

## The Economy in Perspective

*The Big Chill...* The Soviet Union was officially dissolved on December 26, 1991, one day after the resignation of Mikhail Gorbachev. The Cold War was over. Ever since, the countries that made up the former U.S.S.R. have been struggling to govern themselves and to find their places in the world.

The United States has reacted to these developments on two levels. Military bases are closing and spending for national defense is shrinking. New relationships among the United States and the emerging nations are expanding, promising greater trade and employment opportunities. These are the more immediate, visible adjustments, but broader forces are working beneath the surface.

The manifest threat of nuclear attack by the Soviet Union brought a high degree of cohesion to U.S. foreign and defense policies. The vacuum created by the collapse of the "evil empire" is prompting questions that are still largely unanswered. Do we have any enemies now, and what do they want? What are our obligations to protect other nations, and how far should we go to fulfill them? By what means can we best achieve our objectives? How much will these efforts cost? In a dangerous world, how much risk should we bear? There are choices to make, and each comes at a price.

In 1979, the United States initiated a hot war against another seemingly implacable foe—inflation. President Carter appointed Paul Volcker to head the Federal Reserve, giving him a mandate to eliminate double-digit inflation. This effort relied on a demonstrably tight monetary policy and the public's willingness to suffer casualties. Inflation had become so intolerable that having a numerical goal was unimportant; all that mattered was reducing it. With support from President Reagan, the Volcker Fed continued using heavy artillery to break inflation's back, reducing the core rate from 11% to 5% by 1983.

Under the leadership of Alan Greenspan since 1987, the Federal Reserve continued its war against inflation, which it described as a campaign for price stability. Having reduced inflation's imminent threat to economic progress, the Federal Reserve could more gradually squeeze it from the U.S. economy. Initially, the Greenspan Fed followed a course of limited aggression, marked by an occasional preemptive strike and persistently combative rhetoric. This strategy finally paid off in 1991. As Boris Yeltsin faced down the tanks in the Kremlin, the U.S.

inflation trend collapsed from 5% to 3%, the spoils of a seven-year siege. Backing its words with action, the Greenspan Fed cut inflation to levels not seen since Sputnik.

Once again, however, broader forces started working beneath the surface. With inflation lower than it had recently been, voices were heard pronouncing it dead. The economy's pace faltered after the Gulf War, and national attention was focused on expansion and employment, not inflation. Whenever Federal Reserve officials spoke about their commitment to achieving price stability, critics said the Fed was fighting the last war. The Soviet Union was imploding, and the public was tired of combat.

In a sense, people know exactly what they want: peace at *no* price. But on a very practical level, our nation has no clearer idea about what it wants from the Federal Reserve than from the Pentagon or the State Department.

How does an honorable monetary authority achieve a responsible peace with inflation? A workable compromise requires that the public and its central bank understand one another's aspirations and limitations. After all, nations create independent central banks to prevent the popular wish for easy money from running amok. An unduly restrictive monetary policy will eventually lose popular support, but so will policies of appeasement. Although there is ample room for misunderstanding and mischief in the goal-setting process, an honorable monetary authority attempts to be as transparent as possible about its intent and operations. Transparency, alas, does not always equal precision.

"Price stability" has been described as inflation so low that it doesn't enter into people's thinking about economic decisions. So defined, this monetary policy goal does not lend itself to numerical accountability. Some decry this imprecision as a shortcoming of the current monetary policy regime and argue that it lessens the Fed's credibility. Perhaps so. But if the Federal Reserve's aggressive war against inflation has ended, it has been replaced by its own Cold War strategy, designed to attain its goal through less overt means than sustained combat. To keep inflation out of economic decisions, the Federal Reserve must be successful at persuasively shaping inflation expectations. Although a clearly articulated theoretical framework would enhance its actions, this Fed's inflation policy is *realpolitik*. It recognizes that détente does not mean peace.