

Nout Wellink: The business cycle in perspective

Address by Mr Nout Wellink, President of De Nederlandsche Bank and President of the Bank for International Settlements, on the occasion of AkzoNobel's New Year's function for its management, 8 January 2003.

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You are of course familiar with the phenomenon of perspective distortion, which makes things close by look bigger. Interestingly, the effect becomes less strong as the distance from onlooker to object increases. Similarly, a certain distance in time is often required in order to put things in their right perspective. This is why historians so seldom discuss events of less than several decades ago. Economists and policy makers, however, cannot afford to keep that much distance. And by consequence, much of what they write and say shows the effects of perspective distortion: the current recession invariably looks greater than the previous one. Architects in 15th century Florence discovered how to draw a correct perspective. Much later, the architects designing the building of the Nederlandsche Bank used this knowledge: By making the tiles that line the outside of the building larger for higher stories, they cancelled out the distortion in the eye of the observer below. Today, I have set myself the ambitious goal of putting the business cycle in perspective. I intend to regard recent cyclical developments in the light of preceding business cycles. This gathering presents an eminent opportunity to discuss the international and Dutch business cycles, for AkzoNobel is an international concern - active in 80 countries. But you are also a Dutch company, with its head office established here and almost 20 per cent of production concentrated in this country. At the same time, I suspect that AkzoNobel has a greater than average interest in the analysis of cyclical developments: An important part of the firm's activities - basic chemicals - may be characterised as early cyclical. For us, incidentally, this makes companies in this sector interesting, because they provide a leading indicator for the business cycle.

The economic slowdown since the year 2000 has so far been roughly simultaneous in Europe and North America. It has often been claimed that this is the result of the increasing economic intertwinement of both large blocks. That increase can, of course, hardly be denied. World trade today represents 17% of global production, against only 8% in 1914. And this excludes the increased internationalisation of businesses, through the establishment of branches and plants abroad and through cross-border mergers. Also highly visible is the fact that the connection between financial markets has become stronger over time. The terrorist attacks in the United States and the dubious accounting practices revealed in the aftermath of the Enron collapse have hurt stock market sentiments world-wide. Recent research conducted at the Bank confirms this image: the correlation of German, British and US share prices has more than doubled over the past twenty years, from around 0.30 to 0.65.

The simultaneous cyclical movements of the large economies are not determined primarily by increased intertwinement but through the occurrence of global shocks. Cyclical coherence between Germany and the US was especially strong in the aftermath of the oil crises of the 1970s. The current cyclical harmony is explained by two recent global shocks: the oil price rises and the bursting of the ICT bubble. Almost continuously for the ten years up to 1998, oil prices moved within a bandwidth of 10-20 euro per barrel. In the course of 1999 and 2000, however, the oil price rose by almost 300% from the lower limit of this bandwidth to over 37 euros. Since late 2000, oil prices have come down under the impact of global economic slowdown. But a possible war against Iraq might push them up again. The second shock was caused by the bursting of the ICT stock market bubble. Share prices of ICT companies took a plunge from the peak reached in March 2000, losing two-thirds of their value. ICT investments - which in the US had risen by 10% to 20% every year since the early 1990s - have been falling since mid-2000. The present synchronicity of international cyclical movements has largely been caused by these two shocks. There is a good possibility, however, that the international convergence will dissolve again when the effects of both shocks have ebbed away. When the tide turns, the speed of recovery may be different on both sides of the Atlantic.

Another, related phenomenon is the decline in amplitude which cyclical waves have shown in recent years. In most industrialised countries, cyclical movements have been strongly damped since the first half of the 1980s. Several explanations have been offered, one of which is the gradual shift in the economy from industry to services. This may cause damping because fluctuations in industrial production tend to be relatively large. The share of services in overall employment has increased from

47% in 1960 to 70% today. However, research based on US figures shows that this shift has played only a minor part: it appears that the industrial and the services sectors both follow more stable patterns than they did a few decades ago. A second explanation offered for cyclical damping is that ICT developments have led to improved inventory management efficiency. ICT applications have enabled businesses to organise their inventory management in more efficient ways. But ICT applications have not helped predict the future development of consumers' inclination to spend. If consumers spend 100 million euro less than expected on their Christmas shopping, stocks increase by 100 million euro's worth. In other words: greater or smaller-than-expected sales affect inventories just as much as they did ten years ago. Therefore, the observed damping of the business cycle must be attributable to other causes.

A third explanation given for the flattening of cyclical patterns is that monetary and budgetary policies nowadays tend to be aimed more towards the medium term. Over the past two decades, monetary policy has succeeded reasonably well in curbing inflation, thereby enhancing the predictability of the macroeconomic environment. The risk that a cyclical boom will trigger a wage-price spiral has also diminished. As for budgetary policy, the 1960s and '70s were characterised by activism, which served to magnify rather than damp cyclical movements. The 1980s were the years of austerity measures, taking away the potential stabilising effects of public finance. Since then, the budgetary position of the Netherlands - and of some other countries - has greatly improved, allowing a trend-based budgetary policy to be pursued. Such a policy implies that in principle, public finance has a damping effect on the business cycle. In the meantime, however, developments in the US show that active budgetary policy is not yet entirely a thing of the past. The US budgetary position (as a percentage of gross domestic product) has deteriorated by 4½ percentage points in just two years' time. A fourth factor connected with cyclical damping is the fact that fewer global shocks have occurred during the last twenty years. So damping is also a matter of chance. The 1990-91 recession in the US, for instance, was mitigated somewhat by the boost which the European economy received from German reunification and which kept up the level of US exports to Europe. A few years later, the reverse happened. Despite the multitude of possible causes, only 40% to 60% of the damping effect can be explained. The latter two factors - less activist budgetary policies and fewer global shocks - each account for 20% to 30% of cyclical damping since the early 1980s.

Against this background of more moderate cyclical movements, I should like to "zoom in" on the current cyclical downturn in the Netherlands. Contrary to some allegations, this downturn is not very different from previous periods of cyclical decline - in fact, it is a textbook case. The depth of the cyclical trough clearly varies across cycles, but its average level has been 1½ to 2 per cent below the trend. Thus over the past decades, cyclical lows in the Netherlands have tended not to bring an actual shrinkage of the economy. The current five-quarter period of nearly zero growth also appears set to steer just clear of recession. What was unusual about the last cycle was the length of its upturn. After the economy had reached its potential production level, there followed three more years of relative strong growth before the cycle turned down. The prolonged rise is attributable to consumer spending. A strong autonomous increase of employment led to a favourable development of households' incomes. This, combined with low real interest rates and a generous disposition by mortgage lenders, led to a sharp rise in housing prices. The withdrawal of the resulting equity on the value of home property gave a strong additional push to household expenditures.

The decline also shows a few distinct features, most prominently the development of foreign trade. In the past, a decline in the Dutch business cycle usually began with a fall in exports - which should not come as a surprise in such an open economy. This time, however, the downturn in exports was somewhat delayed, indicating that the current cyclical movement has been driven to a much larger extent than usual by domestic factors. The decline of investment demand set in relatively early on and has been stronger than average. On the face of it, the situation here seems to parallel that in the United States. There, the recent slowdown seems to have been initiated by the fall in ICT investments. The development of other investments (i.e. excluding ICT) has been relatively stable. But things are different in the Netherlands. It is true that the share of ICT in total investments increased strongly from 1995 to 2000, from 11% to over 16%. But the cyclical curve of non-ICT investments hardly deviates from the overall pattern. The fall in investments in the Netherlands is mainly attributable to an erosion of private sector profitability from 1998 onwards. The early slump in investment growth seems also to have been caused by supply restrictions, for instance in the construction industry: during the second half of 1999, almost 80% of vacancies in construction were difficult to fill. Reinforcing the downturn in investment demand was the incipient deflation of the stock market bubble from the third quarter of 2000 onwards - a few quarters after the cyclical turning point. Added to this, the sharp increase in

housing prices levelled off in 2001, and with it the boost it had given to consumer spending. This has had a negative impact on private consumption.

Another remarkable feature of the current downturn is the fact that Dutch inflation has risen relatively strongly, not only compared to earlier business cycles, but also compared to other euro area countries. In all EMU countries, inflation was pushed up by rising oil and food prices and the decline in the exchange rate of the euro. In the Netherlands, however, this development was compounded by the unusually low rate of unemployment reached well before the cyclical peak in output. Labour market tightness resulted in strong wage increases, and hence in an acceleration of the Dutch inflation rate. Dutch prices have risen more sharply than elsewhere in Europe, and I do not have to tell this audience what that means for Dutch competitiveness. And although the difference in inflation between the Netherlands and the euro area has declined from 2.2 percentage points in January to 1.2 percentage point in November. This indicates that the rate of deterioration has come down. It does not mean that any lost ground has been regained.

Analysing recent cyclical developments is not an art for art's sake. Understanding the nature of the downturn may contribute to more accurate economic projections. The ongoing adjustments in the Dutch business sector, like those elsewhere in the euro area, have not been completed. Thus far, the US economy has appeared the more resilient. Recovery on both sides of the Atlantic is therefore unlikely to be simultaneous. According to the latest figures, the US economy has already returned to 2½ per cent growth over the past year, whereas the recovery in Europe which was expected for the second half of 2002, failed to materialise. Current expectations are that the European economy will only start to pick up in the course of 2003 - the latest economic projections by CPB, the Netherlands Bureau for Economic Policy Analysis, predict 1¾ per cent growth for the euro area during 2003. The inflation picture is rather flat, with a projected 2% on average for 2003. The projections are surrounded by fairly large uncertainties. I want to mention the developments of the dollar exchange rate and the price of oil in particular. Since 2000, the growth of the Dutch economy has lagged behind that of the euro area, whereas our economy used to outgrow that of the euro area during nine out of ten years in the 1990s. During the past year, the Dutch economy has hardly grown at all, for a number of reasons. Declining stock market prices, rising unemployment and political tensions in the Middle East have sharply depressed both consumer and business sentiments. Added to this, the wealth effect of rising house prices on consumer spending has disappeared. The economy will recover only slowly in the next few years. According to the CPB, economic growth will be only ¾ per cent in 2003, which is well below the projections for the euro area as a whole. Both business investment and employment are expected to show negative growth in the year to come, while Dutch exports will fall behind the expected growth of world trade. At the same time, the inflation rate for the Netherlands is estimated to come out at 2½ per cent. This means that the decline - from an excessively high level in 2001 - continues.

I have reached my conclusions. Or rather, returning to the terminology of spatial perspective, I have reached the point at the horizon where all lines merge: the central vanishing point. In this address, I have been discussing recent cyclical developments in the light of previous business cycles. Basing my argument on a quantitative analysis, I have attempted to avoid being deluded by perspective distortion. Regrettably, it will be some years before we may determine how successful my attempt has been.