ECONOMIC COMMENTARY
Federal Reserve Bank of Cleveland

The Case for Disinflation

by Lawrence B. Lindsey

On March 12, Federal Reserve Board Governor Lawrence B. Lindsey spoke to the Boston-based Government Bond Club of New England about the consequences of inflation in developed economies. "The Case for Disinflation" *offers an intriguing perspective on this* important topic. Here, we reprint Dr. Lindsey's address in its entirety.

Thank you. It is a pleasure to be here tonight. Quite frankly, this time every four years, it's nice to be almost anywhere but Washington, D.C. And, since you've just endured the Super Tuesday limelight, I'll bet you all know what I mean. The Olympics are over and the baseball season has yet to begin. And life just wouldn't be the same without some contest to stir the blood. So I suppose we should be grateful for these Tuesday night events.

My aim tonight is to look beyond tomorrow's bond market, beyond next Tuesday, and even beyond November. There is a major unreported economic story occurring in America, the consequences of which will have a profound impact on our nation's economy for the rest of this decade.

The story I'm speaking of is the continuing reduction in the underlying rate of inflation. Let there be no mistake about it; the Federal Reserve is committed to the attainment of price stability. Furthermore, largely due to actions which took place before I joined the Fed, we have a good chance to achieve effective price stability in America by mid-decade. This is not widely understood and certainly not appreciated in financial markets. But, it is one of the factors which makes me very optimistic about America in the 1990s.

This commitment by the Fed reflects a revolution in monetary policy thinking throughout the economics profession. The underlying policy approach to inflation which is taught today just down the river is radically different from what I learned as a student. This revolution in thinking might better be termed a counterrevolution. The so-called New Macroeconomics has rediscovered the case for price stability that was largely taken for granted in the pre-Keynesian era. The experience of the last two decades has taught that there really is no attractive long-term policy trade-off between unemployment and inflation. At best, lower unemployment can only be attained temporarily at the price of permanently higher inflation. Indeed, the case is now becoming clear that low inflation may actually enhance economic performance.

Still, the case for price stability has not been widely appreciated by the public at large. I believe that one of the reasons for this is the prevalence of three myths about inflation which persist from an earlier period of economic policy. Tonight, I would like to address these myths.

The first myth is that inflation is good for investment and therefore for economic growth. In fact, the opposite is the case: price stability will aid in the process of capital formation. The public finance profession has long pointed out the pernicious effects of inflation on savings and capital formation in our tax system. The usual remedy suggested by the profession is effective indexation, so that taxes are levied on real income and not on nominal income. The legislative changes needed to accomplish this are not in sight. Achieving price stability will accomplish the same end without legislative action.

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Consider, for example, the effect of taxation and inflation on the real after-tax return to savers. Imagine a world of 8 percent bond yields, where 4 percent represents real interest and 4 percent a compensation for inflation. A 25 percent nominal tax rate translates into a 50 percent tax on the real interest. In the absence of inflation, the effective tax rate on real interest income is the same as the statutory rate, or 25 percent. Disinflation, or I should say zero inflation, thus halves the real tax rate in our example.

A similar story could be told about capital gains. It is clear from tax return data that a substantial portion of realized capital gains represents the effect of inflation. To this must be added the effect of inflation on the basis of investments which end up as capital losses. The net effect of our tax system coupled with current levels of inflation is to make the effective tax rate on real capital gains well over 50 percent. Disinflation would mean a real cut in the effective tax rate on capital gains. Zero inflation would provide a real boost to after-tax returns to savings and investment by reducing our currently very high effective tax rates.

Disinflation could also accelerate capital formation by substantially improving the tax treatment of productive equipment by increasing the present value of depreciation deduction schedules. The effective tax rate on new corporate investment depends on the present value of depreciation deduction schedules, which in turn depends on the nominal discount rate. Prevailing nominal discount rates are likely to fall point for point with the inflation rate, thus increasing the present value of the stream of depreciation deductions on plant and equipment. Disinflation from 4 percent to zero would induce nearly the same reduction in the after-tax cost of industrial equipment as a 3.5 percent investment tax credit.

There is a widespread consensus in the economics profession that higher rates of saving and capital accumulation would be beneficial to the U.S. economy. Numerous schemes have been advanced to achieve this end through the tax system. The point is that disinflation would achieve much the same result.

Somehow a fallacy has developed in the thinking of many people that easy money—or inflation—is good for investment. It is not. Consider both the post-War miracles of Japan and Germany and our own history. The German concern with inflation predates the second world war and has been central to German economic policy. Yet the German economic miracle of the 1950s and 1960s occurred in the midst of price stability. During the 1980s, the Japanese inflation rate was less than half of the American inflation rate. Here at home, the level of net private domestic investment in GNP was greatest during the 1950s and early 1960s, when inflation was at its lowest. The evidence suggests that low inflation is not only consistent with rapid industrial growth, but may actually enhance the process.

The second myth about inflation is that it is good for making the income distribution more equal. At first glance, the logic behind this myth seems compelling. Money creation and the consequent inflation provide funds for the state by eroding the real value of financial wealth. As financial wealth is relatively concentrated, this represents a highly progressive and redistributive form of taxation. In addition, inflation transfers real assets from creditors to debtors, effecting a private redistribution in addition to the one carried out directly by the state.

Whatever the merits of this story in the short run, inflation cannot be viewed as a successful long-term instrument of redistribution. Financial markets adapt to policy changes and will ultimately equilibrate at prices that preserve expected real returns. Let us consider our recent experience.

Much has been made recently of the apparent rise in inequality of the distribution of income over the past 20 years. Contrary to the myth about inflation and income distribution, this increase in inequality has occurred in the midst of a sustained period of inflation. While many factors affected the changes in the distribution of income over the period, a cursory look at the statistics suggests that inflation may actually have had the opposite effect than one would assume.

The statistic most often cited to highlight the rise in inequality is the increased share of income received by the top quintile of households. In 1967, the top quintile received 43.8 percent of income. In 1990, this figure was 46.6 percent. In other words, an additional 2.8 percent of household income was received by the top quintile. By contrast, in 1967, interest income represented 7.6 percent of personal income. In 1990, this figure was 15.4 percent. Furthermore, most of this interest income went to households in the top quintile. In other words, the rising share of interest income in the economy, in large part due to a market reaction to inflation, was three and one half times as big as the rise in the share of income going to the top quintile. While clearly not definitive, these statistics should make us seriously question the efficacy of inflation as an instrument of redistribution.

In fact, lower inflation should help to improve one of the very important measures of economic opportunity in America: home ownership. The fact is: *lower inflation and interest rates greatly increase the affordability of housing in America.* The National Association of Realtors puts out a housing affordability index. Today, by this measure, housing is more affordable to the typical family than at any time since 1976. If one uses a slightly more complicated statistic that adjusts for housing quality, the favorable affordability comparison dates back to 1973.

Let us be clear on why this is the case. Higher inflation and interest rates impose a form of forced saving on home buyers. They must pay an inflation premium in their mortgage payment which is offset by a rise in the nominal value of their home. Lower inflation lowers this forced saving component. A lower cash flow is needed to finance an identical house as a result. While the change may not lower the long-term net benefits of home ownership, it does allow more people to afford their own home. I would argue that this is the surest sign we have that disinflation will increase economic opportunity in America.

The third myth about inflation is that it helps to improve America's international competitive position. This myth is now widely discredited. It is clear that in the long run, only changes in real exchange rates affect trade flows, not simply changes in nominal exchange rates. This means that attempts to drive down the value of the dollar through a conscious policy of inflation will prove ineffective.

Contrary to the myth, a policy of price stability is doubly beneficial to America. Not only does price stability enhance international trade, a policy from which we benefit, it also increases the role that America, and our currency, plays in the global economy. Let us consider each link in turn.

A stable medium of exchange has long been recognized as a prerequisite for efficient markets. Today, we have devised financial arrangements that allow for stability even in the midst of unstable currency values. Individuals engaging in international trade may, to some extent, hedge their foreign exchange risks in futures markets. While this achieves the benefits of price stability, it is not a free lunch. The hedging process consumes real resources. Clearly, the more stable are currency values, the lower these costs need be.

Complicating the instability in markets is the potential for deliberate policy actions by governments and central banks to gain temporary advantages by manipulating currency values. In general, these activities are avoided today. But their potential increases the risks, and therefore the costs, of international trade. Establishing the dollar as a stable currency, one not subject to persistent inflationary pressures, will help to lower these risks and therefore enhance world trade.

Such a policy will also enhance the value and role of the dollar in world markets. To see this most easily, consider recent developments in Europe. If all goes according to plan, Europe will have a single currency by 1999. For the first time since the second world war, a currency zone of a size that rivals the dollar will have emerged on the world scene. If this currency—the ECU—is managed in a way that conveys stability, it may gradually replace the dollar as the world's reserve currency. America would not benefit from this occurrence. Thus, our need to achieve price stability for international reasons involves both a threat and a promise. The promise is expanded world trade with the dollar as a preeminent force in world markets. The threat is being displaced from this role.

In sum, I think the case for disinflation in the 1990s is a strong one. While disinflation is not a costless process, most of the costs in reducing inflation have already been borne. The benefits are ones we can reap in the years ahead if we remain vigilant. These benefits include increased capital formation, expanded economic opportunity, particularly home ownership, and an expanding role for our country in an expanding world economy. If true, then we will soon be enjoying the fruits of a revolution—or counterrevolution—in economic thought.

Lawrence B. Lindsey was sworn in as a member of the Board of Governors of the Federal Reserve System on November 25, 1991, to fill an unexpired term ending January 31, 2000.

Prior to becoming a member of the Board, he served at the White House as a special assistant to the President for policy development (1990–91) and as associate director for domestic economic policy (1989–90).

Dr. Lindsey worked as a research assistant at the National Bureau of Economic Research (NBER) from 1978 to 1981. He then joined the staff of the Council of Economic Advisers during the Reagan administration, where from 1981 to 1984 he was, successively, junior staff economist, Public Finance; staff economist, Taxation; and senior staff economist, Tax Policy. In 1984, he returned to the NBER, where he served as a faculty research fellow until 1989.

Born July 18, 1954, in Peekskill, New York, Dr. Lindsey received an A.B. from Bowdoin College in 1976, an M.A. in economics from Harvard University in 1981, and a Ph.D. in economics from Harvard in 1985. He was a teaching fellow (1978–81), an instructor (1984–85), an assistant professor (1985–88), and an associate professor (1988–90) at Harvard, where he also administered the introductory economics program (1984–89) and taught American Economic Policy (1987–88).

Dr. Lindsey is the author of The Growth Experiment: How the New Tax Policy Is Transforming the U.S. Economy *(Basic Books, New York, 1990) and has contributed numerous articles to professional publications. His honors and awards include selection as a Citicorp/Wriston Fellow for Economic Research, 1988; the Outstanding Doctoral Dissertation Award from the National Tax Association for his work "Simulating the Response of Taxpayers to Changes in Tax Rates," 1985; and the Noyes Prize in Political Economy, Bowdoin College, 1976. He was elected to Phi Beta Kappa in 1975.*

1992:IQ Economic Review Now Available

Economic Review is published quarterly by the Federal Reserve Bank of Cleveland. Below we present a summary of each of the three articles contained in the most recent issue. Copies are available through the Public Affairs and Bank Relations Department, 1-800-543-3489.

Recent Behavior of Velocity: Alternative Measures of Money

by John B. Carlson and Susan M. Byrne

Changes in the structure of the U.S. financial industry over the last decade have raised questions about the reliability of M2 as the primary guide for monetary policy. Although the simple ratio of economic activity to M2—that is, M2 velocity—indicates nothing unusual, the relationship between velocity and interest rates has been disrupted in recent years. This appears to be related to a breakdown in money demand in 1988, which could in turn be linked to the restructuring of depositories. In this article, the authors examine the velocities of two alternative monetary aggregates, but find that, like M2, these measures are not impervious to financial change.

Commodity Prices and P-Star

by Jeffrey J. Hallman and Edward J. Bryden

The P-Star (P*) model forecasts inflation by exploiting the stability of M2 velocity and the tendency of the real economy to operate near its potential. For a given stock of M2, P* is the price level that would prevail if velocity were at its mean and real income equaled potential output. The ratio of the actual price level (P) to P* can be considered an indicator of how the current money stock will affect inflation over the next several years. Over shorter horizons, other factors may be expected to influence the inflation rate. This paper shows how the P* model can be modified to include information about the recent behavior of commodity prices. This modified model yields more accurate short-run inflation forecasts while still retaining the property that, over longer horizons, only money matters.

The Causes and Consequences of Structural Changes in U.S. Labor Markets: A Review

by Randall W. Eberts and Erica L. Groshen

During the initial stages of the expansion of the 1980s, wage growth remained relatively subdued. Even as the economy picked up steam later in the decade, tight labor markets did not drive up wages to the extent that past experience would have suggested. In an effort to find out what was behind this unusual wage restraint, the Federal Reserve Bank of Cleveland held a two-day conference in October 1989 on the causes and consequences of structural changes in U.S. labor markets. This article provides an overview of those proceedings.

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