

# The Economy in Perspective

*What goes around comes around...* Before anyone gets the wrong idea, let's be clear about one thing: This is not another essay declaring that business cycles are dead. To paraphrase a popular bumper sticker, recessions happen. But business cycles are commonly thought of as recurring fluctuations in economic activity. Considering that we are now in the seventh year of an expansion, and have experienced growth for 14 of the last 15 years, who could fault us for reappraising the business cycle concept?

Business cycles have never been regarded as following a fixed periodicity. Their earliest chroniclers, Wesley Mitchell and Arthur Burns, found patterns of co-movement and sequencing in economic activity that tended to be stable over time. For example, in the recovery phase of the cycle, labor productivity rises sharply as firms expand output without having to expand labor hours proportionately. Furthermore, overtime hours tend to increase first, with additional employment coming only later, as confidence in the expansion deepens. Output gets an added boost from the need to restock inventories and increase distribution lines.

Analysis shows that a cycle tends to peak when imbalances develop. The classic end to the expansion phase materializes when firms seek to expand capacity and bolster inventories. They finance this spending by borrowing, and their capacity for repayment becomes increasingly dubious as pressures on resource availability push up interest rates and add to debt-service costs. Typically, inflation accelerates.

Eventually, economic conditions become substantially incompatible with people's prior expectations and plans: Consumers do not want what retailers are stocking, retailers do not need what manufacturers are producing, factories refuse to hire people who want to work, and debtors cannot repay creditors. The longer the inconsistency in planning persists, and the greater the resource mismatch, the sharper and deeper the correction period.

For most of the past 50 years, mainstream economists have tended to think that recessions could be explained by insufficient aggregate demand, and that monetary and fiscal policies could stimulate enough demand to put total spending on the full-employment path. Of course, policy mistakes could be responsible for both over- and undershooting this ideal output level, and quite often were blamed for inadequate macroeconomic performance.

Research conducted in the last 20 years has added new insights. For example, instead of regarding all business cycle fluctuations as disequilibrium events, it allows that a significant proportion might arise from people simply making decisions in their own self-interest, following random economic shocks. The prevailing levels of ag-

gregate supply and demand, although not always conforming to an idealized condition of full employment, might be the best the economy can do under the circumstances of the moment.

Some contemporary researchers have reached another conclusion: Disturbances in aggregate supply account for a considerable amount of the variation in economic activity. This observation implies that periods of slow growth may result from adverse supply conditions, such as those caused by an oil cartel, and that periods of fast growth may be due to favorable supply conditions, like those following large-scale technological innovation.

Why does the distinction between supply and demand disturbances matter? Consider economic conditions over the past two years. According to the traditional demand-oriented view, the economy reached full employment when the unemployment rate hit 6%; full employment could be maintained only if aggregate demand grew at the economy's potential rate of about 2%. More rapid growth would push aggregate demand beyond the economy's ability to supply output, creating inflation pressures. In this view, the Fed would need to dampen aggregate demand by allowing the federal funds rate to rise. Money growth would then slow down enough to keep inflation in check.

But economic growth has been exceeding 2% for a while, and the unemployment rate has fallen well below 6%. The absence of inflation pressures might result from transitory factors that will soon dissipate. Alternatively, we could be benefiting from positive developments in aggregate supply. The current expansion has been marked by a capital spending boom, which may signal the onset of productivity-enhancing business tools and practices. Moreover, this investment wave follows a period in which several important industries became deregulated, and trade restrictions were reduced, both of which improved marketplace flexibility. Labor force participation rates have reached record levels, and hours worked remain very strong. There are even some signs that productivity growth has finally picked up its pace. This is unusual for the latter stages of a demand-driven, supply-constrained expansion.

If aggregate supply is growing, and productivity trends are improving, the quickened pace of demand will now match that of supply, creating no interest rate pressure. In this case, however, the public would require more money to support increased spending, so an unchanged funds rate would actually reduce inflation.

Differentiating between these two possibilities is easy in theory, but difficult in practice. In announcing an increase in the funds rate last month, the Federal Open Market Committee seemed to favor the demand-side hypothesis. Whether it holds firmly to that view will depend on how *what goes around* comes down.