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After Six Years of Expansion can recession be far behind?

THE ECONOMY is now in the seventh year of expansion from the Great Recession of·1981-82. Real output has risen almost 30 per cent from 1982, an average annual rate of increase of 4.25 per cent. Unemployment has fallen to nearly 7.5 percent from a recession high of close to 13. Wage and price inflation is drifting up.

The current expansion is, at 25 quarters, the longest of the postwar period, even longer than those that ran from 1947 to 1953 and 1961 to 1966. It. has exhibited the largest decline in the unemployment rate of any postwar cycle. How long can it persist? Is a recession inevitable in the near future? Or even worse, what about a depression?

This is a spectre conjured up by Ravi Batra in his apocalyptic best seller, *The Great Depression of 1990*. He· draws scaremongering 'parallels between the 1980s and the 1920s.The economy in his. view is cyclical. This view is based on the philosophy of an Indian guru, P.R. Sarkar, who has transformed the Hindu caste system into a theory of historical development. Dr. Batra contends. that the economy is currently in the era of acquisitors (Vaishyas). He believes there are 30-year cycles of monetary growth, inflation and government regulation. Every 30 years, a major recession or depression is said. to occur. If one is missed, as in the 1960s, the next one, forecast for the 1990s, will be that much worse .

Dr. 'Batra speaks with more authority than he deserves because of his position as professor of economics at Southern Methodist University in Dallas and his impressive publications as a mathematical trade theorist. But mathematical eruditlon should not be confused with common sense.

There was much talk of parallels with 1929 and a depression after the stock market crash· of October 1987, helping no doubt to boost sales of Dr. Batra's book. The economy is a contrary beast and 1988 turned out to be a banner year in both the United States and Canada; real growth averaged around 4 per cent. Was the inevitable day of reckoning just being postponed?

Most economists believe that a, replay of the Great Depression is not on for two reasons. First, the economy today is much more stable than it was in the 1920s. Second, , thanks to John Maynard Keynes and his revolutionary *General Theory ,of Employment, Interest, and Money*, much more is known about how the economy works, and how to prevent a recession with fiscal and monetary policy.

The more volatile goods-producing sector of the economy has shrunk from one-half of output in the 1920s to less than one-third today. The more stable service sector has taken up ,the difference. The built-in stability of the economy has been augmented by an Increase in the government sector of the economy from around 15 per cent of gross national product in the 1920s to 45 per cent today.

The financial system is also more stable. Between 1920 and 1933, before the establishment of deposit insurance; cascading bank failures in the United States brought about a crushing 30 per cent decline in the money supply that economists, and not just those of a monetarist persuasion, view as a main cause of the Depression.

The greater stability of the economy since the Second World War is also due to the application of Keynes' counter-cyclical fiscal and monetary policy. When the economy started to slow, the government was quick to introduce expansionary fiscal· policies of tax cuts or spending increases and to lower interest rates.

Central banks, too, learned an important lesson from the mistakes of the Depression. After the 1987 stock market crash, central banks moved quickly to head off a financial crisis through a much-needed injection of liquidity.

And so depressions have become a thing of the past. What about re cessions?

There have been nine distinct economic growth cycles of varying duration and intensity in the post-war period. Most have been so mild as to not qualify under the classical definition of a recession as two consecutive quarters of decline in output. The two exceptions were1953-54 and 1981-82.

For a recession to be severe imbalances such as an over-stocking of inventories, an over-building of homes, or over-investment, must emerge in the economy. This has yet to happen in the present expansion. Growth has been relatively balanced.

The bane of the postwar period has been inflation, not recession. This too was a legacy of Keynes. The successful efforts of governments to keep the economy operating at a high level of activity sowed the seeds of accelerating inflation over the 1960s and 1970s,that culminated in bouts of double-digit inflation in the 1970s and 1980s.

The painful cure for double-digit inflation was the big recession in 1981-82. It took an unemployment rate of almost 13 per cent and much personal hardship to bring inflation back down to the more acceptable 4-per cent level.

There is an important lesson to be learned from the Great Recession: it does not pay to let the inflation genie out of the bottle, because there is hell to pay to get it back in.

Central banks, whose main role is to ensure the stability of the currency, are understandably concerned to avoid repeating mistakes. In the past year the Bank of Canada and the U.S. Federal Reserve have raised short-term interest rates by well over 3 percentage points to cool off an economy showing signs of overheating.

In North America, monetary policy has been forced to bear the burden of restraining a surging economy because governments have been unwilling to do their share through fiscal policy. Instead, governments have allowed politics to take precedence over economics and have been busy chalking up, a string of budget deficits of unprecedented magnitude. Had the gov- . ernments taken tougher deficit-cutting action, it would not have been necessary for interest rates to increase so much, and the risk of a recession would now be less.

The best outcome for the economy is a "soft landing," in which economic growth in North America slows in 1989 and the unemployment rate inches up, taking some of the infIationary pressures, off labor and product markets. This would set the stage for a pick-up in growth in 1990. Sustained expansion without an acceleration of inflation is still a good possiblity, provided the economy begins to slow soon without the need for further interest-rate hikes.

The prospects for a soft landing would be enhanced by a hard-hitting, deficit-reducing budget that would take some of the pressures off interest rates. Recessions need not be inevitable if we don't make them so through avoidable policy errors.