

# The Plot Thickens with More Evil in the Cycle

A more volatile business cycle is now resurfacing after nearly three decades of moderate behaviour. Economic cycles in emerging markets too are set to be more fickle



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When asked why evil exists in the world, Indian saint Ramakrishna answered, "To thicken the plot." Well, then, downturns must be evil incarnate, for, while most economies expand steadily over time, recessions are the twists that create dramatic tension.

But over the past 30 years, the global plot seemed to thin out as the good times lasted longer and the bad times hit a bit less hard. From 1982 to 2007, the US enjoyed unusually-long expansions, and unusually-short and shallow recessions, compared to the averages established over the preceding century. The three upturns in this recent period lasted six to 10 years — nearly triple the previous average of three years. And the two recessions saw economic output fall barely 1% over a couple of quarters, much less painful than the prior average of 2.5%, stretched out for five quarters. The data for the rest of the world is sketchy but the story is similar. Since the early 1980s, economic cycles in the developing world have typically run for around eight years, double the historical average.

That's why the Great Recession of 2008-09 and its aftermath are such a shock. The US had come to believe in the moderate new business cycle when it suffered its steepest fall in post-war history, contracting by almost 4%. Now, the upturn since mid-2009 is one of the weakest on record with the US taking twice as long as normal to recover its lost output. More worryingly, the recovery usually picks up steam in its third year, but here we are in year three, and already there are signs that economic momentum is fading.

All of this raises the question of whether the volatile business cycle is back, for good. Volatility abated in the 1982-2007 period in large part because of the almost limitless ability of the US to fund growth by borrowing. Between 1950 and 1980, the US debt burden held basically steady as a share of GDP at around 150%, before increasing sharply after 1982 and reaching 350% in 2008.

Such massive borrowing was facilitated at least in part by globalisation, forcing companies to become more productive, which means producing more for less and lowering the threat of inflation. Low inflation made it possible for the Fed to keep interest rates low, and to cut rates further at the first sign of recession. The government could also throw money at the threat of recession, because federal debt had fallen from over 100% of GDP at the end of World War II to less than 40% in 1980. In the following years, as public and private borrowing rose, the business cycle grew longer and flatter.

Now, however, the US government is running out of bullets. Its stimulus programmes have driven government debt back up to near 90% of GDP, a level that can knock a full percentage of trend growth, as econom-



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ists Carmen Reinhart and Kenneth Rogoff have shown. And with short-term interest rates close to zero, the Fed is out of ammo too. Its crisis policy of quantitative easing is causing more damage than good, because much of that easy money is finding its way into speculative investments rather than new bank lending.

Interestingly, the long expansions and short recessions did little to increase the long-term US growth rate, which was no higher in the 1980s and 1990s than in the rest of the post-WWII period. Nor do sharp recessions necessarily decrease the long-term growth rate; in the late 19th century, the US grew strongly despite steep booms and busts.

In fact, the evidence is mounting that the battle to tame the business cycle can be counter-productive. For one, the US economy is becoming addicted to debt. While it took \$1.5 of debt to generate a dollar of annual growth in the 1950s and 1960s, that figure since rose to the point where over the past decade, it took \$5 of debt to generate a dollar of growth.

Worse, the effort to fight off recession tends to benefit the status quo economic powers. It is probably no coincidence that since 1980, the top 10% of the US population has seen its share of national income rise steadily from 35% to 50%. Noted economist Robert Reich has been warning that just the top 1% of the US population holds 23% of the wealth, a share similar to what they held in the run-up to the Great Depression, when inequality helped trigger a breakdown of the economic system.

It is ironic that many left-leaning economists keep calling for more stimulus to help the unemployed, when it is clear that stimulus ends up bailing out inefficient players who benefit hugely from the status quo, but are the least likely to generate new sources of growth in the eco-

nomy. Japan is a classic case of why trying to engineer a 'soft landing' can hurt in the long term: for two decades, Japan has used big spending and bailouts to prop up its economy, and all it has achieved is a fatter public sector and falling productivity.

On the other hand, nations that are forced into a hard landing often wind up better off, because the pain forces deep reform that sets the stage for rapid growth. This has happened repeatedly in recent years, from Sweden and Finland in the early 1990s to South Korea and Indonesia after the 1997-98 Asian financial crisis. They were all forced to clean up the bad debts of their banks, allow their currencies to fall sharply to make exports more competitive, and to eventually reduce government spending.

**Integration of supply chains is a major reason why developed & developing economies now expand and contract in sync**

Execution must be swift, and the programme must promote private competition while cutting back government spending, which releases government workers into the labour force, reducing wage costs and raising corporate profitability. As inefficient public spending falls, interest rates tend to fall, while households tend to invest more, because they figure falling public debt means lower taxes in future. The key driver of growth, during these periods of austerity, was resurgent private investment.

It is unlikely that the US is going to embrace austerity, at least not until its back is against the wall. Few countries volunteer for suffering, and because the dollar is the world's re-

serve currency, the US still has no problem funding its deficits, and little sense of urgency. So, the Washington stalemate over the debt mess is likely to continue, resulting in a muddle path for growth, and a return to shorter recoveries and sharper recessions. If history is any guide, expansion phases are likely to last about three years that could signal a short life for the current recovery.

Will volatility make a comeback in poorer countries as well? Emerging markets have much less debt than the US, so they still have room to cut interest rates and raise spending in a downturn. But they are also more connected to the US than ever, due to the surge in global trade and capital flows. Over the last 15 years, the share of production inputs sourced by US manufacturers from emerging markets has shot up from 9% to 15%.

The integration of global supply chains is a major reason why developed and developing economies have begun to expand and contract in sync, even though the long-term growth rate of the developing nations is still much higher.

The disconnect between the length of economic cycles and average economic growth rates is vitally important. It suggests that the current trends — relatively high growth in the emerging world, tepid growth in the West — can and will continue. Growth rates in emerging markets could still match the 5% average of the 1950s and 1960s, while the debt-strapped US will find it hard to grow at the 3.5% pace seen back then. But economic cycles in emerging markets too are set to be more volatile than was the case in the 1980s and 1990s, as a result of more volatility in the US. The plot then is about to thicken with more dramatic twists everywhere.

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