

Another Reason to Keep Inflation in Check

BY DOUG CAMPBELL

“Avoiding the Inflation Tax.” Huberto M. Ennis, Federal Reserve Bank of Richmond Working Paper No. 05-10, October 2005.

Even people who don't pay much attention to the workings of the Federal Reserve System have a vague awareness that part of the institution's job is to stabilize prices. High rates of inflation, it is largely taken for granted, spell problems for the economy. But why precisely is that so?

One of the chief reasons is thought to be the so-called “inflation tax.” In times of fast-rising prices, money loses value — a dollar at some time in the future probably will buy less of the same good than it does today. In this environment, consumers begin to expect that prices will continue to rise. A rich economic literature, pioneered by the early neoclassical economist Irving Fisher, posits that consumers may be in a hurry to avoid what they presume will be even higher prices in the near future.

Pinning down this intuition in a more formal manner has been elusive, however. Economists have been largely unable to build mathematical models that demonstrate the potential harm caused by the inflation tax. In fact, many models suggest that the welfare costs of high inflation are relatively small.

In a recent article, Richmond Fed economist Huberto Ennis sets out to directly test Fisher's hunch that the inflation tax incites people to spend their money with undue haste. His model differs from previous ones in that he tries to align the interest of buyers and sellers to more accurately reflect inflationary pressures on both of them.

What Ennis found is that consumers settle for lower-quality goods, particularly for goods they buy infrequently. Rushed, consumers have no patience for distinguishing between high-quality or low-quality goods — it is too costly to spend much time searching for the best product in an environment where money is losing value.

Such behavior could make the economy less efficient, Ennis says. If people are willing to buy goods without spending the usual amount of effort finding the best quality, then producers may anticipate that they no longer need to produce goods of decent quality. “Inflation distorts in many important ways the pattern of transactions of individuals in a monetary economy,” Ennis writes. Ennis' model doesn't look at the producer side of the equation, but his findings on buyers' behavior suggests it's worth a look.

“Changes in the Federal Reserve's Inflation Target: Causes and Consequences.” Peter N. Ireland, Federal Reserve Bank of Boston Working Paper No. 05-13, August 2005.

With the change in leadership of the Federal Reserve System, economists have been weighing in on the relative merits of a rules-based or discretionary-based monetary policy. The rules-based school of thought favors an explicit inflation target. The discretionary school prefers more of an implicit target of between 2 percent and 2.5 percent, much as the Fed operated under the leadership of outgoing Chairman Alan Greenspan.

Peter Ireland, an economist at Boston College and a consultant to the Boston Fed, created a model that aims to determine the Fed's implicit inflation target from 1959 forward. What's striking is the wide variability. Ireland found that the implicit target bounced around a lot, from about 1.25 percent in 1959 to more than 8 percent in 1974 and 1980. Without these target changes, Ireland says, inflation never would have topped 4.5 percent. By attributing most of the rise and fall in inflation to Fed policy, “the results confirm that to a large extent indeed, postwar U.S. inflation is a ‘monetary phenomenon.’”

“Accounting for the Secular ‘Decline’ of U.S. Manufacturing.” Milton Marquis and Bharat Trehan, Federal Reserve Bank of San Francisco Working Paper 2005-18, September 2005.

Despite a barrage of news stories that suggest domestic manufacturing is dying off, manufacturing continues to hold a central place in the national economy. Since the 1950s, manufacturing output has remained constant relative to overall GDP, for example, even as manufacturing employment and prices have dropped. This has fueled a debate about the relative causes: faster productivity growth in manufacturing or increased imports.

In a recent paper, Milton Marquis of Florida State University and Bharat Trehan of the San Francisco Fed argue that U.S. consumers hold the key to understanding this puzzle. They develop a model with two key characteristics: faster productivity growth and the unwillingness of households to substitute between services and manufactured goods. Together, the authors argue, these features of the model “can go a long way to explain” developments in U.S. manufacturing over the past 50 years. However, the model cannot account for several notable developments — for instance, the sizes of manufacturing employment drops in the late 1960s and early 1970s and again in the early 1990s.

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