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Economics focus: Beyond the business cycle?

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Abstract (Summary)

Early in 2000, the US will set a new record for the length of an economic upswing. However, it is wrong to include that the business cycle is dead. The built-in forces that drive the business cycle are still there in numbers, masked though they may be by the unusual convergence of circumstances seem in the late 1990s.

Full Text (1009 words)

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[Headnote]
Early in 2000, America will set a new record for the length of an economic upswing. But it is wrong to conclude that the business cycle is dead

TWO main versions of the "new paradigm" have attracted followers in America lately. One says that the country's long-term growth rate has shifted upwards. The other says that the old pattern of boom and bust has disappeared. America's current expansion makes both claims plausible. But they should not be muddled up. Even if the trend of growth in productivity had shifted higher, there would be no reason to expect, as a result, greater stability year by year. Growth optimists who also believe that the next recession will never come are piling a second set of brave assumptions on top of the first.

Victor Zarnowitz, a business-cycle scholar (and director of research at the Foundation for International Business and Economic Research in New York), set out a taxonomy of recession-free thinking in the Spring 1999 issue of the Journal of Economic Perspectives. The optimists, he says, point to one or more of the following:

* Downsizing. After years of squeezing costs, American businesses are said to be leaner and meaner-- and more robust in the face of fluctuating demand. But this effect seems likely to be one-off. Initially, efforts to cut labour costs should increase profits and raise unemployment; later, as displaced workers find new jobs, the consequence will be higher productivity and output. But sooner or later rising demand causes firms to increase their payrolls; any fall in demand would again leave them overmanned. The basic cyclical friction involved in waves of downsizing and upsizing is unchanged.

* Technology. There's a lot of it about. By and large, however, greater use of Pcs and so on is more plausible as a cause of faster growth than of greater stability around a steeper trend. A possible exception is:

* Inventory control. This looks more promising. Inventories do propagate and amplify other fluctuations. Imagine a fall in demand. In the first instance, inventories increase. But if the shortfall in demand persists, inventories are run down, leading to an even sharper fall in output. Just-in-time methods, made possible by the computing revolution, have spread; the ratio of manufacturing and trade inventories to sales has been moving gradually lower. On the other hand, investment in inventories has been about as volatile and as cyclical this decade as in the past-and inventories, though smaller than before, are still big enough to exert a clear cyclical effect. Cycles might be a bit gentler than before, therefore, but you would not expect them to disappear.

* Growth of services. Again, the optimists have a point. The decline of manufacturing and the rise of services should be helping to reduce volatility, because demand for services is usually more stable than demand for manufactures. But this may be changing. Services are becoming more cyclical: output of business and consumer services declined in the recessions of 1981-82 and 1990-91, whereas in previous downturns their growth had merely slowed.

* Deregulation. As with technology, it is easier to see how deregulation might raise the trend of growth, rather than stabilise output around the trend. One oft-cited case of stability-enhancing deregulation was the abolition in the early 198os of Regulation Q, which put a ceiling on interest rates paid on deposits. Under this rule, if short-term market rates went up, deposits would be withdrawn from banks and thrifts and put in the money market. Result: less bank credit, and a stronger cyclical pattern of demand. It is an effective example, but not a typical one. As a rule, deregulation exposes firms to greater competition, implying more growth but less stability. At

best, then, deregulation seems neutral so far as the cycle is concerned.

* Better government. Central banks have learned to manage the economy so well, it is sometimes argued, that they have more or less abolished the cycle. It also helps, on this view, that governments are less inclined than before to use fiscal policy in attempts to stabilise--efforts that, as often as not, had the opposite effect. Nice though it would be to believe this, there are many problems with it. The biggest is that, by their own account, Alan Greenspan and the Fed are as mystified as everybody else is by what is going on in the economy. Another is that we have heard it all before. The popularity of "Now we know better" as an explanation for growth ranks high among the most reliable leading indicators of recession.

* Globalisation. At first sight, this seems to make more sense. Increasing integration with the global economy reduces the dependence of the American economy on domestic demand; it also opens new channels of supply, reducing inflationary pressures on costs and wages. Without question, in the past couple of years, global conditions have helped greatly to sustain America's expansion. Recessions in the third world and sluggish growth in Europe have kept the dollar up and American import prices down. This has given the expansion longer legs than it would otherwise have had. But there is nothing systematic about this stabilising pattern: it was just a fluke. If demand in the rest of the world had been as strong last year and the year before as it was in the United States, then America's expansion would have been much more inflationary. Instead of offsetting or suppressing the American business cycle, events in the rest of the world could have amplified it--and that in turn would have obliged the Fed to stop the expansion by raising interest rates.

The built-in forces that drive the business cycle--the sub-cycles of profits, inventories, investment and credit--are still there in the numbers, masked though they may be by the unusual convergence of circumstances seen in the late 1990s. America did not abolish the business cycle in the 1920S or the 196os, nor did Japan in the 198os, though many were certain of the fact on all three occasions. A downturn will come. The question is when, not whether.

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