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Should we learn to love recessions?

WHEN America's bubble burst last year, the Fed swiftly cut interest rates. This has become a habit: every time there has been any financial turmoil at home or abroad—such as the crises in East Asia and Russia and the near-collapse of Long Term Capital Management in 1998—the Fed has pumped more money into the economy. Low interest rates have saved America from a deep recession. But after such a binge, might the economy not benefit from a cold shower?

Most people would consider this a heretical question. They assume that it is a central bank's job to avoid recessions at all cost. According to one survey, four-fifths of Americans believe that preventing recessions is as important as preventing drug abuse. But are recessions always an unmitigated disaster, or do they also offer some economic benefits? And if central banks respond to every danger sign by pumping in more money, does this not risk simply transferring the problem elsewhere? As America's stockmarket bubble has burst, another bubble now seems to be inflating in its housing market. This allows consumers to go on partying, but what happens when the drink runs out?

According to the Austrian economic paradigm described in the second section of this survey, recessions are a natural feature of an economy. Joseph Schumpeter argued that recessions are not an evil that should be avoided, but a necessary adjustment to change. Only by allowing the “winds of creative destruction” to blow freely could capital be released from dying firms to new sectors of the economy, thereby boosting future productivity.

Hayek counselled against massive monetary easing to prevent a recession. If unprofitable investments were made during a boom, then it was better to shut those firms down and clear the way for new, more productive investment. For the Austrian economists the policy choice is not between recession or no recession, but between one now or an even nastier one later. A recession is necessary to work off an imbalance between too much investment and too little saving.

Keynes, quite reasonably, ridiculed the idea that in the long run the Great Depression might turn out to have been a good thing. In the early 1930s the Fed and the American Treasury did not pursue expansionary policies, precisely because they thought these might hinder the necessary adjustment. Andrew Mellon, the secretary of the Treasury, urged the market to "liquidate labour, liquidate stocks, liquidate the farmers, and liquidate real estate...It will purge the rottenness out of the system." America's output duly fell by 30% as the Fed sat on its hands.

Today, a slump on that scale would be unlikely even if the Fed had not cut interest rates swiftly. It would have been headed off by a variety of changes made since the Great Depression: higher government spending and hence more powerful automatic fiscal stabilisers; bank deposit insurance; and a stronger commitment by the Fed to its role of lender of last resort. But even the Austrian economists themselves came to reject the idea that faced with a potentially severe recession, policymakers should do nothing. They approved of stimulus measures to stop recessions from turning into deep depressions, but not of preventing recessions altogether.

The case for the defence

Why is economic instability always assumed to be bad? Some economists argue that recessions result in a permanent loss of output. This rests on the notion that there is a fixed ceiling for output, rising over time, so any shortfall against potential is a permanent loss. On this view, demand-management policies can fill in the troughs without shaving off the peaks, thus increasing average growth.

A more realistic way of looking at it, however, is that business cycles are fluctuations in output above and below an equilibrium trend. This suggests that demand-management policies can mitigate recessions only to the extent that they also choke off expansions; they cannot increase the average rate of growth or employment. Admittedly, cyclical increases in unemployment may become permanent if labour-market rigidities, such as strict hiring-and-firing laws, make it hard for the jobless to find work even when the economy recovers, a condition known as hysteresis. If this is present, as it is in many European countries, then recessions can have a permanent cost. But this is really an argument for labour-market reform to minimise the cost of recessions, not one for measures to prevent them altogether.

A second argument against letting recessions rip is that households may value economic stability for its own sake, even if it makes no difference to the average unemployment rate. Justin Wolfers, an economist at Stanford University, has used surveys of consumer satisfaction from several rich economies to estimate the value that households place on stability. He reckons that starting from current levels of volatility, eliminating the business cycle would increase average well-being by the equivalent of a fall in the unemployment rate of only 0.2 percentage points. By contrast, labour-market reforms could reduce unemployment by several percentage points.

A third common claim is that economic instability and uncertainty may discourage investment, thereby reducing long-term growth. Yet the evidence is weak. More volatile economies do not appear to invest less as a share of GDP. Moreover, looking back, the 20 years to 1938 were by far the most volatile in economic history, yet the average growth rate in developed economies was 3.8%, well above the average growth of 2.7% during the past two decades of relative stability. An analysis of 20 developed economies since 1960 by Bill Martin of UBS Global Asset Management finds little evidence that macroeconomic stability promotes faster growth. If anything, he concludes, countries with greater output variability have enjoyed slightly faster growth in productivity.

This is not as odd as it sounds. A perfectly stable economy would miss out on the advantages of booms as well as the alleged disadvantages of slumps. For instance, in boom times, when credit

flows freely, it is easier to finance the risky innovations that may boost future productivity growth. Booms also encourage mergers and acquisitions, a powerful tool for restructuring. More important, as Schumpeter argued, recessions are a process of creative destruction in which inefficient firms are weeded out, releasing resources for more productive firms.

But can we be sure that it will be the least productive firms that go bust in recessions, and that they really will be replaced by new, more profitable ones? Awkwardly, work by Ricardo Caballero and Mohamad Hammour, economists respectively at MIT and DELTA, a French research organisation, finds that good times may be more conducive to economic restructuring than bad. The two economists examined gross job creation and destruction in American manufacturing over the period 1972-93 and found that at the onset of a recession job destruction increases, but it then falls below normal levels until well into the recovery. Job creation declines during a recession and remains relatively low during the initial recovery. Adding up the net effect of job destruction and creation, Messrs Caballero and Hammour conclude that the pace of restructuring actually falls during a recession.

The figures on which the study was based are available only for manufacturing, which has a shrinking share of the economy. Once services are added in, the picture might look different. Still, the study does raise the question of why recessions might hinder rather than help industrial restructuring. One answer is that credit markets are imperfect. When credit is tight in a recession, even profitable firms can find it harder to raise money to finance restructuring or new investment.

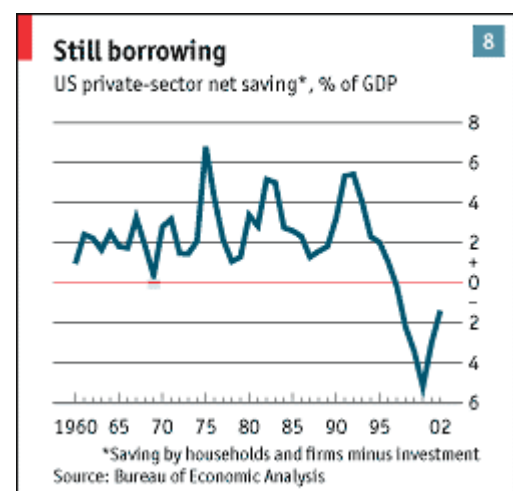
The dark side of the boom

Even if recessions are not always the most efficient way to reallocate resources, they are necessary to purge the excesses of the previous boom. Stephen King at HSBC argues that a recession should be seen as an unpleasant cleansing experience which leaves the economy in a healthier state: "A bit like taking a cold shower with a lump of carbolic soap." But America's economy has not yet completed this cleansing process: it still has an inadequate savings rate, excessive debt and a huge current-account deficit. The recent mild recession did little to correct these imbalances, making further pain inevitable.

A good indication of the size of the adjustment yet to be made is the private sector's financial balance (or private-sector net saving, equivalent to saving minus investment), a concept elaborated by Wynne Godley, an economist at Cambridge University. In the United States the private-sector balance shifted from a surplus of 5% of GDP in 1992 to a deficit of 5% of GDP in 2000 as households and firms went on a borrowing spree, an astonishing change after almost four decades when the private sector never ran a deficit at all (see chart 8).

The corporate sector's financial position was not wildly out of line with previous periods of expansion: firms usually run a deficit during booms to finance investment. It was the behaviour of the personal sector that was exceptional, and remains so. The surge in share prices during the 1990s encouraged households to save less and less.

In the past, when a country's private-sector net saving has fallen so sharply, a deep recession or a prolonged period of stagnation has usually followed. Events in Japan, Britain and Sweden after their late 1980s booms are prime examples. Mr Godley has long argued that the same outcome is



inevitable in the United States. But America's adjustment still has a long way to go. The private sector's financial deficit has narrowed to 1.4% of GDP this year, but that still leaves it well below its 1960-95 average of a surplus of 3% of GDP.

So far, most of the belt-tightening has come from firms, which have slashed their investment and laid off workers. Consumers, on the other hand, have continued to borrow, encouraged by easy money and rising house prices. But the collapse in share prices is now likely to prompt households to save more of their income. If the household saving rate rises back to its long-term norm, at the very least a period of slow growth, and perhaps another recession, will surely follow.

Was it a mistake for the Fed to slash interest rates last year and thereby delay this adjustment by households? Some economists believe that a deep but short recession is preferable to a prolonged period of sluggish growth, because recovery comes much sooner, with less damage to the economy's potential growth rate. However, it is arguably better to unwind imbalances gradually to avoid the risk of severe financial problems. Moreover, the Fed has been worried that a deeper recession at a time when inflation is already so low might lead to debt deflation, which central banks should avoid like the plague.

Lower interest rates have helped to prop up spending in America largely by fuelling a credit-driven boom in house prices. This fixes one problem at the risk of creating another. Rather than injecting more liquidity, would it not be better if central banks tried to smooth the path of credit over the whole business cycle?

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