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Chapter 14

Recession Slows Inflation

Over and over again lately the refrain is heard: A recession will not cure inflation. It is a theme with variations. Some say it would take a disastrous depression to have any effect on inflation—and who wants that? Others say that a slowdown might have some effect but only if it lasted five or ten years. Still others take a "positive" view: the only way to stop inflation is with wage and price controls. Once in a while there is an appeal to "history": since the inflation rate kept right on rising during the last recession, which was the worst since the 1930s, what can another recession be expected to do?

The record of recessions and inflation does not support any of these positions. It does support this statement: no significant decline in the rate of inflation has occurred that was not associated with a slowdown or recession, and virtually every slowdown or recession has been accompanied by a reduction in the rate of inflation. The statement holds not only for the United States, but also for Britain, West Germany, and Japan (see Figure 14-1). Taking all four countries together, there have been twenty-seven instances of slowdown or recession in economic growth between 1950 and 1975, and twenty-six instances of significant declines in inflation rates. There is virtually a one-to-one correspondence between the slowdowns or recessions and the declines in the rate of inflation.

In view of this record it seems to me reasonable to expect that another recession will be accompanied by another significant decline in the inflation rate. When something has happened twenty-six times

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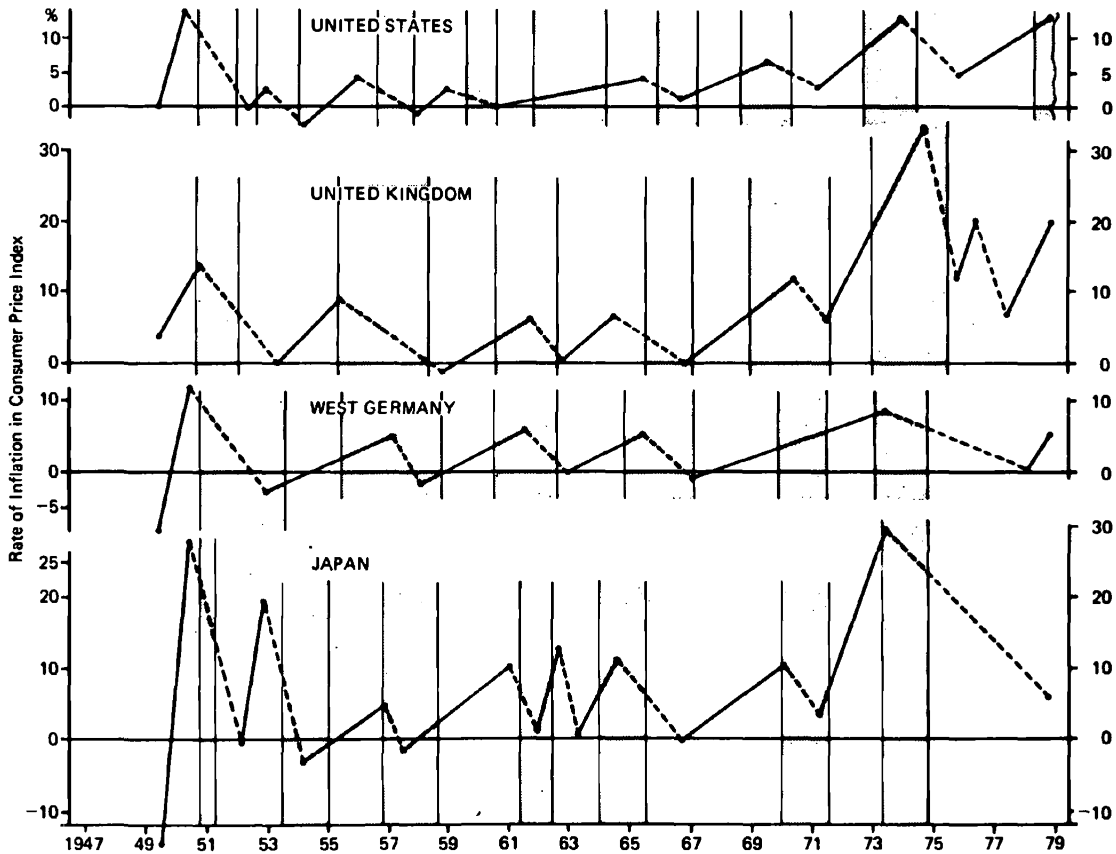
Figure 14-1. Does Recession Slow Inflation? Evidence from Four Countries.



Note: Shaded areas are growth slowdowns or recessions. Declines in inflation rate are marked ----.
Source: Center for International Business Cycle Research, Rutgers University.

it is quite likely to happen again. It also seems reasonable to assume—since the four countries have tried almost everything—that nothing else will do it.

This is not to say, however, that a recession will "cure" inflation, that is, bring the rate down to zero. Some recessions have done this, but many have not. Nor is it to say that the inflation rate will start moving down as soon as a recession starts. In some cases the inflation rate has lagged, and not started down until a recession was well under way or indeed almost over. In other instances, however, it has not lagged. As a matter of fact, again taking the record for all four countries as a whole, downturns in the rate of inflation have started at just about the same time, on the average, as downturns in the economy.

To understand this, look at some of the factors at work. In a recession, businesses try to cut costs, and are often successful. They are forced to shave profit margins and give discounts to get rid of heavy inventories. The cost of holding even a normal inventory—in terms of interest charges—is likely to prove excessive. Some businesses fail, and sell out for what they can get. Overtime work is cut back or eliminated, which not only reduces costs but reduces the incomes of workers who have been earning the higher overtime rates. Layoffs occur, wage increases are deferred, and the uncertainty about jobs and earnings makes people cautious about spending for frills, postpone big ticket purchases, seek ways to economize, borrow less. Construction projects get postponed, delayed, or stretched out. Banks take a hard look at new loans, and may urge repayment instead of refinancing of existing loans.

All these factors make it more difficult to raise prices and more difficult to get wage increases. More prices remain steady and some fall. The price indexes go up less rapidly; that is, the rate of inflation declines.

This process usually begins in one or more lines of business before recession strikes the economy as a whole. If the influence of these sectors on the price level is significant enough, the overall rate of inflation may decline before the onset of recession. If not, there will be a lag.

The effects of recession on inflation show up at the grocery store, at the haberdashery, at the auto dealer's. Look for markdowns and discounts. Some of this price cutting, like the coupons in newspaper ads, does not get into the statistics. The coupons are a form of paper money, and their supply is apt to increase in a recession. Unlike real paper money, however, they reduce inflation.

Look at the wholesale commodity markets, where things like scrap steel, hides, print cloth, and lumber are sold. These markets react quickly to weakness in demand, and if the weakness is widespread the reaction will be widespread, too. Buyers of merchandise and materials for manufacturers, wholesalers, and retailers are always aware of such trends. The National Association of Purchasing Management surveys its members every month on whether the prices they are paying are going up, remaining the same, or going down. The percentage reporting price increases is a highly sensitive indicator of what is happening in these markets—perhaps surprisingly so, since the survey does not even ask how big the price changes are or what prices are changing. It is really a report on the buyers' feel of the market, but they are experts and are paid to know.

Another sensitive indicator of these commodity markets is the Bureau of Labor Statistics' weekly index of spot market prices of thirteen industrial materials. This index has declined in every recession since 1948, and in every economic slowdown as well. The declines in this index have preceded the declines in the rate of inflation, as measured by the Consumer Price Index, in every instance. One should look not only at the index, but also at its thirteen components, to see whether weakness is running across the board, or affecting only one or two commodities.

When price reductions in these markets become the rule rather than the exception, and if other signs of recession have also multiplied, a declining rate of inflation in consumer prices will probably not be far off.