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St Johns University
Collegeville, Minn.

The Recession Obsession

by Mark H. Willes
President, Federal Reserve Bank of Minneapolis

The crystal balls that so many economists use to foresee the future are growing dark. Many say this is because the outlook is so grim. Others say it is because the devices are so unreliable they just aren't working anymore. The latter group has even suggested that the crystal ball industry will soon be stung by the announcement of a vast recall.

Many crystal balls are indeed having trouble dealing with President Carter's recently announced programs to fight inflation and increase confidence in the dollar. The crystal balls of the critics (and even some of the friends) of these programs say that a recession is all but guaranteed. Some say it will come sooner, some later. Some say it will be mild; some say it will make the Great Depression look like fun. But a recession is the prognostication that most analysts have come up with.

Granted, recent actions have made the future a bit more difficult to predict. But a good crystal ball shouldn't be fooled. It should see that the anti-inflation plan has reasonably good prospects of working, not because of its wage and price guideposts but because its key elements treat the causes of inflation: the large federal deficit, the rapid growth of the money supply, and the government's expensive regulation of the private sector. The federal deficit is to be cut to less than half the 1976 deficit, or by more than $30 billion, partially by reducing the share of the gross national product that goes to the government. The growth of the money supply is to be curbed by increasing reserve requirements on certificates of deposit of $100,000 and over and by allowing interest rates to rise. Finally, at least some government regulation is to be eliminated with help from a newly created agency. If the government faithfully carries out these steps, the rate of inflation should improve.

Equally important, as long as government policy is careful, systematic, and credible, these steps are not likely to cause a recession. Admittedly, this contradicts much of the conventional wisdom. Leading economists claim, for instance, that to knock just one percentage point off inflation we must sacrifice $200 billion in gross national product. To reduce inflation significantly, it's argued, we must endure a massive recession. Many of those who do not share this profound gloom are still concerned that cutting the deficit and slowing the growth of money will produce at least a minor recession. No one can guarantee that there won't be one, of course--even the best crystal balls aren't that precise. But the newly announced policies, if properly implemented, should have substantially lower costs than many economists predict. In fact, by mitigating the destructive consequences of inflation, both at home and abroad, these policies may actually reduce the chance of a major recession.

People's Expectations Make a Difference

This appraisal is more optimistic than many because it is based on some insights that are surprisingly new to macroeconomists, although they have long been self-evident to the average mortal. One of these revolutionary "new" insights is that what people think meaningfully affects what they do. Thus, an anticipated change of policy can have results quite different from an unanticipated one. Most of the models that economists rely on to predict the results of a change in monetary or fiscal policy assume that the new policy is totally unanticipated. If the money supply keeps growing faster than the announced rate, or if the government keeps spending more than it budgets, it is assumed that no one catches on quickly enough to make appropriate adjustments. Most economists, if pressed, would concede that people do exist. Some would even admit that people have wills of their own, however inconvenient. But these humanistic values find no home in most mathematical models of the economy. Most forecasts of the impact of a new economic policy are based on the implicit assumption that people can be repeatedly fooled and don't act in their own best interests.

Economics, however, is a study of people's economic behavior. When people anticipate a policy, their behavior may conflict with what most economic models predict. Suppose that the growth in the money supply is held back by the increased reserve requirements and higher interest rates that were recently announced. Suppose further that this new policy is "unanticipated," because people didn't expect it or because they don't believe that the government will stick to it. As time goes on, there is less money available than there would have been under the old policy. Because there is less money, aggregate demand grows less rapidly. Businesses, in order to keep their customers, do not raise their prices as fast. Wages, though, keep rising at their former pace because workers' contracts--which were written in expectation of greater money growth and greater inflation--cannot be changed. In this way workers become more and more expensive, while the value of the goods they produce doesn't change much. Some workers, in fact, are soon paid more than the value of what they produce, and firms that strive to maximize profits are forced to lay people off and cut back production.

The result of an unanticipated reduction in money growth, then, is that the rate of inflation improves but production and employment suffer. In more technical terms, the aggregate demand curve shifts downward, so that both output and prices are lower than otherwise expected.

If the reduction in money growth is anticipated, though, the picture is much brighter. Suppose now that people expect the newly announced policies to succeed in slowing the growth in money and reducing inflation. At first, this change in expectations makes little difference in the way the policies work. As time goes on, less money becomes available and aggregate demand grows less rapidly. Businesses, trying to keep their customers, do not raise their prices as fast. But this time wages do not rise as fast either, because workers' contracts have been written in expectation of slower money growth and slower inflation. This is the switch. Workers don't become more expensive than what they produce, and firms that strive to maximize profits do not have to lay people off or cut back production.

The result of an anticipated reduction in money growth, then, is that inflation is reduced while real wages, employment, and output are barely affected. In more technical terms, the aggregate supply and aggregate demand curves both shift, yielding lower prices but no big change in output.

While this example focusses on monetary policy alone, the social and economic costs of any policy could well depend on people's expectations. If everyone expects a new policy to make prices more stable, workers will know that they can maintain their buying power with smaller wage hikes. Businesses will know that if they raise prices too fast, they will no longer be competitive. The crystal ball, in short, is now an important instrument of policy. If an inflation-fighting policy is anticipated, it does not have to disrupt the economy or start a recession.

Lowering the Costs of Fighting Inflation

For the effects of a policy to be anticipated, it is not necessary that every American watch the evening news with a pocket calculator and a sheaf of graph paper. All that's necessary is that people use information efficiently so that they avoid making systematic errors. What probably happens is that they make plenty of errors, but not systematic or repeated ones. Although they can be fooled the first time a policy is used, the more often it is tried, the better they are able to correct past mistakes.

Labor leaders, who are obviously concerned about the economic outlook, avoid systematic errors in predicting inflation by at least two means. One is to hire forecasters who use sophisticated economic and statistical techniques to improve their predictions. The other is to index their contracts to some measure of prices, so that when the cost of living goes up, pay goes up automatically. Over 60 percent of all major labor contracts are now indexed. Those that are not indexed are tending to cover shorter periods, so that workers can receive more frequent raises to keep up with rising prices. By these and other means, workers anticipate inflation.

Perhaps anticipate is too limited a term to suggest all the social mechanisms that help people protect themselves from future inflation. Because of the way the labor market works, a few key people can in effect "anticipate" inflation for a large number of workers. Even if these people have little or no understanding of macroeconomics, they can learn to estimate future inflation by trial and error, provided that government policy is reasonably consistent. The term anticipate does not really mean that everybody has great knowledge or perfect foresight. It only means that somehow people use whatever information they have efficiently.

To allow people to make more accurate forecasts--which makes it easier to fight inflation--there are some steps that government must take. They are not difficult or expensive. They do not require any new bureaucracies. They are simple, straightforward steps that government probably should be taking anyway. First, new policies should be announced in advance, so that people can better plan for the future. If the policies are inflationary, people will no doubt try to protect their incomes--and a new round of inflation will hit earlier than it might have. But if the policies are anti-inflationary, people will see that they don't have to keep raising prices and wages frantically just to stay even--and the rate of inflation will come down sooner than it otherwise would have.

The second step that the government must take to encourage the right kind of expectations is to stick to its announced policies fastidiously. If it announces that the federal deficit will be cut by $30 billion, it needs to cut it by $30 billion with no excuses. If its tax revenues are not as high as expected, then its public services must be trimmed. Should it announce policies and fail to carry them out, it will have less credibility and its future announcements will not have the desired effect. Once it announces one or two policies and carefully follows through, however, it will be able to reduce inflation without causing much of a drop in employment or production.

These steps to make government policies better understood and more systematically implemented are necessary mainly because many people do not think government is credible anymore. For the last eight quarters, the government has allowed the supply of money to grow at a rate much faster than the announced target rate. Likewise, for several years it has allowed the federal deficit to become far larger than anyone wanted or predicted. People could easily expect the government to continue these inflationary policies despite the trumpeting to the contrary.

Recession: Not Necessary

What this means is this: although a serious anti-inflation policy is beginning, it is largely unanticipated. The costs will therefore be higher than for any subsequent actions, actions taken after the government has demonstrated that it intends to do what it says. This policy will most likely produce mixed results--the desired lower rate of inflation should be coupled with an uninvited slowdown in output.

The slowdown in output, though, ought to be less severe than a recession. This is not to say that we are certain of dodging a recession. A major work stoppage, a harsh winter, or anything else that hits the economy with a particularly hard shock could cause a recession. Should something like that happen, the hardship would probably be blamed on the new anti-inflation policy. This would be unfortunate. If we get burned putting out the fire, we shouldn't blame the fire hose.

The threat of recession exists primarily because past policies have added gas to inflation for so long. There have been mammoth federal deficits year after year, the money supply has expanded rapidly, and government regulation has become increasingly burdensome. Such policies have made people anticipate more inflation and be skeptical of government efforts to fight inflation. This makes the economy more fragile and makes lowering the rate of inflation more costly than it needs to be. But letting inflation continue would be even more costly. Doing this would risk a major recession and a serious collapse of international trade.

The chances are that the costs of the new anti-inflation policy will be minor compared with the benefits. For the government, the most immediate and useful benefit will be a potent new weapon for fighting inflation: increased credibility. As the government gains credibility, it can keep lowering the rate of inflation a little at a time, each time with less impact on output and employment. The more credibility the government gains, the easier it will be to bring down inflation without reducing real economic activity, because people's expectations will be working to fight inflation, not to aggravate it. In fact, if the government had enough credibility, it could not just reduce inflation by a few percentage points but eliminate it almost entirely with very little real cost. For the moment, though, it is necessary to build that credibility by cutting the deficit, slowing the growth of the money supply, and reducing the jumble of government regulations as promised.

To make the anti-inflation plan work, the government must deliver on its promises better than it has in the past. After all the hoopla, it will be soundly embarrassed if it does not deliver. Worse, it will have tremendous difficulty making people believe in the next anti-inflation plan. If the current plan fails because the government does not keep its word, the costs of the next one--in lost output and employment--will be unnecessarily high, because people's expectations will be working against it.

But if the government does attack the fundamental causes of inflation as promised, inflation will begin to retreat and future battles will be less damaging to the economy. Then, even the gloomiest economists will have to whistle a different dirge.