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Lessons from History

Donald L. Kohn

My thinking about the Great Inflation period starts from the premise that high inflation could not have emerged without accommodative monetary policy, but policymakers did not seek the result that they obtained. At the time, many observers in addition to the Federal Reserve overestimated the response of inflation to rising interest rates and underestimated the persistence of inflation. These misperceptions are illustrated by the behavior of real interest rates. Medium- and long-term real interest rates were often zero or negative, calculated using backward-looking measures of inflation, indicating quite clearly that people in financial markets did not anticipate the inflation that occurred.

A lot of factors in addition to bad policy contributed to this episode of persistent high inflation: faulty ideas about the causes of inflation, underestimates of the costs of inflation and overestimates of the costs of disinflation, supply shocks, the unexpected slowdown in productivity growth, demographic shifts that raised the natural rate of unemployment, institutional factors such as labor contracts with escalator clauses, political pressures, and so on. My conclusion is that policymakers were dealt a bad hand, which they played poorly. My remarks on this panel will try to draw some lessons from this episode that can help us avoid a big mistake in the future, whether that mistake be sustained inflation or sustained deflation and recession.

Lesson 1: Central banks must remain focused on effective price stability over time as the most important long-run objective of policy, and long-run price stability is the responsibility of central banks. Central banks do not

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need convincing of this lesson, but they do operate in democracies. Political support for a price stability goal is essential. I was struck when looking at Ed Nelson's charts on the Great Inflation that both the US and UK inflation episodes came to an end in the late 1970s or early 1980s. Arguably, it took fifteen years for the political systems in both countries to become sufficiently unhappy with the results their economies were experiencing to be ready to back disinflationary policy. Even as late as 1977 and 1978, the Humphrey Hawkins Act was more focused on reducing unemployment than on achieving price stability.

The contrast between the economic performance of the 1970s and that of the 1980s and 1990s has greatly strengthened the support for central banks seeking price stability, and this support has been manifest over recent years in many countries in the adoption of inflation targeting. In my view, the overt political buy-in for a price stability mandate for the central bank is one of the most important benefits of inflation targeting. That support could be tested, however. I was struck by the last chapter of Alan Greenspan's recent book, in which he argues that the good inflation performance of the 1980s and 1990s was in part due to fortuitous circumstances that could reverse. He cites increases in globalization, deregulation, and greater productivity growth as contributing to lower inflation in the past few decades, and he questions whether they will continue to exert downward pressure on price increases.

The current turmoil in financial markets and the economy will pose interesting challenges to the focus on price stability as the main responsibility of central banks. Central banks need to deal with the present financial instability and its implications while keeping their long-run focus on price stability. The intellectual framework for inflation targeting is already being questioned in the aftermath of the turmoil. People are asking whether a macroeconomic policy focused closely on medium-term price stability was partly responsible for the bubble in financial markets, and whether central banks should take explicit account of the potential for financial instability as well as inflation in policy setting.

A corollary to the need for political support is the requirement that the political system be willing to grant a great degree of independence to central banks as they pursue their mandates. And independent central banks need to utilize the scope for action they get from this independence. As many have remarked, in the 1960s and 1970s, the Federal Reserve did not exercise its independence, perhaps because it sensed that it did not have political support for the actions that it would have needed to take. An aspect of the lack of true independence in the late 1960s was a great deal of coordination between monetary and fiscal policies. The fiscal and monetary authorities jointly considered the economic outlook and settled on a policy mix. For example, if fiscal policy was tightened through an increase in taxes, the central bank would agree to lower interest rates. Those sorts of agreements do not pay off over time. Circumstances change from the time of the agreement, or fiscal policy does not have the intended effect, and the central bank has committed to a policy path that turns out to be inappropriate. Importantly because of the experience in the Great Inflation, political support for independence is higher now, but we cannot take this support for granted.

Lesson 2: Inflation expectations are critical for controlling inflation. Increases in expected inflation make disinflation more costly. And changes in expectations feedback on the dynamic properties of economic activity and inflation in ways that are hard to predict, and make the appropriate policy setting that much more difficult to calibrate. The lesson of the importance of well-anchored inflation expectations has been taken on board by central banks as they have responded to supply shocks in recent years.

Lesson 3: Vigorous debate inside central banks, along with understanding and informed commentary by the public, provides safeguards against severe and persistent policy errors. Having alternative perspectives supported by good analysis and research heard and understood within the institution will help produce good policy. In theory, those discussions should be fostered by having a panel of experts making monetary policy. But the Federal Reserve under Chairman Burns did not seem to be a place that encouraged the development of differing viewpoints by staff members or policymakers. My experience on the Board's staff beginning in 1975 was one of vigorous discussions on the staff level, but limited opportunities for those discussions to bubble up to the policymakers. Publications by Board staff and by Reserve Bank staff were very tightly controlled to limit any hint of disagreement with the public stance of the institution. That sort of control feeds back negatively on incentives to do research.

Moreover, the difficult economic circumstances of the time might be expected to produce an unusual number of policymaker dissents. Yet, the number of dissents at meetings of the Federal Open Market Committee (FOMC) in the Burns era was a lot lower than under Chairman Volcker and for most of the Greenspan era. One can only infer that discussion of alternative perspectives was limited under Chairman Burns. Current practice does provide ample opportunities for putting forward differing perspectives at FOMC meetings, and these opportunities are routinely seized by meeting participants. And staff publications at the Board and Reserve Banks regularly express a variety of views about the appropriate practice of monetary policy.

Good external communication is critical for building support and for getting useful perspectives from outside the central bank. The public needs to understand why decisions were made. And it should have confidence that alternatives were considered and understand why they were not taken. To be sure, tension can exist between the diversity of views within the committee and the clarity of external communications. We have been through episodes in which the open expression of the diverse views of FOMC participants has confused the public about the considerations being weighed by policymakers at the center of the committee. But it is important to have those diverse views and public understanding of the complex calculus of policymaking if we are to avoid the persistent miscalculations of the 1970s.

Lesson 4: There are no shortcuts to price stability once inflation becomes embedded in practices and expectations. Attempts to reduce the pain of disinflation will not succeed for long, and those attempts distort market signals to private agents and central banks, further complicating policy decisions. Income policies of the 1970s and credit controls at the beginning of the 1980s made it hard to figure out the extent of underlying inflation pressures and how financial markets were reacting to policy initiatives. In addition, once the central bank had allowed inflation to rise, it could not expect instant credibility once it adopted a disinflationary policy. Moreover, gradualism in the face of an imbedded inflation problem will not succeed. Under such circumstances, slow policy adjustment will tend to allow inflation expectations to rise and pressures to build further. In such a situation, policy needs to make a major shift and find a mechanism for sticking to the vigorous pursuit of its price stability objective.

Final lesson: Humility! We need to be humble about what we know. As I noted at the outset, policymakers in the late 1960s and 1970s did not seek the results they got. In the Great Inflation, the Federal Reserve did a poor job predicting what would happen to inflation and what policy would be required to bring it under control. As I emphasized, expectations are critical to the inflation process, but we have little understanding of how expectations are formed, and we do not even measure them very well. Our ability to measure and analyze such key concepts in policymaking as the level and growth rate of potential GDP, the nonaccelerating inflation rate of unemployment (NAIRU), the nature and persistence of shocks, and economic dynamics as shocks work through the economy is quite limited. We must continuously remind ourselves of how little we know, we must be ready to acknowledge that developments are not working out as we expected, and, as a consequence, we must also be open to adjusting policies, to reconsidering our analyses, and to looking at different ways of accomplishing our objectives.