Few people claim to like inflation. Yet few people can intelligently explain why they dislike it. Even economists frequently find it hard to explain why inflation is bad, especially if the inflation is fully anticipated.

Indeed, some economists argue that a low level of inflation is desirable. Others argue that inflation would be eliminated in an ideal world but that the short-run costs of eliminating inflation are so high that the Federal Reserve's monetary policy should aim instead at maintaining the current level of inflation or at achieving some other goal.

This Economic Commentary contends that monetary policy should aim at completely eliminating long-run inflation. We specifically explain how society could benefit if monetary policy were directed toward producing a stable price level, making temporary any unforeseen deviations from this long-run target.

In addition to the empirical evidence cited above, recent simulations by Mariam Baxter suggest that these effects may be quite large. See "Approximating Subcyclic Dynamic Equilibrium: An Euler Equation Approach," Working Paper No. 193, Rochester Center for Economic Research, University of Rochester, April 1988.

While economists generally consider liquidity costs of inflation to be minor, a recent study by Thomas F. Cooley and Gary D. Hansen estimates that the welfare cost of reduced liquidity resulting from a sustained 10 percent inflation is between 0.1 and 0.4 percent of GNP. See "The Inflation Tax and the Business Cycle," manuscript, University of Rochester, July 1986.

financial “advice” industry that is concerned with protecting investments from inflation risk. Specific markers have been created to trade futures contracts in foreign exchange and interest rates. There was also a brief period in which the futures market traded futures in the government’s reported level of the Consumer Price Index. This market folded as the inflation rate declined in the 1980s.

The creation and maintenance of these institutions is socially inefficient. The resources used in them could be better devoted to creating products and services that people desire in an environment of zero inflation. The costs incurred in minimizing private losses from inflation are greater when inflation is very high or very unpredictable. But important costs may still be present even at low and stable inflation rates.

- Inflation Is Costly When
- Inflation Creates Uncertainty
- Inflation Restricts Economic Growth
- Inflation Reduces Economic Growth Positively

Inflation reduces the real quantity of these assets. Valuable resources are wasted as people attempt to conserve their money balances, and the resulting lower level of liquidity reduces the benefits that people receive from holding money.

This negative effect of inflation on long-term growth may reflect a variety of channels, including adverse effects of inflation on capital formation (either directly or through interaction with the tax system), effects on the use of scarce resources to form socially inefficient institutions, and effects from the distortion introduced into the price system by inflation; or it may reflect various other channels.

Whichever of these channels is most important, the evidence indicates that the reduction in the economic growth rate associated with higher inflation is large and pervasive.

Sometimes it is argued that eliminating inflation is undesirable because policymakers can use inflation to try to reduce unemployment in the short run. The theoretical basis for such a policy, and the evidence on whether it can work, is weak. But even granting that more inflation could lead to a temporary increase in employment, the reduction in long-term economic growth associated with inflation probably outweighs any short-run gains by so much that these short-run considerations should play little role in policy formation.

- Zero Inflation Adds Liquidity to the Economy
- Inflation Creates Uncertainty

The elimination of inflation would give people the incentive to hold what Milton Friedman has called the optimal quantity of money. People derive benefits from holding various forms of money, facilitating trade and serving as a temporary store of value. Inflation, by acting as a “tax” on holdings of currency and other non-interest-bearing forms of money, reduces the real quantity of these assets. Valuable resources are wasted as people attempt to conserve their money balances, and the resulting lower level of liquidity reduces the benefits that people receive from holding money.

This liquidity cost of inflation is the cost traditionally emphasized in discussions of inflation. It is only one of many costs of inflation, however, and probably one of the less important.

Inflation Creates Uncertainty

For reasons that are not well understood, higher levels of inflation have typically been associated with greater variability in inflation, and so greater uncertainty about inflation.

To this point, our arguments have not relied on whether inflation was expected or unexpected. There are, however, many adverse effects associated mainly with unanticipated inflation. Perhaps the most important of these is the misallocation of resources associated with forecasting real interest rates. Just as with expected inflation, unexpected inflation may be directly responsible for lower investment, for the creation of socially wasteful institutions, and for lower rates of economic growth.

Even though it may be possible to have a low and stable positive rate of inflation over some period of time, the existence of inflation continues to create uncertainty. Little or nothing in historical experience suggests that a low inflation rate can be maintained for long at a stable level. As a consequence, there is little reason for people to expect it.

Any nonzero rate of inflation is in some sense arbitrary; people will have greater uncertainty because they will not understand why inflation is 5 percent, for example, rather than 2 percent or 16 percent. Zero inflation is not arbitrary; it corresponds to the complete elimination of inflation. A policy aimed at the elimination of inflation is qualitatively different from a policy in which policymakers can control the overall price level only indirectly through control over the monetary base, the price level will sometimes rise or fall even if policymakers attempt to hold it fixed. A policy directed only at elimination of short-term inflation could allow the price level to drift over time in response to these unexpected changes: it could make short-term expected inflation zero even if the price level had previously risen or fallen. As a consequence, over longer periods of time the price level would drift up or down.

A policy directed toward elimination of long-term inflation, on the other hand, would eliminate this price-level drift by adopting a price-level target.

Policymakers would, following an unexpected increase in the price level, engineer a decrease in the price level to keep it at the target level. Consequently, while long-term inflation would be zero, short-term expected inflation would need not always be zero.

Other reasons support the argument that policymakers should eliminate long-term inflation by stabilizing the price level. People cannot be sure whether any increase in the price level is intended or whether it is the result of a change in economic conditions that policymakers did not foresee. If the price level rises because of an unforeseen change in economic conditions that policymakers did not foresee, it may be perceived to have been a policy error.

Economists have long been trying to analyze the results of inflation, but the conclusions they reach are often at odds. Economists have long been trying to analyze the results of inflation, but the conclusions they reach are often at odds.