

INFLATION AND MONETARY POLICY

Getting Inflation-Fighting Right

Interview with Alan Blinder

What are the true lessons from the inflation of the 1970s? Alan Blinder, former vice chairman of the Federal Reserve, thinks we have learned the right lessons. Inflation is under far better control, he argues, and he thinks the Fed under the new chairman will do fine. But he is concerned that wages are not rising.

Q In many respects you have had a different view of the rising inflation of the 1970s from that of other economists. Now the lessons learned from the 1970s reportedly are being called into play regarding current monetary policy. Some believe inflation will rise inexorably from here. What do you think we should have learned from the 1970s?

A. In large measure we have actually learned the lesson. First, when you get an energy shock, as we did in the 1970s, it is both contractionary and inflationary, which leads to stagflation. When the first shock hit us as OPEC [Organization of Petroleum-Exporting

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Countries] tripled and quadrupled oil prices in 1973 and 1974, and then again in 1978, we did not quite know what to make of it. It was a new kind of animal. Now it is a familiar animal, and we do know what to make of it. Second, the first-round effects of an energy shock like that naturally dissipate without the central bank's having to do anything about them. Therefore central banks should concentrate on the second-round effects. That means the Federal Reserve should concentrate on core inflation.

Q Let us explain that, please. Headline inflation is all inflation, while core inflation is typically measured by deleting food and energy prices.

A. The Federal Reserve's definition commonly excludes food and energy. But food has not been an issue for thirty years or more. It has not gone up much faster or been much more volatile than other prices. So the exclusion of energy is the only thing that is operational. However, the lesson has not been learned around the world. The European Central Bank (ECB) right now is fretting about high headline inflation even though their core inflation is only about 1.5 percent per annum. If you look at the central banks that target inflation, almost all of them target headline inflation, not core inflation. That is a mistake, but it is a mistake the Federal Reserve has not made.

Q. Is the ECB more worried than the Fed about second-round effects from headline inflation?

A. Yes, they are. But even so, that is not necessarily a reason to move away from the core because the core ought to embody the second-round effects.

Q In the 1970s, going back to those extremely inflationary days, did we not worry about headline inflation?

A. Yes, and we still do. The point about focusing on the core is that the gap between the two will typically go away all by itself. Two conclusions follow from that. First, if you want to forecast headline

inflation a year or two ahead, you are probably better off looking at core inflation than at current headline inflation. In my paper with Ricardo Reis presented at the Jackson Hole conference a year ago, we demonstrated that conclusion statistically.

Q. What were the conclusions from that paper exactly? You found a pretty high correlation between core inflation and future headline inflation?

A. Yes, we found that, statistically, if you want to forecast headline inflation one year, a year and a half, or two years ahead, it is better to ignore current headline inflation and use core inflation. The second reason for the central bank's concentrating on core is that it is the part of inflation that the central bank can actually do something about. I do not believe the Federal Reserve or the ECB or any of the other central banks can do anything about the price of oil, which affects headline inflation.

Q Did we worry too much about headline inflation in the 1970s?

A. Yes. You remember there was hyper-excitement about inflation going up into the high double-digit range. We hit 16 or 18 percent annual inflation rates for a brief time. But core inflation never got higher than 10. That is why we got only a bit carried away. Ten percent core inflation is too high. So it is not that we should have complacently looked at 10 percent inflation and said everything is fine. It was not fine. But 10 percent inflation is not 18 percent inflation.

Q. So we take Draconian measures to deal with 18 percent inflation when perhaps more modest measures would do.

A. Yes, but it was still serious. Getting 10 percent inflation down to 3 or 4 percent, which is what we did, was going to take some heavy lifting.

Q Let us talk a bit about the second-order effects. Are these basically wage-price spiral effects?

A. Yes, both wages and prices. If energy prices go up, and workers

demand and win more compensation for the higher prices, for example, then business may raise prices still more. If workers' wages were literally indexed to headline inflation, they would get that compensation automatically. Not many workers have that power to demand compensation for higher oil prices. But we should also remember that higher energy prices seep into almost everything else as well, such as transportation costs and manufacturing costs.

Q. Is that less likely to occur in the current environment than it was back in the 1970s?

A. Yes, for two principal reasons (and probably eighteen minor ones). The two principal reasons are that energy is a much smaller input now than it was thirty-some years ago, roughly half as large a share of costs. So it does not have as great an effect. The second reason, which Fed Chairman Ben Bernanke emphasizes all the time, is that inflationary expectations are probably better anchored now, so they do not run up as easily as they did in the 1970s.

Q What do you mean by well anchored? You mean inflationary expectations are much lower than they were back then?

A. They are lower. But by "well anchored" I mean that they do not rise as quickly in response to fleeting phenomena such as a blip in energy prices. So workers do not demand higher wages, and other people do not raise prices, in anticipation of ever-higher inflation the way they did in the 1970s. The belief is that, should the Fed make a mistake and let annual inflation get up to 3, 4, or 5 percent, it will bring it back down quickly.

Q. What about the faltering power of labor itself to demand higher wages?

A. That is one of my other eighteen smaller reasons. It seems to most of us that labor's power is very much diminished relative to what it was thirty-plus years ago.

Q. Have you seen any good evidence of that? Labor power to keep pushing up wages—and its effect on prices—was all the talk back in the 1970s.

A. No, the evidence is all indirect. But we do know a few things. First, we know that the fraction of the workforce in labor unions is much smaller than it was then. Second, we know that because of globalization there is greater implicit and explicit competition from low-wage labor abroad. But actually measuring the effects of that on wages is extremely tricky. Third, we know that real wages have performed poorly in recent years. By poorly, I mean relative to productivity gains. This is true even though the labor market is putatively tight right now, with a 4.6 percent unemployment rate.

Q Do you not find that the concerns about inflation are still often linked to wages and the possibility of a wage price spiral by policymakers?

A. No, not necessarily. Let us take right now, for example, when there are some concerns about rising inflation. None of this is coming through the wage channel. Nobody is talking about wages exploding or anything like that. To the extent that they are worried about a spiral, it is what we might call a price-price spiral.

Q. So they are worried that price increases will lead companies to raise prices because their costs are going up?

A. Yes, they have to pay for energy, for example, which then gets into the prices of widgets.

Q. Do you see any evidence of that going on?

A. Yes, you see a little.

Q. And how do you see it, in the increase in the core inflation rate?

A. Exactly.

Q Is there reason at the moment to be concerned about inflation?

A. Yes, somewhat. We have now had four consecutive monthly ticks of 0.3 percentage points in the core Consumer Price Index. That cumulates to an annualized rate of about 3.7 percent. That is much too high, almost double the rate of core inflation that we have been

experiencing for the previous several years. There is reason to think it could be a transitory problem. The CPI is following the rising price of energy with a lag. When the price of energy stabilizes—it does not have to go back to \$30 a barrel; it could just stabilize at very high rates of \$65 or \$70 a barrel—the inflationary impulse coming from energy will end, and inflation may subside. But with all that said, if you are sitting at the Federal Reserve and you see what the last four monthly numbers have been, you start shifting uncomfortably in your seat.

Q. You raise rates a little bit.

A. And you raise rates a little bit.

Q. But again, it is a mini version of the bad old days of the 1970s.

A. It is exactly a mini version.

Q. Maybe this is just the rat going through the snake, so to speak. Once digested, it will disappear.

A. That is an appropriate metaphor. But what the central bank worries about is that some of the rat stays in the snake.

Q. What is your view about Federal Reserve policy at the moment? Is it on target?

A. It is about right now. We are sitting here on June 20, so you will publish this interview long afterward. The Fed will push the Fed funds rate to 5.25 percent in late June. Given where inflation is now, and how the economy looks, I do not have any problems with that. I do not believe the Fed is going to go much beyond that, if at all. If I did believe that, I would be more worried than I am about overtightening and killing the economy in the effort to kill inflation.

Q. What about the great mystery of the long end—interest rates on longer maturity bonds? Rates at the long end are now going up. To what do you attribute that? As we know, in recent years they did not always go up when the Fed raised short rates.

A. Normal behavior is for long rates to go up when short rates go up. For a long time we had the so-called Greenspan conundrum: that short rates were going up a lot and long rates were barely budging and, indeed, falling in part of that period. I do not quite

know what to make of that. There are many partial explanations, but no full, coherent explanation. Therefore, when I see long rates finally going up, I say it is about time, and why did they not do this before? Where this ties into your previous question, by the way, is that if long rates do not go up, the Fed has to push short rates up higher to do a greater share of the work. And that is what is going on right now.

Q. How do long rates do a greater share of the work?

A. Let me start by contrasting long rates with the Fed funds rate. The Fed funds rate, which the Fed usually targets, is a rate on overnight lending that affects basically nobody's spending. Only a few banks buy and sell at that rate. What are the rates that actually matter for spending? Consumer credit card rates, auto loan rates, home mortgage rates. Rates like home mortgage rates tend to be tied to five- or ten-year bond rates. Auto loan rates tend to be tied to two-, three-, four-year rates, and it is the same with bank lending rates to business. So to affect the interest rates that really matter to real people and real businesses, you have to see the Federal Reserve's effect on the overnight rate ripple out to rates of one-, two-, five-, ten-year duration. And that is what we have not seen enough of.

Q. The rise in long rates is unlike the situation in earlier years. But is it at last happening because expectations of inflation among bond investors are going up? They demand higher rates to compensate for higher inflation.

A. I believe, actually, that expectations that the Fed will push rates still higher are driving the long rates. That outcome, of course, is linked to higher inflation. So the answer is indirectly yes.

Q. But you could say that higher short-term rates could lead to lower inflation down the road and therefore lower long rates.

A. That is the reason that I put the intervening variables in. It is expectations of what the Fed will do that presumably drive long rates. The problem is that if you actually look at the evidence, the so-called expectation theory of the yield curve works terribly. This is one of the great paradoxes of monetary policy, and that is putting it charitably. It is almost a useless theory empirically, and yet, for lack of a better

theory, all of us, including academics, the Federal Reserve, and market people, pretend that the emperor has clothes.

Q What is your sense of what is going on with the economy? Do you believe that it is strong or that it will be hard to stop inflation?

A. It is slowing down more or less as the Fed would like it to slow down to something around trend growth in the 3 to 3.5 percent range. The housing market, which is the first thing the worrywarts are looking at, seems to me to be slowing down “at a measured pace” rather than any bursting of a bubble. Now, that view could yet be wrong. But the indicators for the past six to eight months are consistent with that view, and certainly that is the Fed’s view. If you ask a central bank economist, what are the classic channels by which a higher interest-rate policy slows an economy down, he or she starts with housing. Second is automobiles, and third is business investment.

Q How much does the level of the dollar influence monetary policy? These days, it is a difficult and often contradictory situation.

A. Pretty little, I would say, and only indirectly, in that the level of the dollar is going to affect U.S. net exports, and that is a component of demand. Now, of course, the last way we would like to slow this economy down would be by failure to export due to a high dollar. We are already failing to export (compared to imports) on a grand scale. We do not want that to get worse.

Q. I think we would like the dollar somewhat lower.

A. The dollar is going to fall lower eventually. Everybody knows that. I suppose I should not say everybody knows it because if everybody knew it, it would have fallen already. Everybody at the Fed certainly believes that the dollar will eventually fall. Every economist I know certainly believes it.

Q. But will keeping the dollar up too high keep the Fed from raising interest rates too rapidly?

A. Only a little. Exports are a small minority of the economy. Besides that, you are dealing with an economy in which the dollar seems to

have surprisingly small effects both on the real side and on the inflation side. So, it is almost in the rounding area for the Fed.

Q Let me ask you about your view of inflation targeting in terms of setting monetary policy. Bernanke, a former Princeton colleague of yours, is known for a version of this. What is your view of this general idea?

A. I am a big booster of the version of inflation targeting that I believe will be adopted by the Fed and that can be described very simply. It is a matter of turning a vague phrase, "price stability," into a specific number, a precise inflation target. Period. Nothing else, no other change. In some other countries, inflation targeting is almost a religion, with a lot of ritual attached to it.

Q What has been some of these countries' experience with it?

A. It has been generally good, in the sense that most of the countries—not all, but most—that have adopted it did so because they had troubles. For example, New Zealand, where it started, had been dealing with intractably high inflation for quite a long time, and they basically threw in the towel on the old regime and said we are going to do inflation targeting and be very serious about getting inflation down. Another good example is the United Kingdom, which in the early 1990s had been on the deutsche mark standard, with the pound shadowing the deutsche mark. When they broke out of the agreement, they needed some other nominal anchor, and they adopted an explicit target, with great success.

Q. Would one call the current European Central Bank policy a version of that?

A. I would, but they do not. This is a doctrinal dispute that has quasi-religious overtones. They do not, for example, issue an inflation report. They do not put an exact number on their inflation target. Instead, they have ambiguous language about an objective that is "close to, but just under 2 percent" a year. To me that is close enough to an explicit number. I listen to those words, and I think: 1.8 percent. But the ECB has never actually specified a 1.8 percent target.

Q. Would you call the ECB inflation targeting a success?

A. A modest success. In general, they have done fine. But on average over their brief history, I think that they have been too tight. One reason for this is the focus on headline over core inflation. I also want to point out that, inflation targeting or not, the men and women who sit on the ECB governing council have to live under the Maastricht Treaty and all its amendments. The Maastricht Treaty gives them a single goal, which is to control inflation. It is very different from the Federal Reserve Act, which provides two goals, both the control of inflation and the maintenance of high employment. So, if you are going to be true to the statutes by which you are governed, ECB'ers should be more hawkish than Federal Open Market Committee members. So I do not blame them for it, I blame the treaty.

Q It seems the experiences of the individual countries are so disparate that it is hard to get a single policy to work.

A. Of course. That was one of the foreseeable problems with a monetary union. So now, in Europe, peripheral countries like Finland, Ireland, and Spain are growing nicely, Germany is chugging along at only 1 percent or something, and Italy is doing the same. It is clear that the same monetary policy is not optimal for all, but they decided that there are virtues in a single currency that compensate for that. This does not come as a surprise to the Europeans. They knew there would be times like this.

Q. We had regional variation as well. Look how long the South lagged, for example.

A. Yes, and then later it grew faster than the rest of the country. There are considerable disparities every once in a while. The present does not seem to be one of those times in the United States, but every once in a while you see an economy where the coasts are doing great and the heartland is doing terribly or vice versa.

Q. In sum, you think we have basically learned the lessons of the 1970s. But are we still too afraid of inflation?

A. There is a possibility that the Fed will overdo it on this round, and we are all watching and hoping that it does not happen. I believe that it will not happen.

Q Let me ask about this central mystery in the economy. We have had five years of pretty stellar productivity growth, at least measured by the GDP accounts. And, by any historical standard of the postwar period—and I would argue earlier as well—we have had a poor performance of family income and of wages in general. What do you think is going on here? Should we be worried?

A. Yes, we should be worried. I do not think there is a single explanation. One we already mentioned: the decline of unions. The fact that we have not raised the minimum wage in nine years, which helps those at the bottom, is another. In addition, we have a government that is—I do not know how to put this politely—hostile to the lower 50–60 percent of the income distribution. And that sets a tone.

Q. So do you think social norms have a role in this?

A. Sure. We have also been living now for a quarter of a century or so with what economists antiseptically call “skill-biased technical progress.” This is a polite term that means the market has turned ferociously against the unskilled. And that continues. I am not sure it will continue for another twenty-five years, but today we are still living in that world. The demand for labor is shifting toward the more highly skilled, as it has been doing for a long time.

Q You have written recently about the impact of globalization.

A. Which is what may stop that trend, actually. In the article to which you are referring, I draw the key distinction between services that can in principle be offshored and services that cannot. That distinction divides the labor force very differently. It is not skilled versus unskilled workers, because some highly skilled services like accounting and some legal services, and maybe even journalism and college teaching, can be offshored. And, of course, some very low-skilled positions, like call center telephone operators, can also be offshored. The jobs that are safe are those that have to be done here, and they vary across the skill spectrum. A worker in a child day care center, for example—a low-wage job—cannot be offshored. But

skilled and high-wage jobs like brain surgeon and airplane pilot also must be done here. My vision for the next twenty-five years is that there will be incessant wage pressure on the jobs that are potentially offshorable and a much better labor market for the jobs that cannot be offshored. That schism does not correspond at all to skilled versus unskilled work.

Q. Is it possible then that relative wages for the caring laborer—teachers and so forth—will go up in that kind of environment?

A. Yes, it is possible. But here is the counterforce. To the extent that people in America have to flee the other service jobs that get offshored, they will move into the jobs that cannot be offshored, and you will get a supply response.

Q. Would you call the current unemployment rate low by historical standards, even given the falling labor participation rate?

A. Yes. There was a good paper by several Fed staffers that looked into this in detail. They concluded that the low participation rate does not vitiate the conclusion now—but did in the early parts of this recovery.

Q. So they say that the lower participation is mostly voluntary now?

A. Or mostly permanent, not cyclical. They do not expect it to bounce back.

Q. Yet the weak wages would strongly suggest it is not such a low unemployment rate.

A. That is correct. That is a phenomenon that is hard to explain and may be dependent on many factors, as we discussed.

Q. So you are satisfied we are pretty close to full employment at the moment?

A. Yes, I am. But I am not satisfied at all with the real-wage performance, which has been pretty poor.

Q We have very rich corporations whose profits are rising rapidly and wages that are not growing at all. Do we need a different kind of safety net, a different kind of attitude in government to apportion the benefits from the economy differently?

A. I think we do. And we are going to need it more and more in the brave new world that I was describing before, where more and more workers are going to come under the threat of foreign competition. The safety net we have for our workforce is too weak.

Q. Are we talking about broader unemployment insurance, job training?

A. Yes, those kinds of ideas, but I can also imagine wage insurance schemes of various sorts. Now, all of these require some financing, and, of course, the government has—for no good reasons—put itself in the position of being broke.

Q. Can the Democrats rally around any of these points?

A. I do not know the answer to that.

Q. My concern is always that Democrats need to be able to raise government revenues to implement needed policies. That is the problem, not a lack of ideas.

A. There are ideas, but a lot of these ideas require money.

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