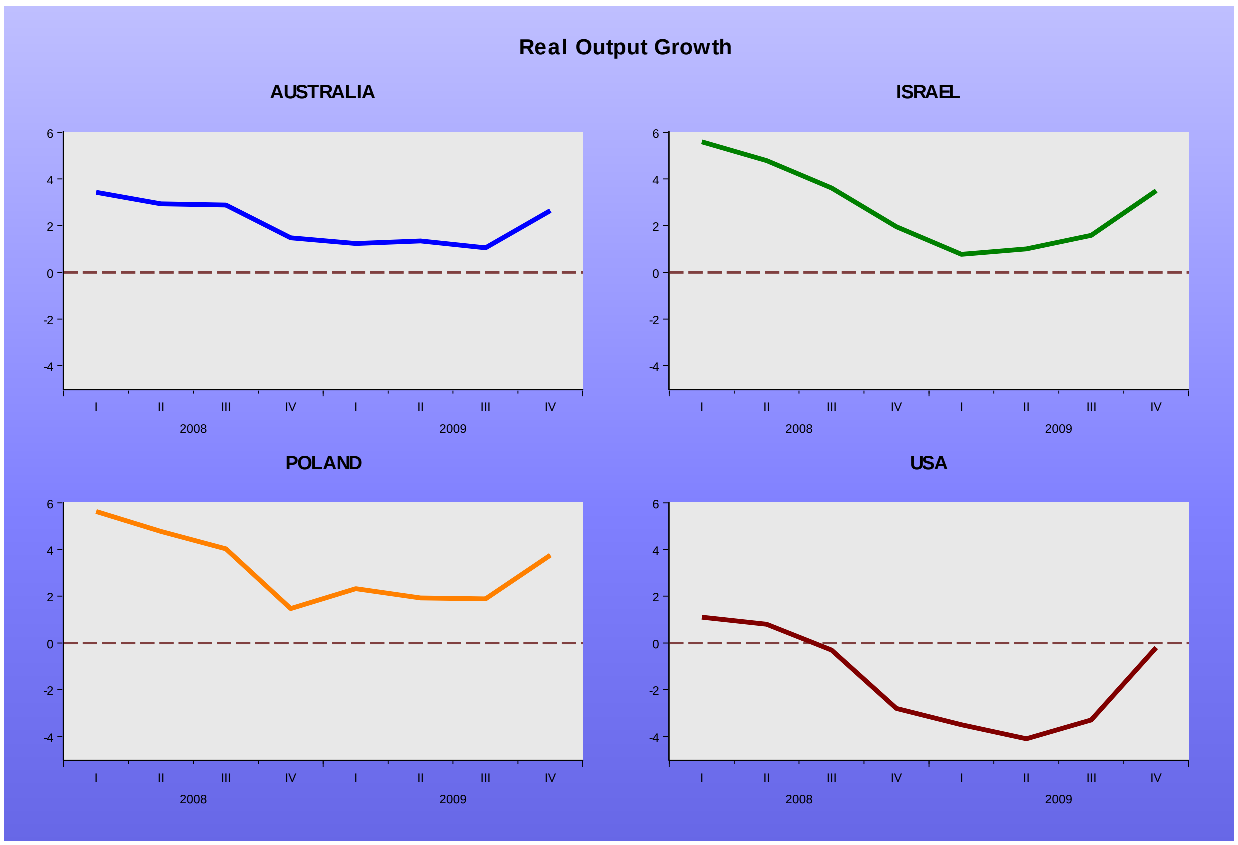
There is no Business Cycle

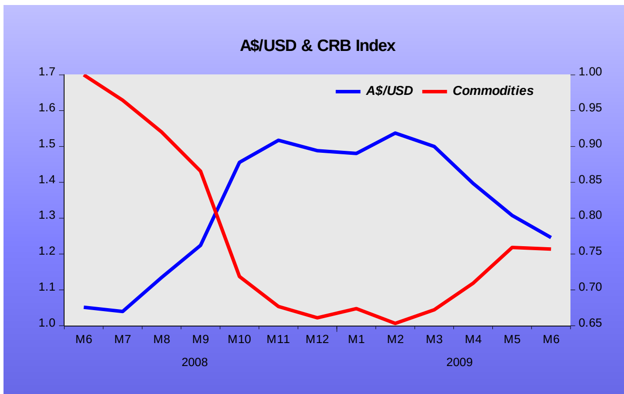
An oft-overlooked, but fascinating question which arose following the Great Recession is: “why did so many countries have recessions at the same time?” A corollary to this is: “Why didn’t certain countries have recessions?”

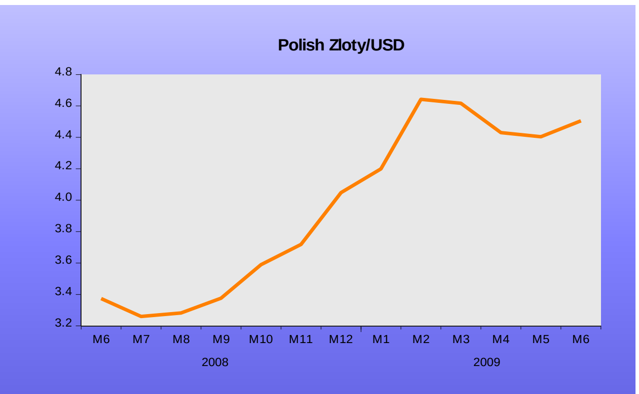
On this second question, we would bring to your mind three economies: Australia, Israel and Poland. None of these places had recessions in the 2007-2010 period. These are advanced economies, structured, more or less, within the same general framework as other OECD economies. Why did Poland avoid recession while all its neighbors saw a marked fall in output? Why did Israel avoid downturn while neighbors Greece and Cyprus were run over? Why hasn’t Australia had a recession since 1991 while other resource-driven economies (Canada, Norway, Russia, Brazil) have had deep recessions? The US is included in the chart for contrast.

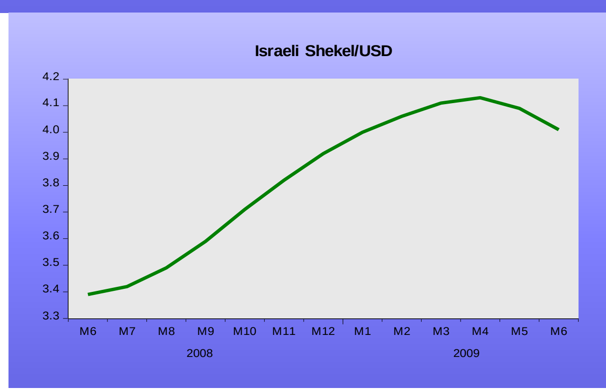


The lack of recession in these three economies is not explained in other macroeconomic frameworks, but it’s easily explained by the NGDP Advisers approach (Market Monetarism). The answer to why our three exemplar economies didn’t have recession is because nominal GPD remained rather stable, holding around the long run trend in all three through the Global Financial Crisis. As long as the central bank is able to meet changes in the public’s demand for money, nominal spending will continue to grow in a predictable way, obviating the need for businesses to cut prices and wages, a cumbersome and slow process for a whole economy to undertake.

We can tell that it was monetary policy which spared Australia, Israel and Poland (Call them AIP) by looking at exchange rates. All three saw marked depreciations in their currencies around the bottom of the Great Recession, in March 2009. This indicated that the AIP currencies became relatively more abundant compared to the reference currencies (Euro and US dollar). The story being that in 2008 and 2009, waves of financial panic caused financial market participants to hoard major currencies, the important fact here being that there was less cash with which to buy and sell, not that the price of imported to exported goods fell or rose. Exports didn't bail the AIP countries out, monetary policy, by keeping domestic demand growing adequately, did. Note that the Australian Dollar fluctuates according to the index (CRB) of commodity prices. When commodity prices fell at the onset of the Great Recession, the Australian Dollar depreciates.







This may seem like a strong statement to make: that a cheaper currency saw these countries through the crisis with relative ease. Imagine however what would have happened had the AIP countries run fixed change rate regimes with the Euro or US dollar. A case in point is Denmark, where the Danish Krona is tied to the Euro. To keep their currencies pegged, the central banks in these countries would have had to markedly tighten monetary policy, soaking up high-powered money in order to keep their currencies scarce enough to maintain the peg. This episode, wherein relatively small developed countries sailed through the worst global crisis since the Great Depression shows how powerful astute management of the value of money (monetary policy) can be.

The common features among the AIP set are: marked depreciation of the foreign exchange rate, stable nominal GDP growth, and higher inflation during the global crisis. These countries did exactly what a Market Monetarist adviser would have told them to do: when faced with a supply-side shock, use monetary policy to keep the level of nominal spending growing at trend. In this way, employment and output can be propped up at the cost of (temporarily) higher inflation and a weaker currency. If we're to take the AIP example seriously—we could point to many other cases in history like it—then it would follow that *there is no business cycle*. The single most common and weighty error we see business people make is to speak about cycles in the macro-economy. There may well be cases in specific industries where predictable, multi-year cycles exist, but for most businesses, nominal spending growth in the broader economy towers above industry-specific cycles.

Instead of looking for signs of an ill-defined macroeconomic cycle, view recessions as accidents. Recessions happen when the monetary authority who oversee a country's money supply get it wrong and fail to provide enough money to keep spending growing in a steady, predictable way. Accidents, say on a road way, or at a factory, may happen at fairly regular intervals. But the time between accidents is ultimately random, there's no reliable cycle to it. So it is with recessions; we may be able to improve our accident/recession record through proper management, but recessions are ultimately caused by human error.

The timing, depth and duration of a recession are almost exclusively determined by the decisions of a handful of economists and former bankers who hold voting power at a given central bank (say the Federal Reserve). As a result, macro-economic forecasting is, in large part, a matter of anticipating what these central bankers will do. This policy-maker forecasting is in turn a large part of what financial market participants do and why we put so much focus on what FOMC members are up to and why we drive our forecasts using information from the financial markets. ***Point is, there is no business cycle***.