Keeping a lower profile
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Economies have become less volatile—but they may not stay that way

ECONOMIES are much less volatile than they used to be, for all that the newspaper headlines seem to suggest otherwise. A century ago deep recessions were common; now they are rare. Why has economic activity become less bumpy?

America's NBER has dated the peaks and troughs of the country's cycles back to 1854. Over the years, expansions have got longer and recessions shorter and shallower (see chart 3). An analysis by Victor Zarnowitz, an economist at America's Conference Board and one of the world's leading experts on business cycles, has found that before 1945 the American economy was in recession for two years in every five. Since the second world war, it has been in recession only about one year in six, and the average length of a recession has fallen from 21 months to 11. Since 1945 the standard deviation (a measure of volatility) of quarterly changes in GDP has been only half of what is was before 1918 and only one-third of its level in 1919-45.

Other economies have also experienced flatter cycles. An IMF study of 16 developed countries found that the average peak-to-trough decline in GDP during recessions was 4.3% in 1881-1913, 8.1% in the turbulent period between the wars but only 2.3% since 1950.

The business cycle has continued to moderate during the past half-century. In the past 20 years, America has been in recession for only 18 months (assuming the recent one ended in January). Indeed, the past decade was the economy's most stable in its history. An OECD study of 13 developed countries found that economic volatility rose in the 1970s, but has since fallen sharply everywhere. In the 1990s all the big economies were less volatile than in the 1960s—even Japan's (see chart 4).

After 1945, recessions in Japan and continental Europe seemed to disappear. Following the devastation of the war, these economies grew without pause for a couple of decades: Germany did not suffer a fall in GDP until 1967, Japan not until 1974. In general, America's economy has been more volatile than Europe's, with more frequent, though shorter, recessions.
Seeking the source

Economists have plenty of theories about why the business cycle has flattened:

• **Services**. One of the most common explanations involves the shift in output and jobs, first from agriculture to manufacturing and then from manufacturing to services. The variability of harvests makes agriculture the most volatile sector. Services, it is argued, are the least volatile. Households buy durable goods, such as cars, to use over a period of time, so if income falls such purchases can more easily be postponed than services such as haircuts.

• **Better inventory control**. Inventory investment is the smallest component of GDP, but it plays a big role at turning-points in the cycle. Over the past 50 years, changes in inventory investment have, on average, accounted for more than half of the fall in GDP during recessions. But now, thanks to information technology, up-to-the-minute information about sales and inventories and just-in-time production techniques allow firms to hold fewer stocks and to match output more closely to sales. This, it is argued, helps to prevent an unwanted build-up of stocks. American manufacturers of durable goods now hold only two-thirds as much inventory relative to sales as in the 1970s.

• **Globalisation**. Increasing international trade, the theory goes, operates as a safety valve. During a boom America, say, can tap spare capacity abroad through imports. This helps to hold down prices and so allows the economy to expand for longer without overheating. Conversely, in a recession exports help to offset weak domestic demand.

• **Bigger government**. In recessions governments, unlike firms, do not slash spending and jobs, so they help to stabilise the economy. At the start of the 20th century, public spending amounted to less than 10% of GDP in most countries. Today public spending in developed economies accounts for an average of 37% of GDP. Europe’s higher public spending helps to explain why its economies have tended to be more stable than America’s.

• **Automatic fiscal stabilisers**. Even more important is the counter-cyclical role played by taxes and unemployment benefits. In a recession, income taxes fall and unemployment benefits automatically rise. This helps to support incomes.

• **Discretionary fiscal policy**. Traditional Keynesians argue that since the Great Depression active measures by governments to cut taxes or increase spending have made recessions less severe. But the effectiveness of fiscal policy is debatable. The stimulus often arrives too late, fuelling tomorrow’s boom rather than preventing today’s recession.

• **Better monetary policy**. Until the 1930s the money supply typically shrank during recessions, partly because the gold standard denied countries any independent monetary policy. This caused deflation, and by increasing the real burden of debt deepened recessions. According to the IMF, before the second world war two-fifths of recessions were accompanied by falling consumer prices. Since then, only Japan has experienced deflation. At
the other extreme, rising inflation in the 1970s exacerbated economic volatility because it forced central banks to slam on the brakes. Since the 1980s, more prudent monetary policy has helped to stabilise output.

- **Bank reform.** Some of the worst recessions before the second world war were aggravated by banking crises. The introduction of deposit insurance, bank supervision and regulation, and a stronger lender-of-last-resort role for central banks has helped to prevent the panics that could turn recessions into depressions.

- **Financial deregulation.** The improved efficiency of financial markets in recent years has made it easier for consumers and firms to smooth their spending over time. Better access to consumer credit has allowed households to go on spending even if their incomes drop temporarily.

**Taking stock**

With so many reasons for greater stability, it is a wonder that the business cycle has any pulse left at all. But which of these reasons really matter? If volatility has lessened because of structural changes, such as the shift to services or new technology, then the change may be permanent. If, as others claim, milder recessions largely reflect better monetary policy, or a large dose of good luck, then the flatter cycles will persist only for as long as good policy or good luck continues.

Probably the two most important reasons why recessions have become milder since the second world war are higher government spending and hence more powerful built-in fiscal stabilisers, and measures to prevent banking crises. Neither of these is likely to be fundamentally reversed. But there is less agreement about the reasons for the decline in economic variability over more recent decades. Several of the explanations that hinge on structural changes do not stand up to scrutiny.

Take the shift from manufacturing to services. Services have increased from 39% of America's GDP in 1960 to 55% in 2001. But if the relative weight of manufacturing and services had remained constant over those 40 years, the decline in economic volatility would have been virtually the same. Many services, from telecommunications and air travel to finance and advertising, are in fact highly cyclical.

The idea that globalisation can cushion downturns is also suspect. If anything, increased global integration exacerbated the recent downturn, as most of the world slowed in unison. As American firms slashed their IT spending, they pushed East Asia into recession. Those economies, in turn, cut their imports from America, deepening the initial downturn.

Better inventory control as an explanation for reduced volatility has also lost some of its appeal. In the fourth quarter of 2001 American firms slashed their inventories by the equivalent of more than 3% of output, the biggest reduction in over 50 years. At first sight, this suggests that for all their investment in IT, firms are still not managing their inventories effectively. A study by James Kahn and Margaret McConnell, two economists at the New York Fed, concludes that during most of last year's recession firms did manage their stocks better than in previous post-war cycles, but that in the fourth quarter of last year firms were caught out by an unexpected rise in demand as consumers took advantage of free credit, so they had to run down inventories. IT allows firms to adjust output more rapidly to changes in sales, but it has not solved the problem of forecasting demand.

A study by Olivier Blanchard, at MIT, and John Simon, at the Reserve Bank of Australia, concludes that much of the dampening of the economic cycle in the big economies is due to a decline in inflation volatility (on top of the fall in inflation itself). The volatility of inflation increased in the 1970s, at the same time as output volatility, and then fell from the mid-1980s onwards as central banks were given more independence to pursue price stability. By anchoring inflationary expectations, central banks have made economies more stable. Unlike other theories, this explains why economic instability increased in the 1970s and then declined.

James Stock, at Harvard, and Mark Watson, at Princeton, agree that better monetary policy has been an important factor. They estimate that it could account for up to a quarter of the total reduction in the volatility of America's GDP in the 1990s. They rule out better inventory management as an important cause of lessened volatility. A large part of the fall in output volatility seems to be due to a fall in the volatility of sales rather than to an improved match between production and sales. Another quarter of the decline in volatility seems to be due to the fact that there were fewer external shocks, such as jumps in oil prices. But the two economists reckon that sheer luck explains as much as half of the fall in volatility in the 1990s. In other words, it cannot be relied
One important element of good luck in the 1990s was that the big economies became unusually decoupled, in contrast to the 1970s and 1980s when they were more synchronised. When different economies boom together, inflation is likely to pick up sooner and so bring the expansion to a halt. But in the 1990s the big economies were mostly out of step. When America fell into recession in 1990 the economies of Japan and continental Europe remained robust, helping to cushion America's downturn. Europe was given a boost by German unification, and Japan's economy remained bubbly until 1992. Only after America's recovery was well under way did Japan and continental Europe stumble.

During America's boom, European growth was restrained by tighter fiscal policies in preparation for monetary union, and Japan stagnated. Weak overseas demand helped to hold down America's inflation, allowing its boom to continue for longer than usual. Later in the decade, the spare capacity caused by the slump in East Asia also helped to restrain inflation. But this decoupling was a fluke. If economies become more synchronised again, volatility is likely to return.

**The reluctant recession**

Whatever the reasons for the flatter business cycles over the past couple of decades, the mildness of America's recent recession is still surprising. Despite a stockmarket slump, the bursting of the IT investment bubble, a jump in oil prices and the tragic events of September 11th, the recession was one of the mildest on record. From peak to trough, GDP fell by only 0.6%, compared with an average decline of just over 2% in recessions since the second world war.

One possible explanation is that because America's trend rate of growth has risen, thanks to faster productivity growth, an absolute drop in output becomes less likely when the economy slows. Most economists reckon that America's potential growth rate is now 3-3.5%, compared with 2.7% in 1980-95. This means that if growth falls by three percentage points below trend the economy now simply stalls, whereas previously it would have contracted.

Monetary and fiscal easing played a big part in keeping the recession in check. Interest rates had been cut by three percentage points even before September 11th, to be followed by almost two more points afterwards—the biggest reduction in two decades. And by sheer luck, the tax cuts, planned when the economy looked stronger, turned out to be particularly well timed, as did the increase in government spending in the wake of September 11th.

Another element of luck was that America entered the recession without the over-supply of housing that has been the norm in previous downturns, because builders had underestimated the extra demand resulting from immigration. Combined with low interest rates, this has fuelled a housing boom, helping to shore up consumer spending.

The increased efficiency and resilience of financial markets also deserves some credit. American banks entered the recession with strong balance sheets. More important, the capital markets provided a ready alternative supply of credit through last year's downturn. The financial sector, it is argued, helped to insulate the economy from the financial implications of the recession by redistributing risk. A large chunk of bank lending during the boom had been bundled into securities and sold on the secondary market, shifting risk away from banks to institutions better able to bear it.

A final explanation for America's surprisingly mild recession, favoured by Alan Greenspan, is the increased flexibility of business, thanks in part to its use of IT. More nimble firms with better information are able to adjust more quickly. Flexible labour and product markets also allow economies to cope with shocks more effectively. This may explain why recessions often last longer in Europe's set-in-their-way economies. In Germany, recessions since 1960 have on average lasted almost twice as long as in the United States. Because of market rigidities, economic excesses take longer to wring out.

Economies may be less bumpy than they used to be, but until somebody invents an antidote to swings in the mood of firms, investors and consumers, cyclical fluctuations will persist. The mildness of the recent recession and the decline in economic volatility over the past decade were both partly due to luck. In a later chapter this
survey will argue that the economic cycle could become more volatile as the luck of the 1990s fades, and booms
and busts in asset prices occur more often. What can fiscal and monetary policy do to cushion the ride?