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Monetary Policy in the Cold War Era

by Mark S. Sniderman

When the inflation rate hit the double digits in the late 1970s, the Federal Reserve was given a mandate to push it back down, and quickly. Inflation had become so intolerable that few questioned the government's decision to wage a "hot war" against it. Now, with the economy booming and inflationary pressures scant, there is less public support for such a hard-line approach. Is it indeed time for the Fed to relax its stance and make peace with our current low and stable inflation rate? This article explains why the battle against inflation—a cold war instead of a conventional war this time—is continuing, and why peace requires a broad public understanding that monetary policy best contributes to national prosperity by eliminating both inflation and the expectation that it will reemerge.

The Soviet Union officially disbanded on December 26, 1991, one day after the resignation of Mikhail Gorbachev. Ever since, the countries that made up the former USSR have been struggling both to govern themselves and to find their places in the world. The cold war against communism was over.

The palpable threat of nuclear attack by the Soviet Union brought a high degree of cohesion to U.S. foreign and defense policies. Now, the vacuum created by the "evil empire's" collapse is prompting questions that remain largely unanswered. Do we still have adversaries, and, if so, what harms can they inflict? How can we best achieve our objectives, and to what lengths are we willing to go to fulfill them? How much will these efforts cost? In a dangerous world, how much risk should we bear? Answering these questions requires making choices, and each choice comes with its own price tag. Like the former Soviet republics, we too are struggling to define our relationships with the rest of the world.

Complicating the reconstruction of a new foreign-policy framework is the fact that, seven years after the fall of the Berlin Wall, the United States faces fewer evident threats to its national security than at any time since World War II. Some argue that our defense establishment is paranoid when it seeks public support for more resources. It's not that Americans no longer care about national security. Rather, the public expects the Defense and State Departments to justify their policy stances in terms of a new world order—one that no one yet fully grasps.

I suggest that there is an analogy between the search for this new world order in foreign policy and recent attitudes about monetary policy. The cold war against communism is indisputably over; however, can the same be said about the war against inflation? The U.S. economy has been expanding almost continuously for 15 years, the unemployment rate lies near 5 percent, and inflation pressures appear scant. Yet, to take a hard line against inflation today is, like being opposed to communism, passé. Are people who advocate a price-stability objective for monetary policy indeed fighting the last war?

■ The War against Inflation

In 1979, in the midst of the cold war, 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. In conducting that war, the Fed relied on demonstrably tight monetary policy and the public's willingness to suffer temporarily higher unemployment rates if warranted. Inflation was so intolerable that having a numerical goal was unimportant; all that mattered was bringing it down. With the support of President Reagan, the Volcker-led Fed continued its use of heavy artillery to end the inflationary spiral, reducing the core inflation rate from 11 percent to 5 percent by 1983.

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Under the leadership of Alan Greenspan, who took the helm in 1987, the Federal Reserve continued its battle against inflation, which it described as a campaign to achieve price stability. With inflation now a lower-level threat to economic progress, the Fed could squeeze it down more gradually. Initially, the Greenspan Fed followed a course of limited aggression and persistently combative rhetoric. This strategy finally paid off in 1991. As Boris Yeltsin faced down a tank in Red Square, the U.S. inflation trend collapsed from 5 percent to 3 percent, capitulating to a seven-year siege. The Federal Reserve reduced inflation to levels not seen since Sputnik. The monetary policy hot war was over, and the United States could feel proud of its victory.

The Monetary Cold War Era

The surprisingly swift transition to lower and more stable inflation rates caused some to declare that inflation was dead. The economy's pace faltered after the Gulf War, and the nation's attention was focused on expansion and employment, not inflation.

The inflation rate has not varied much during the last six years, despite predictions that it would advance when unemployment dropped below 6 percent in mid-1994. In early 1995, it was not uncommon to hear forecasters state that a 7 percent or greater federal funds rate would be required to repel the coming inflationary invasion. The Federal Reserve never raised the funds rate to these heights, but even as the rate crested at 6 percent and monetary policymakers spoke about their commitment to stable prices, critics said the Fed was fighting the last war. The public, it seemed, was tired of combat.

Yet, Federal Reserve officials still talk publicly about the importance of achieving price stability, a condition that some have described as inflation so low that it doesn't affect people's economic decisions. However, for inflation not to enter into economic decisions, the Federal Reserve must succeed at informing the public about the value of price stability in a market economy, and at convincing them that its policies will be set to achieve that goal. This is a tall order at a time when many Americans are relatively satisfied with the inflation rate and worry that efforts to contain or reduce it may entail slower economic growth. In their view, "close enough" is "good enough."

Others are pushing for even greater accountability. Price stability as a goal does not lend itself as readily to accountability and oversight as a numerical inflation objective. Some observers decry this imprecision as a shortcoming of the current monetary policy regime, and, believing that it lessens the Fed's credibility, have proposed revising the legislative framework within which policy decisions are made. Advocates of stricter accountability attribute a fair portion of the nation's favorable economic performance over the last decade to monetary policy. Hence, they are looking for ways to institutionalize the goal of price stability in the policy-setting process.

These contrasting views about the nature and desirability of an inflation objective illustrate an often underappreciated aspect of policymaking, namely, that policies must be understood and supported by the public. Americans eventually accepted the Federal Reserve's hot war against inflation, but only after they became convinced that an accelerating price level would not be accompanied by more output and employment growth. I think it is reasonable to characterize the post–1991 policy regime as a monetary cold war—a strategy designed to attain policy objectives through less forceful means than strenuously and persistently tightening money and credit conditions. Public acceptance of this war has been easier to achieve and maintain, I believe, because inflation has continued to drift down throughout the course of a lengthy economic expansion. But the conflict will not be complete until inflation psychology itself is undermined, so that the public sees no reason to legitimize it or embrace its cause.

The Importance of Price Stability

Most economists agree that once inflation is fully anticipated, employers, employees, savers, and borrowers simply adjust the prices at which they are willing to transact with one another to reflect their expectations about the currency's declining purchasing power. If this is true, inflation imposes no real effects on economic activity.

But the premise is not true, for several important reasons. When a monetary authority debases the purchasing power of its currency, it drives a wedge between what people will realize from a monetary transaction and what that transaction is actually worth to the economy. For example, the U.S. tax code contains an indexing provision for labor income (personal exemptions, income brackets, and so on), but levies tax obligations for capital income in nominal dollars. As a result, inflation—even if fully anticipated—increases the effective tax rate on capital income, which discourages capital formation and long-term economic growth. The potential impact is huge.

Another distortion to economic decisions comes in the form of an inflation-uncertainty premium. Even though two parties may have the same expectation regarding inflation's average rate over time, they may have different degrees of confidence about their estimate, or different tolerances for being wrong. Periods of high inflation tend to be periods in which the price changes of individual goods and services vary considerably. As inflation accelerates, one party in a transaction may demand a premium from his counterparty for bearing the risks of error. People devote time and real resources to avoiding the costs of uncertain inflation, and these costs—like a rising flood plain—can accumulate and become large.

Accelerating inflation is like the game of musical chairs: Everyone knows that when the music stops, someone will come up short. For an individual, it is rational not to want the music to stop, but collectively, society is wasting its resources. Once inflation reaches high levels, its distortions are so substantial that everyone is dizzy and wants the game to end.

Ending inflation can be costly, however, because doing so disrupts plans and decisions that have already been made. An excellent example can be found in the housing markets of the 1970s, when many people thought that home ownership would be an effective hedge against inflation. These buyers sought houses not because they wanted the shelter or amenities that a home offers, but because they assumed that the property could be readily sold at a profit. The boom brought land, labor, and financing into housing markets from other uses merely to satisfy the demand for an inflation hedge. When the boom ended, many people suffered a sudden reversal of fortune, including those who entered at the tail end and never benefited at all.

But when the musical chairs game is played at a slow pace, few seem to mind. And, to be honest, economists have had difficulty quantifying large social losses in low-inflation circumstances. The tax and uncertainty distortions I've mentioned are proportional to the amount of inflation. So, what's wrong with a little inflation?

I will cite two reasons for opposing this attitude. The first has to do with unbounded expectations. What is a "low" inflation rate? If 3 percent inflation is thought to cause little harm, then neither will 4 percent; after a while, 5 percent becomes only a small differential from 4 percent, and so on. Regarding our current 3 percent inflation rate as just the happenstance of where we are economically imparts an ephemeral quality to it. Although very low inflation, per se, may cause few distortions, this "here today, gone tomorrow" mind-set would likely inject an inflation risk premium into interest rates and economic decisions. Zero inflation need not be the only acceptable rate: The criterion should be rates so low that they do not alter economic decisions.

The second reason for resisting inflation tolerance has to do with the false notion that inflation can be traded off permanently for something of value, such as faster economic growth or lower unemployment rates. Is it really likely that debasing the purchasing power of money will lead to more wealth creation?

Yes, easy money can temporarily stimulate economic activity, just as tight money can temporarily retard growth. And a sequence of stop/go monetary actions can be very destabilizing to economic activity. But over time, wealth creation depends on the availability of skilled labor, productive capital, and a legal infrastructure that facilitates economic exchange. Stable expectations about money's purchasing power—especially over long horizons—enable people to make decisions that better reflect the value of the resources called into play.

Recall the previous example of housing markets in the 1970s. With hindsight, it should be obvious that our country would have been better off had more savings been channeled into the creation of productive business capital, instead of being poured into housing markets as an inflation hedge. Unfortunately, rationally formed expectations about future inflation meant that the proper incentives were not in place.

When the inflation rate hit double digits and the pace was accelerating, the Federal Reserve simply aimed to get the rate down, and down fast. No one asked where inflation would settle out, and no one bothered to set a target. At the time, policymakers realized that a gradual approach would not work, since that strategy had been tried unsuccessfully during the 1970s. The failures of that era stemmed not from the absence of a strategy, but rather from a two-pronged strategy of first, thinking that more economic growth could be purchased with a little more inflation, and second, demonstrating an unwillingness to risk disrupting the pace of economic activity in order to reduce inflation.

The irony is that economic activity was being disrupted in a very serious way, but not an obvious one. The disruption came in the form of escalating prices for homes, art objects, and farmland. The psychology of the times was to become a debtor and to use someone else's savings to acquire hard assets. Business plans were premised on rising prices. The game was to raise your prices faster than your suppliers could raise theirs. Accelerating inflation also transferred resources from the private sector to the government through the unindexed tax code. Output and real incomes were lower than they otherwise would have been because resources were diverted from wealth-creating activities to wealth-protecting ones. By the end of the 1970s, it had become painfully clear that our political leaders' unwillingness to risk any slowdown in output was shortsighted. Moreover, the public's change of heart illustrates that what is regarded as politically expedient at one moment may become political poison the next.

■ A Just Peace

I am certainly not dismissing the prospect that inflation might accelerate again, perhaps even imminently. I am trying to point out why a relaxed view about inflation is misguided. In my opinion, the Federal Reserve is not engaged in a conventional war against inflation, but rather in a cold war. One difference is the seriousness of the threat we're facing. The Fed's conventional war was launched only after inflation spiraled seemingly out of control, while today's cold-war policy is directed against a lower-grade enemy. A related difference can be seen in public attitudes: The Federal Reserve's 1979–90 anti-inflationary policy enjoyed strong popular support, whereas today's climate is not so universally accepting.

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, as the choices of the 1970s illustrate. Although there is more than a little room for misunderstanding and mischief in the goal-setting process, an honorable monetary authority attempts to be as transparent as possible about both its intentions and its operations.

Transparency, unfortunately, does not always equal precision. The Federal Reserve has not declared a numerical objective for inflation or a timetable for

reaching its goal of price stability. Although I believe that a more clearly articulated framework would enhance its actions, the Fed's monetary policy is *realpolitik*—rooted in what can work rather than relying on ideals alone.

I might say that the Fed has achieved détente with inflation, but I would also remind you that détente does not equal peace. In my opinion, peace will be attained when the public supports the principle that monetary policy best contributes to national prosperity by eliminating inflation and the expectation that it will reemerge.

Perhaps the current expansion, whose features include low and stable inflation, a capital spending boom, and strong employment growth, will instill confidence in the merits of such an approach. And perhaps it will not be long before we can welcome, to paraphrase the title of a famous novel, the Fed that Came in from the Cold:

It was man *who ended the Cold War in case you didn't notice. It wasn't weaponry, or technology, or armies or campaigns. It was just* man. *Not even Western man either, as it happened, but our sworn enemy in the East, who went into the streets, faced the bullets and the batons and said: we've had enough. It was* their *emperor, not ours, who had the nerve to mount the rostrum and declare he had no clothes. And the ideologies trailed after these impossible events like condemned prisoners, as ideologies do when they've had their day.*[1]

Footnote

1. John le Carré, *The Secret Pilgrim,* New York: Knopf, 1991, p. 321.

Mark S. Sniderman is a senior vice president and director of research at the Federal Reserve Bank of Cleveland. This article is based on a speech he presented to the Financial Executives Institute in Cleveland, Ohio, on February 11, 1997.

The views stated herein are those of the author and not necessarily those of the Federal Reserve Bank of Cleveland or of the Board of Governors of the Federal Reserve System.

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