Taking the Business Cycle’s Pulse

BY PAST standards, America's latest recovery is already mature. Since the second world war, periods of economic expansion there have lasted for an average of 50 months. Because it is now 55 months since the recovery started, it could be time to start worrying about the next recession. But how predictable is the business cycle? And are industrial economies on the brink of another recession, or simply in the foothills of a long upward climb? GDP figures for the third quarter of the year are just starting to trickle out. Britain's year-on-year rate of GDP growth slowed to 2.4% in the year to the third quarter, down from 4.3% 12 months ago. Although America's third-quarter figures, due out on October 27th, were likely to show a pick-up in the quarterly rate of growth, its 12-month rate of expansion was also expected to slow, to 2.8%, compared with 4.4% a year ago. Continental European economies have also slowed sharply of late, and surveys show that businessmen are gloomier about the future. As for Japan, its economy is barely inching its way out of the doldrums.

Few economists are actually predicting an outright recession in America or Europe over the next couple of years, but that "R-word" is popping up more and more frequently. For Europeans that is disconcerting, since their economic recovery has not been under way for as long as America's. Britain's is three-and-a-half years old, and those in Germany and France an even more youthful two-and-a-half years old.

In the near future, however, a recession looks unlikely, mainly because the symptoms that usually precede a slump—rising inflation, high interest rates or large financial imbalances in the corporate or household sectors—are missing. But few people foresaw the recession of the early 1990s. Economies have moved in cycles, from boom to slump, for centuries. There will certainly be another recession some day. The only question is when. Does past experience provide any clues? The snag is that business cycles come in all shapes and sizes. Since 1945 America's shortest expansion (measured from the trough to the peak in output) lasted only 12 months, in 1980-81; its longest was 106 months, from 1961 to 1969, during the Vietnam war. America's longest peacetime expansion was the 92 months up to July 1990. Such variability makes it impossible to guess at the life expectancy of a recovery solely on the basis of its maturity. Expansions have no natural lifespan.

There is no shortage of possible explanations for the business cycle. Some economists have blamed the effect on harvests of sunspot activity or the alignment of planets. Keynes blamed the inherent instability of investment caused by swings in the mood of producers from optimism to pessimism. Many recessions have been triggered by external factors, such as an oil-price shock or a trade war. There is probably no single cause of business cycles, which would help to explain why they still dance to such an irregular beat. Victor Zarnowitz, an economist at the University of Chicago and a leading expert on the business cycle, has dissected the ups and downs of America's GDP since the 19th century. The bad news is that, over time, the duration of economic expansions has become more variable and hence even less predictable. But the good news is that since the second world war, economic activity has been less bumpy (see chart). The volatility of quarterly GDP changes in the past half-century has been only one-third as high as it was in 1919-45.

Moreover, expansions have been longer and recessions shorter, as well as shallower. Since 1946 the average downturn has lasted only 11 months, the average expansion 50 months. In contrast, in 1919-45 the average cycle had only 35 months of expansion and 18 months of recession; and in 1854-1918 only 27 months of expansion and 22 months of recession. Cycles not only vary in shape over time, they also differ between countries (see box on next page). In Germany, for instance, recessions have been less frequent than in America, but when they occur they have tended to last longer.

[TABULAR DATA OMITTED]
Vanishing act

Extrapolating from these trends, optimists might conclude that recessions will eventually disappear altogether. One reason that the business cycle has become more muted is the shift in the structure of output and jobs from manufacturing to services. Many services are less cyclical than goods because demand for them is less sensitive to changes in income.

The growing share of the state in economic output has also made a difference. In recessions, governments, unlike firms, do not slash spending and jobs. In addition, as public spending and taxation have increased, so “automatic stabilisers” have become more important: unemployment benefits rise in slumps, while taxes fall.

Another factor that has made activity less volatile is the introduction of government deposit insurance, which has helped to prevent banking crises that once exacerbated downturns. More controversial is the alleged role of macroeconomic policy, which can stabilise or destabilise depending upon its timing. Fiscal stimuli have often been too big and come too late, fuelling tomorrow's boom rather than preventing today’s recession. On the other hand, monetary policy has helped to stabilise output over the past half-century. Previously, the money supply was allowed to shrink in line with output during recessions. Now central banks keep it on a more stable path, helping to cushion demand.

A popular argument for why economic cycles have become less bumpy, and why they may become even less so in future, is that producers are using better methods of stock (inventory) control. Computers and just-in-time production techniques allow firms to match output more closely to sales, and so avoid an unwanted build-up of inventories. Although stockbuilding is the smallest component of GDP, it has often played a big role in recessions. In the early part of a downturn, stocks pile up as producers are wrongfooted by a drop in demand. To trim stocks, they then cut output sharply. Swings in stockbuilding have accounted, on average, for more than half of the drop in GDP during post-war American recessions.

Thus, if fluctuations in stocks could be tamed, the business cycle could be made even flatter in future. However, a recent study by Andrew Filardo, an economist at the Federal Reserve Bank of Kansas City, finds little evidence that this has been happening. In the 1990-91 recession, the drop in inventories was no less significant than in the past, accounting for 59% of the (admittedly small) fall in GDP.

There is another version of the "business cycle is dead" school of thought which maintains that the present recovery could stretch indefinitely into the future. This argues that industrial economies are embarked on a long-wave expansion, driven by a surge in investment in information technology (similar in importance to the 19th-century development of railways and electricity) and the forces of economic globalisation. The result, it is argued, may be a faster potential growth rate—the maximum rate that can be sustained without stoking up inflation—and milder downturns. It is true that in periods of rapid growth economic downturns tend to be milder, as in Japan and Germany in the 1950s and 1960s. However, the evidence that America's potential growth rate has risen is flimsy. Indeed, a study by George Kahn, another economist at the Kansas City Fed, concludes that on the basis of a revised measure of GDP due to be introduced later this year, America's potential growth rate has actually fallen from 2.5% a year in the 1980s to 2% in the 1990s. A modest pick-up in productivity has been more than offset by slower labour-force growth.

History is littered with false pronouncements of the death of the business cycle. The correct question is not whether the current upswing will end; but when and why. The recent slowdown in America and Britain partly reflects rising interest rates over the past year. By preventing a runaway boom, these countries have most probably extended the lives of their expansions. The current spurt of growth is not about to expire— but nor is the business cycle.

COPYRIGHT 1995 Economist Newspaper Ltd. (UK)