



Fiscal Dimensions of Inflationist Monetary Policy

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Shadow Open Market Committee
October 21, 2011

Introduction

Policymakers and the public have held fast to price stability ever since the Federal Reserve under the leadership of Paul Volcker brought the “Great Inflation” to an end in the mid-1980s. Broad-based support for low inflation was born of the memory of what high and variable inflation had wrought and what price stability has yielded. For instance, unemployment in the United States averaged around 4 ½% from 1950 to 1970, then rose and fluctuated with inflation and averaged nearly 7% from 1970 until 1985. After inflation was stabilized, average unemployment fell back to 5 ½% prior to the recent credit turmoil and its aftermath.

The broad-based support for price stability is at risk today in the United States and in Europe. Prominent voices in academia, the media, the International Monetary Fund, and inside the Federal Reserve have proposed that the commitment to price stability should be relaxed in one way or another to concentrate on achieving more pressing objectives. The inflationist policy proposals are varied with respect to their objectives and operating guides. For instance, the objectives range from reducing unemployment, to depreciating the real public debt, to facilitating international adjustment within the Euro area.

Below, I compare and contrast various inflationist proposals and consider their overall advisability in light of lessons from the Great Inflation. Before doing so, however, I consider the costs involved in employing available stimulative policies more intensively as envisioned in these proposals. I presume that interest rate policy is immobilized at the zero bound, as is the case in Japan and nearly the case in the US and the Euro area. That leaves three options: monetary policy, portfolio maturity extension, and credit policy. Importantly, all these remaining alternatives exert stimulus via fiscal policy. I describe the costs, risks and effectiveness of employing these measures more intensively in terms of their implicit fiscal policy dimensions and explicit budgetary costs to taxpayers. I group various “inflationist” proposals together for consideration according to their aggressiveness---whether they are willing to risk higher inflation, to tolerate higher inflation, or target higher inflation temporarily or persistently to achieve other objectives.

I conclude by recalling why higher inflation worsened unemployment during the Great Inflation. The lesson is that any short run employment benefits that might be achieved by tolerating higher inflation today, and these are questionable, would likely produce protracted adverse effects on unemployment in the future as inflation scares repeatedly force the Fed into contractionary interest rate actions.

Monetary Policy at the Zero Bound

Ordinarily, monetary policy stimulus is delivered by expanding bank reserves via the purchase of short-term Treasuries to lower short-term interest rates. However, short-term Treasuries are nearly perfect substitutes for reserves at the zero interest bound. So a central bank must purchase longer-term Treasuries to deliver monetary policy stimulus when short-term interest rates are zero. In fiscal policy terms, the central bank must assume a significant maturity mismatch between its assets and its liabilities in order to deliver monetary policy stimulus at the zero bound. Thus, the cost of monetary stimulus at the zero bound is best understood in terms of the expected return and risk of carrying the maturity mismatch, which is borne by taxpayers, who are

the beneficiaries of the revenue from monetary policy or the source of funds to recapitalize the central bank in the event of financial loss.

The effectiveness of monetary stimulus at the zero bound is also best understood in terms of fiscal policy. Although monetary interest on short-term Treasuries and related money market instruments is zero, we can infer that total perceived returns to the public must include a substantial “implicit liquidity services yield.” Otherwise, we cannot explain why households and firms in the United States hold around one GDP worth of short-term Treasuries, deposits, and money market instruments in their portfolios together with investments in long-term securities, equities, and real estate that pay much higher money returns.

By injecting bank reserves and withdrawing long-term Treasuries, monetary policy increases the net stock of liquid assets in the economy, and drives down the “implicit liquidity services yield.” The effects are felt in a variety of ways. For instance, if new reserves are used to pay off bank loans, they offset a prior tightening of bank credit, reduce the finance premium on other loans, or shift bank credit to borrowers more in need. By depressing the “implicit liquidity services yield,” monetary policy also induces the public to bid up the prices of relatively illiquid assets commensurately.

Thus, monetary stimulus at the zero interest bound is fiscal policy because it works by increasing publicly provided services, liquidity services in this case, at a fiscal cost, the cost of carrying interest rate risk on the government balance sheet. Aggressive monetary policy at the zero bound should be used only if deflation becomes a clear and present danger. The reason—such monetary policy would have to be used at a scale difficult to calibrate, and at a scale that involves substantial interest rate risk for taxpayers.

The Portfolio Maturity Extension Program

Recently, the Fed embarked on a \$400 billion program to lengthen the average maturity of the securities in its portfolio. Under the program, the Fed purchases long-term Treasuries with funds acquired by selling short-term Treasuries to increase the average maturity of Treasuries in its portfolio. Clearly, the maturity extension program is fiscal policy not monetary policy, since it has no effect on aggregate bank reserves or currency. As fiscal policy, the maturity extension program works the same way as monetary policy at the zero interest bound— by increasing the net stock of liquid securities in the market to bring down the “implicit liquidity services yield.” However, the maturity extension program is more limited since it is constrained by the volume of short-term Treasuries currently on the Fed balance sheet. The program is best regarded as a means of increasing the maturity mismatch of the Fed’s portfolio and thereby increasing the potential of any given monetary stimulus at the zero interest bound.

Credit Policy

Credit policy consists of extending credit to the private sector and non-Treasury government entities with funds acquired by selling Treasuries from the central bank’s portfolio. Pure credit policy is debt-financed fiscal policy. Why? At the margin, the Fed returns to the Treasury the interest earned on Treasury securities that it holds; so when the Fed sells Treasuries to finance the acquisition of non-Treasury assets such as mortgage-backed securities, the result is just as if the Treasury financed this purchase by borrowing from the public.

Fed credit policy works by interposing the government between private borrowers and lenders and exploiting the government's creditworthiness to lower private borrowing costs and facilitate credit flows. In contrast to holding United States Treasury securities, all credit policy favors one sector over another, distorts credit ex ante, and exposes taxpayers to credit risk and losses ex post. A more intensive use of credit policy by the central bank to stimulate economic activity at present would be politically divisive, potentially costly, and at best subsidize particular sectors at the expense of others without necessarily stimulating aggregate output as a whole.

Inflationist Policies Considered

In light of the discussion above, there is reason not to employ monetary or credit policy more intensively today when deflation is not a concern and actual inflation has been moving up. Nevertheless, I consider the following inflationist proposals on their own terms, as if monetary and credit policies were costless to employ with more intensity as needed.

I group inflationist proposals for consideration below into four groups. First, are those willing to risk higher inflation to deliver more monetary and credit stimulus against unemployment. Second, are those that propose to target higher inflation expectations to achieve lower long-term real interest rates to stimulate spending. Third, are those that propose to target higher inflation to depreciate the real value of public debt. Fourth, are proposals willing to tolerate higher inflation in the Euro-area core to facilitate international adjustment in the Euro periphery.

Risk Higher Inflation to Deliver More Monetary or Credit Stimulus

Modest inflationist proposals are willing to risk higher inflation to administer more monetary or credit stimulus against unemployment. These proposals would not set out to elevate inflation expectations, though they might accept some elevation. Setting aside the costs of using monetary and credit policy more intensively, it is not clear what data one would use to guide monetary policy against unemployment. History teaches that targeting a particular unemployment rate or output gap is inadvisable. This is particularly true in current circumstances. Even apparent success could present a problem. More intensive stimulus could succeed in pulling unemployment down considerably without much increase in inflation or inflation expectations. Such success would naturally call for more stimulus. But one could not be sure that policy had not pushed unemployment below the current sustainable natural rate, with adverse consequences for inflation and unemployment down the road as occurred in the Great Inflation. Thus, this inflationist proposal would be like "flying blind" without an assurance of policy success.

Target Higher Inflation Expectations to Lower Long-term Real Interest Rates

Targeting higher inflation constitutes a more aggressive type of inflationist proposal, more aggressive because its objective would be to raise inflation expectations so as to achieve more deeply negative real interest rates. This proposal has two problems. First, expected inflation would have to be increased far enough into the future to produce more deeply negative real interest rates at maturities that effect aggregate demand significantly. This proposal has the virtue that expected inflation measured in surveys or in inflation indexed bonds could serve as an operational guide. But it would still have to decide how much to push monetary and credit stimulus to try to elevate expected inflation. Second, even if these obstacles could be overcome, it is far from clear that a central bank could prevent markets from undoing the intended benefit of

inflationary policy by incorporating inflation premia into nominal interest rates at long maturities. The central bank's promise to keep short rates low at long maturities might lack credibility. A central bank that tried to defend a ceiling on nominal long Treasuries might lose contact with other market rates as it bought more and more of the Treasury market.

Target Higher Inflation to Reduce the Real Public Debt Overhang

A more aggressive inflationist proposal would have the central bank target deliberately a higher rate of inflation over a number of years to achieve a significant depreciation of the real value of the public debt. Even ignoring the costs of stimulus needed to get inflation going and the consequences that inflation instability would cause for unemployment thereafter, the proposal would be less effective than realized. As soon as the inflationist policy was announced, or even intimated, markets would build inflation premia into nominal interest rates. Moreover, actual inflation would rise gradually. Therefore, short-term debt could roll over at higher interest before inflation could depreciate its real value very much. The average maturity of U.S. marketable Federal debt is around five years, which would make the net effect of depreciating the Federal debt overhang via inflation less than might have been imagined.

About 50% U.S. marketable Federal debt is held abroad. But any saving of real payments to foreigners from inflation would have to be weighed against the present discounted value of the net returns to the United States from the use of U.S. Treasuries as the primary liquid international reserve asset. The main domestic deterrent to such inflation is that enough lead time to protect the current generation of retirees on fixed nominal income would also deprive the "inflationist" policy of most of its power reduce the real value of the debt overhang. Finally, the inflationist proposal would have the independent central bank utilize the inflation tax for an unlegislated repudiation of the public debt. This would amount to a gross misuse of the independent monetary policy power of the central bank for a fiscal policy purpose that ought to be authorized explicitly by the fiscal authorities.

Tolerate Higher Inflation to Facilitate International Adjustment in the Euro Area

The Euro area has an international adjustment problem. Unit labor costs in the periphery must come down relative to those in the core to restore competitiveness of peripheral economies within the Euro area. If the Euro area adheres to its low inflation mandate, then low inflation will be maintained in the core economies which constitute the bulk of Euro area GDP. In this case, competitiveness in unit labor costs must be restored by significant unemployment and deflation of prices and wages in peripheral economies.

Implicit inflationist proposals in the Euro area call for the Eurosystem to tolerate if not target temporarily a higher rate of inflation in the core economies to facilitate the restoration of competitive prices and wages in Europe without deflation in the periphery. In effect, such inflationist policy proposals can be understood as a call for the Eurosystem to substitute inflation for an overtly fiscal transfer from core economies to peripheral economies to ease the deflationary burden of adjustment in the latter.

The problem with such implicit inflationist proposals is that they would shift the inflationary bias from the periphery to the core of the Euro area. Periphery economies rescued by inflation in the core countries would have little incentive to discipline their own wages and prices. Inflation

stability throughout the Euro area would be jeopardized since “inflationist” policies adopted by the Eurosystem in the name of short-run stability would destabilize Euro area inflation over time with negative adverse consequences for average unemployment in the future.

Lessons from the Great Inflation:

Tolerating Higher Inflation Raises Unemployment Over Time

The Federal Reserve’s inclination to put unemployment ahead of inflation during the Great Inflation, with the idea that the Fed could play “catch-up” against inflation as needed, produced six recessions from the mid-1950s through the mid-1980s that account for much of poor performance of unemployment during the period. The Great Inflation occurred because the Fed would deal with rising inflation only after it became a predominant public concern. The Fed persisted in policies that pursued low unemployment until the inflation rate and the expected inflation rate both began to rise. The problem became particularly severe in the early 1970s. The Fed would raise interest rates to create enough slack and disinflationary force in the economy when needed to counteract the momentum in inflation and inflation expectations. By playing “catch-up” the Fed had to create recessions simply to stabilize the inflation rate.

Today, inflation expectations are better anchored than in the 1970s. Markets appear to believe that the Fed has learned from past mistakes. Yet inflationists today would have the Fed use this leeway to take risks with easier monetary policy to bring unemployment down. Worse, aggressive inflationists want the Fed to make the same mistake as in the 1970s. The lesson from the Great Inflation is to resist this temptation. Playing catch up with inflation is a losing game. Making low inflation the priority yields a lower unemployment rate on average over time and the lowest inflation rate too.