

## **Beyond Price Stability: A Reconsideration of Monetary Policy in a Period of Low Inflation**



Does price stability indicate that monetary policy is being appropriately conducted? It would seem so based on the increasing number of central banks that have adopted price stability as their primary, if not sole, objective. It is certainly a welcome change from the belief that monetary authorities had the responsibility and capacity to fine-tune fluctuations in the real economy. This doctrine, however, may have caused many economists and policymakers to overlook its potential limitations. Writing in 1929, too late to prevent the Great Depression, the famous economist A.C. Pigou warned that in times of changing productivity, macroeconomic stability and stable prices “are fundamentally incompatible with one another.”<sup>1</sup>

Proposals for making price stability the Federal Reserve’s primary monetary policy objective still deserve serious consideration and support, but perhaps this objective should be considered in a broader context than has been the case in recent years. In this essay, we resurrect arguments—most from around the time of the Great Depression—that seem particularly relevant for thinking through the puzzles and potential pitfalls of our current environment of benign price pressures, rapid asset appreciation, and substantial liquidity. We hope to incite a more substantive discussion on the role of monetary policy in an era where the attainment of a near-zero inflation environment appears to be a real possibility.

### The Case for Zero Inflation

Economic policies have always been forged from a combination of economic theory, institutional design, political acceptance, and personality. The particular set of economic policies a nation follows at any point in time are governed by factors no single player completely controls. Sometimes the confluence of these parameters is strong enough and long enough to define an era. For example, the period from 1960 to 1980 marked an era in U.S. monetary policy governed by the principle that the Federal Reserve could—and should—promote low interest rates and easy money to reduce unemployment, possibly even at the cost of permanently greater inflation. Monetary policy was a tool to be used to “manage growth” in the economy.

Poor economic performance during the 1970s, including unacceptably high inflation, multiple recessions, and weak productivity growth, disenchanted those who thought inflation was benign and that growth could be closely “managed” over the course of a business cycle. Zero-inflation advocates accepted the premise that countercyclical monetary policy could temper extreme fluctuations around predetermined trends, but they contended that policy’s primary contribution to economic prosperity lay elsewhere. In their view, a stable-price monetary policy could contribute to the economic landscape by eliminating distortions and uncertainties from economic decisions.

Monetary policy in the last two decades has been geared toward price stability, that is, creating an environment in which neither inflation nor inflation expectations enter into economic decisions. The idea that monetary policy should be set to achieve long-term price stability has supplanted the idea that policymakers can systematically obtain more economic growth by engineering, or even tolerating, more inflation. Few economists and experienced policymakers now believe that monetary policy can be used to determine trends in unemployment or GDP growth; they accept the notion that these properties are determined by a nation’s legal system, the education and skill of its workforce, capital formation, productivity, and innovation. The economy’s remarkable performance during this period has apparently convinced many that we have arrived at a new era of monetary policy, one of low and stable inflation.

The victory of price stability over managed growth deserves more appreciation than it commonly receives. The Federal Reserve’s acceptance of price stability as the most important course of action by which it can contribute to economic prosperity has created an environment in which Americans expect inflation to remain low for long periods of time. If unforeseen events push inflation away from this norm, Americans will expect the Fed to aim its policy instruments in the direction of price stability. U.S. citizens will no longer need to spend time and money looking for ways to protect their wealth from erosion due to changes in the purchasing power of the dollar. Decisions to consume and invest will be based on the underlying value of these activities, and not on their usefulness as a hedge against inflation. Over time, the nation’s standard of living will benefit considerably.



The triumph of price stability, however, should not make policymakers complacent. Though price stability brings clear benefits to an economy, it does not always correlate with acceptable economic performance. As Japan and several other Asian countries are now demonstrating, severe economic contractions can result from financial system imbalances that are not clearly signaled by consumer price inflation. Despite its many virtues, an economy characterized by a low, or zero, rate of increase of consumer prices may not necessarily exhibit financial stability and sustainable growth.

### **Do Stable Prices Imply That Monetary Policy is Stabilizing?**

The argument that price stability is not a sufficient condition for sustainable growth has been made by observers of economic fluctuations since before the Great Depression. Price-level stabilization during “years of rapidly advancing productivity,” argued D.H. Robertson in the 1920s, can “become a serious source of trouble.”<sup>2</sup> Other scholars who analyzed the “great contraction” of the 1930s, including A.G.B. Fisher, Ralph Hawtrey, Gottfried Haberler, F.A. Hayak, Ludwig von Mises, and A.C. Pigou, all concluded that the absence of consumer price inflation in the 1920s sent false signals about financial and economic stability.<sup>3</sup>

These scholars thought about monetary policy differently than we do today because their ideas were formed when nations adhered to a gold standard. These economists believed that the price level would *fall* if money growth remained unchanged during a period of accelerating productivity because they expected the quantity of gold to be fixed in the short term. The notion that a monetary authority could manipulate money supply growth to choose the price level (or inflation rate) was not a policy option.

Contemporary monetary authorities have the ability to determine the price level through their policies. If the authorities do not wish to see the price level fall during a period of accelerating productivity, they must allow the rate of money growth to accelerate. But, given this option, what should the monetary authority actually choose: to promote deflation (or disinflation) by holding the money supply steady, or aim for a stable price level by expanding the money supply? Does it matter which path is chosen?

### **Historical Precedent**

There is no general consensus among economists as to what caused the “great contraction” of the 1930s, but one school of thought is that the seeds were sown during the prior boom. Austrian and neoclassical writers have argued that the wealth gains of increasing productivity during the 1920s *should* have been observed in rising real incomes as the prices of goods and services fell relative to unchanged wages. A favorable “productivity surprise” *should* have meant that workers’ pay went further than before, not because salaries increased, but because their unchanged nominal values would have purchased

more goods and services.<sup>4</sup> After all, more output could be produced with the same amount of labor. These economists expected the money supply to remain steady, forcing the prices of goods and services to decline (or not increase as much as previously had been anticipated).

But that is not exactly what happened. The industrialized nations were not following a pure gold standard at that time, but a modified gold regime that permitted more price-level flexibility than the classical economists had contemplated. The productivity boom did not bring deflation. The monetary regime allowed for an expansion of liquidity which, in turn, enabled nominal money wages to rise (although not as rapidly as productivity) and the price level to hold relatively steady. Early in the boom, returns to capital accelerated significantly relative to the returns to labor.<sup>5</sup> Although it would have been foolish to expect that the share of national income going to businesses could continuously rise relative to the share going to labor, it appears in retrospect that asset market valuations may have reflected this belief. The bust following the boom is a storied episode in U.S. economic history.

The imbalances that ultimately led to the Depression may have been due, in part, to two illusions. Working people, for their part, did not realize that the value of their skills was rising faster than their paychecks. All they saw, for a while, was increased job availability and escalating salaries. The fact that the labor share of national income was trending down while business profits trended up was not an issue for wage earners. However, expecting that workers would never overcome their illusion and seek to be paid commensurate with their new, higher productivity was a different sort of illusion on the part of investors. Since it was inevitable that the labor share of national income would revert back toward its long-run value, capital's share was also destined to fall back toward its own norm.

The turmoil caused by the sharp decline of asset prices when business profits began to fall short of past experience caused a curtailment of new investment and reduced the demand for more workers—a recession. Without the widespread bank failures, a prolonged depression might not have occurred, but a correction of the inherent imbalances was unavoidable.

### **An Alternative Outcome**

New Zealand economist A.G.B. Fisher argued in 1935 that the mistake of the 1920s was that the economy's extraordinary productivity gains failed to elicit an increase in the purchasing power of money. In other words, the average of consumer prices should have decreased in the face of improved productivity—just as food prices fall when there are bumper crops. However, monetary expansion arrangements that kept the average of prices from falling generated “false profits signals, causing resources to be misallocated.” These false signals led to excessive investment in capacity and surplus inventory. Fisher contended that, “Not only is a fall of prices which is a result of increased productive efficiency not a bad thing, but efforts to check such a fall will inevitably lead to disequilibrium and depression.”<sup>6</sup>

Fisher, of course, wrote in a time when notions like disequilibrium had a different, and much less precise, connotation than in our age. But the basic message of his argument seems perfectly relevant to modern macroeconomic thinking: Unless people know how the money supply will evolve, they will have trouble determining the value of money and goods. Valuing assets becomes problematic as well, because assets represent claims to the future purchase of goods and services. In addition to being a store of value, assets serve as collateral for borrowing. Whenever the market prices of office buildings, hotels, apartment buildings, farm land, shopping centers, or common stock rise above levels consistent with future revenue streams, borrowers can incur debts that ultimately turn bad. Moreover, lenders suffer loan losses, and if those losses are severe enough, lenders can become insolvent. In the process, credit is channeled to sub-optimal undertakings and economic performance is impaired.

When the owners of capital disproportionately reap the new wealth that is created by accelerated productivity, shortsighted projections can cause asset valuations to rise to unsustainable levels relative to goods and factor prices. Investment, supported by strong corporate cash flows and ample collateral, feeds the economywide boom. Money supply growth contributes to and extends this process when price signals are uncertain due to confusion about how policymakers will respond to productivity improvement. Accordingly, monetary authorities should be on the lookout for unusual strength in money growth and asset prices at a time when productivity appears to be accelerating.

### **Monetary Policy Today**

As we entered 1999, the pace of real economic activity once again exceeded market expectations of sustainable growth by a wide margin. Consumers continued to acquire houses and durable goods at a fast clip, and financial institutions provided the credit necessary to support a prodigious rate of national spending. The United States is borrowing from abroad to consume far more than it produces and, at the same time, through Social Security, it is transferring resources from future generations to bolster the consumption of current retirees. This spending frenzy finds additional support from equity markets, where price levels and earnings multiples continue to set records.

The experiences of the 1920s and 1930s provide a perspective from which to think about today's monetary policy. Real growth may indeed reflect the transition to a permanently higher level of material well-being, ushered in by the information technology revolution that began some 20 years ago. Current spending patterns may indeed be a justified response by current generations to the prospect of permanently greater wealth for themselves and future generations.

But exceptional demand conditions in the United States have also been accompanied by torrid monetary expansion. M2 growth has been accelerating for the past five years, reaching a nearly 9 percent rate last year. Its growth rate exceeds what would normally be seen in an economy with 5 percent to 6 percent nominal growth and relatively stable interest rates.

Surprisingly, consumer price inflation registers only between one and two percent. The conventional explanation for reconciling strength in economic activity and monetary growth with the benign inflation rate is a shift in the demand for money. A surge in money demand means that people have decided to hold more of their wealth in the form of money balances. This could happen if the cost of holding money relative to other assets has declined, or if people desire more liquidity. If money demand surges along with an expansion of money supply, harmful inflationary developments or other types of market instability might be considered unlikely.

There is, however, a significantly more troubling interpretation of events, a view grounded in historical precedent. Suppose that people have been overestimating the size of the productivity gain and confounding asset price valuations. These mistakes may have converted a real burst of productivity-driven output and wealth gains into speculative excess. In this view, asset prices do not accurately reflect projections of the future earnings streams. Instead, they reflect a situation in which earnings are overvalued and supported by excess liquidity. Conventional consumer price inflation, then, becomes only one concern.

Even worse is the possibility that when the speculative excess ends, it will bring with it the type of real dislocation that has surfaced in the past and has recently plagued Japan and other countries. Similar signs were present in those economies—fast money growth accompanied by stable goods prices but soaring asset prices. The warning signals were neglected, and those economies paid for that neglect.

### **Money and Asset Prices— Irrational Exuberance and Expectations Traps**

Accelerating money growth in the United States during the past few years might have been accommodating more than a burgeoning volume of dollar-based goods and services transactions around the world. Some portion of the expanding money supply might have been supporting increased asset prices including, farm land, housing, and equity prices, but especially the latter.

How might this process work? Essentially the same way that A.G.B. Fisher reasoned in 1935. Initially, people rationally expect corporate profits to rise during an expansion. In our current expansion, there have been good reasons to suspect productivity gains would boost profits even further. Encouraged by low inflation, stable interest rates, technological progress, and a stable global political climate, companies stepped up their rates of capital formation. Increased capacity, in turn, contributed to further price competition in world markets. Collectively, these developments encouraged people to expect stronger corporate earnings into the future. As the U.S. expansion gathered momentum, aggregate demand outstripped supply by wider margins, pulling in capital from abroad. An appreciating exchange rate made import prices decline at ever-faster rates and contributed to the picture of emerging price stability.



None of this appears unhealthy, but for the possibility that it is prolonged and accentuated by a surplus of money growth. Although the process by which monetary factors influence the real economy is not well understood, most economists recognize that, in the short run, wages are slow to adjust to liquidity-driven demand. In time, such rigidities relax and economic fundamentals prevail. This process may be slow or rapid, depending on institutional arrangements and the clarity of environmental information. With this latter point, however, we distinguish the concept of price stability from *monetary stability*. For in the event that monetary policy itself is artificially boosting demand and short run economic activity, the conditions are set to turn positive productivity gains into a speculative bull run. This outcome becomes all the more plausible when normal impediments to expanding demand are slackened significantly by weakness in the rest of the world.

In other words, a pessimistic story about the state of the U.S. economy might go as follows: Legitimate expectations of future earnings prompt a boom in consumption, investment, and equity prices. Moreover, weak economic activity elsewhere in the world has the effect of relaxing capacity constraints, providing a safety valve of imported goods and services at dollar prices that are actually declining sharply. This phenomenon depresses U.S. consumer price inflation, but only temporarily, because of rapid money growth. With no inflationary pressures in sight, the Federal Reserve does not interpret money and credit conditions as being quite stimulative.

A particular problem arises when the absence of overt inflation acceleration leads analysts, producers, and consumers to underestimate the corrosive influence that easy monetary policy can accommodate in the economy. Do these corrosive influences now exist in the U.S. economy? Households may feel wealthier, but the most significant portion of that wealth now consists of equities, not their homes. Consumer spending has been brisk lately, but its pace has been achieved through declining saving rates and increased debt-to-income ratios. Consumers appear to be relying heavily on their equity holdings as a financial cushion.

For their part, banks find it increasingly difficult to fund commercial loan growth without purchasing funds in money markets. Banks' balance sheets show that securities share of total assets has been dwindling, reflecting reduced liquidity. Consequently, the economy could be vulnerable to a sharp downward revaluation of stock prices, because consumer spending could fall off and because equity finance has become a vital source of corporate funding.

Does this explanation of recent events require irrational exuberance to hold it together? Yes and no. It certainly requires that mistakes are made, but it does not necessarily imply that a chain of negative consequences can occur only in the presence of widespread irrationality. Ordinarily, economists would expect market forces to correct mistakes in judgment about equity valuations and bond prices as more information becomes available about the underlying strength of corporate profits and monetary policy. But suppose that financial market participants think that monetary policy will respond to unsettled market conditions by injecting more liquidity. The results of such actions could short-circuit the normal forces that would generate market corrections, at least for a little while. For its part, the monetary authority could find itself in a sort of "expectations

trap.” The best choice of action at each decision point may seem to be one that validates private expectations and calms roiled markets, despite the fact that excess liquidity conditions would still prevail.

### Prognosis

If this pessimistic story accurately describes U.S. economic conditions during the past few years, a stronger case can be made today that monetary policy should have moved more decisively toward tightness early in 1997. At that time, there was still no sign of accelerating inflation, and the economy appeared to be on solid footing. However, it is only in the last two years that asset prices have surged and put households, businesses, and financial institutions at risk to a sharp correction. Economists still disagree about the causes of the boom and bust that took place 70 years ago, so it is not surprising that there is no consensus yet on how to interpret the data being generated by today’s economy, including the role of monetary policy. Conventional frameworks appear inadequate. The point of this essay is not to claim sure knowledge, but rather to illustrate how a responsible monetary authority could inadvertently foster excessive liquidity in an economy characterized by accelerating productivity and slowly adjusting wages.

There is another, equally important point. If the economy does suffer a downturn exacerbated by financial market corrections, it would be wrong to conclude that a monetary policy geared toward price stability was a mistaken choice. Price stability represents a significant improvement over managed economic growth. But price stability is, after all, a means to an end. And, as has been demonstrated, it has limitations as an overall indicator of economic health. During a period of rapid technological change and exuberant financial markets, monetary authorities must still account for—and reckon with—excessive monetary growth.

### Notes

1. A.C. Pigou, *Industrial Fluctuations*. 2nd ed. London: Macmillan, 1929, p. 254.
2. Dennis H. Robertson, *Banking Policy and the Price Level*. London: P.S. King, 1926, pp. 68, 58.
3. This paraphrases arguments presented in George Selgin, “The ‘Productivity Norm’ versus Zero Inflation in the History of Economic Thought,” *History of Political Economy*, vol. 27, no. 4 (1995), pp. 712-17, 723-31.
4. See Selgin, pp. 708-27.
5. Between 1920 and 1929, the average annual increase in output per man-hour was 2.7 percent, while the average increase in money earnings was only 1.0 percent. From 1922 to 1929 disposable personal income rose an average of 4.6 percent per annum, while corporate profits rose at 10.3 percent per year in the same period. Corporate profit data could not be found annually for 1920 and 1921, but the annual increase 1922–23 was nearly 28 percent, compared with a 14.4 percent increase in disposable personal income. For the years 1921–23 the average annual increase in real private GDP per unit of capital increased 8.7 percent while increasing only 0.8 percent per unit of labor.
6. Allen G.B. Fisher, “Does an Increase in Volume of Production Call for a Corresponding Increase in Volume of Money?” *American Economic Review*, vol. 25, no. 2 (1935), p. 209.

### Sources

- U.S. Department of Commerce, Bureau of the Census, *Historical Statistics of the United States, Colonial Times to 1970*. Washington, D.C.: GPO, 1975.
- U.S. Department of Commerce, Bureau of Foreign and Domestic Commerce, *Statistical Abstract of the United States, 1922–24, 1926, 1929, 1932*. Washington, D.C.: GPO, 1923–25, 1927, 1929, 1932, respectively.