OPINION

Is Greenspan a Wicksellian?

BY THOMAS M. HUMPHREY

Sir Isaac Newton's remark about seeing farther because he stood on the shoulders of giants also applies to central bankers. The latter stand on the shoulders of Knut Wicksell, a Swedish economist who in 1898 advanced the policy-analysis prototype that central bankers have been using ever since. It was Wicksell who first showed that inflation and deflation result when the central bank sets its interest rate at the wrong level — and that it can stabilize prices through judicious adjustment of the rate.

Some have alleged that Federal Reserve Chairman Alan Greenspan is a Wicksellian because he implicitly targets the economy's natural rate of interest. This reasoning is suspect. Greenspan has never indicated that he targets the natural rate. And Wicksell himself denied that the unseen natural rate could be targeted. Instead, he thought central bankers should target the price level because it is observable and because its deviations from target indicated corresponding deviations of market interest rates from the unseen natural rate.

Are there other, valid grounds to believe that the Federal Reserve is Wicksellian? To answer that, let's reverse the question and ask if Wicksell would see his beliefs embodied in recent Federal Reserve policy. The evidence is mixed at best.

On the yes side is Wicksell's understanding of rational expectations, a concept he employed after World War I to claim that a preannounced and fully anticipated deflation would not affect real activity. All central bankers are Wicksellians now in believing that credibility and rational expectations in a flexible-price economy are capable of rendering systematic monetary policy neutral in its real effects. Equally, they believe that unpredictable, random policy would have painful real effects. It would drive the economy away from the growth path depicted in real business cycle (RBC) models.

Against these similarities are at least three differences. First, Wicksell defined price stability as absolute constancy of the price level. The Fed, by contrast, typically defines it as a rate of inflation so low as to leave business decisionmaking unaffected. Wicksell would complain that this definition trivializes the idea of price stability. Believing that price-level constancy is as important as that of all standard weights and measures, he advocated a government board to determine an unvarying standard price level for the central bank.

Second, in advocating stabilization of the price level rather than merely keeping inflation low, Wicksell offered tradeoffs different from those offered by inflation-targeting central bankers. Wicksell's price-level targeting yields zero-price drift at the cost of greater price and interest-rate volatility. By contrast, implicit inflation targeting yields less price and interest-rate volatility at the cost of more price drift.

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Third, Wicksell rejected the New Economy notion that rapid technological progress and productivity growth ease the central bank's job by holding inflation in check. Wicksell always claimed that such forces, prevalent in his time as they are in ours, influenced relative prices but not the general price level. The latter, in his view, was determined by monetary policy, thus rendering the eradication of inflation and deflation the responsibility of the central bank. The upshot of these differences is that Fed policymakers are Wicksellian only in the broad sense that all modern monetary economists are: They concur with some but not all of Wicksell's views.

The question remains: Would Wicksell, whose analytical frameworks dictated his policy stance, have been a good chairman of the Federal Open Market Committee? Here the key point is that Wicksell's analysis of the relation between money and prices — his famous cumulative process model — was completely divorced from his analysis of business cycles in which fluctuations are seen as driven by real shocks such as technological progress and wars. In one sense, the mutual exclusivity of real and monetary models is right and correct: When agents have rational expectations and the central bank has credibility, then monetary policy, being entirely neutral, is disconnected from the real sector, which follows the dictates of real business cycle models. If you believe RBCs are optimal — that is, they offer the best dynamic paths along which the economy can grow — then Wicksell's analysis, and the divorce between his money and real models, makes perfect sense. Armed with these models and the policy stances emanating from them, he would have made a good chairman.

On the other hand, if you use sticky-price models, as many central bankers do, to show that money temporarily affects real activity, then Wicksell is wrong. With sticky prices, money and monetary policy affect real as well as nominal variables, making Wicksell obsolete as a policy advisor. Indeed, the message of sticky-price models is that central banks that use their credibility to anchor price expectations also have the flexibility to mitigate slumps in real activity. The Federal Reserve in the Greenspan era has appreciated this. Wicksell arguably did not. **RF**