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BREAKING THE INFLATION-RECESSION CYCLE

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Breaking the Inflation-Recession Cycle

The Canadian and United States economies are approaching a critical juncture. As the current expansion strains against capacity limits, some forecasters warn that we will soon have to make a choice between inflation and recession. Unfortunately, over the years we have come to believe that we can prolong expansion, or avoid the pain of a recession, with more inflation. Given this choice, as risk takers in the business world, you may view inflation as a reasonable gamble and, perhaps, the lesser of the two evils. My message today is that these are false choices.

A look at recent history reminds us vividly of the economic pain resulting from inflation. Every economic recession in the recent history of Canada and the U.S. 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 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 to stabilize the price level. In the U.S., 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 recession and, inflation 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 a slowdown in the economy that is widespread across enough industries or regions to make the slowdown general for the economy. Although we don't 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 we had recessions caused by monetary policy mistakes. The policy mistakes were the excessive monetary growth rates of the 1970s. This excessive growth of money in both Canada and the United States allowed accelerating inflation and rising interest rates that led to the need for disinflationary monetary policies. The disinflationary policies were necessary to get our economies back on acceptable real growth trends. Yet even today, we are apt to blame the policies which reduced inflation for the recession instead of blaming those which created the inflation to begin with.

Why is it that inflationary policies cause recessions? As managers of businesses, you face a great many sources of uncertainty surrounding any investment decision. First, you must know your market and offer a product that people want. Next, you have to monitor costs and build in the highest possible quality. Implicit in this task is a whole 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 which may lead to incorrect investment or inventory decisions.

For some, costs due to 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, real estate -- fell into bankruptcy when high inflation rates failed to continue into the next decade. However, the people who made this bet in the 1960s became very wealthy. The history of the business cycle is a history of gyrations in money and prices.

Nonmonetary "surprises" also can cause disruptions in resource use that may be widespread enough to be a recession. These surprises have many sources. They include technological innovations such as we have seen in computers, information processing, and management techniques. They also come from economic disturbances like droughts, strikes, wars, cartel actions, and political change. For example, political reforms in countries like Poland and China may produce recession because people have to learn how to reorganize and develop institutions that use the market. Recessions can also emanate from the combined effects of many particular disturbances to individuals, firms, and industries.

Even if we could eliminate all the influences from monetary policy, there would still be recessions and expansions because of these surprises. Consider an analogy between recessions and earthquakes. Earthquakes occur when the plates of the earth shift. We don't completely understand the shifting of the plates, but scientists believe that this shifting may result in many small quakes or a few large ones. We have no reason to believe that, if geologists suddenly discovered a way to delay the next earthquake, then it would be good to do so. In fact, if the plates must shift, we may only be causing a much worse quake if we try to prevent the small ones.

I think that the same is true of recessions. Shifts are occurring in the economy that economists and policymakers do not completely understand -- for example, technology and the changing tastes of consumers and investors. Shifts occur which are considered to be uncontrollable -- droughts, oil spills, etc. If we let market forces operate, these changes will be accommodated or corrected in a natural and gradual fashion. Market forces work best in a stable policy environment. Without a doubt, there will always be short-term difficulties, but it is to our long-term advantage to allow for some shift in the economic "plates" 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 business cycle. Let me emphasize, I am not in favor of recessions. On the contrary, I believe that variable and uncertain 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 persistent 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; that is, if we could forecast recessions, we probably wouldn't have to worry about a policy to eliminate them. A recession is one kind of economic fluctuation. Consider another kind of fluctuation -- seasonal fluctuations 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 the data to account for seasonal downturns. Seasonality can be adjusted because seasonal fluctuations are predictable based on past experience. People can anticipate and prepare for seasonal downturns.

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. Construction 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. Consequently, their budget plans and banking relationships reflect this cash flow problem.

People survive business cycles in many of the same ways that they survive seasonal cycles. Firms build up a reserve of profits in good times to survive the bad times. Households save during good times -- and postpone large purchases in bad times. Government programs like unemployment insurance and the graduated income tax operate automatically to even out or stabilize spending over the business cycle.

The point is that if business cycles were predictable -- a necessary condition to justify a stabilization policy -- adjustments by people would make such a policy unnecessary.

Even if we thought that eliminating the business cycle was a desirable and healthy long-term goal, I believe it is impossible to do so. There are several reasons that 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.

The Crystal Ball Syndrome: The limitations of economic forecasting are well-known. Analysis of forecast errors has shown that we often don't know when a recession has begun until it is well underway. At any point in time there is such a wide band of uncertainty around economists' forecasts that the plausible outcome ranges 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. And when the economy is performing poorly, forecasts that the slump will continue are also usually correct. The problem lies in predicting the turning points. However, the turning points are the things we must forecast to prevent recessions.

Monetary Policy's Long and Variable Lags: Even if we could predict recessions 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 upon conditions in the economy and the public's perception of the policy process. The effect of today's monetary policy actions will probably not be felt for at least six to nine months, with the main influence perhaps two to three years in the future. The act of trying to prevent a recession may not only fail, but it may also create a recession where there was not going to be one.

The other reason for a lag is that you, as the operators of businesses, do not act in a vacuum. You understand the political forces operating on a central bank. You know that a return to inflation is always a possibility. Uncertainty about future policy makes you cautious about future investments. Uncertainty about future inflation will raise real interest rates, drive investors away from long-term markets, and delay the very investments needed to end the recession. The more certain people are about the stability of future monetary policy, the more easily and quickly inflation can be reduced and the economy recover.

Poorly Understood Linkages: We don't know exactly how a particular policy action will affect the economy. The effects of monetary policy is the topic of great debate underway among economists today. Macroeconomic ideas about

monetary policy and its effect on real output have changed profoundly in the last decade. We have learned that the effect of monetary policy depends on peoples' expectations about policy.

If we have learned anything about economic policymaking in the last twenty years, we ought to have learned to think about policy as a dynamic process. To claim that, "in order to reduce inflation, we must have a recession," is a wrongheaded notion that completely ignores the ability of humans to adapt their expectations as the environment changes.

People do their best to forecast economic policies when they make decisions. 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 acceleration of inflation and misallocation of resources that will lead to the need for a correction -- a recession. Suppose for a moment that the recession followed a period of excessive monetary expansion -- a common occurrence in the United States and Canada over the last three decades. An economy often goes into recession following an unexpected burst of inflation because people have made decisions that were based on an incorrect view of the course of asset prices and economic activity. The central bank can do little to cure the situation except to provide a stable price environment. This will be the optimal setting in which you can adjust your business plans to work off inventories and bad debts generated during the inflationary expansion. How long this takes depends on many factors, some of which are outside the control of the central bank.

Canada, the U.S., and many other western countries are experiencing extraordinarily long expansions. It is no coincidence that these expansions have proceeded in the presence of reduced inflation. I think it is because of, not in spite of, restrictive monetary policies that we have done so well. The combination of prolonged growth and relatively low, stable inflation will

make it easier for central banks to continue fighting inflation. It is very important that we not return to the inflationary policies of the past. Doing so will almost certainly cause a repeat of the terrible recessions we suffered in the early 1980s.

Central Bank Credibility and the Need for an Anchor

I believe the way to achieve prolonged growth and stability is a monetary policy that seeks to stabilize the price level. The first, necessary step is to anchor the price level, to create a world where people expect the average long-run inflation rate to be zero.

Advocates of a countercyclical monetary policy disregard the long-term inflation consequences. To maintain the value of money, monetary expansions must be kept in line with the capacity of our economy to grow. Proponents of a countercyclical policy assume that the trend or overall average growth rate of the money supply will be unaffected by the policy. They assume that excessive money growth today will be offset by a lesser money supply growth tomorrow. Because this is usually not the case, there is no benchmark or anchor for the monetary system and the economy's participants. Instead, inflation is allowed to change randomly with the fortunes of the economy and uncertainties are induced by trying to follow this countercyclical policy. By focusing on a stable price level, the central bank would automatically resist inflationary pressures that occur when aggregate spending is excessive. Likewise, it would automatically resist deflationary pressures that occur when the economy turns down.

What Is a Zero Inflation Policy?

A successful zero inflation policy would completely eliminate long-run inflation or any upward trends in the general level of prices. When I use the phrase "zero inflation policy," I mean a two-part policy. The first part is a

firm commitment to long-term price stability. The second part is a firm commitment to an explicit timetable.

A successful zero inflation policy does not mean that actual price indexes would remain constant. Central banks cannot control the price level over short horizons such as one quarter or even one year. No matter how much people may wish otherwise, there will always be temporary and unforeseen factors that will cause the price level to deviate from the desired policy target of no change in the price level. It would be a mistake to try to keep some inflation index on target each and every quarter, or even each and every year.

By price stability, I mean an economic environment in which people can make decisions about the future without having to worry about long-run inflation. In practice, non-policy aspects of the economy that affect inflation have to be partially accommodated. The price level might remain slightly above or below the target path for a year or two, but during that time the public would know the Fed's goal. They would expect to see a policy stance directed toward returning the price level to the target path.

A complete zero inflation policy would require a transition period in which we get to zero inflation gradually. This transition should be stated 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 well below levels 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 use of our resources. Adopting zero inflation will allow the economy to perform at a higher level. During the transition to this higher level of performance, the economy will grow faster. Eventually, we would expect the economy to return to some "normal" growth trend, but at a level of output that is much higher than will be possible if we continue to operate with this unnecessary "sand" in our economic machinery.

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 that have the sole purpose of hedging against inflation. 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. Inflation undermines peoples' trust in government. Why do we allow this sand 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 U.S. 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. In the end, 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.

Fortunately for Canada and the U.S., their central bankers have made such a public commitment. It is now up to us to have the resolve and the will to carry it out.