The Australian Business Cycle: A New View

by Don Harding
The Melbourne Institute

Comments by

David Gruen*
Reserve Bank of Australia

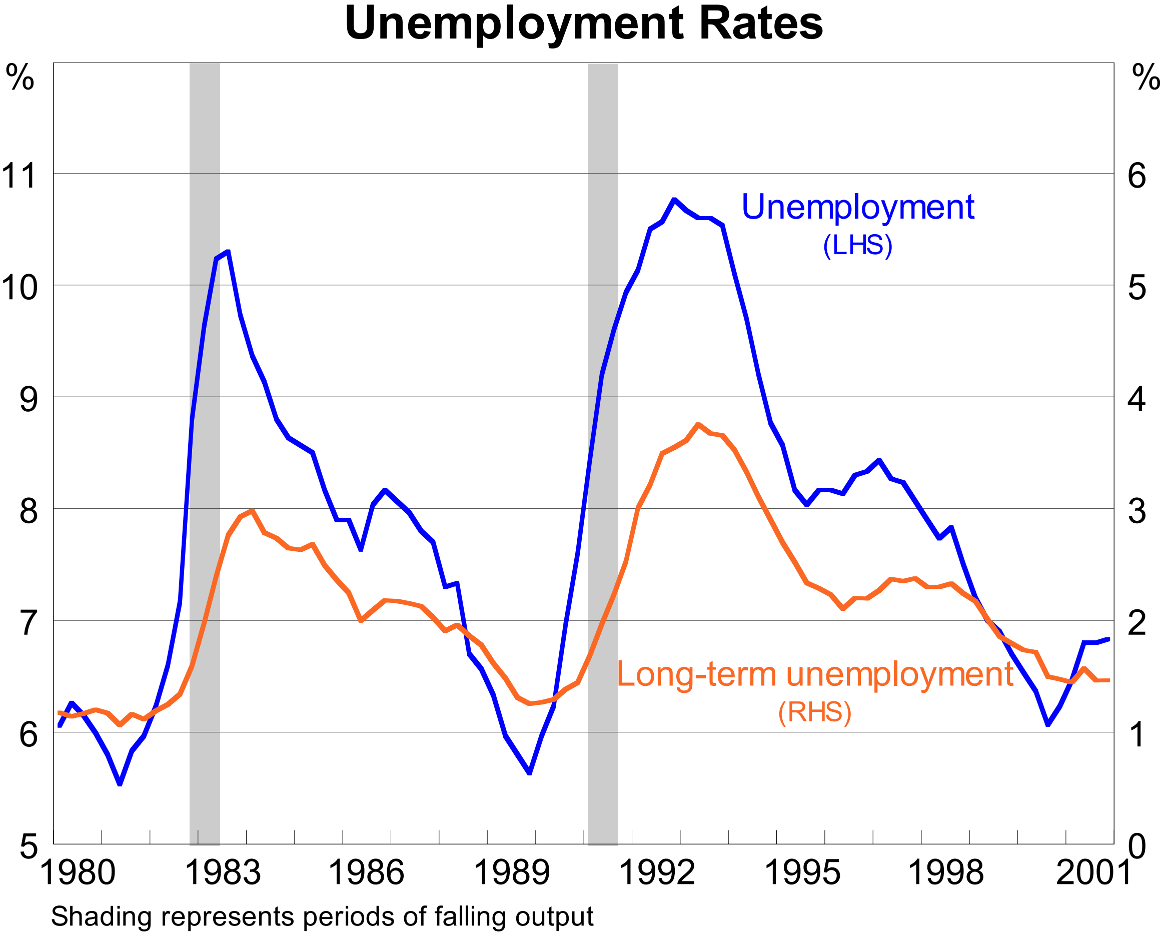
Towards Opportunity and Prosperity Conference
organised by
The Melbourne Institute and THE AUSTRALIAN

FRIDAY 5 APRIL 2002

* The views expressed are those of the author and should not be attributed to the Reserve Bank of Australia

Business Cycles Matter

To give just one example of the effect of business cycles: recessions cast a long shadow in the labour market.



SHOULD THE RBA CARE ONLY ABOUT INFLATION, OR ALSO ABOUT OUTPUT STABILISATION?

In discussing the objectives of a range of central banks, Governor Laurence Meyer of the US Federal Reserve Board, drew a distinction between those with a hierarchical mandate, and those with a dual mandate. A hierarchical mandate makes price stability the primary objective for monetary policy and subordinates other potential objectives. A dual mandate, by contrast, recognises two objectives – both price stability and output stabilisation (or full employment, as Meyer puts it).

Meyer argues in favour of a dual mandate for monetary policy. After discussing the objectives of several OECD central banks, he makes the following comment about the Australian approach:

> Although Australia is counted among inflation-targeting countries, it has a dual mandate rather than a hierarchical one. Indeed, it is a model for the combination I prefer: an explicit inflation target within a dual mandate.
>
> Governor Laurence Meyer 2001

Meyer puts forward the following propositions:

- low and stable inflation ("price stability") is essential to good macroeconomic performance and hence should be an objective of macroeconomic policy;
- the central bank is uniquely responsible for the inflation rate in the long run;
- monetary policy can make some contribution to lowering the variability of output relative to potential; and
- the public desires both low and stable inflation and a low variability of output relative to potential.

This seems to me to strike an appropriate balance between these two legitimate objectives of monetary policy.

DON HARDING'S FINDINGS

- Death of the business cycle has been exaggerated
  – its still with us

- Analyses the business cycle in terms of cycles in the level of GDP, not de-trended GDP. Recessions are associated with falls in GDP, not simply periods of below-trend growth.

- Australian business cycle in second half of 20th century looks a lot like that in the second half of the 19th century,

  … although expansions in second half of 20th century last longer and are associated with larger rises in GDP.

  First half of 20th century is outlier – more and deeper recessions – partly the Great Depression.

  Role for policy?

MORE CONTROVERSIAL:

- No statistically significant signs of 'ageing' of business cycle expansions or contractions.

  A long-lasting expansion doesn't raise the chance that it will end within the next year.

  Likewise for recessions.

  But … unclear how much power these statistical tests have against economically relevant alternatives.

  For example, would hope that well-executed policy would become increasingly expansionary the longer a recession lasted, which should increase the chance that it will end.

Of course, both samples (1861-2001 and 1959-2001) include a range of monetary policy regimes.

I also suspect that business cycle expansions often sow the seeds of their own destruction

ALSO CONTROVERSIAL:

- Recent signs of declining volatility in the business cycle are illusory
- Focus on year-ended growth, not quarter-to-quarter growth.

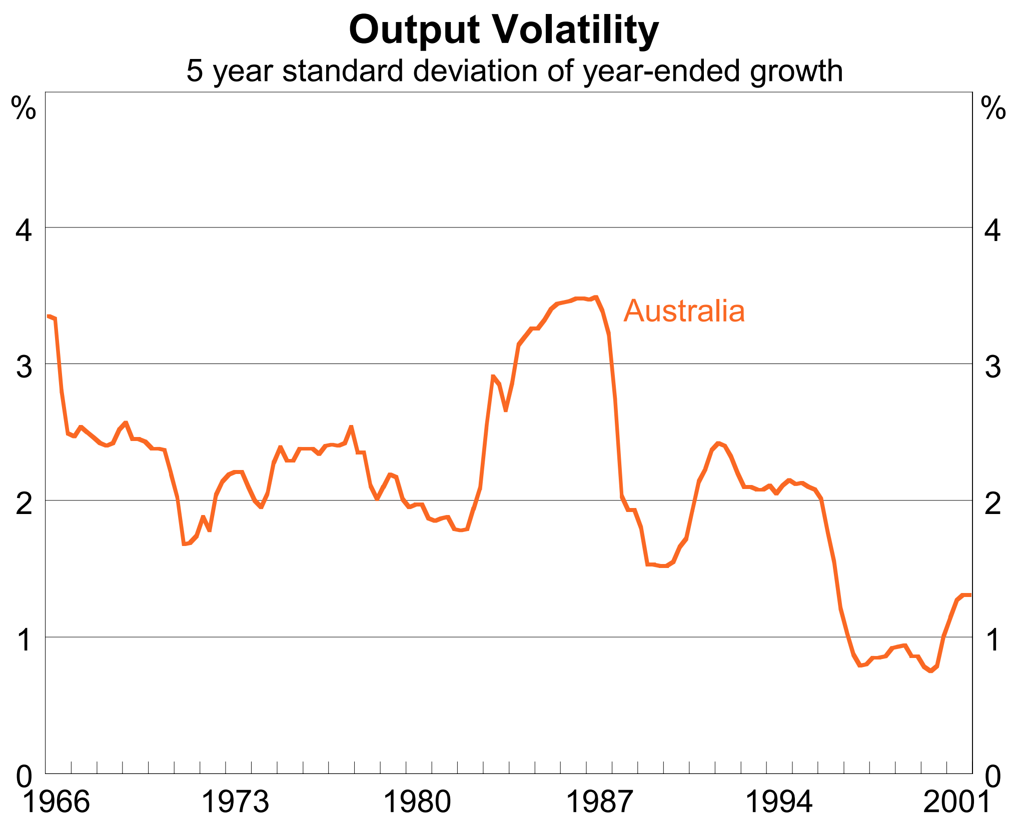
  I agree.

- Don makes a 'first pass' at estimating the measurement error in GDP growth and concludes that it explains ALL the decline in business-cycle volatility.

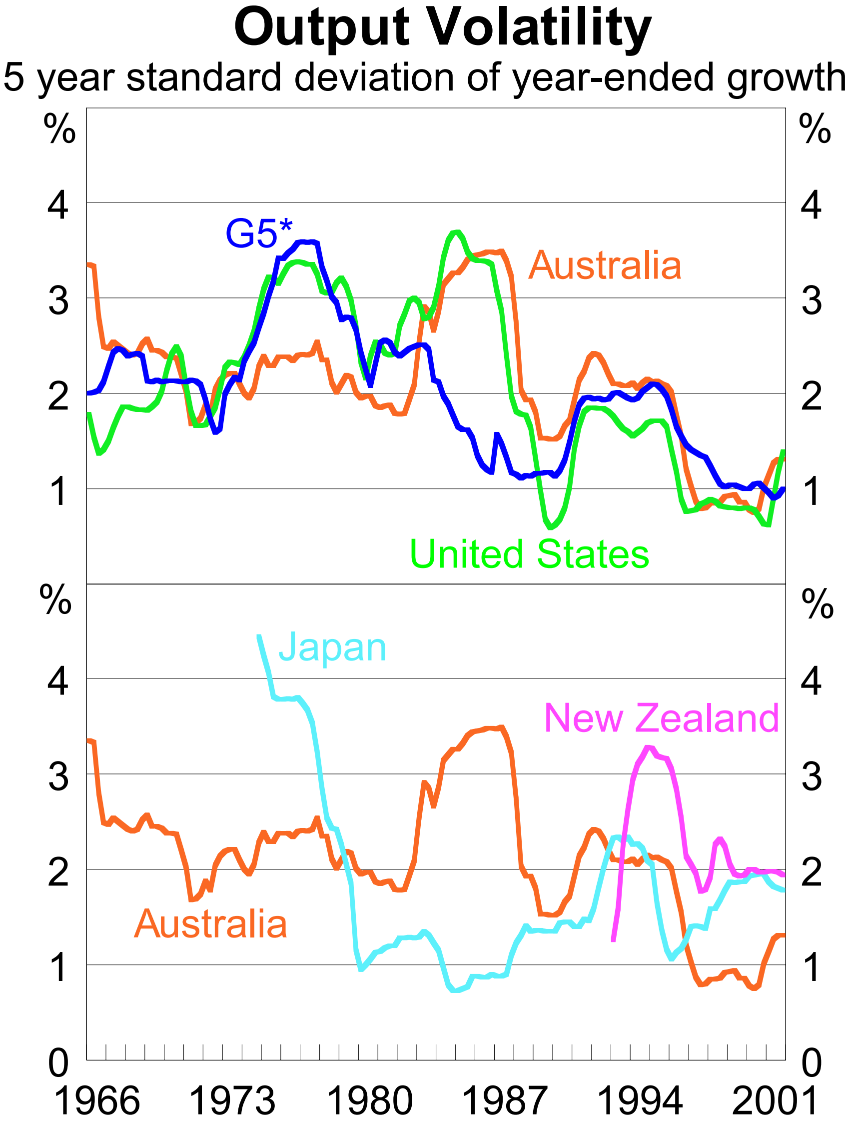
  But Don's assumptions are heroic ones, and I think he overstates the contribution of measurement error.

- Alternative explanations for decline in measured GDP volatility:
  - Better inventory management ('just-in-time')
  - Gradual shift to more stable sectors – services instead of primary sectors
  - Better macro-management of the cycle
- A topic that requires a lot more work
- This business cycle expansion is the longest of the last three, and is approaching the length of the 1960s expansion.

- The decline in volatility, at least as measured, is an impressive one.



And it has occurred in many countries …



THE LOWER VOLATILITY OF THE US BUSINESS CYCLE: IS IT MONETARY POLICY?

"I'm baffled. I find it hard to believe …

What I'm puzzled about is whether, and if so how, [the US Federal Reserve] suddenly learnt how to regulate the economy. Does Alan Greenspan have an insight into movements in the economy and the shocks that other people don't have?

… It looks as if somehow in … 1991-1992 [the US Federal Reserve] were able to install a good thermostat instead of a bad one."

Milton Friedman, May 2000

It seems plausible that, once central banks have established their anti-inflation credibility, they are able to make some contribution to reducing the amplitude of the business cycle – they can, if you like, 'top and tail' the business cycle.

But it may be some time before the decline in volatility is sufficiently pronounced and long-lived to be statistically significant.

REFERENCES

Meyer LH (2001), "Inflation Targets and Inflation Targeting", Remarks by Governor LH Meyer at a University of California Economics Roundtable, San Diego, California, USA. http://www.federalreserve.gov/boarddocs/speeches/2001/20010717/

Taylor, John B (2001), "An Interview with Milton Friedman", *Macroeconomic Dynamics*, 5, pp 101-131, based on an interview conducted in May, 2000.