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What New Economy?

Why the new economy doesn't mean boundless growth with zero inflation.

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Economics has many myths. One is that in this “new economy” the “old rules” no longer apply—we can now have high growth with low inflation, indefinitely. A second is that inflation is dead, slain by the forces of globalization. As a professional economist, I find it difficult not to groan and roll my eyes as I read these claims.

You’ve no doubt read various pop economists arguing that the North American economy has, over the past few years, entirely rewritten the traditional rules of economics. Strong growth and a large decline in the unemployment rate have occurred together with a *reduction* in inflation. Isn’t high growth and low unemployment supposed to lead to more inflation, not less? If you listen to the pop economists, it has something to do with globalization and the rise of the information economy, though exactly how these things have caused inflation to disappear is never made clear.

There is actually nothing puzzling or new in the North American economy’s remarkable performance. The key to understanding recent events is what economists call a supply shock. A supply shock is any event that causes firms’ costs to change. Some supply shocks raise costs, such as an increase in the price of oil, as happened on a huge scale twice in the 1970s when OPEC restricted the oil supply. Other supply shocks reduce firms’ costs—this is precisely what happened when the 1997-98 Asian crisis produced a world glut in commodities.

As the Asian countries fell into recession, their demands for raw materials dropped precipitously. Since they make up a large part of world demand, this caused a huge fall in raw materials prices. But for all countries that use raw materials in their production, and there is no bigger user than the United States, this glut of raw materials was a boon to business. Resourcebased firms that produce these commodities were hurt by this glut. But the many more firms making cars, machinery, furniture, clothing, food, and computers benefited tremendously.

How does the Asian crisis explain the apparent paradox of high growth and low inflation in North America? As raw materials prices fell, so did firms' costs, leading them to cut prices. But as prices fell, consumers were naturally led to demand more goods, and this caused firms to increase their production. The Asian supply shock therefore led to a rise in growth and a fall in inflation. There is no "new economy" at work here, just an ordinary supply shock.

How about the "death of inflation"? Though various shocks affect inflation in any given year, *sustained* inflation is caused by the rate of growth of the money supply, which is determined by the actions of central banks. The close relationship between inflation and the money supply has been borne out by experience in many countries over many years. Countries that print money at higher rates also have higher inflation. This relationship is also at the heart of famous hyperinflations, from Germany's in the 1920s to Russia's in the 1990s; in each case, the cause of the hyperinflation was the printing of money at astonishing rates.

This long-run relationship illustrates why inflation is not dead. The long-run path of inflation is determined by central banks; there is nothing about globalization that guarantees us a future with low inflation. In Canada and elsewhere, the central bank's continued vigilance is necessary if inflation is to remain low.

Speaking of low inflation, should we always want it as low as possible? On the whole, economists agree that inflation is bad, distorting rational economic decisions and discouraging saving and investment. They also agree that printing money causes inflation. It seems to follow that rapidly increasing the money supply is always a bad thing. But this isn't quite right. Economics is full of subtleties, and one of the most important is the distinction between the long-run and short-run effects of particular policies. And this distinction is nowhere more important than in the case of Japan, an economy that has been shrinking or stagnant for the past six years.

Japan needs to print more money. If the Bank of Japan were to increase the growth rate of its money supply, real interest rates would fall and the yen would depreciate. The first effect would stimulate domestic investment, the second would stimulate Japanese exports. On both counts there would be an increase in the demand for Japanese goods and thus an increase in production by Japanese firms. Eventually, Japan would crawl its way out of recession. Crazy? No. This strategy is in fact widely accepted by mainstream economists. From MIT’s center-left champion Paul Krugman to the Hoover Institution’s ultra conservative Milton Friedman, most economists agree that what the Japanese economy really needs is a strongly expansionary monetary policy.

If the solution is so simple, why isn’t the Bank of Japan doing it? The Bank of Japan is apparently afraid of inflation. After all, they know all about the long-run effects of printing money. But this fear is misplaced—it confuses the short-run and long-run effects of printing money. Printing more money leads to more inflation only because it first causes an increase in output above the economy’s capacity to produce. But Japan is mired in recession: its output is so far below the economy’s productive capacity that it would take two or three years of rapid growth to approach that constraint. A commitment by the Bank of Japan to print more money will immediately begin increasing output and generating the much-needed economic recovery. Only a few years down the road will inflation rise. At that point, and with the recession behind it, the Bank of Japan can reduce the growth rate of money to keep inflation in check.

Is there a punchline to all of this? Unfortunately, the honest punchlines in economics are neither funny nor memorable. But feel secure in the knowledge that the “old rules” of economic orthodoxy still work. And the next time you read something about the “death of inflation,” feel free to roll your eyes. As for Japan, hopefully it won’t go down in the textbooks as the classic example where the central bank’s misplaced fear of inflation resulted in permanent stagnation.