Macroeconomics

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ZERO INFLATION The word ‘ inflation’ has the dubious distinction of being the most widely used economic word in the U. S. media. Inflation refers to the continuous increase in prices throughout the national economy (Hellerstein). The Inflation Rate is measured by the percentage change in the price level {an average of all prices called the ‘ Consumer Price Index’ [CPI-U]}(Jensen). There is no doubt that high inflation rates are disruptive, as it lowers economic growth rate and raises doubts about future price and income trends (South-West College). Public fears tend to alarmingly rise if the inflation rate hits 5 or 6 percent; consequently, when levels climb to double digit levels {as it did in the mid/late 1970s}, there was little surprise that Americans named inflation as the ‘ public enemy number one’(Hellerstein). Recently, the U. S. has experienced low and stable rates of inflation {3. 4% in 2005 and 3. 2% in 2006} (Jensen); this has given rise to speculation among policy makers about achieving zero percent inflation.

Yes, I recommend the central bank to aim for zero inflation. The main reason is that zero inflation is best suited to achieve what every international monetary policy strives for – maximum sustainable growth via the price stability conduit. This advice was put forward by Alan Greenspan, who had a distinguished career as Chairman of the Federal Reserve from 1987 to 2006 {he was succeeded in August 2006 by present Chairman Ben Bernanke}. Greenspan repeated this advice many times during his 18 year career under 4 U. S. Presidents, namely, “ the fundamental aim of the Fed is maximum sustainable growth over time; the primary role of monetary policy in the pursuit of this goal is to foster price stability.” Economists deduced that Greenspan meant price stability will be achieved when economic growth is increased to the maximum ‘ with a stable price level’ {meaning zero

inflation}. Greenspan confirmed their deduction during the July 1996 FOMC meeting when he said a zero inflation level would no longer alter decision – making. The famous Greenspan principle “ maximum sustainable economic growth is accomplished at zero inflation” was born (Rasche et al.).

Price stability should always remain as the explicit key objective for Federal Reserve Monetary Policy. There are several reasons for this. Price stability encourages economic growth; it reduces interest rates, stabilizes financial markets and those economic sectors affected by interest rates; it creates an environment that permits money and the price system to function at the optimum; it promotes fiscal discipline; and it lends openness, responsibility and believability to monetary policy. In recent years, several other countries like the U. K, Australia and Canada have targeted achievement of price stability in monetary policy. Inflation rates in these countries have dropped to unprecedented low levels. In the present U. S. scenario, inflation has receded with the result that price stability does not constitute a ‘ headline grabbing’ issue. It is therefore the ideal time to implement such a concept (Keleher). Economist W. Lee Hoskins put it well: “ If the Federal Reserve commits to an explicit plan for achieving price stability, the transition costs would be reduced, and any costs that arise will be outweighed by the benefits. These benefits will be large and permanent, and will far outweigh the costs of getting there” (South-West College).

Many economists think Greenspan’s principle essentially involves a long-term pessimistic connection between output and growth, and is therefore different from what is considered ‘ normal’ in economics, and is certainly not mirrored in modern conventional monetary police analyses (Rasche et al.).

Those in favor of the ‘ Phillips Curve’ {a comparatively unexcitable inverse

relationship between inflation and unemployment rates} (South-West College), contend that lower rates of inflation can be achieved by lowering the level of output. Others who prefer the ‘ Milton Friedman & Edmund Phelps’ theory, argue that the level of output has no relation to the inflation rate (Rasche et al.).

I believe these economists are wrong. Four reasons point to it. First of all, they wrongly assume external factors {that have no connection with monetary policy} like technology and labor force growth rate, are driving factors in economic long-term growth rate. Secondly, the concept of price stability has implicitly worked in the U. S. in recent years; the Federal Reserve’s emphasis on price stability has lowered inflation, thus making possible the sustained current expansion. Thirdly, several other countries have take up and successfully put the concept into practice, lowering inflation rates to figures never earlier expected. Lastly, a number of Federal Reserve officials and several Members of Congress have firmly endorsed the concept. It is therefore high time that conventional models like the Phillips Curve and Friedman-Phelps theory be modified to allow for the Greenspan principle (Rasche et al.).

Greenspan gave an indisputable finishing touch to his principle when he said: “ As the inflation rate falls, it becomes increasingly difficult for producers to raise prices. They therefore try to reduce costs in order to maintain margins” (Rasche et al.). This effectively puts to rest the uppermost concern in the minds of Americans, namely, inflation may lower their standard of living and result in their income not keeping pace with the rise in prices (Hellerstein).

References:

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