The inflation rate has risen this year, causing concern among policymakers about the inflation outlook, it is important to note that monetary actions occur with a substantial lag. Inflation has become one of today's major economic issues. Inflation is a formidable foe for policymakers because it has pernicious effects on the economy, its relationship to money growth has become unstable, and its response to monetary policy actions occurs with a substantial lag. The inflation rate has risen this year, and many measures indicate that it is likely to rise further.

Nevertheless, some financial market participants appear to believe that recent and possible future increases in the inflation rate will be temporary. It is unclear whether this belief is based on a view that sufficient tightening of monetary policy has already taken place, or on confidence that policymakers will tighten policy with sufficient alacrity and force in the future. Consequently, even the indicators of market participants' inflationary expectations offer little comfort to policymakers. There can be no doubt that interpreting economic conditions is a difficult task. Certainly there is room for thoughtful people to disagree about the meaning of recent events and about the outlook for inflation. Nevertheless, even if monetary policymakers respond to what turns out to be false signals of a further acceleration of inflation, the consequences need not be seen as undesirable. Since the Federal Open Market Committee wants to "foster price stability over time," responding to false signals that the inflation rate will be temporary is likely to rise even further.

Inflation, rather than economic growth, is the major issue facing monetary policymakers today. Real gross national product (GNP) has been growing rapidly for some time now, and the consensus forecast is that its growth will continue in the foreseeable future. The inflation situation is much less optimistic. The inflation rate has risen recently, and many indicators point toward even more rapid inflation.

Inflation is a continuous rise in the general price level, is harmful in several ways. It redistributes income arbitrarily, it reduces national income by fostering inefficient decisions about production and consumption, it induces people to use scarce resources both to forecast inflation and to protect themselves against or to profit from its income-redistributing effects, and it hampers growth of productive capacity by discouraging saving and investment and channeling resources into suboptimal uses. These adverse effects of inflation probably are greater when the inflation rate is higher and also when the rate is more variable and less predictable. Inflation's Relationship With Money Has Become More Important. Federal Reserve policymakers have long known that excessive growth of the money stock causes inflation. Moreover, monetarists economists had a thesis that the relationship between money and prices was stable. Consequently, monetarists' debates in the 1970s were about which measure of money policymakers ought to control, and about the optimum rate of money growth for policymakers to seek.

The former relationship between money and prices has been broken in recent years. The new relationship is not sufficient to predict monetary policy. Policymakers are now more at sea in their efforts to fashion a noninflationary monetary policy, and have become more dependent on nonmonetary indicators of future inflation for guidance to appropriate policy.

Fiscal Policy Is Important. Early detection of an impending acceleration of inflation is very important, for several reasons. Fiscal policymakers' primary method of warding off an increase in the inflation rate is to slow the growth rate of the nation's restraint. However, short-term interest rates may have risen less than one broad-based measure of inflation expectations this year, so short-term interest rates may have actually fallen. Judged by that standard, monetary policy has not tightened in 1988. Thus, if bond, gold, and foreign exchange market participants are indeed anxious about the inflation outlook, it may be that they are taking comfort from a belief that policymakers will tighten monetary policy in the future rather than from a belief that policy has already been tightened sufficiently.

Conclusions

Inflation has become one of today's major economic issues. Inflation is a formidable foe for policymakers because it has pernicious effects on the economy, its relationship to money growth has become unstable, and its response to monetary policy actions occurs with a substantial lag. The inflation rate has risen this year, and many measures indicate that it is likely to rise further. Nevertheless, some financial market participants appear to believe that recent and possible future increases in the inflation rate will be temporary. It is unclear whether this belief is based on a view that sufficient tightening of monetary policy has already taken place, or on confidence that policymakers will tighten policy with sufficient alacrity and force in the future. Consequently, even the indicators of market participants' inflationary expectations offer little comfort to policymakers. There can be no doubt that interpreting economic conditions is a difficult task. Certainly there is room for thoughtful people to disagree about the meaning of recent events and about the outlook for inflation. Nevertheless, even if monetary policymakers respond to what turns out to be false signals of a further acceleration of inflation, the consequences need not be seen as undesirable. Since the Federal Open Market Committee wants to "foster price stability over time," responding to false signals that the inflation rate will be temporary is likely to rise even further. Inflation, rather than economic growth, is the major issue facing monetary policymakers today. Real gross national product (GNP) has been growing rapidly for some time now, and the consensus forecast is that its growth will continue in the foreseeable future. The inflation situation is much less optimistic. The inflation rate has risen recently, and many indicators point toward even more rapid inflation. Inflation is a continuous rise in the general price level, is harmful in several ways. It redistributes income arbitrarily, it reduces national income by fostering inefficient decisions about production and consumption, it induces people to use scarce resources both to forecast inflation and to protect themselves against or to profit from its income-redistributing effects, and it hampers growth of productive capacity by discouraging saving and investment and channeling resources into suboptimal uses. These adverse effects of inflation probably are greater when the inflation rate is higher and also when the rate is more variable and less predictable.

Fiscal Policy Is Important. Early detection of an impending acceleration of inflation is very important, for several reasons. Fiscal policymakers' primary method of warding off an increase in the inflation rate is to slow the growth rate of the nation's
money stock. However, most economists agree that the impact of a change in the growth rate of the money stock on the inflation rate typically occurs with a lag of more than a year, so policymakers don't have the luxury of waiting until they see the whites of inflation's eyes before firing their anti-inflation weapons. The lag problem is the same if interest rates, rather than money supply, are regarded as the controlling vehicle of monetary policy.

Second, historical experience shows that the inflation rate can rise very quickly. The rate of increase in the implicit price deflator rose from 2.0 percent in 1940 to 6.2 percent in 1941; from 1.6 percent in 1954 to 3.2 percent in 1955; from 3.0 percent in 1961 to 2.2 percent in 1962; from 2.6 percent in 1967 to 5.0 percent in 1968; and from 4.7 percent in 1972 to 6.5 percent in 1973. CPI rose to 2.2 percent in 1967 to 5.0 percent in 1968; and from 4.7 percent in 1972 to 6.5 percent in 1973. CPI has since increased to 1973 to have accounted for the jump in inflation. The Consumer Price Index, excluding energy, jumped to a 6.1 percent rate of increase in 1973 from a 3.4 percent rate of increase in 1972.

Third, inflation is more difficult to stop after it has accelerated. Many workers, producers, and consumers believe that any new, higher inflation rate will continue: Thus, an increase in the inflation rate raises people's expectations of future inflation commensurately, causing them to make price and wage decisions that foster more inflation.

Moreover, inflation is more difficult to subdue if the credibility of policymakers has been allowed to erode. In the 1960s and 1970s, repeated assurances by policymakers that they would prevent inflation or reduce the inflation rate were not followed by successful anti-inflation efforts. Consequently, policymakers' announcements in October 1979 of a vigorous new program to reduce the inflation rate was met with great skepticism, and it took two severe recessions in the early 1980s to dispel the public's deeply imbedded inflationary expectations. If policymakers now fail to prevent a further acceleration of inflation, their credibility could again be impaired.

FLAT Rates Have Already Increased

Measures of the general price level tend to move together in the long run, but in the short run, shocks from special factors, such as a drought's effect on food prices, a large change in the exchange rate, or a big change in oil prices, can cause the paths of price-level measures to diverge. Consequently, policymakers find it useful to look at more than one measure, and to adjust for any obvious special factors.

Today, most broad measures of prices show that the inflation rate has increased, even when those measures are adjusted for special factors (see chart 1). The GNP fixed-weighted price index, the broadest measure of the prices of domestically produced goods and services, rose 2.7 percent in 1986, 4.0 percent in 1987, and at a 4.2 percent annual rate (a.r.) in the first half of 1988 (1988:1H). In fact, it rose at a 3.8 percent a.r. in 1988:1Q. The GNP implicit price deflator has accelerated from 2.8 percent in 1986, to 3.1 percent last year, to 3.6 percent a.r. in 1988:1H, including a 5.5 percent a.r. in 1988:1Q. The Consumer Price Index had been rising by 4 percent to 4.5 percent annually since 1983, but has accelerated to about a 5 percent annual rate of increase in recent months. Excluding its volatile food and energy components, the Consumer Price Index has accelerated from 4.2 percent in 1987 to a 4.5 percent a.r. in the last six months.

Signs of Still-Higher Inflation Rates

Policymakers monitor many measures of labor costs, of capacity availability, and of prices at early stages of production because those measures can give indications of the likely future performance of the prices of final goods and services. There are, unfortunately, no simple relationships between these indicators and the broad measures of final prices discussed above. Thus, while the indicators can provide an early warning of an increase in the inflation rate, they can also give false signals of an impending acceleration of inflation.

Today, those indicators are signaling that even more rapid inflation lies ahead. For example, the producer price index for finished goods accelerated to a 5.6 percent a.r. in 1988:1H, from 2.2 percent last year, and crude materials prices rose 11.0 percent between January and June. Hourly compensation of private industry workers increased at a 5.3 percent a.r. in 1988:1H, up from 3.2 percent in 1986 and 3.3 percent in 1987 (see chart 2). Unit labor costs accelerated to a 4.0 percent a.r. in 1988:1H, from 2.1 percent over the four quarters of last year. Further accelerations of labor compensation are quite likely if the unemployment rate, recently at a 14-year low, and the labor-force participation rate, now at a record high, continue along their recent trends. That there are upward pressures on prices is hardly surprising. Real GNP has been growing faster than its long-run trend throughout this expansion, and the level of real GNP has been above its level of long-run trend, as estimated by the U.S. Department of Commerce, since mid-1985. The positive and widening gap between the two suggests a growing shortage of production capacity. In the late 1960s and again in the late 1970s, similar positive gaps were accompanied by accelerating inflation.

Other measures also suggest strains on production capacity. Capacity utilization in manufacturing is higher than it was a year ago, and is now in a range that in the past has been associated with accelerating prices. Producers of nondefense capital goods are unable to keep up with demand, and their order backlog has been rising for over a year. Capital goods prices have been rising at a roughly 3 percent a.r. in 1988, up from an approximately 2 percent a.r. in the previous four or five years. Purchasing managers continue to report slower deliveries,

The Consumer Price Index had been rising by 4 percent to 4.5 percent annually since 1983, but has accelerated to about a 5 percent annual rate of increase in recent months. Excluding its volatile food and energy components, the Consumer Price Index has accelerated from 4.2 percent in 1987 to a 4.5 percent a.r. in the last six months.