

The Economy in Perspective

by Mark Sniderman

“Money talks” because money is a metaphor, a transfer, and a bridge. Like words and language, money is a storehouse of communally achieved work, skill, and experience.

—Marshall McLuhan,
Understanding Media, ch. 14 (1964)

Inflation—the rate at which the purchasing power of money declines—is a big deal. In his 1931 *Essays in Persuasion*, John Maynard Keynes wrote, “The best way to destroy the capitalist system is to debauch the currency. By a continuing process of inflation governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens.” History is filled with examples of governments, elected or not, that cheapened their currency to the detriment of their own citizens.

The United States last experienced a serious bout of inflation in the 1970s: The buying power of a 1970 dollar was reduced to about 47 cents by 1980. And inflation was not only high but also variable. People found it difficult to plan from one year to the next, and those who saved demanded protection in the form of higher interest rates to compensate them for inflation. Nevertheless, Americans tolerated accelerating inflation for a while. They had been told that inflation in itself was not very harmful to economic growth and that lower inflation would require significantly higher unemployment. But inflation was taking a toll on the economy. Investment suffered and productivity declined. Working people felt that their wages were not keeping up with the prices of the things they bought; retirees feared that they would outlast their savings.

The public eventually demanded an end to the Great Inflation, as it has since been dubbed, and ever since the 1980s has supported Federal Reserve policies designed to bring inflation down and keep it down. People seem to accept the proposition that inflation does not buy more economic growth—on the contrary, they understand that chronic inflation actually harms economic growth and their own welfare.

Returning to the very low inflation rates that prevailed in the 1960s has taken quite a while and has been a gradual process. The purchasing power of a 1980 dollar declined to 63 cents by 1990—a much better performance than the drop to 47 cents in

the previous decade, but still a long way from representing a stable currency. Inflation performance improved in the 1990s: The purchasing power of a 1990 dollar was down to 76 cents by the end of the decade. It held its value even better in the new century: From 2000 to 2005, a dollar’s worth fell to 88 cents; if inflation finishes this decade at the same pace as in the first half, a 2000 dollar will purchase 79 cents in 2010. This is pretty good performance. By way of comparison, at an average inflation rate of 2 percent per year, a dollar’s buying power will decline to 82 cents after 10 years. Given various problems in accurately measuring the full value of goods and services that reflect new and improved products, 2 percent inflation approximates stability in purchasing power.

Thanks to public support and reasonably successful monetary policy, inflation stayed out of the spotlight for a long while, but during the past couple of years a surge in energy prices has propelled inflation concerns back to center stage. It’s not that inflation has actually become a serious problem again, but rather that so many people are concerned that it could. From a historical perspective, this manifest public anxiety about inflation represents a heartening development. It means that far from having to convince the people that preserving price stability merits public support, the Federal Reserve can rely on their support when it becomes necessary to take actions toward achieving this goal.

After 17 consecutive increases in its federal funds rate target, the Federal Open Market Committee declined to take further action at its August, September, and October meetings. During this interval, inflation news has been promising: The plunge in oil prices promises some relief. Commodity prices appear to be stabilizing after a period of rapid ascent. House prices have begun to slip in many markets, and a number of experts anticipate further declines. Yet, despite the potential for good news on the inflation front, worries persist.

Weighing all of the evidence, the FOMC continues to cite inflation as one of the key risks our economy faces. But inflation would pose a far more serious risk if the FOMC did not cite it and the public did not support its reduction.