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HIGHLIGHTS

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Who Pays for Disinflation?

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Many economic observers applaud the current rate of inflation in the United States, claiming that the rate is so low that inflation has ceased to matter much in the decisions of individuals and businesses. Some, such as Martin Feldstein (1997), want to see inflation fall still further--to zero--arguing that such a reduction would yield substantial gains by allowing resources to be allocated more efficiently. Feldstein advocates that the Federal Reserve engineer a recession that reduces real gross domestic product by 5 percent to wring inflation out of the economy. The problem with such a policy is that it would disproportionately burden those most at risk in our society--poorer families, minorities, and inner-city workers.

Distributional Effects of Contractionary Monetary Policy

Economic theory predicts that disinflationary monetary policy will burden interest-sensitive industries, small firms, and low-income workers and will benefit bond market investors and other creditors. Contractionary policy, by raising interest rates, will reduce spending on interest-sensitive items such as houses and cars. This reduction in demand will reduce employment among low-skilled individuals much more than among high-skilled individuals. As Blanchard and Katz (1997) discuss, the wages of low-skilled workers tend to be low, and even a small decrease during an economic downturn can reduce those wages below the level at which workers are willing to work. High-skilled workers, on the other hand, are paid much higher wages and will continue to earn enough to induce them to work even if an economic slowdown reduces their wages. While low-skilled workers will thus be harmed a lot and high-skilled workers a little by the reduction in wages that comes with disinflation, individuals holding assets such as bonds that pay a fixed nominal return, who tend to be at the upper end of the income distribution, will benefit because the assets yield higher real returns with disinflation.

Econometric evidence supports these theoretical predictions that disinflationary monetary policy burdens certain industries and workers and benefits wealthier bondholders. Research shows that African Americans and Hispanics tend to have lower incomes than whites. Although the reasons for this wage gap are not absolutely clear--it could reflect discrimination, productivity differences, differential access to job information, or other factors--the implication of the gap for monetary policy is clear. The brunt of contractionary monetary policy falls on blacks and other minorities earning lower wages rather than on whites. Evidence presented in Thorbecke (1997) indicates that an increase in interest rates by the Fed raises unemployment almost twice as much among blacks and Hispanics as it does among whites. An examination of the period from October 1979 to the end of 1982, during which Federal Reserve chairman Paul Volcker raised interest rates in order to fight inflation, corroborates econometric results. Over this period black unemployment increased 9.5 percent, Hispanic unemployment increased 7.1 percent, and white unemployment increased 4.5 percent. Minorities, who tend to have lower incomes, clearly paid a higher price for the reduction in inflation.

Both econometric evidence and examination of the Volcker disinflation indicate that the durable goods and construction industries suffer from contractionary policy more than other industries. During the Volcker disinflation, for example, employment in durable manufacturing decreased 18 percent and employment in construction 15 percent. The only sector in which the employment decline was close to these amounts was transportation, in which employment fell 3 percent. The techniques of Roland-Holst and Sancho (1992) make it possible to determine how a decline in the durable goods and construction sectors will affect the incomes of different groups of workers. They find that slowdowns in these sectors will affect non-union workers who are not covered by union contracts much more than union workers and other workers covered by union contracts and will affect urban employees more than rural employees. Workers in jobs that are not covered are much more likely to earn low incomes than workers in covered jobs. Thus, these results indicate that contraction disproportionately harms poorer, urban workers.

Gertler and Gilchrist (1994) present evidence that contractionary monetary policy reduces sales of small firms much more than sales of large firms. They also find that small firms exhibit an asymmetric response to monetary policy, but large firms do not. Small firms are harmed more by contractionary monetary policy during recessions than they are helped by expansionary monetary policy during expansions. In Fama and French's (1995) examination of the Volcker period, they find that the profits of small firms declined much more than the profits of large firms and that the earnings of large firms recovered quickly after the recession, but the earnings of small firms never returned to prerecession levels. This evidence confirms theoretical predictions that small firms will be disproportionately burdened by contractionary policy.

Studies of the response of the bond market to declines in inflation by Mishkin (1990) and Campbell and Amner (1993) show that long-term bond prices respond primarily to news about future inflation and that news of higher inflation pushes bond returns down. Contractionary policy that reduces inflation should produce large capital gains to holders of fixed income securities over time. This expectation is confirmed by events during the Volcker disinflation. Inflation in 1981 was high, just short of 9 percent, but in 1982 it fell below 4 percent. Long-term Treasury securities provided a total return in 1982 exceeding 40 percent, easily the highest return ever. Which households tend to hold bonds? According to Moore (1989) and Niggle (1989), the wealthiest 10 percent of households held almost 95 percent of all bonds and trusts in 1982. Thus the soaring return on bonds that year accrued primarily to wealthy investors.

Policy Implications

Theoretical predictions, econometric results, and the example of the Volcker disinflation present a consistent picture of the distributional effects of disinflationary monetary policy. Minority unemployment increases twice as much as white unemployment. Employment in construction and durables decreases disproportionately. Within these sectors income falls most for workers not covered by union contracts, who tend to have lower-paying jobs. Profits of small firms decline more than those of large firms. Bond market investors gain. Disinflationary policy thus redistributes wealth from low-income families to high-income families. Would a further transfer in this direction, produced through contractionary policy, be desirable?

To answer this question it is useful to look at how income is distributed presently in the United States. Bradbury (1996) shows that for the poorest 10 percent of families, real income declined almost 30 percent between 1973 and 1994, for the second poorest decile real income fell almost 20 percent, and it was not until the median decile that incomes increased at all. The top four deciles, on the other hand, showed steady increases, with the largest increase (over 20 percent) going to the top decile. These results contrast with the period between 1947 and 1973, when all deciles experienced steady increases in wages of about the same size. Commenting on the recent trend toward inequality, Federal Reserve chairman Alan Greenspan stated that it could be a major threat to our society and Federal Reserve Bank of New York president William McDonough warned that it could endanger our ability to go forward together as a unified society.[1]

Given the economic difficulties facing lower-income families and the threat to our society that increasing inequality represents, engineering a disinflationary recession now would be inappropriate. Such a slowdown would burden low-income families, minorities, and interest-sensitive industries while providing a bonanza to fixed-income investors, who are primarily among the wealthy. A further redistribution from poor families to these investors could risk tearing the fabric of our society.

Not only would disinflationary monetary policy be harmful at present, but also the danger that expansionary monetary policy will trigger an inflation seems less now than in the past. As Greenspan (1997) testified, although unemployment has fallen to about 5 percent, inflation remains quiescent. Greenspan attributes the failure of unit labor costs, and thus prices, to increase as the economy expands to workers' willingness to accept lower wage increases in return for greater job security, partly due to fears of job skill obsolescence. He cites other factors moderating pressures for wage and price increases such as international competition, the decline of unions, the deceleration of health care costs, and deregulation.

In the past the Fed sometimes applied the monetary brakes when employment grew more than expected. Coppock and Thorbecke (1997) find that prices of assets harmed by contractionary monetary policy fell after news of strong employment growth. This indicates that Wall Street expects the Fed to tighten when employment expands quickly. Prominent Fed watcher David Jones (1994) said that employment was Greenspan's favorite series to watch, and he was more inclined to tighten monetary policy when it grew quickly. The problem with restricting employment to fight inflation is that it forces low-income workers and minorities to pay the lion's share of the costs of controlling inflation. With these groups suffering and inflation risks low, now is an appropriate time to let the economy grow rather than limiting the amount employment can increase. As Joseph Stiglitz, former chairman of the Council of Economic Advisers, stated, allowing the jobless rate to remain low will particularly help workers such as inner-city blacks and people on welfare who have difficulty finding jobs (*Washington Post* 1997).

Some people might object that if the Fed were to come to be perceived as being less willing to tighten when employment increased, bond market participants would demand a larger inflation risk premium and push up long-term rates. While this argument might have some validity, it is not compelling for several reasons. First, by not raising short-term interest rates when there are signs of economic strength, the Fed could prevent a lot of the increases in longer-term rates (see Thorbecke 1996; Coppock and Thorbecke 1997). Second, the U.S. Treasury has recently issued inflation-indexed bonds, giving those concerned about inflation an instrument free of inflation risk. Third, if inflation did not materialize, investors would bid interest rates back down. Fourth, the Fed should not focus narrowly on the interests of the bond market but broadly on the interests of the country (see Blinder 1996). If it is determined that allowing unemployment to fall is a sensible policy, the Fed should follow that policy even if it displeases bond investors who would prefer zero inflation risk.

The combination of the facts that lower-income families are suffering in today's economy and that risks of inflation are low indicates that rather than causing the economy to contract, the Fed should let it expand. Allowing employment to grow would disproportionately benefit individuals most at risk for shrinking income and unemployment. Although "testing the waters" by letting unemployment fall would involve some risk of price increases, the Fed would have ample time to contain any incipient inflation before it became embedded in wages and prices. Given that growing income disparity may endanger our ability to go forward together as a unified society, implementing policies that promote distributive justice and social cohesion is of particular moment.

Note

1. Greenspan's statement was made in his Humphrey-Hawkins testimony before Congress in July 1995. McDonough's statement was quoted in *The New Yorker* , October 16, 1995, p. 113.

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