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Recent downturn wasn't your average recession

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Wild economic swings could be on the way out, write Dr Justin Wolfers and Rohan Wolfers.

While the Australian and US economies have moved in virtual lockstep for the past three decades, recent commentary suggests a sudden break.

The Economist rhapsodises about the merits of an economy they now call "Down Wonder", while gloom about the US economy peaked when the events of September 11 further deflated an economy suffering from the bursting of the dot com bubble.

Should the US be looking to Australia for lessons on how to run an economy?

In a stark reversal of national traditions, Australian hubris about our economic prospects is in contrast with US hand wringing. Why this sudden divergence in the economic outlook?

One likely explanation is that while our economic rhetoric may be out of step with the Americans, our economic reality is not. US pessimism over the recession is overwrought, while closer to home complacency threatens.

The similarities between the two economies are more striking than the differences.

Both have had a similar record of mild inflation over recent years. Both have also seen unemployment rise sharply.

In the US, unemployment has risen 1.75 percentage points since its trough, while local unemployment appears to have peaked one percentage point above earlier levels.

What then is the source of Australian hubris? Federal Treasurer Peter Costello boasts that our current output growth of 4 per cent is the highest among the world's leading economies.

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But this compares us with a pretty miserable lot. Perhaps a better marker is our own history, and on this scorecard, current growth rates are barely above our long-run average of 3.75 per cent.

But despite this, it is our performance relative to the US that has drawn the most attention. Even on this score, Australian triumphalism appears premature; an increasingly influential view suggests the US is not doing too badly after all.

The National Bureau of Economic Research declared that the US entered recession in March 2001. Its determination on when or if the recession has ended will not be made for several months, but many are prepared to pre-empt its decision. At its most recent meeting, the Federal Open Market Committee of the Federal Reserve Board declared the US economy to be "expanding at a significant pace".

Recent numbers provide support for this view. While the US economy fell back in the third quarter of 2001, it appears to have resumed a healthy forward momentum, growing at an annual rate of 1.7 per cent in the final quarter of 2001 despite the sharp shock to consumer confidence following the terrorist attacks. Latest numbers suggest it is probably growing even faster today.

US Treasury Secretary Paul O'Neill goes a step further, arguing that "it seems quite clear now that our economy never suffered a recession". In support of this, Dr Randy Krozner, a member of Bush's Council of Economic Advisors, noted: "Some people use two quarters of negative growth. We haven't had that."

Latest forecasts suggest that US real output will grow by around 2.5 per cent in 2002 and 3.5 per cent in 2003.

Yet if it is business as usual in the US, someone forgot to tell the employers. John Sweeney, head of the AFL-CIO, the country's peak union body, captured the mood of his members nicely, noting: "The much anticipated economic upturn continues to elude millions of workers". While output growth is continuing at a healthy pace, the US economy has shed over 400,000 jobs over the past year, and several pundits suggest the unemployment queues will keep growing.

Taking these numbers together, it appears the US has suffered a fairly unusual type of recession. Why has this downturn been so short, and why does the labour market look so ill, while the output numbers look reasonably healthy?

Some clues may be found in research presented at a meeting of leading US economists held last week by the National Bureau of Economic Research, where academic pundits pondered the future of the US business cycle. Several research findings are of particular relevance to our current situation.

Professors Jim Stock and Mark Watson, of Harvard and Princeton respectively, argued that the US economy has become fundamentally more stable. Recessions have not only become less common, they have become milder. And the latest business cycle - the longest boom on record followed by arguably the mildest recession - fits their story perfectly.

The applicability of this finding to Australia is confirmed in recent research from RBA economist Dr John Simon. He suggests the Australian business cycle also seems to have stabilised. Indeed, the slumps that have plagued us may be replaced by a milder form of "growth recession".

Focusing on the current downturn, Stanford economist Professor Bob Hall suggested that while the bursting of the dot com bubble was bad news for the US, this particular cloud had a silver lining: a large, positive productivity shock associated with ongoing innovations in information technology. Thus, output has continued to grow even as employment falls.

Rather than simply considering economic conditions as good or bad, Hall urges analysts to consider the various shocks to the economy separately, listing the negative shocks attributable to both September 11 and the wealth effects from a declining stockmarket, and the positive shock due to advances in IT.

The implications for Australia are immediate. Each of these shocks is affecting the Australian economy, but in each case, they are having a more subdued effect.

September 11 undermined consumer confidence on both sides of the Pacific, but it seems to have had only a minor impact in Australia. According to Tim Harcourt, chief economist at Austrade, much of this reflects the fact that the main "concern for Australian exporters has been the impact of the US downturn on East Asia rather than the US-Australia direct impact".

The fallout from the tech wreck has been less important for Australia than the US because the wealth effects are much smaller. (IT stocks only ever made up 15 per cent of the market capitalisation of the Australian stock market; at the peak they were 45 per cent of the US market.) Furthermore, Harcourt argues that the effect on our exports "has not been as bad as expected by many analysts, mainly because we are not large producers of information technology".

Yet in a provocative paper titled "Productivity Growth in the 2000s", University of California, Berkeley, Professor Brad de Long argues that IT holds the key to a more productive future. He argues that the productivity boom catalysed by IT improvements in the mid-1990s is likely to continue for at least a decade or two.

Fortunately for Australia, while we are only small IT producer, the key to de Long's optimism lies in the thoughtful deployment of computers in industry, not in the production of computers themselves. On this score, Australia does pretty well, with Dr Simon (this time working with co-author Sharon Wardrop) finding that our "use of computer technology is amongst the highest in the world" and growing rapidly.

All of this yields a nuanced explanation of our current situation. Current hubris appears misplaced. That we have weathered the US recession probably says more about the peculiarities of this particular slowdown than it does about the Australian economy. Yet the longer-run forces shaping both the US and Australian economies show cause for optimism. Productivity growth will be strong, and the business cycle will be milder. Surprisingly then, the dismal science finally has some good news.

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