Paul Volcker was the Chairman of the Federal Reserve from 1979 to 1987. The Federal Reserve (Fed, for short) is the central bank of the United States. Established in 1913, the Fed's original purpose was to add resilience to the workings of money and credit so that bank panics could be prevented or at least minimized. Another way to put it is that the Fed was supposed to stand in the gap and become the "lender of last resort" when needed to preserve the financial system and thereby the economy.

The stability of the value of money was not a concern in 1913 because the United States, like other major countries, adhered to the gold standard. In the decades that followed, however, the United States would first temporarily and then permanently abandon the gold standard. (The gold standard had serious drawbacks; for example, the effort to maintain it in a crisis could further sink the economy, which is exactly what happened during the Great Depression of the 1930s.) For most of the period since World War II, with the 1970s being a conspicuous exception, the Fed has considered keeping inflation under control as its number one job.

The Fed controls inflation primarily by raising or lowering interest rates, which is the cost of borrowing money. When inflation is too high or is on its way to becoming too high, the Fed acts to raise interest rates and thereby slow the economy. When the economy is slowing too much and unemployment is becoming a problem, the Fed acts to lower interest rates and speed up the economy—that is, unless inflation is still a big concern, as was the case when Volcker was Fed chairman.

Paul Volcker on Price Stability

(*Keeping At It: The Quest for Sound Money and Good Government*, by Paul A. Volcker with Christine Harper, Public Affairs, 2018, pages 222-227.)

Early in my second term as Fed chairman, a colleague complained during an Open Market Committee meeting that we'd been accused of being "knee-jerk inflation fighters." My immediate reply was that was "a pretty good reputation," a sign we were making progress.

Trust in our currency is fundamental to good government and economic growth. The influence extends far beyond our shores, given the role of the dollar and the American financial system in the world.

Our monetary system, like that of almost all countries, rests on a fiat currency. There is no gold or other valued hard asset into which a paper dollar (or bank deposit) can be exchanged at a fixed price. Implicitly, we take for granted, or should, the stability of our currency in terms of what it can buy today, tomorrow, and for years ahead—groceries, a home, or maybe even a bond that promises to pay a fixed amount of dollars into the future.

Maintaining that expectation, that confidence, is a fundamental responsibility of monetary policy. Once lost, the consequences can be severe and stability hard to restore. Interest rates rise, savings are squeezed, the currency declines in foreign-exchange markets. Some traders and speculators may win but wage earners and those on fixed incomes, like most retired people, will fall behind.

The United States had a taste of that in the “stagflation” of the 1970s, culminating in the highest rate of price increases in our peacetime history. As is typically the case, the inflation process came to feed on itself as expectations of price increases contributed to more inflation. In the absence of other effective options, it was finally extinguished by forceful monetary policies [high interest rates]. A crippling recession could not be avoided. Our experience in the mid-1970s, when weak anti-inflation efforts failed, and again in the early 1980s, when a much more sustained effort was required, were reminders enough of the importance of maintaining price stability once it is restored.

Now the environment is quite different. The generation with direct experience of stagflation [high inflation plus high unemployment] is passing on. In contrast, over the past thirty years we’ve maintained sufficient price stability to engrain expectations of little or no inflation into our thinking. Factors such as cheap imports from countries like China have helped, but our monetary authorities have clearly recognized the importance of maintaining price stability. There can be little question that those firmly grounded expectations have contributed enormously to allowing the United States to absorb huge budget deficits and a massive injection of official liquidity during and after the 2008 financial crisis without reawakening inflationary forces.

A lesson from my career is that such success can carry the seeds of its own destruction. I’ve watched country after country, faced with damaging inflation, fight to restore stability. Then, with victory in sight, the authorities relax and accept a “little inflation” in the hope of stimulating further growth, only to see the process resume all over again. The sad history of economic policy over much of Latin America offers too many examples.

The United States is not Latin America, with its history of recurrent inflation. But it does face an ongoing challenge for monetary and fiscal policy. The now long expansion and full employment with signs of growing pressures on labor markets have, so far, not upset price stability. But it is a crucial period for monetary policy.

The late Bill Martin [Fed chair, 1951-1970] …is famous for his remark that the job of the central bank is to take away the punch bowl just when the party gets going. The hard fact of life is that few hosts want to end the party prematurely. They wait too long and when the risks are evident the real damage is done.

Central bankers are the hosts at the economic party. Too often, monetary restraint—never popular—has been delayed too long. The inflationary process begins and then the challenge becomes more difficult.

Now, in recognition of the need for discipline, a remarkable consensus has developed among modern central bankers, including in the Federal Reserve, that there’s a new “red line” for policy: a 2 percent rate of increase in some carefully designed consumer price index is acceptable, even desirable, and at the same time provides a limit.

I puzzle about the rationale. A 2 percent target, or limit, was not in my textbooks years ago. I know of no theoretical justification. It's difficult to be both a target and a limit at the same time. And a 2 percent inflation rate, successfully maintained, would mean the price level doubles in little more than a generation.

I do know some practical facts. No price index can capture, down to a tenth or a quarter of a percent, the real change in consumer prices. The variety of goods and services, the shifts in demand, the subtle changes in pricing and quality are too complex to calculate precisely from month to month or year to year. Moreover, as an economy grows or slows, there is a tendency for prices to change, a little more up in periods of economic expansion, maybe a little down as the economy slows or recedes, but not sideways year after year.

Yet, as I write, with economic growth rising and the unemployment rate near historic lows, concerns are being voiced that consumer prices are growing too slowly—just because they're a quarter percent or so below the 2 percent target! Could that be a signal to "ease" monetary policy, or at least to delay restraint, even with the economy at full employment?

Certainly, that would be nonsense. How did central bankers fall into the trap of assigning such weight to tiny changes in a single statistic, with all of its inherent weakness?

I think I know the origin. It's not a matter of theory or of deep empirical studies. Just a very practical decision in a far-away place.

New Zealand is a small country, known among other things for excellent trout fishing. So, as I left the Federal Reserve in 1987, I happily accepted an invitation to visit. It turns out I was there, in one respect, under false pretenses. Getting off the plane in Auckland, I learned the fishing season was closed. I could have left my fly rods at home.

In other respects, the visit was fascinating. New Zealand economic policy was undergoing radical change. Years of high inflation, slow growth, and increasing foreign debt culminated in a sharp swing toward support for free markets and a strong attack on inflation led by the traditionally left-wing Labour Party.

The changes included narrowing the central bank's focus to a single goal: bringing the inflation rate down to a predetermined target. The new government set an annual inflation rate of 0 to 2 percent as the central bank's key objective. The simplicity of the target was seen as part of its appeal—no excuses, no hedging about, one policy, one instrument. Within a year or so the inflation rate fell to about 2 percent.

The central bank head, Donald Brash, became a kind of traveling salesman. He had a lot of customers. I was reminded of the practical appeal when I read a colloquy in a July 1996 FOMC meeting about the Federal Reserve's price stability target. Janet Yellen asked then chairman Alan Greenspan: "How do you define price stability?" To me, he gave the only sensible answer: "That state in which expected changes in the general price level do not effectively alter business or household decisions."

Janet persisted: "Could you please put a number on that?"

And so Alan's general principle, to me entirely appropriate, was eventually translated into a number. After all, those regression models calculated by staff trained in econometrics have to be fed numbers, not principles.

I understand reasonable arguments can be made for 2 percent as an upper limit for "stability." There is a body of analysis that suggests official price indexes typically overstate increases by failing to account for improvements in the quality of goods and services over time. The point is also made that expectations and behavior are determined by the price of goods, where productivity gains and strong competition restrain price increases, rather than by the cost of services like education and medical care, where productivity gains are slow.

But it is also true, and herein lies the danger, that such seeming numerical precision suggests it is possible to fine-tune policy with more flexible targeting as conditions change. Perhaps an increase to 3 percent to provide a slight stimulus if the economy seems too sluggish? And, if 3 percent isn't enough, why not 4 percent?

I'm not making this up. I read such ideas voiced occasionally by Federal Reserve officials or IMF economists, and more frequently from economics professors. In Japan, it seems to be the new gospel. I have yet to hear, in the midst of a strong economy, that maybe the inflation target should be reduced!

The fact is, even if it would be desirable, the tools of monetary and fiscal policy simply don't permit that degree of precision. Yielding to the temptation to "test the waters" can only undercut the commitment to stability that sound monetary policy requires.

The old belief that a little inflation is a good thing for employment, preached long ago by some of my own Harvard professors, lingers on even though Nobel prize-winning research and experience over decades suggests otherwise. In its new, more sophisticated form it seems to be fear of deflation that drives the argument.

Deflation, defined as a significant decline in prices, is indeed a serious matter if extended over time. It has not been a reality in this country for more than eighty years.

It is true that interest rates can't fall significantly below zero in nominal terms. So, the argument runs, let's keep "a little inflation"—even in a recession—as a kind of safeguard, a backdoor way of keeping "real" interest rates negative. Consumers will then have an incentive to buy today what might cost more tomorrow; borrowers will be enticed to borrow at zero or low interest rates, to invest before prices rise further.

All these arguments seem to me to have little empirical support. Yet fear of deflation seems to have become common among officials and commentators alike. (Even back in July 1984, as my Fed colleagues and I were still monitoring the 4 percent inflation rate, the *New York*

Times had a front-page story warning about potential deflation.) Actual deflation is rare. Yet that fear can, in fact, easily lead to politics that inadvertently increase the risk.

History tells the story. In the United States, we have had decades of good growth without inflation—in the 1950s and early 1960s, and again in the 1990s through the early 2000s. Those years of stability were also marked by eight recessions, mostly quick, that posed no risk of deflation.

Only once in the past century, in the 1930s, have we had deflation, serious deflation. In 2008-2009 there was cause for concern. The common characteristic of those two incidents was collapse of the financial system.

We can't expect to prevent all financial excesses and recessions in the future. That is the pattern of history with free markets, financial innovation, and our innate "animal spirits."

The lesson, to me, is crystal clear. Deflation is a threat posed by a critical breakdown of the financial system. Slow growth and recurrent recessions without systemic financial disturbances, even the big recessions of 1975 and 1982, have not posed such a risk.

The real danger comes from encouraging or inadvertently tolerating rising inflation and its close cousin of extreme speculation and risk taking, in effect standing by while bubbles and excesses threaten financial markets. Ironically, the "easy money," striving for a "little inflation" as a means of forestalling deflation, could, in the end, be what brings it about.

That is the basic lesson for monetary policy. It demands emphasis on price stability *and* prudent oversight of the financial system. Both of these requirements inexorably lead to the responsibilities of a central bank.