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Inflation should not change how policymakers respond to recession

Policy Memo • By Josh Bivens • January 18, 2023

The next recession may hit while inflation remains above the Federal Reserve's preferred 2% inflation target. This will lead many to claim that policymakers are constrained in how aggressively they can use the traditional tools—lower interest rates and fiscal relief—to fight the recession. This is not true. If the U.S. enters a recession next month (with year-over-year inflation rates still running at 7% or higher), policymakers should still move quickly to cut interest rates and undertake significant fiscal relief. This argument is based on the following observations:

- Inflation is already normalizing rapidly in the U.S.—a recession is not needed to move it down faster than it is already receding, and hence there is no need to tolerate a recession for longer than normal in the name of normalizing inflation.
- Recessions reliably put downward pressure on inflation and nominal wage growth. Given today's trajectory of inflation and wage growth, and given the normal downward pressure recessions put on these, any recession will end with the Fed's inflation target very close to being met regardless of the policy response.
- Even before the COVID-19 recession, there were persuasive arguments that the Federal Reserve's 2% inflation target was too low. If this is true, it is obviously not necessary to tolerate a recession for longer than normal to get all the way back down to 2%.
- Some claim that the "Volcker shock" of the 1970s and early 1980s showed the benefit of not providing

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stimulus in the face of a steep recession as it was this steadfastness in tolerating high unemployment that broke the inflation of the 1970s. Much of this is wrong—but most fundamentally, Paul Volcker's Fed reduced interest rates *significantly* when an actual recession hit.

- In 2008, a shock to oil prices pushed up inflation modestly even while the U.S. economy was in the beginning of what would turn out to be a fierce recession. This modest inflation shock delayed strong actions from the Fed, making the subsequent recession worse.
- Finally, this debate reinforces how important strong automatic stabilizers are for the economy—and the U.S. currently lacks these. Automatic stabilizers would pull much of the debate about the appropriate response to any given recession out of a polarized political realm and would instead respond simply based on hard economic metrics.

Below, I provide more background on why these observations are true and should guide policymakers.

The economics of recessions and what it means for policy

Contrary to what many think, economics has provided a near certain remedy for ending recessions: using the tools of monetary and fiscal policy to boost economywide spending. The main monetary policy tool is lowering interest rates, and the main fiscal policy tools are transfers of resources to spending-constrained households and the direct expansion of public goods and services. There is a long and convincing research literature demonstrating conclusively that such remedies work if applied together and at scale (and that other proposed remedies are either a sideshow or totally ineffective).

When the economy has remained stuck in a recession or a too slow recovery for extended periods, it is because these tools have not been used concurrently or at the proper scale. The clearest example is the decade-long period when the economy operated in a depressed state following the financial crisis and Great Recession of 2008–2009. This period is fully explainable by the failure to use fiscal policy appropriately during that time, with spending austerity throttling growth and job market recovery after 2011.[2]

The post-2011 fiscal austerity that impeded growth from the Great Recession had clear political roots: Republican policymakers—both at the federal and the state level—thought that the political credit for a rapid recovery would accrue to the benefit of the Obama administration and so actively sought to slow it with spending austerity. This spending austerity was promptly reversed once the Trump administration took power.[3]

Inflation is no excuse to meet the next recession with austerity

Given the divided government after the 2022 midterm elections, the prospect of the Republican House majority blocking needed recovery efforts if a recession occurs in 2023 or 2024 seems likely. In the earlier episode after 2011, Republican austerity was enforced by gamesmanship over the debt ceiling, and the rationale for this austerity used vague appeals to fiscal responsibility.

The debt ceiling remains a troubling potential tool that could be used to enforce spending austerity in coming years. But another problem is that the *rationale* for austerity—the need to enforce fiscal discipline—will likely receive undue respect in much economic reporting and commentary. The burst of inflation in 2021 and 2022 has often been blamed on overly generous fiscal relief in response to the COVID-19 recession. Further, it is often claimed that getting inflation back to the Federal Reserve's 2% inflation target is the policy goal that must trump all others. If one believed both of these claims, the argument for not fighting the next recession with aggressive fiscal aid if the recession starts with inflation at elevated levels might make some sense.

But neither of these claims are true. The inflation of the past two years is not the result of excessive fiscal stimulus—it is instead the result of enormous global economic shocks (pandemic and war) hitting the U.S. economy and causing large (but steadily dampening) ripples. Further, whenever recession does hit, it will put ferocious downward pressure on all sources of inflation. Whatever inflation is when the next recession starts, it will be very close to—or even below—the Fed's target when the recession ends, even if we appropriately fight the recession with monetary and fiscal policy.[5]

Recessions almost always occur when economywide spending by households, businesses, and governments (aggregate demand, in the jargon of economists) falls short of the economy's productive capacity. This productive capacity (sometimes called potential output) is a measure of the value of goods and services that could be produced in the economy if all productive resources were fully employed. The most important of these productive resources is, of course, labor. Thus, the economy's potential output can be reached only when unemployment is very low. Other productive resources include the economy's capital stock—factories, equipment, and real estate needed for businesses or the public sector to produce goods and services.

If aggregate demand is weak, there are too few customers (including of public goods) to justify using all available resources in production (because some of the output produced would go unsold). The answer to this imbalance of aggregate demand and potential output is simple—cut interest rates to encourage more spending and less saving, and use the power of the federal government to run deficits to finance direct transfers to low- and middle-income families (the ones most likely to translate these increased resources into new spending right away) and to directly provide more public goods and services (for example, pull forward infrastructure investments).

This recommendation does not really *ever* change depending on the state of inflation, and it certainly does not change for the U.S. economy of 2023. For one, recessions put completely predictable downward pressure on inflation. For example, since the 1960s, price inflation has fallen 1.8% on average between the beginning and end of recessions, while nominal wage growth has fallen 1.6% on average.[6] Given the consistent normalization of inflation and nominal wage growth that already occurred in the second half of 2022, a price and wage deceleration of these amounts would be fully sufficient to quickly return the economy to growth rates consistent with the Fed's 2% price inflation target. We do not need a recession to restore inflation to normal, and a recession should not be allowed to linger in the name of fighting inflation.

Theoretically, one could imagine entering a recession with inflation far above the Fed's 2% target (say 6%) and exiting the recessionary period (if it is very short) with inflation still higher than this (say 4%). The first thing to note about this hypothetical is that if inflation is thought to be too high at both the beginning and the end of a recession, then inflation almost by definition is not being driven simply by excess demand (as recessions are evidence of deficient demand). Given this, imposing a "cure" (allowing a recession to grind on) that utilizes aggregate demand restraint is not a direct solution.

In the 1970s, there was much talk of this kind of *inertial* inflation, in which too high inflation persists through recessions. It is true that inertial inflation can be broken by a long and steep recession. But making this an intentional policy goal would impose *far* too large a collateral cost relative to the benefit of doing this.[8] Bringing down inertial inflation (which again, is not the type afflicting the United States today) should be done with gradual tools that don't require mass unemployment. Further, even before the COVID-19 shock there was a convincing case to be made that the Fed's 2% inflation target was too low.[9] The benefit of returning the economy to this potentially excessively low target certainly cannot be worth extending a recession.

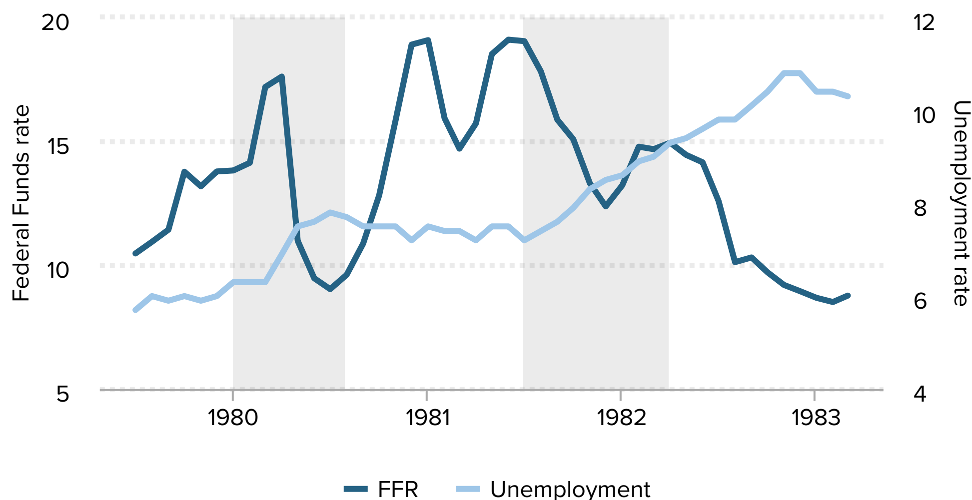
Even Paul Volcker pivoted and slashed interest rates when outright recession hit

The inflation of the late 1960s and 1970s was reduced significantly in the early 1980s by a long and extremely costly recession. (Unemployment rates peaked at just under 11% in 1982.) This recession was largely caused by the Federal Reserve—then led by Chair Paul Volcker—raising interest rates to just under 20%. This so-called Volcker shock is often interpreted as Volcker steadfastly refusing to relent on raising interest rates even as recession hit. It is clearly true that interest rates were historically high (and likely inappropriately so—though that's another debate) for much of the recession and recovery period. But it's not true at all to say that Volcker did not cut rates as recession struck. In fact, as **Figure A** shows, the Fed cut interest rates rapidly and sharply as the unemployment rate rose.

Figure A

Even the Volcker Fed slashed interest rates during recessions

Unemployment and the federal funds rate, 1979–1983



Note: Recessions are shaded gray.

Source: Author's analysis of Federal Reserve Bank of St. Louis, "Federal Reserve Economic Data (FRED)" (database), n.d., accessed December 2022.

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Further, this easing of monetary policy occurred even as fiscal policy pivoted to being extremely expansionary in the recession and early recovery. **Figure B** (reproduced from Bivens 2016) shows that real per capita public spending grew far more rapidly following the 1980s recession than in any recession since.

In short, it is untrue to suggest that the early 1980s "Volcker shock" showed the benefits of keeping macroeconomic policy contractionary even in the face of outright recession. Instead, both monetary and fiscal policy were made far more stimulative as recession hit. There is no historical episode proving the benefits of failing to fight recessions in order to fight inflation.

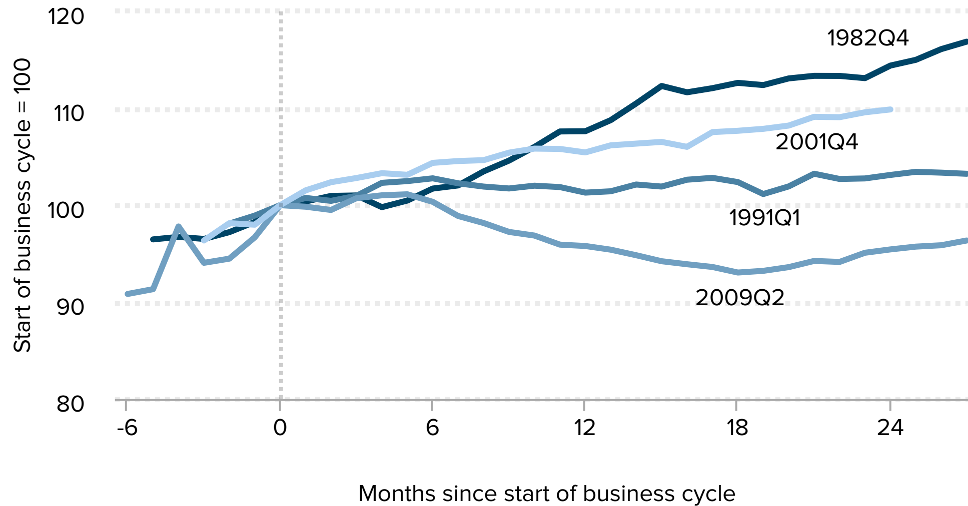
Even small delays in implementing anti-recession policy can hurt

In 2008, as the economy was clearly already in a recession (which had been modest up to that point but would turn out to be devastating), oil prices surged due to global factors. This high oil price inflation became a big political issue and led the Fed to delay its full recession-fighting actions. At a Federal Open Market Committee (FOMC) meeting in September 2008—just one month before the collapse of Lehman Brothers kicked recessionary job losses into a much higher gear—the Fed decided against implementing

Figure B

Fiscal austerity explains why recovery has been so long in coming

Change in per capita government spending over last four business cycles



Months since start of business cycle

Note: For total government spending, government consumption and investment expenditures deflated with the NIPA price deflator. Government transfer payments deflated with the price deflator for personal consumption expenditures. This figure includes state and local government spending.

Source: EPI analysis of data from Tables 1.1.4, 3.1, and 3.9.4 from the Bureau of Economic Analysis (BEA), "National Data: National Income and Product Accounts" (data series), n.d., accessed December 2022.

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further monetary stimulus. Transcripts of the meeting have subsequently shown that this decision was largely due to worry about the oil price shock: Participants in the meeting seemed more concerned with inflation as the greatest imminent danger to the economy. History decided very quickly which side of that debate was right, and less than a month later the FOMC called an emergency meeting to undertake expansionary policy moves.

This was not an instance of the Fed intentionally tolerating a longer or worse recession *per se*. It was mostly poor judgement about whether the monetary stimulus the Fed had already undertaken (along with the modest fiscal stimulus that had already occurred) would be sufficient to end the recession. But intentions aside, this example shows that when inflationary fears are used to delay or water down recession-fighting efforts, there are severe consequences.

Automatic stabilizers would shield this debate from partisan politics

This danger that some policymakers might opportunistically use the higher inflation of the past year to block needed fiscal stimulus during the next recession highlights again that a more robust system of automatic stabilizers should be a key priority. Automatic stabilizers

are programs that put more resources into the economy when it slows on a formulaic basis and without the need for ad hoc legislation. Examples are unemployment insurance, food stamps, Medicaid, and progressive income taxes.

However, in the U.S. automatic stabilizers are far too weak. In the recovery after the Great Recession, this was a problem because policymakers cut off fiscal aid more quickly than a strong system of conditions-based automatic stabilizers would have.[12] For those worried about the potential inflationary effects of large fiscal aid packages passed in 2021, automatic stabilizers that ramped down as the unemployment rate hit conditions-based targets earlier than expected could have perhaps allayed their fears.

Regardless of whether one thinks that the primary problem of fiscal aid in recent decades is that it has been inappropriately long-lived or inappropriately stingy (I certainly weigh in on the "too stingy" side), this dispute could be solved to everybody's satisfaction if automatic stabilizers were more robust. The fact that partisan political positioning becomes a key concern every time the proper scope of fiscal relief following a recession needs to be determined is a big problem for the U.S. economy.

Notes

1. For relatively recent review of effectiveness of fiscal policy, see Wilson 2020. For evidence on monetary policy effectiveness, see Blinder and Zandi 2010. There is lots of evidence that monetary policy is asymmetric—it's much stronger in a contractionary phase than an expansionary phase. There is also evidence that monetary policy gets less and less effective the closer to zero interest rates get. Nevertheless, if one wants more aggregate demand and the only tool available is interest rates, they should be moved lower.

2. For evidence on this, see Bivens 2016.

3. For evidence on this, see Bivens 2018.

4. See Banerjee and Bivens 2022.

5. On the disinflationary effect of recessions and higher unemployment, see Blanchard, Cerutti, and Summers 2015. While this paper mostly emphasizes a reduction in the responsiveness of inflation to unemployment over time, the estimates still indicate that higher unemployment is associated with lower inflation. Further, the previous time periods when the relationship between unemployment and inflation was stronger saw inflation rates much closer to today's rate. There is a lot of reason to think that the responsiveness of inflation to unemployment is substantially stronger when inflation starts at a higher pace.

6. Author's calculations based on Federal Reserve Bank of St. Louis data n.d.

7. See Bivens 2022 on this consistent normalization.

8. On the different types of inflation—including inertial—see Tobin 1974.

9. On the Fed's 2% inflation target being too low, see Bivens 2017.

10. Many accounts highlight the damaging role that excess unemployment played in harming wage growth for typical workers after 1979 (see, for example, Bivens and Mishel 2021). But the excess

unemployment (i.e., unemployment that could have reliably been avoided with different Federal Reserve policy) in the 1979–2007 period occurred mostly during the recovery and expansionary phase of the business cycle, not during the recession. During recessions, the Fed has traditionally tried reasonably hard to engineer lower unemployment. But during recoveries, it has unnecessarily kept interest rates (and hence often unemployment) higher than they need to be to keep inflation in check. In short, the real damage of too-austere monetary policy was that it cut recoveries and expansions short.

11. See Appelbaum 2014 on how the Fed misread this moment in 2008.

12. For steps to improve the unemployment insurance system, see Bivens et al. 2021.

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