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In This Issue

Mammoths . . .

The banking industry has been consolidating, moving to fewer banks of larger average size. Although many view this trend as healthy, John H. Boyd and Stanley L. Graham don't, at least not after "Investigating the Banking Consolidation Trend" (p. 3). Based on their own analysis and other studies, Boyd and Graham conclude that banking consolidation is not primarily due to natural market forces. They find that big banks are neither more efficient nor safer than moderate-sized banks. And they argue that if the demand for banking services is in fact shrinking, as many claim, then theory says big banks shouldn't be expanding; they should be leading the exodus from the industry.

So why are mammoth banks not disappearing? According to Boyd and Graham, government policies are (perhaps unintentionally) helping them survive and grow. The policy of not allowing very large banks to fail, for fear of derailing the economy, has extended insurance at no cost to all of those banks' liabilities—an obviously attractive subsidy. Regulatory policies have also provided incentives for banks to get big: bureaucratic red tape discourages hostile takeovers of banks, which protects bank managers who increase their bank's size along with their own paychecks; and government approval of mergers of banks in the same market gives those banks noncompetitive advantages.

. . . Goose Eggs . . .

Should the Fed not rest until the bottom line of every consumer price report is a goose egg? Last summer in the *Quarterly Review*, S. Rao Aiyagari answered, no: goose eggs—or zero inflation—should not be the Fed's goal. He argued that the benefits of bringing inflation down to zero were small compared to the costs of getting there. In this issue, W. Lee Hoskins disagrees. He responds to Aiyagari in "Defending Zero Inflation: All for Naught" (p. 16).

Hoskins has three main parts to his argument that zero inflation is a worthwhile goal. First, he argues that inflation causes distortions due to our incompletely indexed tax system, and that system is difficult to correct legislatively. Second, Hoskins argues that reducing the average rate of inflation also would reduce the uncertainty about it over long periods of time. That uncertainty, he says, interferes with long-term planning in both the private and public sectors. Finally, Hoskins argues that the costs incurred in the transition to zero inflation could be minimized if the policy were made credible. He contends that even if frictions made the transition costs greater than he thinks, those same frictions would make the benefits of zero inflation higher too.

Aiyagari, in his "Response to a Defense of Zero Inflation" (p. 21), explores the reasons for the disagreement about zero inflation as a policy goal. He counters each part of Hoskins' argument, but he acknowledges that considerable judgment and more research are needed to resolve their differences. Aiyagari also stresses a point from his original paper, a point on which Hoskins does not explicitly comment. The point is that eliminating inflation would have an undesirable effect of removing the major tax on activities in the underground economy. Hoskins may consider this inflation tax insignificant or simply prefer other ways of discouraging underground activities.

. . . A Wolf . . .

In another previous issue (spring 1990), Finn E. Kydland and Edward C. Prescott found that in the period since the Korean War, U.S. prices tended to be countercyclical; that is, they tended to be relatively low when output was relatively high. This finding suggests that supply-side shocks (technological changes) were quantitatively important in the U.S. economy, and it points to an inadequacy in standard demand-driven business cycle models, since they predict prices should be procyclical.

In "Procyclical Prices: A Demi-Myth?" (p. 25), Holger C. Wolf describes two additional features of price/output relationships over the Kydland-Prescott sample period which suggest their finding must be qualified. One feature is that when the postwar period is split at 1973, in the first part prices are procyclical, while later they are countercyclical. This suggests that demand shocks (changes in things like government policy and consumer tastes) have been quantitatively important after all. The other feature is that countercyclicality of prices is more pronounced when output unexpectedly falls than when it unexpectedly rises. This suggests that the practice of modeling the economy as a linear process—which is standard in business cycle modeling—may not be appropriate.

. . . And Sheep

The contents of this issue are especially controversial. Our purpose in publishing them is to stimulate discussion of important policy issues. The positions taken in the papers do not represent official views of the Minneapolis Federal Reserve Bank. In fact, we would gladly consider for publication papers on these issues which take opposing views.

Preston J. Miller
Editor