After the bubbles
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Brace yourself for a bumpier time ahead

DESPITE the slump in share prices, most economists reckon that America's economy will continue to recover this year. They believe that the post-bubble recession was mild thanks to the Fed’s superb monetary policy and the American economy’s amazing flexibility. In reality, though, America's first recession of the 21st century may not be over.

The optimists base their forecasts on their belief that America's economy is “fundamentally sound”—or as sound as an economy can be with inadequate saving, far too much debt and a massive current-account deficit. America not only had a stockmarket bubble in the late 1990s, it experienced a wider economic bubble that distorted decision-making across its whole economy. This created excesses that need to be purged before the economy can return to vigorous and sustainable growth.

Firms have made great strides to cut costs and capacity, yet corporate debts still look uncomfortably large, so further pruning is likely. Troublingly, consumers have continued to borrow as if little has changed. By slashing interest rates, the Fed has encouraged a house-price boom that has partially offset equity losses and allowed households to take out bigger mortgages to prop up their spending. But for how long? House prices are high in relation to income, so the room for further gains is limited. Households’ debt-service payments are also close to a record high, even though interest rates are low.

Households cannot keep borrowing at their current pace. At some stage they will need to start saving more and spending less. If this happens abruptly, it will trigger another, deeper recession. If instead the adjustment is made gradually, America could face several years of sluggish growth of less than 2%. That would be well below the economy’s trend growth rate, so unemployment would rise. In this sense, America's “recession” is far from over.

Could America follow Japan into a decade of stagnation? The popular perception is that America’s economy has held up much better than Japan’s did after its own stockmarket bubble burst in December 1989. Yet America’s economy now looks awfully like Japan's in the early 1990s, when Japanese investment fell but consumer spending and productivity growth remained robust for a couple of years. Deflation did not appear until 1995. America may yet face further troubles.
There are, of course, big differences between the two economies. Market forces work better in America's more flexible and competitive economy, so excess capacity is likely to be scrapped and capital reallocated more speedily than in Japan. America's economy is also much less dependent on banks than Japan's, relying more on capital markets as a source of finance for firms. Capital markets, unlike banks, re-price assets immediately instead of deferring the pain. Japan's sick banks have also been unable to make new loans, which has delayed recovery. American banks are in much better shape.

A third point in America's favour is that its political system is less rigid than Japan's. If politicians fail to deliver economic recovery, in due course they will be replaced. In Japan the LDP is still in power, despite a decade of near-stagnation. The result is policy paralysis.

Nevertheless, American policymakers cannot afford to be complacent. The list of differences between Japan and America has got shorter over the past year. America, it used to be argued, had better corporate governance and more accurate financial accounts than Japan. Enron and WorldCom have exposed that myth. America, it was said, had only a stockmarket bubble, whereas Japan also had a property bubble. The rapid growth in house prices and mortgages in America over the past couple of years is starting to look suspiciously bubble-like.

Last, but not least, America supposedly had plenty of room to cut interest rates, so it could avoid deflation. But by now the Fed has shot most of its ammunition: with interest rates and inflation already so low, there is little room for further easing if the economy stumbles. That raises the spectre of falling prices, which would be devastating in an economy so awash with debt.

Some Europeans may be tempted to gloat over America's misfortunes. But if America sinks back into recession, it will take much of the rest of the world with it. As America's current-account deficit becomes harder to finance, a sharp fall in the dollar will export deflationary pressures to other countries. Worse, policymakers in Japan and the euro area currently seem unwilling or unable to offset such a shock.

Measured by real GDP, last year's global recession was relatively mild, but nominal GDP growth in the G7 economies fell to its slowest rate for decades (see chart 13). In this year's "recovery", nominal GDP growth is running at just over 2%, less than the typical rate seen during other recessions since the second world war. In this sort of environment, it becomes much harder for firms to increase their profits and work off their debts. Most companies, investors, households and policymakers have never experienced anything like it during their lifetime.

**A false sense of security**

Current wobbles aside, most analysts still assume that the greater economic stability of recent decades will continue. They hope that IT will allow firms to go even further in eliminating the inventory cycle, and that sound monetary policies will continue to prevent the high inflation rates that caused economic instability in the 1970s. That would have important implications. A more stable economy is a less risky economy, which would justify a lower equity-risk premium. Historical price-earnings ratios would then be irrelevant, so share prices might now be undervalued. And if incomes and profits fluctuate less over the cycle, then households' and firms' current large debts might prove perfectly manageable.

However, this survey has identified several factors that might make the economic cycle more rather than less volatile over the coming years, thus prompting investors to demand a higher risk premium. One consideration is that America's enhanced economic stability in the 1990s was in large part due to luck, such as the unusually desynchronised nature of business cycles in the main economies. This helped to curb the usual inflationary pressures during America's boom, allowing it to continue for longer. In future, as economies become more internationally integrated, economic cycles are likely to move much more closely in step. If everybody sinks together, recessions could be deeper.
A second cause for concern is that fiscal policy may be less able to cushion downturns than in the past. There is some tentative evidence that fiscal policy is becoming less potent as economies become more open. More worrying, in some circumstances monetary policy may also prove to be a blunter weapon. If central banks try to hold inflation too low over the cycle, they will leave themselves too little room to ease policy in a deep recession, because it will be harder to deliver negative real interest rates. In the next cycle inflation and interest rates could peak at a lower level than in the last one, and as inflation gets closer to zero economies become more unstable, as Japan has discovered. This is not to argue for a return to double-digit inflation, but to suggest that central banks should aim to keep inflation above 2%.

Even then, low inflation can amplify the business cycle in another way. In the 1970s and 1980s high rates of inflation allowed inflated asset prices to adjust back to their fair values without the need for a big drop in nominal prices. For instance, British property prices in the four years to 1993 fell by 25% in real terms, but by only 8% in nominal terms. If today's boom in house prices around the globe does turn out to be a bubble, then with such low inflation house prices would need to fall more sharply in absolute terms to bring the market back into balance. That would be painful for those with big mortgages.

In a world of low inflation, excessive swings in asset values are therefore even more dangerous. Yet this survey has argued that financial liberalisation, combined with central banks' single-minded emphasis on inflation, has increased the risk of asset-price and credit bubbles. Japan in the 1980s and America in the 1990s could be just the first of many.

Moreover, equity and property prices are not only likely to be more volatile, they will also have a bigger effect on consumer spending than they used to. As people live longer after retirement and the average age of populations increases, more people will be dependent on the value of their assets, in the shape of both property and equities, rather than income from employment.

After a period of relative calm, the business cycle is likely to become bumpier again. What does this mean for policymakers? Until recently, central banks believed that so long as inflation was kept firmly under control, booms and busts could be avoided. Yet in reality low inflation does not guarantee stable growth. If central banks are to prevent bigger booms and busts in future, they need to take a broader view and sometimes act to curb excessive growth in debt and asset prices.

A second lesson is that governments need to do more to enable economies to cope with volatility. Flexible markets, stronger financial institutions and better corporate governance can help to minimise the cost of recessions. If Japan and the euro area were to press ahead with reforms, it might also help to boost their domestic growth, reduce their dependence on America, and so partly offset the growing synchronisation of economies.

The third and most important point to remember is that the business cycle will never be eliminated; it is part of human nature. Indeed, once people think that the cycle has become a thing of the past, they act in ways that sow the seeds of the next recession. If central banks succeed in postponing a recession, they will simply encourage more reckless behaviour, making the next downturn worse. A recession once in a while may actually be a good thing, as long as it is not too deep. It reminds companies, households and investors of that other R-word: risk.