What a peculiar cycle

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For the past ten years America has enjoyed a remarkably prolonged economic expansion. Does the "new economy" have a new kind of business cycle?

AMERICA'S economic expansion is already by far the longest in its history. If the economy proves to have grown during the first quarter of this year—opinions are divided on whether it will—then the expansion is exactly ten years old. This means that it has lasted more than twice as long as the average expansion since the second world war. The average forecast for growth in America in 2001, according to *The Economist*'s poll of forecasters, has fallen from 3.5% in October to only 1.6% this month. Most economists still believe that a "recession" (two consecutive quarters of contracting output) can be avoided. Others doubt it. In either case, most base their view on a particular understanding of business-cycle economics. Perhaps, in light of recent developments, that understanding needs to change.

Most economists—including, it seems, Alan Greenspan, the chairman of the Federal Reserve—are assessing the current downturn as if, in key respects, this were a business cycle like any of the other nine that America has experienced since 1945. A main braking force, they believe, comes from the efforts businesses are making to shrink their inventories, which have grown because of slowing demand. If they are right, the interest-rate cuts that have already been made, together with others in the pipeline, should be a swift, effective remedy. They will revive demand and narrow the gap between desired and actual inventories. The question is, does the cycle still work this way?

One observer who demands attention thinks not. Larry Summers, who has just retired as America's Treasury secretary, has recently argued that America's current cycle is fundamentally different from its post-war predecessors—though not because it is "new". He argues that it has more in common with economic cycles as they worked before the second world war—or even, wait for it, with Japan's during the late 1980s. That is a comparison he thought it unwise to draw while still in office. Mr Summers still hopes that a recession will be avoided in America. But if he is right about how things now work, predictions based on orthodox business-cycle calculations are of little use.

In the Bible, seven years of plenty were followed by seven years of lean. Business cycles have never been that regular. Since 1945, expansions have varied in length from 12 months to the current 120 months and counting (assuming the economy has not already contracted). Recessions have ranged from six months to 16. The deepest modern recession was in 1973-75, when output dropped by 3.4% from peak to trough. The shallowest was in 1969-70, when output barely dipped (see table 1).

The post-war blues 1

Duration and depth of US recessions

Recession dates	Duration in months	% fall in GDP from peak to trough
1948-49	11	3.6
1953-54	10	1.9
1957-58	8	3.2
1960-61	10	0.5
1969-70	11	0.1
1973-75	16	3.4
1980	6	2.2
1981-82	16	2.8
1990-91	8	1.3

Sources: Thomson Financial Datastream; NBER

No two cycles are identical, yet the pattern during the past half-century has been reasonably familiar. After several years of expansion, aggregate demand outpaces supply. This causes inflation to accelerate. The Fed raises interest rates, which squeezes demand. As inventories build up, firms cut production. The economy moves into recession. Next, the Fed cuts interest rates. Demand recovers, and so does output. The next expansion has begun. This sequence once prompted Paul Samuelson, one of the past century's most celebrated economists, to remark that American recessions come stamped "Made in Washington by the Federal Reserve". This time, if the economy does move into recession, it will not be because of high interest rates.

Every recession during the past four decades has been preceded by a marked rise in inflation. During this expansion, inflation has remained relatively subdued. As a result, the Fed raised interest rates by only one percentage point between the summer of 1998 and their peak in 2000; real interest rates actually fell slightly over that period. Demand is currently weakening not because of a sharp increase in

interest rates, but because of factors such as weaker profits, falling share prices and falling investment.

The trouble with low inflation

Economists at Goldman Sachs, as opposed to stockmarket analysts at Goldman Sachs, have long been warning about the "dark side of the new business cycle". Greater vigilance from central banks, industrial deregulation and ample productive capacity (as a result of strong investment) have all helped to hold down inflation. The traditional trigger of recession, therefore, has not been pulled. Deregulation and new technology may also have made it easier for firms to avoid the build-up of unwanted staff and inventories, another precursor of traditional recessions. As a result, the expansion has endured for longer than usual.

The snag is that longer periods of expansion allow other sorts of imbalance—notably, personal and corporate debt, and overinvestment—to build up instead. Lulled into a sense of security, with expectations of everlasting prosperity, lenders relax their standards, and consumers and investors lose their inhibitions about borrowing. Lenders and borrowers alike take bigger risks, though it does not feel that way. Fuelled by credit and optimism about future profits, investment increases and asset prices soar. Success breeds success—but then, at some point, excess. Eventually, overinvestment reduces the return on capital and firms decide to cut their spending on capital. Consumers feel overburdened with debt and increase their saving. Optimism gives way to pessimism, and demand falls sharply. In the 19th and early 20th centuries, in fact, this was the typical business-cycle pattern.

The "investment boom and bust" model seems a far better way to understand the current cycle than the usual one based on rising inflation and higher interest rates. This has two important implications for policy.

First, if the American economy does now slide into recession, interest rates may be less effective than usual in reviving demand. Consumers may be too intent on saving more, and businesses on reducing their debts and excess capacity, to pay much attention to a reduction of half a point here or there in the Fed Funds rate. This, in turn, raises the possibility that the recession, if it starts, could be deeper or longer than its recent predecessors.

Second, idle as it may be to point this out now, interest rates should have been raised earlier in the expansion. With hindsight, the reason for this was not to deal with the risk of imminent inflation, as some, including this newspaper, argued at the time—incorrectly, as it turns out. The reason was that it would have been better to temper the boom, curb overinvestment and restrain the rise in equity prices. The cost of that policy would have been somewhat slower growth. The benefit would have been an economy that is not so financially extended—one that is less, as it may prove, financially fragile.

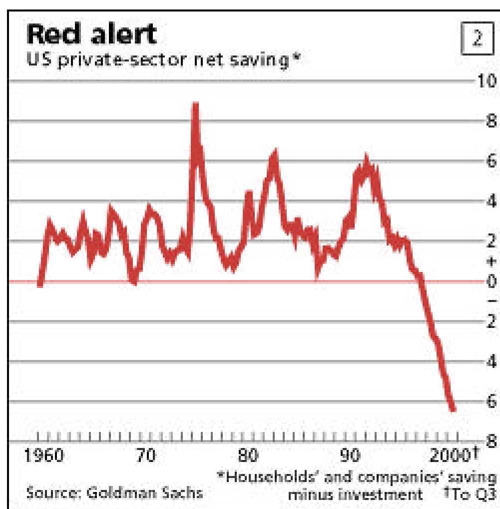
A spoke in the wheel

There is another way to look at it. Suppose that the technological revolution of the late 1990s lifted the return on capital and increased opportunities for profitable investment. It probably did so—if by less than the new-economy zealots argued at the time, then by more than the recent wave of new-economy pessimists now suppose. This increase in profitable opportunities means an increase in the demand for capital. It raises the equilibrium real rate of interest, the rate at which the long-term supply of capital (saving) matches the long-term demand for it (investment).

But real interest rates have not risen, nor has the domestic supply of capital (despite the government's budget surplus). American households are saving less, much less: they now have "negative saving", spending more than their income.

Monetary policy that was "neutral" in the face of a breakthrough in technology would allow real interest rates to rise a bit. If instead the central bank holds interest rates down, this will further fuel the investment and stockmarket boom, and further depress personal saving. An important implication is that it is not enough for central banks to focus narrowly on consumer-price inflation. They also need to keep a keen eye on asset-price inflation, rapid credit growth and saving-investment imbalances. Admittedly, this is exceptionally difficult at a time when, thanks to a boom in investment, capacity has expanded and inflation is under control. Nobody said monetary policy is easy.

America's recent combination of a sustained boom in business investment together with a deep slump in household saving is historically unprecedented. As a result, private-sector net saving, the difference between the total saving and investment of households and firms (that is, the extent to which they need to borrow to finance their spending) has moved dramatically, from a surplus of 5% of GDP in the early 1990s to a deficit of 6% last year (see chart 2).

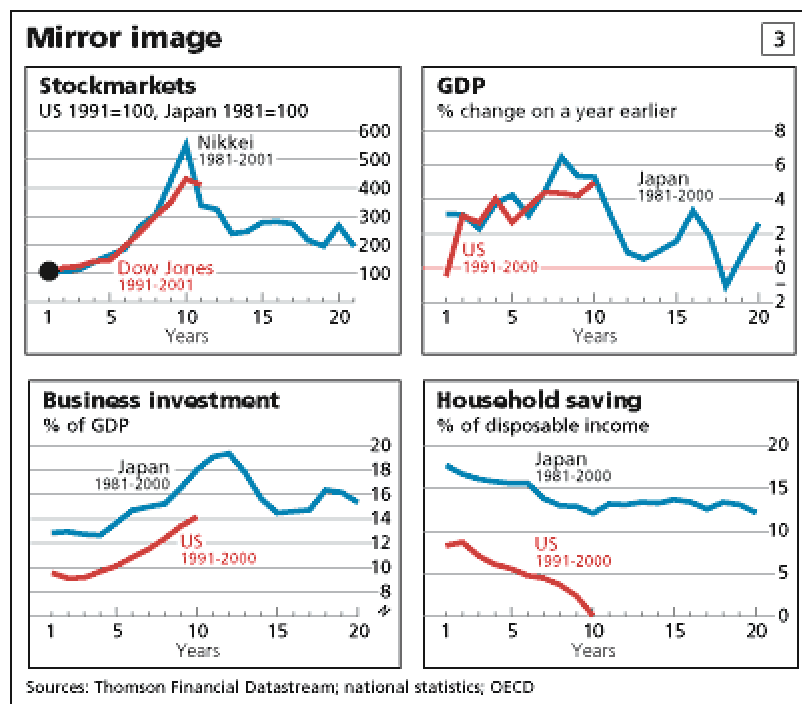


To find similar recent cases, it is necessary to look abroad—disturbingly, to Japan, Britain and Sweden in the late 1980s. All three experienced a similarly dramatic deterioration in private-sector net saving; in their cases, the switch coincided with booms not just in share prices but also in the price of property. When asset prices tumbled, firms and households tried to restore their financial positions and net saving increased sharply. This caused deep recessions. In Britain, during the boom, private-sector net saving fell from plus 5% in 1985 to minus 6% in 1989; then, as recession took hold, it reversed even more abruptly, to plus 6% by 1994. Japan's net saving fell from plus 5% in 1986 to minus 2% in 1990. Later, it rebounded. Again that caused a deep recession, from which the economy has yet to recover, ten years on.

This old-fashioned kind of recession may in general tend to be longer-lived, as well as deeper, than the ordinary post-war sort. Stephen Roach, an economist at Morgan Stanley, points out that since 1945 the average recession has lasted 11 months; between 1854 and 1945 the average was 21 months. He argues, plausibly, that this is because it takes longer to purge financial excesses than to tame inflation.

A return to investment-boom-and-bust cycles need not mean that output will become as volatile as a century ago. Obviously, many other things have changed since then. The composition of output has shifted heavily from manufacturing to services, which tend to be less cyclical. Taxes and public spending—including "automatic stabilisers" such as unemployment benefits, which rise in recession and so cushion demand—have vastly increased. Deposit insurance and stricter bank regulation help to prevent the financial crises and panics that made recessions so ferocious a century ago.

Unfortunately, the comparison with Japan—absurd as it seems to most Americans to draw any such parallel—cannot be so easily discounted as the comparison with the distant past. America in the late 1990s had much in common with Japan in the 1980s (see chart 3). Both economies displayed some classic symptoms of economic and financial bubbles: rapid monetary growth, surging share prices, rampant GDP growth and a boom in investment. In both America and Japan during their booms, inflation remained low so central banks had no reason to raise interest rates despite rapid monetary growth. As a result, the cost of borrowing was especially cheap relative to the expected gains in asset prices.



Terrible twins?

The path of share prices in America over the past decade looks similar to that of Japan in the 1980s. Since the Tokyo stockmarket peaked in 1989 share prices have fallen by 70%. In America, only Nasdaq has threatened to challenge that achievement: it is down by around 55%. So far, America's widest stockmarket index, the Wilshire 5000, has fallen by a modest 20%, and the Dow Jones Industrial Average by less than that. But there may be further falls to come. By most equity-valuation measures, American shares are still dear.

True, Japan's bubble (the term is no longer controversial in that case) was all-encompassing. Property as well as equities were caught up in it. America's property market has seen nothing remotely on the scale experienced in Japan. In 1989 the grounds of the Imperial Palace in central Tokyo were supposedly worth more than all the real estate in California. On the other hand, America can boast some similarly outlandish valuations in its equity market—as when, in 1999, an online travel agency, was deemed more valuable than America's three biggest airlines. Also America's equity-market exuberance has had a much bigger effect on the economy than the Japanese equivalent, because shares are more widely held in the United States. At the beginning of 2000, American households owned shares worth 180% of their disposable income. When the Tokyo stockmarket peaked in 1989, households' shareholdings were worth only 90% of their income.

All very well, you may say, but America has had a technological revolution: this justifies at least some of the surge in asset prices. So it does, but it is still sobering to recall that much the same was said about Japan in the 1980s. Back then Japan was also thought to have discovered a superior economic model. As in America today, it was believed that Japan's growth had increased permanently and substantially thanks to enormous investment. Japanese business investment jumped from 13% of GDP in the early 1980s to more than 19% by 1990; American business investment has jumped from 9% of GDP to 15% over the past decade. And during the 1980s, growth in labour productivity accelerated in Japan by even more than it has in America in recent years. All the signs are that some of America's productivity improvement, unlike Japan's, will be sustained. But it is too soon to take that entirely for granted.

Banking on prudence

As well as similarities such as these, too often ignored, there are two crucial reassuring differences. First, markets and institutions in America and Japan are quite unalike. Second, policy in America is likely to be far better conducted than it has been in Japan.

After Japan's bubble burst, banks continued to lend to favoured firms that should have been allowed to fail. The availability of finance and Japan's traditional policy of "lifetime employment" discouraged firms from cutting investment or workers as profits fell. As a result, Japanese firms were slow to eliminate their overhang of capacity. In America, such adjustment is likely to happen more rapidly because labour and product markets are much more flexible. Other things equal, that could mean a sharper contraction at the start—but it would help to prevent worse problems later.

American firms are more transparent. Nomura, a Japanese stockbroking firm, has recently published a handy comparison of America in the 1990s with Japan in the 1980s. It points out that Japanese companies and banks tried to conceal their financial problems through shady accounting practices. In all manner of ways, Japan's financial system was weaker than America's. During the bubble, firms

depended almost entirely on banks which, in turn, relied on shares and property as collateral for lending. That left banks completely exposed to falling asset prices.

In contrast, America is less dependent on banks for credit, and more dependent on capital markets, so any losses are less concentrated on banks and more evenly spread around the economy. America's double-pillared financial system with its well developed capital markets makes it easier for firms to switch sources if for any reason bank credit dries up.

That is not to claim that American firms and banks have been as prudent as they should have been. Far from it. There has been a clear deterioration in the quality of lending and default rates are at their highest since the last recession. Many companies have taken on huge amounts of debt. And American tech-stock analysts have pioneered some shady accounting practices the Japanese never dreamed of. All in all, though, the American economy, despite its financial overstretch, looks sounder now than Japan's was before the crash.

Learning from mistakes

Arguably, errors in policy bear even more of the blame for Japan's prolonged stagnation than the bursting of the bubble itself. In 1990, before the recession started, Japan's budget surplus was actually bigger in relation to its GDP than America's is today. After years of throwing money at doubtful public projects in a bid to get the economy moving again, the Japanese government has turned this surplus into the biggest deficit of any rich country—while failing to revive the economy. Much of the spending was wasted on building bridges to places people did not want to visit, or on propping up failing industries that would have been better left to die.

Monetary policy has been worse. The Bank of Japan was slow to ease monetary policy after the bubble burst. The bank did not cut interest rates until the summer of 1991, 18 months after share prices collapsed. By then business confidence had already slumped. The Bank of Japan has dragged its heels ever since, allowing deflation to take hold and so swell the real debt burden of companies. The Fed's prompt interest-rate cuts in January show that it can be relied upon to act more swiftly.

America, however, does have two disadvantages, which will make things harder for the Fed if boom turns to bust. First, America's personal saving rate is now negative; Japanese saving remained high. If American share prices fall and unemployment rises, households could feel under greater pressure to increase their saving abruptly. Second, Japan had a large current-account surplus when the bubble burst; America has a large deficit. This makes it more vulnerable to a run on the dollar if foreign investors lose their appetite for American assets. A falling dollar would complicate monetary policy.

The character of this current cycle, and the similarities it highlights between America now and Japan in the 1980s and 1990s, are enough at least to raise the possibility that America may face a recession this year—and maybe a bad one—rather than a mere pause. Even when proper weight is given to these risks, which it rarely is, the idea that America could follow Japan into a decade of pitiful underperformance still seems utterly incredible. Let us hope it still seems so a year from now.

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