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ECONOMIC VIEWPOINT
By Glenn Hubbard

A Gold Medal For The Fed's Inflation Fighters

The New Year offers a time for New Year's resolutions. One good resolution is to keep doing something healthy for yourself, even if you've been doing it so long it seems routine. The Federal Reserve's 20-year successful effort to rid the U.S. economic system of inflation is something Americans should value. The Fed's victory over inflation constitutes what is, in effect, the biggest tax cut for investment over the past two decades.

That inflation is associated with macroeconomic instability is clear in the memories of those who lived through the Great Inflation of the 1960s, '70s, and early '80s. Inflation's rise was accompanied by a stop-go monetary policy with some serious downturns. There were two small and two large recessions from 1969 to 1982. During this long period, equity values of U.S. companies stagnated, as did growth in living standards.

As a textbook author and teacher of financial markets, I know that students' interest in inflation has faded. Recent years have instead seen more attention to deflation -- a falling general price level -- and an appreciation of the Fed's role in averting financial crises by maintaining liquidity, as it did after the terrorist attacks of September 11, 2001.

This shift in perception is understandable, as inflation peaked in 1979, gradually declining to about 2% a year today. This period of gradually decreasing inflation has been associated with the mirror image of the macroeconomic events of the years of great inflation. We've had larger expansions and only two mild recessions since 1982, plus rising equity values and more pronounced increases in living standards. Business leaders worry more about losing pricing power from globalization and e-commerce than they do about inflation.

But let's remember the key role that monetary policy has played in reducing inflation and interest rates, and improving economic outcomes. With lower inflation, aggressive tightening of monetary policy by the Federal Reserve has become rarer, smoothing out the business cycle. Fed credibility in battling inflation has lowered market interest rates by making investors less worried that rising prices will cut into the value of their investment. In addition, because of the Fed's commitment to low and steady inflation, interest rates have become less volatile. That, too, makes investors more willing to accept lower rates.

High inflation acts as a tax on investment, raising rates, increasing the cost of equity-financed investment, and reducing corporate equity values. Capital gains generated by a rising price level are taxed the same way as gains arising from increases in expected future profitability. And because depreciation allowances are based on historical cost, inflation reduces the real value of depreciation allowances. It is these effects of inflation that reduce investment.

Using data on the U.S. corporate sector, Darrell Cohen, Kevin A. Hassett, and I estimated that a decline in inflation of four percentage points -- as during the 1990s -- would reduce the cost of capital enough to lift business fixed investment by 6.5%. This increase in capital accumulation affects living standards by boosting output per worker and raising sustainable real consumption per capita. In the case of a four-percentage-point decline, this gain would be equivalent to a gain in consumption per person each year of more than 1% permanently.

Of course, there are other ways that the government can reduce the inflation tax on investment. One way would be to index parts of the business tax code to take price changes into account. An alternative approach would be to tax income once (eliminating investor-level taxes on dividends and capital gains) and to allow businesses to write off their full capital investment in the year it is made. Such shifts would extend the changes in the tax code championed by President George W. Bush and would fit easily into a framework for tax reform.

But it is the Fed, wisely insulated from the political process, that has provided the greatest and most competent leadership in reducing taxes on investment. Maintaining the gains from low inflation requires a continued Fed commitment to price stability. Explaining to the public the costs of even modest rates of inflation is a vital part of Fed communication. So, too, is anchoring inflation expectations with a description of the range the central bank finds acceptable. The Fed has done a remarkable job in cutting the inflation tax on investment. We should not take that effort for granted.

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