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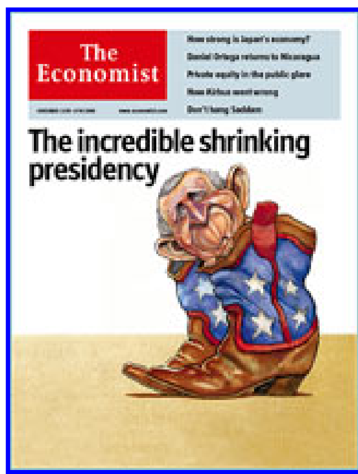

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SURVEY: THE WORLD ECONOMY

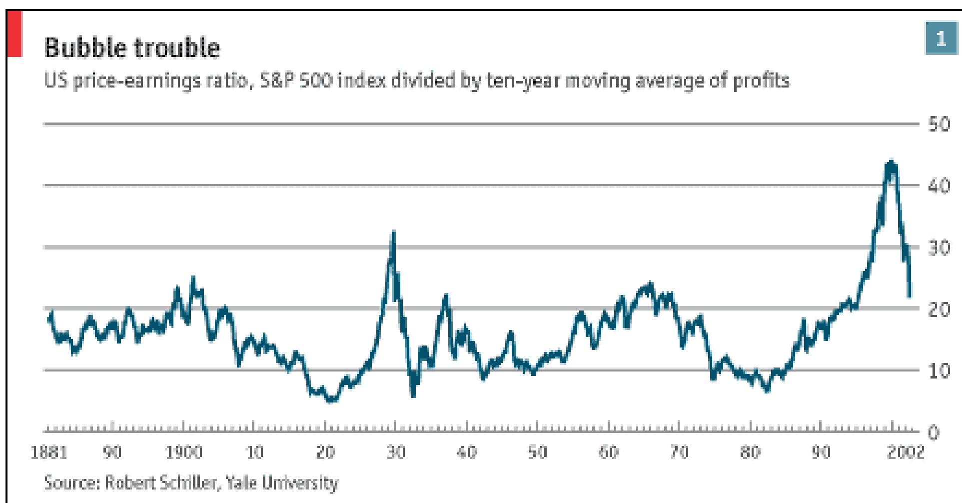
The unfinished recession

Sep 26th 2002
From *The Economist* print edition

Obituaries for the business cycle were premature. Indeed, economies could become more volatile again over the coming years, argues Pam Woodall, our economics editor

“IT'S only when the tide goes out that you can see who's swimming naked.” This famous remark by Warren Buffett, America's best-known investor, is a perfect description of what is happening in the American economy at present. The bubble in the late 1990s masked excessive borrowing by firms and households, widespread accounting fraud and the incompetence of company bosses, but now the effects of irrational exuberance and infectious greed are being shockingly exposed. Share prices have suffered their steepest slide since the 1930s. The tide has well and truly receded.

Yet most economists are still predicting robust economic growth of 3-3.5% over the next 12 months. Many of these are the same economists who in the late 1990s dismissed the idea that America was experiencing a bubble, and who insisted only last year that the economy was not heading for a recession. They were wrong then and are likely to be wrong again. America's economic downturn is not yet over. A protracted period of slow growth—perhaps even a further slump in output—is likely to expose more financial embarrassment of the Enron and WorldCom sort.



This is no normal business cycle, but the bursting of the biggest bubble in America's history. Never before have shares become so overvalued (see chart 1). Never before have so many people owned shares. And never before has every part of the economy invested (indeed, overinvested) in a new technology with such gusto. All this makes it likely that the hangover from the binge will last longer and be more widespread than is generally expected.

Three-way split

America's mild recession last year followed its longest unbroken expansion in history. The euro area, now in its ninth year of growth, has escaped outright recession, but has seen a sharp slowdown. In contrast, Japan's economy has suffered three recessions since its own bubble burst at the beginning of the 1990s. This survey will consider what the varying fortunes of the big economies reveal about the changing nature of the business cycle.

Views about governments' ability to tame the business cycle have themselves moved in cycles. In the 1950s and 1960s it was widely believed that Keynesian demand-management policies could stabilise economies: a slight touch on the brake or the accelerator was all that was needed. But the stagflation of the 1970s produced a new economic consensus that governments were powerless to do anything except restrain inflation. The business cycle returned with a vengeance: America had three recessions between 1974 and 1982. However, since then it has enjoyed two long booms, in the 1980s and again in the 1990s, interrupted only briefly by a mild downturn, leading many to believe that recessions were a thing of the past.

The “death” of the business cycle has often been exaggerated. In the roaring 1920s, just before the Great Depression, firms and investors thought the good times would never end. In the late 1960s, after what was then the longest expansion in history, America's Department of Commerce, deeming the business cycle to be defunct, changed the name of one of its publications from *Business Cycle Developments* to *Business Conditions Digest*, only for the expansion to end a year later. Again, in the late 1990s the “new economy” was thought to be immune to the business cycle, thanks to information technology, more flexible markets and globalisation. Yet economies, like drunks, continue to move in wavy lines.

Receding recessions

The business cycle is not dead, but it does appear to have become more subdued. During the past 20 years, the American economy has been in recession less than 10% of the time. In the 90 years before the second world war, it was in recession 40% of the time. In most other economies, too, expansions have got longer and recessions shorter and shallower. The exception is Japan, which in the past decade has suffered the deepest slump in any rich economy since the 1930s.

The revolt against Keynesian policies since the 1970s was based on the belief that government intervention destabilises the economy. However, America's recent experience shows that the private sector is quite capable of destabilising things without government help. The most recent bubble was not confined to the stockmarket: instead, the whole economy became distorted. Firms overborrowed and overinvested on unrealistic expectations about future profits and the belief that the business cycle was

dead. Consumers ran up huge debts and saved too little, believing that an ever rising stockmarket would boost their wealth. The boom became self-reinforcing as rising profit expectations pushed up share prices, which increased investment and consumer spending. Higher investment and a strong dollar helped to hold down inflation and hence interest rates, fuelling faster growth and higher share prices. That virtuous circle has now turned vicious.

Since March 2000 the S&P 500 index has fallen by more than 40%. Some $7 trillion has been wiped off the value of American shares, equivalent to two-thirds of annual GDP. And yet share prices still look expensive. Martin Barnes, an economist at the Bank Credit Analyst, a Canadian research firm, estimates that over the 40 years to 1995 the S&P 500 traded at an average of 15 times historic operating profits; today the ratio is 20. Moreover, experience shows that markets generally overshoot on the way down: at the trough of the previous bear market in 1982, the S&P 500 traded at only eight times profits.

For corporate America, the recession has been far from mild: profits and business investment have suffered their steepest decline since the 1930s. But despite the collapse in share prices, the economy as a whole has so far held up much better than expected. Consumer spending has remained strong, partly thanks to rising house prices that have offset some of the equity losses suffered by households. By refinancing their mortgages, households have been able to borrow more against the increased value of their homes. But debt cannot rise faster than household income forever. Eventually households will be forced to save more and spend less.

Optimists cling to the fact that growth in labour productivity remains strong, which should help firms to restore profits as well as ensure robust long-term growth. The slide in the stockmarket, they argue, largely reflects a crisis of confidence in corporate governance and accounting fraud, not deep-seated economic problems. They need to get some spectacles.

Diminishing returns

It is true that America has benefited from faster productivity growth since the mid-1990s (although the rise is less than once thought). But as with all previous technological revolutions, from railways to electricity to cars, excess capacity and increased competition are ensuring that most of the benefits of higher productivity go to consumers and workers, in the shape of lower prices and higher real wages, rather than into profits. Equity returns are therefore likely to be a lot lower over the next decade than the preceding one.

Mr Barnes reckons that investors will be lucky to see an average real return on equities of 5%, compared with 25% in the four years to 1999. As a result, households will need to save much more towards their pensions, which will drag down growth. And if the profitability of investment in IT turns out to be significantly lower than expected, investment will remain much weaker than in the late 1990s, eroding productivity growth.

The unwinding of America's economic and financial imbalances has barely begun. Share prices are still overvalued by many measures. Companies still need to prune much more excess capacity. Most worryingly, debts still loom dangerously large. Although much of the increase in reported profits in the late 1990s was illusory, the increase in corporate debt to finance that unprofitable investment was horribly real. Dresdner Kleinwort Wasserstein, an investment bank, estimates that American corporate balance sheets are more stretched than at any time during the past half-century.

American households' net worth is likely to shrink again this year, for the third year running, after a long, uninterrupted rise since the second world war. If lower share prices cause households to increase their saving sharply, America could be pushed back into recession. Even if saving rises more gradually, the economy is headed for several years of below-trend growth. A weaker dollar would help to cushion the economy, but only by squeezing growth in other countries. The rest of the world, which benefited so handsomely from America's speculative binge, will now have to share its hangover.

American short-term interest rates are already at their lowest for 40 years. If the economy went back into recession now, the Fed would have little room to cut rates. Recession would reduce inflation from its already historically low level of around 1%, raising the risk of a deflation along Japanese lines. Falling prices would increase the real debt burden, reduce spending and so push prices even lower.

The bursting of a bubble is much riskier when inflation is low, and inflation in America today is even lower than it was in Japan in the early 1990s. Even if America escapes deflation, low inflation will mean that wages and profits grow more slowly, making it harder for firms and households to work off their debts.

Vicious cycles

Over the past decade investors, firms and consumers put far too much faith in the power of information technology, globalisation, financial liberalisation and monetary policy to reduce volatility and risk. IT, the very sector that was supposed to smooth out the business cycle through better inventory control, has ended up intensifying the current downturn.

In principle globalisation can help to stabilise economies if they are at different stages of the cycle, but the very forces of global integration are likely to synchronise economic cycles more closely, so that downturns in different countries are more likely to reinforce one another. Financial liberalisation is supposed to help households to borrow in bad times and so smooth out consumption, but again it is a two-edged sword: it also makes it easier for firms and households to take on too much debt during booms, which may exacerbate subsequent downturns.

Alan Greenspan is widely considered a highly successful chairman of the Federal Reserve, but the belief that he has special powers to eliminate the cycle is foolish. In July 2001 Mr Greenspan himself said in testimony to Congress: “Can fiscal and monetary policy acting at their optimum eliminate the business cycle? The answer, in my judgment, is no, because there is no tool to change human nature. Too often people are prone to recurring bouts of optimism and pessimism that manifest themselves from time to time in the build-up or cessation of speculative excesses.”

Indeed, speculative excesses in asset prices and credit flows might occur more frequently in future, thanks to the combined effects of financial liberalisation and a monetary-policy framework that concentrates on inflation but places no constraint on credit growth. The current conventional wisdom that central banks will reduce economic and financial instability by keeping inflation low and stable is flawed. Low inflation is no guarantee of economic stability.

If the Fed had increased interest rates sooner in the late 1990s, America's economy might now be in better shape. Some economists worry that it may be making a similar mistake now by allowing low interest rates to encourage a rapid increase in house prices and mortgage borrowing. The Fed may be offsetting the bursting of one bubble by inflating another.

This survey will analyse the causes of recessions, examine whether economies are becoming more or less volatile and ask what policymakers can do to prevent downturns. It will also explore the controversial idea that recessions are a necessary, sometimes even desirable feature of economic growth: they purge the excesses of the previous boom, paving the way for the next expansion.

Its two main conclusions will not make comfortable reading. They are, first, that after decades of declining economic volatility in developed economies, the business cycle is likely to become more volatile again over the coming years; and second, that America's “recession”, defined as a period of growth significantly below trend (and hence accompanied by rising unemployment), is far from over. Until America's excesses have been purged, robust growth is unlikely to resume.

The job of policymakers is ideally to curb the build-up of speculative excesses. If they fail, then their task is to ensure that recessions do not become too deep, rather than try to prevent them altogether. Such efforts simply leave large economic imbalances. An economy that has been on a binge will inevitably suffer indigestion. Stuffing it with yet more credit is unlikely to aid its recovery.

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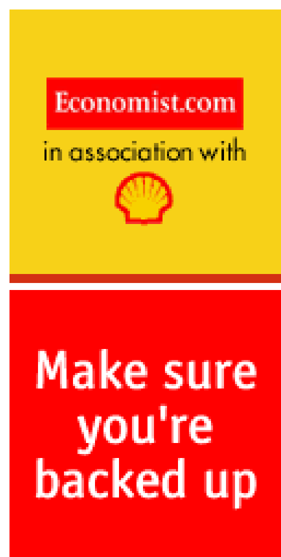

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