A Zero Inflation Policy Is a Pro-Growth Policy

We know that both the U.S. and Canadian economies are currently operating at levels well below those that could be achieved if we eliminate inflation. Zero inflation would make our monetary system more efficient, contribute to better decisions, and result in a monetary system more efficient, con-
dermines public trust in government.

Fears of recession create an apparently insurmountable barrier to price stability. This is unfortunate. The perceived trade-off between inflation and recession is an illusion. In the end, inflation itself is the cause of most recessions, and continued inflation will reduce economic growth. To achieve maximum sustainable growth in the economy in the 1990s, central banks should commit today to achieving zero inflation.

Conclusion

Monetary policy is being tested today. Although we have enjoyed high levels of economic growth, recent slowing in economic activity in Canada and the United States has prompted calls for easier monetary policy—lower interest rates and more rapid monetary growth. Yet, such a policy would not only sup-
port the current inflation rate, but would also lay the foundation for ac-
celerating inflation. The result would be an economy operating even further below its long-run potential, with growing vulnerability to frequent and severe recessions. A monetary policy that leads to zero inflation, even if it risks a recession, is our best opportunity for long-term growth.

W. Lee Hoskins is president of the Federal Reserve Bank of Cleveland. The material in this Economic Commentary is based on a speech presented to The Fraser Institute, Toronto, Canada, on September 19, 1989.

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ECONOMIC COMMENTARY
Federal Reserve Bank of Cleveland

Breaking the Inflation-Recession Cycle

by W. Lee Hoskins

Over the years, many people have come to believe that recessions can pro-
long an economic expansion, or avoid the pain of a recession, with more infla-
tion. Given this choice, some observers may view inflation as a reasonable gam-
ble and, perhaps, as the lesser of two evils. These are false choices, however.

A look at recent history reminds us vividly of the economic pain resulting from inflation. Every recession in the recent history of North America has been preceded by an outburst of cost of goods and services which, in turn, led to inflation. Eventually, the target would become a constant price level.
when high inflation rates failed to con- vince the public that we could not allow people who made this bet in the 1960s, how- ever, became very wealthy. The history of the business cycle is a history of gyrations in money and prices.

Nonmonetary "surprises" also can cause recessions. Shifts that may be widespread enough to result in a recession. These surprises often arise from economic disturbances as droughts, wars, cartel actions, and politi- cal change. For example, political reform in the last decade can change the way governments operate to offset nonmonetary surprises. First, we would need to understand the planning and management of the economy. Recessions can also emanate from the combined effects of many par- ticular disturbances to individuals, firms, and industries.

Even if we could eliminate all the in- fluences from monetary policy, there would still be recessions and expansion because of these surprises. Con- sider an analogy between recessions and earthquakes. Recessions occur when the plates of the earth shift. Al- though scientists do not completely un- derstand this shifting, they believe that it happens in areas of very large earth- quakes or a few large ones. We have no reason to believe that it would be beneficial if we could shift the plates of the earth. The next earthquake, however, is not predictable; it can happen any time. If the earth's plates must shift, we may only be causing a much worse quake if we try to prevent the small ones.

The same is true of recessions. Shifts are occurring in the economy that we cannot control. Economists and policymakers do not completely understand—for example, technology and the changing names of consumers and investors. Other shifts that are considered to be uncontrollable, such as droughts and oil spills, also occur. If we let market forces operate, these changes will be accommodated or corrected in a natural and gradual fashion. Without a doubt, there will al- ways be short-term difficulties, but it is our long-term advantage to allow for some shift in the economic "plains" as the world changes. Perhaps the earthquake analogy seems a bit extreme, but it is no more extreme than the idea that monetary policy can or should be used to eliminate the busi- ness cycle. Let me emphasize that I am not in favor of recessions. On the con- trary, I believe that variable and uncer- tain monetary policies exacerbate the business cycle. We must remember that recessions will occur even under an ideal monetary policy, but they will not be as frequent or as severe. Under an ideal policy, we would not have recessions induced by inflation and the persis- tent need to eliminate it.

Nonmonetary Surprises: Why Don't We Use Policy to Thwart Them?

There is a bit of irony in the idea of forecasting recessions: if we could forecast them, we probably would not need a policy to eliminate them. A recession is one kind of economic fluctua- tion. Others include seasonal fluctua- tions due to weather, tax laws, and cultural events like holidays.

There is a fundamental difference in the way we treat seasonal and business cycle fluctuations. Seasonal downturns can be larger than cyclical downturns, yet the government adjusts its economic data to account for seasonal downturns. Seasonalities can be adjusted because seasonal fluctuations are predictable based on past experience.

People have developed a variety of ways to deal with seasonal variations in employment and output. Farmers know that a single fall's harvest has to feed the family for a whole year. Construc- tion workers know that their relatively high incomes during the summer must carry them through the winter months. Successful retailers know that nearly one-third of their sales come in the winter holiday season. Conversely, if we set market prices, these changes will be accommodated or corrected in a natural and gradual fashion. Without a doubt, there will al- ways be short-term difficulties, but it is our long-term advantage to allow for some shift in the economic "plains" as the world changes.

The Crystal Ball Syndrome: The limits- ations of forecasting monetary policy are well known. Analysis of forecast errors has shown that we often fail to recognize a recession until it is well under way. Economic forecasts at any point in time entail such a wide band of uncertainty that the plausible outcomes range from expansion to recession. The people who make forecasts and those who use them often get a false sense of confidence because forecast errors are not distributed evenly over the business cycle. When the economy is doing well, forecasts that prosperity will continue are usually correct. When the economy is performing poor- ly, forecasts that the slump will con- tinue are also usually correct. The prob- lem lies in predicting the turning points — the critical junctures that we must forecast in order to prevent recessions.

Monetary Policy's Long and Variable Lag

Economists have learned that the effect of monetary policy on the business cycle was a desirable and healthy long-term goal, I believe it is impossible to do so. Several reasons prevent us from using monetary policy to offset nonmonetary surprises. First, we cannot predict recessions. Second, policy does not work immediately or predictably; it works with a lag. The effects of monetary policy on the economy are highly variable and poorly understood.

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Nonmonetary "surprises" also can
cause recessions, and monetary events
that may be widespread enough to result in
a recession. These surprises often arise
from particular economic disturbances
such as those we have seen in computers,
information processing, and manufac-
turing techniques. They also come from
such economic disturbances as droughts,
war, cartel actions, and politi-
 cal change. For example, political
reforms can occur in a few countries
and China may produce recessions be-cause
people have to learn how to reorganize
and develop institutions that use the
market. Recessions can also emanate
from the combined effects of many par-
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Even if we could eliminate all the in-
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cial if we could predict and prevent
the next earthquake, however. In fact, if the
earth's plates must shift, we may only
be causing a much worse quake if we
try to prevent the small ones.

The same is true of recessions. Shifts
are occurring in the economy that
some economists and policymakers do
not completely understand—for example,
technology and the changing tastes of
consumers and investors. Other shifts
that are considered to be uncontrollable,
such as droughts and oil spills, also
occur. If we let market forces operate,
these changes will be accommodated
in a corrected or in a natural and
 People live business cycles in many of
the same ways that they survive
seasonal cycles. Firms build up a
reserve of profits in good times to sur-
vive the bad times. Households save
during good times and postpone large
purchases in bad times. Government
programs like unemployment in-
surance and the graduated incom-
et tax operate automatically to stabilize
spending over the business cycle.

Monetary Policy's Long and Variable
Lag. Even if we could predict recess-
sions and wanted to vary monetary
policy to alleviate them, we still face
an almost insurmountable problem:
monetary policy operates with a lag.
Moreover, the length of the lag varies
over time, depending on conditions in
the economy and the public's percep-
tion of the policy process. The effect
of today's monetary policy actions will
probably not be felt for at least nine
months, with the main influence per-
taking perhaps two to three years in the future.
The act of trying to prevent a recession
may not only fail, but may also create a
recession where there was not going to be
one.

The other reason for a lag is that
businesspeople do not act in a vacuum. They
understand the political forces
operating on a central bank and know
that a return to inflation is always a pos-
sibility. If they are uncertain about fu-
ture policy, they will be cautious about
future investments. Uncertainty about
future inflation will raise real interest
rates, drive investors away from long-
term markets, and delay the very invest-
ments needed to end the recession. The
more certain people are about the
stability of future monetary policies, the
more easily and quickly inflation can be
reduced and the economy can recover.

Macroeconomic ideas about monetary
policy and its effect on real output have
changed profoundly in the last decade. Economists have realized that the effect of monetary policy depends largely on
expectations about policy.

The experience of the last 20 years has
shown us that we must think of policy
as a dynamic process. The philosophy
that a recession is inevitable in order
to reduce inflation completely ignores the
ability of individuals to adapt their ex-
ceptions as their environment changes.

People do their best to forecast eco-
nomic policies when they make deci-
sions. If the central bank has a record
of expanding the money supply in attempts
to prevent recessions, people will come
to anticipate the policy, setting off an ac-
celeration of inflation and misallocation of
resources. The key issue is what we need
for a correction—a recession.

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cele
The Federal Reserve’s goal. They would expect to see a policy stance directed toward returning the price level to its target path. A complete zero inflation policy would require a transition period in which zero inflation is approached gradually. This transition should be seen as a path for the price level. Adopting a zero inflation policy today would mean that the price level would continue to rise for the next three to five years, for example, but at a lower rate each year. Eventually, the target would become a constant price level.

A Zero Inflation Policy Is a Pro-Growth Policy

We know that both the U.S. and Canadian economies are currently operating at levels well below those that could be achieved if we eliminate inflation. Zero inflation would make our monetary system more efficient, contribute to better decisions, and result in more efficient usage of our resources. During the transition to a higher level of performance, the economy would grow faster. Eventually, we would expect to return to some “normal” growth trend, but at a higher level of output than will be possible if we continue to operate under the current system.

Inflation adds risk to decisions and retards long-term investments. It changes the nature of the economic environment so that random inflation outcomes overwhelm otherwise prudent managers. Inflation causes people to start up businesses and use costly accounting methods for the sole purpose of hedging against it. In the absence of inflation, the resources working in these areas could be devoted to producing more goods and services. Inflation interacts with the tax structure to stifle incentives and limit investment, and it undermines public trust in government. Why do we allow inflation to clog the wheels of our economy?

Conclusion

Monetary policy is being tested today. Although we have enjoyed high levels of economic growth, recent slowing in economic activity in Canada and the United States has prompted calls for easier monetary policy—lower interest rates and more rapid monetary growth. Yet, such a policy would not only support the current inflation rate, but would also lay the foundation for accelerating inflation. The result would be an economy operating even further below its long-run potential, with growing vulnerability to frequent and severe recessions. A monetary policy that leads to zero inflation, even if it risks a recession, is our best opportunity for long-term growth.

Fears of recession create an apparently insurmountable barrier to price stability. This is unfortunate. The perceived trade-off between inflation and recession is an illusion. In the end, inflation itself is the cause of most recessions, and continued inflation will reduce economic growth. To achieve maximum sustainable growth in the economy in the 1990s, central banks should commit today to achieving zero inflation.

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Breaking the Inflation-Recession Cycle

by W. Lee Hoskins

Over the years, many people have come to believe that nations can prolong an economic expansion, or avoid the pain of a recession, with more inflation. Given this choice, some observers may view inflation as a reasonable gamble and, perhaps, as the lesser of two evils. These are false choices, however.

A look at recent history reminds us vividly of the economic pain resulting from inflation. Every recession in the recent history of North America has been preceded by an outburst of cost and price pressures. Let us not forget the miserable economic situation at the turn of this decade, when unemployment and inflation were at double-digit levels and production was declining. If we learned anything from those dismal times, surely it was that the harm caused by inflation takes years to undo, and usually comes at the cost of permanent losses in income and economic well-being.

Today, in both Canada and the United States, people seem to be more aware than ever that the proper role of the central bank is to prevent these losses by stabilizing the price level. Both Governor Crow and Deputy Governor Freedman of the Bank of Canada have publicly committed to monetary policies designed to stabilize the price level. In the United States, Federal Reserve Chairman Greenspan has repeatedly stated that the way to attain maximum long-run growth and the highest standard of living is to stabilize the price level.

The message is simple. In the long run, there is no trade-off between inflation and recession. Ultimately, inflation itself causes recessions and results in less-than-optimum economic performance. A monetary policy that strives for price stability, or zero inflation, is a pro-growth policy.

Recessions: Why Do We Have Them?

A recession is an economic downturn that is widespread across enough industries or regions to make the slowdown general for the economy. Although we do not understand recessions completely, we have seen that they can be caused by monetary policy actions as well as by nonmonetary factors.

In the early 1980s, recessions were caused by monetary policy mistakes, namely the excessive monetary growth rates of the 1970s. This excessive growth of money in both Canada and the United States allowed inflation and interest rates to rise, which led to the need for disinflationary monetary policies in order to get our economies back on acceptable real growth trends. Yet even today, we are apt to blame a recession on policies that reduced inflation instead of those that created the inflation to begin with.

Why is it that inflationary policies cause recessions? Business leaders face a great many sources of uncertainty surrounding any investment decision. First, they must know their market and offer a product that people want. Next, they must monitor costs while providing the highest possible quality. In fact, in this task is a host of decisions that require guessing future rates of interest and inflation. Generally, high and variable rates of inflation cause mistakes in these decisions, mistakes that may lead to incorrect investment or inventory decisions.

For some businesses, costs arising from inflation and interest rates may not seem critical; for example, those with low fixed costs and those that are able to adjust wages and prices for inflation. For most, though, inflation and interest rates will be critical. Otherwise capable managers who made investments in the late 1970s in inflation-sensitive areas—farming, timberland, oil, or real estate—fell into bankruptcy.

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