economy magazine, various experts have commented on the so-called NAIRU theory — whether the U.S. economy can grow long-term by more than roughly a 2.5 percent rate. There is, however, a second debate underway in U.S. policy circles concerning the question of how low an inflation rate is desirable for the economy. Some experts argue that a monetary policy that targets zero inflation is potentially dangerous, as it risks having the economy slip into a deflationary interest rate trap, a la Japan. Other experts counter that under such a policy, whatever is designated as the ceiling for a suitable inflationary range will automatically become the floor, as Fed policymakers feel the usual round of political pressure. How realistic is the goal of zero percent inflation or is a little bit of inflation quite acceptable?



“Achieve price stability, then head for zero inflation. Otherwise, real asset prices get distorted. Look at Japan.”

WAYNE ANGELL

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A central bank can promote optimal growth by making price stability its primary objective. Both anticipated inflation and deflation distort economic behavior as decisionmakers divert resources from productive activities to those designed to shield themselves from the consequences of price changes. With persistent inflation, some capital investment is more heavily taxed than otherwise, discouraging some types of lending and investment. In addition, inflation and deflation are likely to be associated with greater uncertainty about future prices, further complicating economic decisionmaking.

Targeting zero inflation once price stability has been achieved is neither costly nor dangerous. Once economic decisionmakers expect price stability, they can plan by assuming that real and nominal measures will be the same. Abrupt inflationary or deflationary changes in central bank policy, however, can distort real asset prices, as we have seen in Japan. If real asset prices are falling, then loan demand to buy real assets at zero interest rates would be scarce. But monetary policy is not impotent; if the Bank of Japan expands its balance sheet, then increased yen liq-



“Zero’s rare, but people don’t expect it anyway. Lawrence Summers misread Japan, and central bankers should improve their means of measurement.”

ALLAN MELTZER

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The goal should be zero inflation, on average, to protect the purchasing power of money. Uncertainty about inflation raises both real and nominal interest rates, hinders long-term investment and planning for retirement. Maintaining zero inflation forces business to control costs, thereby encouraging productivity improvements. Uncertainty about future purchasing power is particularly costly for the timid, cautious, and poorly informed.

Faulty reasoning by Lawrence Summers suggests that, at zero inflation, it may be impossible for the central bank to reduce interest rates enough to end a recession. Summers uses careless and casual observation of recent Japanese experiences to support this argument.

The Japanese experience teaches two very different lessons. First, low interest rates are not the same as monetary ease. Money growth was low or falling. Second, a central bank has many ways to inject money into the economy. It can buy foreign exchange, long-term bonds and, if necessary, real assets. Soon after the Bank of Japan ended its deflationary policy by buying dollars heavily, the recession ended despite continued banking problems and low short-term interest rates.

Paul Krugman and others have speculated publicly that the costs of reducing inflation from 3 percent to zero are much higher than going from 9 percent to 6 percent or from 6 percent to 3 percent. I believe they make the mistake of extrapolating from behavior during a period in which inflation was rarely, if ever, zero. If inflation is expected to be positive, on average, people base their prices and wages on that belief.

For the past 30 years, no rational person had reason to believe that inflation was, or would be, zero. People acted on that belief. The only three year periods of near zero inflation since the Federal Reserve was founded in 1914 have been 1924 to 1929, 1953 to 1955, and 1960 to 1964. Those years do not show the problems Krugman

and others claim.

Central bankers should improve measurement so that they can have a clearer idea about where zero is. They should not pretend that a little inflation is a good thing. That’s how the mistakes of the past 30 years got their start.

ROBERT A. MUNDELL

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Money, like all commodities, obeys the law of supply and demand. When money is scarce its value rises; when it is in excess, its value falls. Because the value of money is the inverse of the price level, inflation, defined as an increase in the price level, implies a decrease in the value of money.

Because of economic growth, the economy needs and the public wants to hold more real money balances every year. In the absence of monetary expansion, growth of the demand for money would result in deflation. To prevent deflation in a growing economy, some provision must be made for an increase in the supply of money. Price stability results when the increase in the money supply is just equal to the increase in money demand at zero inflation.

It is universally recognized that inflation has harmful effects on the economy. It undermines the credit system, misdirects investment, deforms the distribution of income and wealth, and, by reducing real liquidity, misallocates resources. While special interests may gain from inflation, the gains to a few are swamped by the losses to many and society as a whole is worse off.

If inflation is bad, why is it so prevalent? There are three reasons. One reason is that special interests — in particular debtors — gain from unexpected inflations; whenever debtors achieve power, they reach for the printing

press. A second reason is that inflation (more precisely money expansion) is a great fiscal resource; a typical motive for the “money tax” has been wartime or post-war exigencies. A third reason is the argument that inflation benefits the economy; this is the motive that concerns us here.

In the hey-day of mercantilism, inflation and devaluation were popular prescriptions for the 17th and 18th centuries. David Hume, who was a bridge between mercantilist and classical thinking, conceded that inflation could bring short-run benefits, but only at long-run costs. Classical economists like John Stuart Mill took Hume strongly to task for his “heresy.” During the classical era, infla-

“Let’s aim for a target of 1 percent to 2 percent. But let’s get there slowly. We don’t need any shock therapy.”