The Death of Inflation and Other Metaphors

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For economics tracts aimed at the non-economist, mortality is clearly in the air. Browsing at my local business bookstore in downtown Toronto, I quickly came across three recently published instances: The *Death of Economics; The Death of Money;* and *The Death of Inflation*.

The death of "Economics", which is in any case commonly thought of as a rather dismal discipline, can be left unmourned for now. The passing of "Money" would surely excite more heartfelt concern—money being in our purses and chequebooks we might think. But the obituary for "Money" is in fact more about what the author calls "megabyte money", the potential of finance, liquid capital, and electronic trading to affect and shape the world—much to do with the power of capital markets, but nothing much to do with transactions balances. If that book had been about transactions balances—that is, money as a medium of exchange for goods and services—it might have offered a ready-made explanation for *The Death of Inflation,* Roger Bootle's contribution to the list of casualties and the subject of this article. No supply of money, no inflation of prices, so to speak.

But money, alive or dead, is not the prime focus of the Bootle book in any case. In its view of things, money and monetary policy, if not exactly a sideshow, are certainly of secondary importance in the decline of inflation that has occurred throughout the industrial world in recent years.

The Squeeze on Prices

The book's position is that the advanced industrial economies are now in the grip of competitive forces of such a scale and intensity that the threat of inflation is practically non-existent. Pride of place among these forces is the worldwide technological revolution in production over the past couple of decades (such as computerisation and labour-saving automation), leading to an erosion of labour's bargaining power and strong competitive pressures on businesses. A sampling of the book's sub-headings sums the argument up neatly: "the information revolution", "globalisation", "privatisation", "the end of cosiness", "trade unions in decline", and so on. In this kind of world, red in tooth and claw, it is far more difficult to push up wages or prices than it used to be, at least in the more mature industrial economies. Competitively speaking, everyone, even government, is up against the wall.

Obviously, as such forces spread, they can well have something to contribute to the lowering of inflation pressures. But *The Death of Inflation* goes further. In its view, inflation is not only down but out. It will soon be extinguished entirely, with the clear likelihood of extended periods of generally falling prices and wages—that is, with periods of deflation.

About half the book is taken up not with these broad macroeconomic issues, but rather with the implications of such a zero-inflation or even deflationary world for economic and financial behaviour and management. Indeed, its subtitle is "Surviving and thriving in the zero era."

This "survival" part is certainly for the non-economist. No harm in that either. And from that perspective it contains all kinds of informative insights as to how the world will be when inflation has disappeared. It catalogues the illusions and distortions concerning economic values that are generated by the inflation process. Correspondingly, it worries somewhat about the costs and complications of the transition from inflation as those illusions and distortions are laid bare—and whether some people and businesses will find it more difficult to make the adjustment than others.

By way of example, there is an extensive discussion of why real property will not be the attractive asset that it generally is during inflationary times. In part this attractiveness is due to "money illusion"—the buoyant feeling the property owner will have that the asset is increasing in value when the increase only reflects the fact that the prices of all goods and services are rising. But property prices are bid up still further under inflation because real estate appears a natural haven of value compared with financial assets such as bonds. These are bound to suffer as inflation takes hold and interest rates rise. Conversely, the arrival of a less inflationary climate leaves real estate values sorely exposed. The forces that earlier pushed property prices up combine now to push them down. This is a vivid example of the process of transition from an inflationary environment that is well-known to many a real estate investor. But the same processes—the effect on relative prices of the unwinding of inflation distortions—apply in many areas, if not generally as dramatically as for real estate.

Given the author's assumptions about the disappearance of inflation, this kind of survey of how disinflation affects attitudes and economic sectors (including governments) fits very naturally. The only point that I will add is that the effects detailed in the book in fact operate in a continuum. They can and do show up when inflation has merely lessened, not disappeared. Look for instance at what has already happened to property prices in many industrial countries. It did not take deflation or zero inflation to bring those prices down—just persistently less inflation. Similarly, bond prices have been increasing in recent years as interest rates have come down in response to the better inflation experience.

The challenging part of the book, however, does not lie in its charting of the particulars of this assumed strange new world (strange at least if judged by the standards of the past half-century). Nor does it lie in the author's views as to the value of having our economies operate under conditions of price stability. He does argue clearly that our economies can be expected to work better when they are unburdened by the costs incurred on account of inflation. And in this view he surely echoes the thinking of most people. The challenge lies in his assessment that

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monetary policy has not mattered much in the reduction in inflation that has occurred in recent years, that monetary policy will be misapplied as regards inflation in the future, and that the industrial world is as likely to fall into deflationary recession as it is to develop a climate of price stability. These are the matters to which I will now turn.

Is Monetary Policy Relevant?

The incautious reader might deduce from many of the book's pronouncements that inflation, whether going up or going down, has nothing much to do with monetary policy. In particular, Mr Bootle is at pains to take issue with Milton Friedman's dictum that "inflation is always and everywhere a monetary phenomenon."

In point of fact, however, he does not dispute (or at least does not dispute very clearly) the point that monetary expansion is the driving economic force of any sustained inflationary process. And this is what Milton Friedman was getting at. Where the author does direct his attack is rather against the usefulness of a particular monetary doctrine—that of "monetarism". Here, monetarism is defined as "the doctrine that inflation is always caused by increases in the money supply". In particular, he makes the valid, but rather narrow, point that the links between particular monetary aggregates and inflation have proven with experience to be unreliable.

Given the wealth of institutional and technological change in the financial sector, it is indeed reasonable to wonder whether there is now any particular measure of money that bears a relationship to total spending in the economy or to inflation that is sufficiently stable to act as an operational guide for monetary policy. Such a relationship is very important for a strict monetarist approach to policy. And even if such a stable relationship could be identified, would it continue into the future? The book does indeed express considerable scepticism in this regard—scepticism that I and others have long regarded as justified. It is well summed up in the aphorism (some twenty years old, I believe) of the US economist Herbert Stein, to the effect that there is indeed a stable relationship between money and inflation, provided the definition of money is allowed to swing around in a wide and uncontrolled manner. There certainly were quite a few changes in definitions when monetary targets were in vogue.

In point of fact, however, virtually all central banks around the world have eschewed specific targets for monetary expansion, whether M1, M2 or some other M, in implementing monetary policy. The Bundesbank may seem an exception since it still publishes monetary targets, but closer examination reveals that those targets are adhered to rather loosely at best. The Bank of Canada dropped its monetary targets back in the early 1980s, or rather, as my predecessor, Gerald Bouey, put it, "We didn't abandon M1, M1 abandoned us!" But the point to emphasise is that neither the Bank of Canada nor other central banks abandoned their concern about inflation. They just went about their anti-inflationary business by means other than setting specific targets for specific monetary aggregates.

The reason central banks persistently focus on inflation, monetary aggregate targets or no, is not that they view inflation as the only significant economic issue facing modern industrial states. Far from it. More reasonably, they take the considered view that what they are unavoidably responsible for—managing primary liquidity and in that crucial sense creating money—will in the end also be the crucial factor in what happens to inflation, and that good inflation performance is a plus for the economy as a whole. This is true whether or not there happens to be a particular monetary aggregate that closely corresponds to what happens to the general price level. Therefore, in thinking through their policy framework, they cannot sidestep the broad issue of inflation and what they plan to do about it. And they must of course try to be clear to the general public about where they are headed in regard to monetary policy and its ultimate effects.

Even if Relevant, is Monetary Policy Appropriate?

Elsewhere in the book, the focus is on questions more rewarding than the straw man of "monetarism"—whether monetary policy will be properly guided in a new era of diminished inflation and what kinds of risks are likely to be run. And the big threat that the book warns of is that monetary authorities will act like generals fighting the last war. That is to say, they will not recognise the extent and depth of the non-monetary downshift in inflation, will therefore be inappropriately tight in regard to monetary conditions, and thereby push their economies into unintended and unnecessary deflation—a sustained period of generally falling prices.

Now this is, as arguments go, quite a big one to chew on. So I will tackle it in three steps: first assessing the overall force of the non-monetary disinflationary tendencies that are around; then reviewing the usefulness of measures of slack or tightness in the economy; and finally discussing the dangers of pre-emptive monetary approaches to curbing inflation.

- *Non-Monetary Disinflation.* It is surely common knowledge (at least among economists) that there are disinflationary factors at work apart from monetary policy. While *The Death of Inflation* suggests that central bankers are conditioned not to see such factors, the fact that they tend not to dwell in their speeches on subjects outside the monetary domain is hardly evidence that they are unaware of them.

And in any event, such factors are not ignored. By way of example, the Chairman of the Federal Reserve, Alan Greenspan, made explicit reference to them in his latest Humphrey-Hawkins testimony, in July. I quote: …*powerful forces have evolved in the past few years to help contain inflationary tendencies. An ever-increasing share of our nation's workforce uses the tools of new technologies. Microchips embodied in physical capital make it work more efficiently, and sophisticated software adds to intellectual capital. The consequent waves of improvements in production techniques have quickly altered the economic viability of individual firms and sometimes even entire industries, as well as the market value of workers' skills. With such fast and changeable currents, it is not surprising that workers may be less willing to test the waters of job change. Indeed, voluntary job leaving to seek other employment appears to be quite subdued despite evidence of a tight labor market. Because workers are more worried about their own job security and their marketability if forced to change jobs, they are apparently accepting smaller increases in their compensation at any given level of labor market tightness. Moreover, a growing share of all output competes in an increasingly global marketplace, allowing fixed costs to be spread over ever broader markets, promoting greater specialization and efficiency, and enhancing price competition.*

This language may not be as dramatic as that in the book, but it makes essentially the same point. However, only up to a point—the Chairman went on to note that the disinflationary momentum could be coming to an end. Recent trends support that view. Certainly, the pick-up in US money wage rates, traditionally a *lagging* indicator of inflation by the way, would not suggest that further disinflation is in the offing. And with overall inflation about 3%, or still 2% when adjusted for the most careful estimates of upward bias in the US consumer price index, the US economy is a good deal away from zero inflation, not to speak of deflation.

In Canada, where inflation declined considerably in the early part of this decade, both supporters and critics of the Bank of Canada's policies focused on its role in bringing this about. This itself suggests that monetary policy had at least something to do with the outcome—could so many economists on both sides of the debate be wrong? Furthermore, and more objectively, that policy was hardly chasing an inflation in retreat. In Canada, as in quite a few other countries, the late 1980s saw a cyclical upsurge in cost and price pressures. For example, inflation overall reached over 5% in Canada and the United States and almost 10% in the United Kingdom (the Lawson boom). It is also worth pointing out that these jumps in inflation were in no case due to external events like the OPEC-led inflationary impulses that had occurred in the early and late 1970s. Indeed, whatever supply shocks have taken place in the more recent period have on balance represented forces that would tend to dampen inflation rather than increase it. In other words, the mid-1980s inflation came from the standard recipe—excess demand pressures generally, or to put it in more homely fashion, too much money chasing too few goods.

Given the change in the financial sector, it is reasonable to wonder whether there is any particular measure of money that bears a relationship to inflation.

The moral that can be drawn from these kinds of instances is not of course that there are no disinflationary tendencies at work in goods and labour markets. Rather, it is that we should be cautious about assuming that a pick-up in inflation cannot occur anymore on account of cyclical economic tightness—even if there are also inflation-limiting tendencies at work in the economy.

When or where such a pick-up could arise depends of course upon the stage each country has reached in its economic cycle. The United States is by all measures further along in a cyclical expansion of demand than the other main industrial nations. That is why inflation is more on its radar.

• *Gauging Slack in the Economy.* This brings me to the second plank in the argument—namely that monetary policy will remain inappropriately tight because of misreadings of the degree of disinflationary slack. Specifically, the book argues that central bankers will be looking at such indicators as the natural (or non-accelerating inflation) rate of unemployment in deciding how to set monetary conditions, but that these indicators will be giving them false signals. And one reason for these false signals is that some of the "structural" factors that the author points to (such as trade union weakness) will be reducing the natural rate.

This is a tough point to argue. Presumably, if the author can see the structural factors that reduce the natural rate, so can the central bankers. They might also see other ones, like payroll tax changes, which in many countries have tended in recent years to point in the opposite direction. So where is the issue?

The issue lies perhaps in a more general concern. This is that the natural rate, while looking very sound and persuasive in economic theory, has proven to be not so easy to pin down in practice. The theory underscores the very important point that the level of unemployment we build into our different economies will be the outcome of a whole range of institutional and demographic factors affecting the incentives for working and the costs of hiring labour. However, it does not provide us with information on the relative impact of those factors at any time and how they might shift over time. To get this information requires complicated and painstaking analysis that at best can yield an approximation. So the best one can hope for in practice is to identify a "natural rate" zone in labour markets rather than a point estimate. This could arguably give central bankers enough rope to be overly tight, though not inevitably.

• *The Risks Arising from Pre-emptive Action.* Clearly, if the monetary authorities do underestimate the extent of non-monetary disinflationary forces in the economy, in part because of uncertainty as to the overall degree of economic slack or tightness, they are likely to finish up with less inflation than they expected. That seems true by definition. But the problem will be compounded—perhaps generating the feared tip-over into deflation—if central banks act pre-emptively to strike down a budding inflation that may not in fact exist.

The book suggests that this problem has only just been avoided in the United Kingdom by virtue of the Chancellor resisting the entreaties of the Bank of England to raise interest rates. However, a more complete test would seem to be developments in the United States. There, the Federal Reserve has been faced, along the lines of the book's argument, with a decline in unemployment to levels that in the past would have generated more inflation. The Fed has also on occasion acted somewhat pre-emptively against inflation, notably in early 1994 (although it should also be borne in mind that the bond market had already begun to act by late 1993). The result, however, has been neither deflation nor recession.

The Fed's experience also raises an interesting analytical point. If it is consistently successful in pre-empting inflation pick-ups, then there will be no such pick-ups to be observed. However, the critic will then be wrong in concluding that the inflation threat was a figment of the Fed's imagination. Rather, it was forestalled by the Fed's readiness to act on the basis of its superior forecasting ability.

However, let us for the sake of argument accept that central banks do get it wrong—that for whatever reason they do see more inflation in the economy than is in fact there. Then the further question is: how damaging is this error likely to be? The short answer is: not much if the central bank is working to inflation targets, as opposed, for example, to interest rates, the exchange rate, or even broad measures of ease or tightness in the economy.

Inflation targets have been commonly viewed as helpful tools in the fight against inflation. After all, they at least make explicit the importance of monetary policy as regards what happens to the value of money. And if they are pitched toward the objective of price stability, together with an appropriately constructed mandate for monetary policy that makes it clear that this objective will be maintained in the future, they can provide the assurance of a non-inflationary future that helps savers, investors, and everyone else to plan their affairs constructively. By the same token, good inflation targets (not just *any* inflation targets) establish a consistent monetary framework for low interest rates. In this particular context, however, it is their properties for avoiding deflation in which we are especially interested.

Monetary policy, whatever guides are used, inevitably acts on spending and inflation with a lag. Therefore, central banks have to peer into the future as best they can and on that basis act pre-emptively regarding both inflation and deflation. It should readily be appreciated, however, that inflation targets, if they are useful in avoiding inflationary tendencies, have correspondingly useful properties for mitigating the risks of deflation. In particular, it is difficult to see how any sustained deflation could occur in those circumstances. To be sure, the author brings in the additional argument that at very low inflation monetary policy is rendered less effective in combatting any deflationary tendencies because interest rates cannot effectively be driven much below zero—the interest yield of cash. However, as the Bank of Japan has shown, this does not stop monetary policy from driving down the exchange rate in the interests of reflation. This is because there is no interest rate limit to the amount of money a central bank can create and no limit on the possibilities for selling it against a foreign currency—or against other financial assets for that matter.

The risk is that the present quiescent state of inflation will suggest to policymakers that further progress in establishing a non-inflationary monetary framework is not necessary.

A Stake Through its Heart?

The more dramatic assertions of *The Death of Inflation* should be taken with a grain of salt. But it is still true that inflation has been brought down for the time being and that central banks, even if they had a lot to do with bringing inflation down, did so in a non-monetary environment that was relatively favourable to an easing in inflation. But how long will this situation last? To put the question more pointedly: can people count on it lasting?

One point in favour of a prolonged remission is that the increased competition brought about by the revolution in production technology and the global spread of markets seems likely to persist. That at least would make it easier for monetary policy to hold the line. The book itself worries about the chances of a rise in protectionism that would stifle competition and give more leeway for cost-push pressures. However, while there certainly are signs of such a backlash, its strength is uncertain. And in any event, the "revolution" we are dealing with goes rather deeper and further than cheaper imports from Asia and Latin America (and incipiently from Eastern Europe). In the advanced industrial economies it is at least as much homegrown as coming from import competition.

Adverse commodity shocks are less systematic elements. They have not been much in evidence recently but could of course return. Here, however, the author is surely correct in arguing that commodity prices are becoming less and less important in cost and price developments in industrial countries. So on that score we seem more insulated than, say, 25 years ago, when oil prices began their ascent.

The final area I want to deal with is the possibility that central banks will print a lot of money. The author worries about them printing too little, not too much. I understand the argument, but am not as worried as he is. Furthermore, the risk of excessive monetary expansion does remain ahead of us.

In saying this, I do not mean that central banks are going to turn consciously inflationary or that governments are going to push them explicitly in that direction. Capital markets are still too stern disciplinarians for that. What I do mean is that while monetary techniques for curbing inflation have been strengthened and refined in recent years, they have not yet been established as an integral part of policy. The Federal Reserve has been successful in restraining inflation, but its longer-term objectives as regards inflation could be clearer. This helps to keep US bond markets jittery. In the United Kingdom and Canada inflation targets exist and have been helpful in crystallising the intention to curb inflation. But will they continue and in what form?

The risk is that the present relatively quiescent state of inflation will suggest to policymakers that further progress in establishing a solid non-inflationary monetary framework is not necessary. But monetary policy mandates and the corresponding longer-term objectives in regard to inflation remain vague in many countries, including the three I have singled out. Lack of further progress in nailing down long-run monetary policy principles means that there is likely to be more inflation in our future than Mr Bootle would have us believe. ◆