The End of the Business Cycle?

Steven Weber

WAVES TO RIPPLES

WESTERN POLITICAL economy since the Industrial Revolution has been a vibrant world of rapid growth and development, at least for countries in the industrial "core." But it has also been a world of continuing and sometimes enormous fluctuations in economic activity. Business cycles—expansions and contractions across most sectors of an economy—have come to be taken as a fact of life. But modern economies operate differently than nineteenth-century and early twentieth-century industrial economies. Changes in technology, ideology, employment, and finance, along with the globalization of production and consumption, have reduced the volatility of economic activity in the industrialized world. For both empirical and theoretical reasons, in advanced industrial economies the waves of the business cycle may be becoming more like ripples.

The dampening of the business cycle will change the global economy and undermine assumptions and arguments that political economists use to understand it. "History counsels caution," Alan Greenspan warned the Senate banking committee in February 1997, about "visions of such 'new eras' that, in the end, have proven to be a mirage." Greenspan is surely right to warn against too easily accepting that the present is fundamentally different from the past,

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but a growing body of evidence suggests that the world may indeed be witnessing important changes in how business cycles work.

CYCLING THROUGH HISTORY

BUSINESS CYCLES have been linked to big changes in international politics and economics over the last century. The depression at the end of the nineteenth century closed a historic era of advancing free trade and saw Germany and America move decisively toward protection. A shift in world economic power laid the groundwork for conflicts that would culminate in world war. The Great Depression of the 1930s brought international protectionism and the near collapse of trade. The gold standard disintegrated after competitive devaluations, and competing monetary blocs developed. The depression tore apart international cooperation, preparing the way for the rise of illiberal nationalist ideologies—most prominently Nazism—that contributed, in turn, to another world war.

Thirty years later, the oil shock and ensuing stagflation of the 1970s forced energy importers to compete intensely for export markets, driving many to borrow heavily from states and banks. A number of developing economies suffered debt crises and slid backward in the "lost decade" of development. In the North, tight monetary policies, slow growth, and high inflation boosted protectionist forces while drawing voters away from liberals and social democrats and toward Reagan, Thatcher, and other proponents of a new conservatism. The Bretton Woods system for international monetary cooperation finally came to a de facto end in 1973 and a de jure one in 1976. Partly in response, the Group of Seven (G-7) was created in 1975 and the European Monetary System, the precursor to the European Monetary Union, in 1979.

Relations between the North and the South are also tied to business cycles. Development depends on sustained global growth that requires trade and open markets, stable investment flows, diffusion of appropriate technologies, and protection of the environment. Business cycles complicate each of these. Foreign aid comes under pressure when economic activity slows. Downturns in the North breed protectionism, closing markets for producers in the South. Interest and exchange rate shifts can make debt service more bur-

densome and bring devaluation or default and the attendant political risks. Finance also tends to follow business cycles; investment flows that increase during upswings often suffer retrenchment and repatriation during downturns.

Perhaps it never before made sense to ask what would look different if something assumed to be a constant was no longer around. But it is not enough to assert, like *The Economist*, that since there have always been business cycles, there will always be business cycles.[1] Understanding what causes business cycles and how those causes have changed suggests that business cycles will not be as important in the future as they were in the past.

BOOM TO BUST

A TYPICAL business cycle has four stages: prosperity, transition, depression or recession, and recovery. The story is familiar. During prosperity, banks lend, consumers and firms spend, and new jobs push the work force toward full employment. But eventually growth slows, interest rates rise and make some investments unprofitable, wage demands exceed gains in productivity, and inputs for production become more expensive. The costs of doing business increase across the board and firms' profit margins begin to fall. Some lay off workers, and the rate of investment declines as businesses focus on selling inventory rather than developing new ideas. The economy moves toward recession or depression as demand slackens: consumers postpone spending while firms reduce investment and try to streamline production by laying off more workers. The general mood becomes increasingly pessimistic as employment, income, and demand all decline. But eventually prices adjust to the decline in demand and wages and interest rates fall, usually as a result of both government action and a drop in the number of people and firms seeking loans. Investment starts to pick up as inventories run down and returns on new projects exceed the costs of borrowing. Businesses start to buy more and hire more labor. New jobs spur consumer

[1] "Taking the Business Cycle's Pulse," *The Economist*, October 28, 1995, pp. 89-90: "Economies have moved in cycles from boom to slump for centuries. There will certainly be another recession some day. The only question is when."

optimism, hence spending. The surge in demand brings the economy back to the prosperity phase, and the cycle begins again.

No one is precisely sure why business cycles occur. Modern business-cycle theory is essentially a series of stories about cyclical responses to external shocks. The real questions are where shocks come from and what turns a shock into a business cycle. There is more disagreement about answers to the first question than to the second.

Two lines of argument see shocks coming principally from the demand side. The first emphasizes "errors" in monetary policy that cause instability in real expectations. If the U.S. Federal Reserve, for example, were to lower or raise interest rates at an inappropriate moment, consumers might well respond by spending more or less, thus affecting changes in prices. Businesses could mistake that move in prices for an actual change in underlying demand, and consequently make poor investment decisions. Suddenly supply and demand are badly out of sync, and a business cycle has begun.

John Maynard Keynes pointed to a second scenario. He claimed that private decisions to consume depend on an individual's psychology and the relationship between his or her income and spending. Businesses, meanwhile, invest by making assumptions about the marginal efficiency of capital. All of these assumptions and decisions have to be made in the context of mixed and confusing data as well as volatile and uncertain expectations—about demand, technology, productivity, future prices, and so on. Those expectations are erratic. "Irrational exuberance" can cause too much spending, while pessimism can do the opposite.

Shocks, however, can also come from the supply side. An embargo, a war, or even a fluctuation in weather could dramatically change the price of important inputs. Productivity shocks, usually brought on by a sudden change in technology that alters the costs of production or results in an entirely new product, can also upset the basic contours of supply. New technologies require decisions about new capital goods, but these take time. In the interim, innovations cause price fluctuations that set off business cycles.

Uncertainty in business planning leads to mistakes that spread throughout the economy. This uncertainty is made worse by the competitive structure of the economy and the time lag between perceived

demand and production. Complex psychological factors come into play as business planners look not only to the external world with its confused signals about prices and demand, but also to each other for signals of optimism and pessimism. Business investment fluctuates while inventories expand and contract in ways that do not closely reflect changes in demand. Prices may shift relatively easily to adjust to new market conditions, but wages, which are sticky, generally shift less, causing unemployment. All these factors multiply and accelerate throughout the economy. Profits fluctuate, and so do future expectations of profits. Investment calculations change. And so on and so forth.

STRANGE DAYS?

As THE American economy enters its seventh year of sustained growth with minimal inflation and historically low unemployment, pundits commonly describe the most recent business cycle as "different," "peculiar," or "strange." In fact, it may not be an aberration, but the next step in a new trend.

Economist Victor Zarnowitz has shown that since World War II, the expansion phases of U.S. business cycles have gotten longer on average but also more variable in length. Meanwhile, contractions have gotten shorter and more uniform in length, as well as milder overall. In that context, the recent American experience does not look so strange. The U.S. economy has been in a sustained expansion phase more or less since the fall of 1982, interrupted only by a shallow and brief recession in 1990-91 that barely deserved the name. Real output declined a total of only 1.6 percent and only for two quarters. Unemployment reached a little above 7 percent. Expansion returned as early as March 1991, and has shown no real sign of letting up.

The expansion of the 1990s has been notable for the lack of inflationary pressures. Two forces that usually drive inflation—low unemployment and high capacity utilization, or the efficiency with which businesses use their machinery—do not seem to be operating "normally." The assumption has been that once unemployment falls below some particular threshold, labor is in such demand that workers can insist on higher pay. This is the classic story of wage-

driven inflation, but in recent years such inflation has been nearly absent. The Federal Reserve reportedly uses 6.2 percent as a conservative estimate of the minimum rate of unemployment consistent with low, steady inflation. Unemployment drifted downward from 6.4 percent in December 1993 to 5.4 percent in December 1994, and has since steadied between about 5.6 percent and 5.2 percent, with an overall average of 5.4 percent for 1996. Yet there is no evidence of substantial inflationary pressure resulting from demands for higher wages. Between 1993 and 1996, average weekly earnings in nonagricultural private industries rose annually by only 2.8 percent, 3.3 percent, 2.3 percent, and 3.0 percent. In real terms, U.S. wages have either fallen or only negligibly increased for at least 15 years.

Business cycles are becoming less prevalent, less severe, and less significant.

Capacity utilization is also supposed to drive inflation when it reaches 81-82 percent. But utilization hit 81 percent in mid-1992 and has remained above 82 percent (mostly above 83 percent) since 1994. In the winter of 1995 it peaked at over 85 percent. The mild slowdown of spring 1995 brought the level down only to 83.7 percent, still significantly above the supposed threshold for inflationary pressures. Yet producer and consumer price inflation remain subdued—around 2.7 percent and 3 percent, respectively, in 1996. And recent studies suggest the consumer price index may overstate the problem by as much as half. At the same time, expectations about future inflation, as reflected in 30-year Treasury bond yields, have steadied; average yields have declined from over 8 percent in 1991 to around 6.71 percent in 1996.

These peculiarities have prompted occasional speculation that the business cycle has somehow died, as well as declarations that nothing fundamental has changed. A more modest and defensible argument is that the current cycle reveals important changes in the operation of modern economies, and that these changes will tend to dampen business cycles and render them less prevalent, less severe, and less significant than in the past. The significance of exogenous shocks is diminishing, and the cyclical dynamics that respond to shocks are increasingly restrained.

THE NEW ECONOMICS

SIX FACETS of the modern economy contribute to the dampening of the business cycle: the globalization of production, changes in finance, the nature of employment, government policy, emerging markets, and information technology. These six factors tend to reduce transaction costs, make supply and demand more fluid, compensate for production imbalances, and smooth out growth and adjustment. There will certainly still be economic shocks, whether from natural or political events or technological change. And just as surely there will be errors in monetary policy and mistakes in business planning. Those fundamental forces of the business cycle have not gone away. They will, however, be less important in a more flexible and adaptive economy that adjusts to shocks more easily and with less propensity for sparking a new cycle.

The shifts in employment—from manufacturing to service jobs and from career employment to temporary employment, often with several employers—contributes to the dampening phenomenon. In 1950 services employed about half of U.S. workers. By the mid-1990s services accounted for almost 80 percent of American jobs. The U.S. numbers are the most dramatic, but they are not out of line with trends in other advanced countries. This is important because service employment is generally less cyclical than employment in manufacturing. Most services are less vulnerable to large swings in inventories, simply because of the difficulty of building up or running down stocks of intangible goods or altering the rate at which services can be provided. Indeed, the demand for many services remains relatively constant through downturns in economic activity. Restaurants and doctors suffer during recessions, but not nearly as much as makers of automobiles. Government services tend to be countercyclical, in greatest demand when times are tough. In the most recent American economic downturn, around 1991, manufacturing output dropped about 3.4 percent, while the output of services did not decline at all. Even in the manufacturing "powerhouses" the difference was clear: Japanese manufacturing output dropped 13.5 percent in the last downturn, while services dropped only 2 percent; for Germany the numbers were 11 percent and 0.2 percent, respectively.

The increase in services employment is also a factor in the general decline in union strength, since unions are typically stronger in manufacturing and industry. In 1953 more than a third of American workers belonged to unions. Today only one in ten private-sector workers are unionized. Finland and Sweden aside, union membership fell in all Organization for Economic Cooperation and Development countries during the 1980s, on average more than 6 percent each year. Weaker unions herald reduced bargaining power for workers and diminished pressure for wage-driven inflation. One measure of that trend, albeit imperfect, is the declining tendency to strike in almost all advanced industrial countries. In 1995 strikes fell to a 50-year low in the United States, and in 1996 only nine strikes involved more than 5,000 workers. Declining union power contributes to the development of increasingly flexible labor markets, extending to downwardly flexible real wages in some OECD countries, notably the United States.

Labor market flexibility also gains from the shift from the old paradigm of lifetime employment to a new one of temporary work, which is expanding briskly. While the Fortune 500 companies reduced their full-time labor force by more than 30 percent over the last 15 years, the number of temps in the United States has grown nearly 19 percent in the last 3 years and now accounts for 10 percent of the American work force. Growth has been most rapid in technical and professional fields (including not-so-low-wage fields like accounting, computer services, and medicine), where, paradoxically, permanent status as a temporary worker is becoming an increasingly respectable career path. The overall effect should be a more efficient labor market where redeploying labor, an expensive factor in the production process, is cheaper and easier. While such changes are certainly neither cheaper nor easier for workers, improvements in continuing education and progress on portable health insurance arrangements could change the parameters.

Rapid innovations in information technology may also work to dampen the business cycle. At an abstract level, information technology reduces the price and raises the quality of the information businesses use to make decisions. This process is making an important practical difference in the management of inventories whose mismanagement contributes to cycling. In the United States and Britain, the ratio of stocks to sales in manufacturing fell about 17 percent during the 1980s,

and U.S. ratios fell an additional 8 percent in the first half of the 1990s. In 1994 inventory expansion added just 0.6 percent to GDP growth. Two years later, changes in inventories accounted for only 0.2 percent of change in real GDP.

Trimming down inventories works in part because more firms are using sophisticated information technology systems for supply chain management. Decisions about how much to produce, what inputs are needed when and where, and whether it is possible to track down alternative sources for an input in short supply are increasingly made with the assistance of sophisticated computer software that tracks hundreds of variables and adjusts production schedules to optimal configurations. Apart from smoothing out fluctuations driven by purchasing for (and selling from) inventory, information technology almost certainly contributes to overall efficiency by shortening the time to market. The computer manufacturer Dell, for example, has just built a factory with no space for inventory at all. In some industries the term "supply chain" is itself becoming obsolete as information systems running in both directions link suppliers directly to factories on one side and customers on the other.

The increasing ease with which the production, distribution, and maintenance of goods and services locate around the world will stabilize business cycles, primarily by reducing the sensitivity of economic activity to conditions in any single country. Claims of a borderless global economy are still a vast exaggeration. But for an increasing number of firms—and not just the biggest multinationals—demand and supply are becoming more global than national. As trade barriers and transportation costs continue their long postwar decline, both capacity and demand—still measured primarily in national accounts—move with increasing ease across political boundaries.

The shift toward services reinforces this trend. Just as services are becoming more important in most businesses, trade in services is increasing, in recent years at a rate far exceeding trade in manufactures. So-called invisible exports, which include services, noncommercial transfers of capital, and income from overseas assets, reached $2.4 trillion worldwide in 1993; global merchandise trade that year was $3.6 trillion. For the United States, which leads the world in invisible exports and accumulates the world's largest invisible trade surplus,

these exports may now account for upwards of 10 percent of GDP. The growth and development of financial markets, further (even patchy) progress in the World Trade Organization (WTO) on services, privatization in telecommunications and energy, and other advances will likely accelerate these trends.

MORE MARKETS, MORE MONEY

DURING THE 1980s finance went high-tech and global. Stock markets, the mainstay, are expanding around the world. Many Latin American countries began the 1980s with stock market capitalizations—the worth of all stocks trading on the market—of around 5 percent to 10 percent of GNP. Now the numbers range between 50 percent and 100 percent, and at least five developing countries have stock market capitalizations greater than national income. Along with larger capitalizations and greater liquidity comes increasing efficiency at linking capital to production and managing risk. Developed countries' market capitalization rates have increased as well, if somewhat less in relative terms, simply because they had larger markets to begin with. Worldwide market capitalization tripled in the decade beginning in 1986.

The growth of other financial markets as well as mutual funds and similar products has been phenomenal—particularly, but not only, in the United States. Concerns about derivatives trading reflect that enormous growth. In developed countries, trading in over-the-counter derivatives exceeded $8.5 trillion in 1993, along with more than $6 trillion in interest rate swaps outstanding. Activity in standard financial instruments traded on exchanges (currency futures, stock market index options, interest-rate futures) doubled between 1992 and 1994. These new financial products spread and diversify risk. And despite a few heavily publicized losses on derivatives contracts in the mid-1990s, these numbers will probably climb higher as corporate treasurers and fund managers become better at using these new tools to stabilize financial flows and protect themselves against shocks.

Money is also increasingly raised and borrowed internationally, with greater diversity in funding sources. The OECD reports that total borrowing on international capital markets rose to more than $830 billion

in 1995, from less than $360 billion just five years before. In 1995 U.S. investors bought almost $940 billion in foreign bonds and $396 billion in foreign stocks. In 1989, the peak year of Japan's boom, that country bought $94 billion worth of foreign bonds and $18 billion worth of foreign equities. Foreign exchange trading has grown most quickly, in part to support trade but also simply as a self-contained market. No one knows exactly how large that market is, but daily turnover exceeded $1 trillion per day sometime back in 1993.

Global capital markets are increasingly efficient at linking capital to production, managing risk, and providing shock absorbers that cushion economic fluctuations. And the wider array of funding sources and more sophisticated risk management techniques are stabilizers for a globalizing economy. A firm that wants to borrow money can now inexpensively choose the currency and terms of a loan. Investors can buy repackaged pieces of risk and spread their holdings across countries, industries, and time periods. While the complexity seems daunting and may lead to greater volatility for some individuals or firms, overall the global economy should benefit as short-term ups and downs in any single market or small group of markets can be compensated for elsewhere. The doomsday argument, advanced by writers like William Grieder, that complex markets might act in synergy and come crashing down together is simply not supported by a compelling theoretical logic or empirical evidence. Two and a half years after the peso collapsed in Mexico, the striking aspect of that "crisis" is how limited the feared "Tequila effect" turned out to be in both scope and longevity.

Complex markets will not act in synergy to come crashing down together.

The explosive growth of emerging markets in the post–Cold War world should also dampen the business cycle. Unlike the Asian Tigers of a decade ago, the new emerging economies include large populations and rapid growth rates. Brazil doubled its inflation-adjusted per capita income between 1961 and 1979; China did the same between 1977 and 1987. International Monetary Fund estimates for growth rates in the developing world are now more than double those for the developed world. Explosive growth in even a few of these very large economies will change the way the world economy works.

The most direct impact is the effect that a billion-odd new consumers could have on demand. A few conservative estimates give a feel for the stakes. The World Bank believes that in 2002 a "Chinese Economic Area" comprising China, Hong Kong, and Taiwan could have GDP of $9.8 trillion, a little larger than America's projected GDP at that point. An embryonic middle class is already fueling a consumption boom. From pagers to refrigerators to automobiles, demand growth in the developing world is set to outpace that in the West. On top of that growth, there will be an unparalleled demand for new infrastructure and public investment. Asian nations alone will spend several trillion dollars in the next decade to build electrical power grids, roads, telephone systems, and airports in staggering numbers.

The developed world will meet a substantial part of this demand. American exports to developing countries make up more than 40 percent of total U.S. exports, while in Japan the figure is nearly 50 percent, and such exports are growing much faster than those to other developed countries. The 1990-91 downturn highlighted the significance of this trade. Developing countries' demand for imports barely slowed. In fact, continuing growth in the developing world, which stayed above 5 percent, was a dynamo that helped keep the recession in the North both mild and short.

Emerging economies will drive supply-side effects as well. In the short term, the fear of losing out to lower-wage producers in the developing world will slow demand for higher wages among workers in the North and thus inhibit wage-driven inflation. But in the longer term, emerging economies will drive developed countries to make investments in human and physical capital and to move upmarket technologically, all of which spurs productivity. Meanwhile, terms of trade will improve as the cost of rich countries' manufactured imports declines. A hard turn toward protection against developing country imports obviously would hamper this virtuous cycle. But the political forces that support general protectionism are not strong in most Western states. In the United States protectionists lose the big wars—over the North American Free Trade Agreement (NAFTA), over most-favored-nation status for China, over the WTO—even if they win the occasional battle. And pressure for broad protection will weaken as exporters and others who gain from open trade advance their

agenda. Add explosive growth in portfolio and foreign direct investment in the developing world, particularly after 1993, and the result is a strong constituency of interest groups from developed countries that benefit from growth in what used to be called the Third World.

THE SOUTH GOES NORTH

An international political economy with subdued business cycles in the industrial core will operate differently from the postwar political economy, with important consequences for North-South relations, government policy, the role of international institutions, and the future of employment.

The central issue of political economy in North-South relations is whether the liberalization of developing economies, a crucial component of rapid growth in the South, will continue. Sustained global growth, open markets for trade, stable and substantial capital flows, technology diffusion, and progress on management of environmental problems are necessary conditions for continued development. The dampening of the business cycle in the core should help at least some: moderate, stable growth provides a more auspicious environment for adjustment than boom and bust. The North must redeploy capital and human resources, steps that require training, education, research and development, and investment. Steady growth with low inflation should facilitate those measures and encourage longer-term planning by businesses, individuals, and governments. Deep downturns, on the other hand, transfer votes and power to protectionists. If there are no deep downturns, protectionist forces can be more easily kept at bay, bought off, redirected, and conciliated—just imagine how much more difficult it would have been to gain passage of NAFTA during a recession. The progressive if gradual opening of markets and a more constant flow of ideas, technology, and capital between North and South both become possible with steady growth.

Along with protectionism, immigration remains a politically significant problem in the North. Immigrants are often unwelcome in stagnant economies but are likely to be accepted—even coveted—during periods of growth. Subdued business cycles could dramatically change the political dynamics surrounding immigration. Developing

countries already contain about 80 percent of the world's population, and almost all net growth in the global labor force over the next 30 years will take place in the South. Capital and labor seek each other out, which implies either migration of workers from South to North or capital flows from North to South. Many of the barriers to capital flows have come down. As capital markets continue to deepen in the South, bank lending, foreign direct investment, and portfolio investment from the North will all continue to grow. The dampening of business cycles should flatten out some of the boom-bust character of capital flows and promote a more regular and predictable transfer of investment to the South. The stark truth is that most political forces North and South prefer capital flows to immigration, so this solution is likely to grow, rendering immigration less of a problem.

Dampened business cycles will promote more regular investment in the South.

Debtor countries in the South today borrow money through contracts with built-in inflationary expectations, paying a premium that foreign banks reap as a windfall profit. In the future, with inflation lower than those contracts predict, growing out of debt will become harder, and at least some developing countries will have to either default on or renegotiate their debt contracts. Does this signal another international debt crisis? Possibly, but because foreign direct investment and portfolio investment have largely replaced bank lending to developing countries, and because private investors and mutual funds can absorb losses better than banks, debt rescheduling need not spawn a systemic crisis as it did in the early 1980s. Eventually low inflation will itself repair some of the damage that it inflicts in the short term; since inflation premiums in lending will decline, developing countries will be able to secure new loans at more reasonable rates. Overall, steady and low inflation rates should improve the efficiency of capital allocation around the world by removing confusion and misinformation from lending calculations. All this is quite salutary, given the growing demands for capital in the developing world.

Low inflation will also affect employment in the developed world. Lost jobs are a major political issue in the West, even if economists disagree about precisely what combination of low-wage imports and technological change leads to the elimination of jobs. How will

developed countries respond? There will certainly be some protection, but countries that capitalize on this new global division of labor by innovating and investing in human capital to boost productivity will do best. Still, some permanent loss of certain types of jobs and an increase in structural unemployment seem likely in the developed world. This could have significant political repercussions if it means a permanent underclass of long-term unemployed, particularly if the economic divide coincides with racial or ethnic lines of fracture. For societies that view themselves as modern democracies with equal opportunity, the implications are troubling.

Some states might find currency devaluation to be politically alluring in a low-inflation world. In the short run, devaluation strategies promise to save jobs by boosting export competitiveness and raising the price of imports. But since many states are similarly tempted, the stage is set for a competitive race to devalue. New problems of cooperation would thus arise as Northern states struggled to deal with the employment consequences of flourishing production in the developing world. The G-7 states will certainly want to avoid a vicious circle of devaluation that would end with higher inflation but no gains in competitiveness. Within the European Union, incentives to avoid competitive devaluation are particularly compelling, since workers in Europe are in a relatively strong position to resist the cuts in real wages that devaluation would entail. Competitive devaluation within the EU would prove futile relatively quickly, and the accompanying political tensions might risk undoing the achievements of the single market. Indeed, those risks are part of what prompted the EU to move toward a single currency sooner rather than later.

But Europe is not the only place where exchange rate policies will be subject to additional constraints. The conventional wisdom, which sees floating exchange rates as the nearly certain future of international monetary matters, could be wrong. There are strong countervailing forces that will push in the other direction, toward a new currency scheme. The incentives states have to fix rates—primarily, reducing transaction costs for international trade and finance—become more important as interdependence increases. Export-oriented producers of tradable goods gain from fixed rates, as do overseas investors. Fixed rates also avoid the temptations of competitive devaluation.

But the argument turns on the strength of the disincentives—the reasons why states shun fixed rates. As the EU learned during its 1992-93 currency crises, states cannot have capital mobility, fixed exchange rates, and autonomous monetary policy all at once. The standard view is that since capital mobility is here to stay, states choose autonomous monetary policy at the cost of exchange rate stability. But that choice may not be so clear in a world with dampened business cycles, where states will have less need for monetary policy autonomy under normal circumstances. Surely there will be unexpected shocks that call for changes in monetary policy. But could such adjustments be successfully coordinated within a fixed-rate system? Possibly: one country's need to change rates would be easier for others to see, evaluate, and understand, thereby facilitating cooperation. The current consensus on inflation among central bankers may already reflect this trend.

Interdependence will also constrain states' fiscal policies. Markets have priced government debt under conditions of great uncertainty about the real fiscal position of states. One reason is that government deficits are broken down analytically into a structural component and a cyclical component. The cyclical component supposedly reflects changes in spending that governments pursue in response to the business cycle, including both automatic stabilizers like unemployment insurance and changes in tax receipts, and discretionary spending like public works programs that stimulate flagging demand. The structural component of the deficit represents "built-in" overspending that would exist even after cyclical components were removed, simply because governments tend to spend more than they take in. In practice, determining a state's real fiscal position is an imprecise science; calculating the cyclical component of a deficit is difficult to begin with, and differences between countries' accounting procedures and the characteristics of their automatic stabilizers and other budgetary tools compound the problem.

But the inherently cyclical nature of government spending will decline as business cycles dampen. As automatic stabilizers diminish in importance, governments may actually gain latitude to spend money in more directly targeted ways. Futhermore, government agencies should find it easier to project revenues and expenditures. This facilitates longer-range budgeting, but it also denies governments the ability to hide behind excuses about cyclical deficits that

will supposedly correct themselves when the recession ends. Politicians will find it increasingly difficult to defend budget proposals that incorporate widely divergent assumptions about growth rates, inflation, and tax revenues. The new transparency will yield increased pressure to reduce deficits. That pressure will likely be greatest in developed countries with particularly high debt-to-GDP ratios, including Sweden, Italy, and Belgium. In this context, the EU's convergance criteria on budget deficits and debt seem to reflect deeper causes that drive the need for tighter fiscal policies.

ROSE-COLORED GLASSES?

WHAT COULD go wrong in this scenario? At least three things, the most immediate of which is short-term unemployment in the developed world. Pressures for trade protection and immigration restrictions will almost certainly get worse before they get better. Neither declining real wages for the working class nor extensive long-term unemployment is politically sustainable in modern democratic societies. The upside is that much of what needs to be done—at least in terms of increasing incentives for investment, retooling, and retraining—is within reach of government policy. In the wake of failed health care reform, the Clinton administration's emphasis on economic security could lead to policy initiatives on education, job training, and other measures that contribute to productivity. There was, unfortunately, no single post–Cold War conference to dramatize the international importance of this challenge, but there has been a series of smaller successes, from the Maastricht Treaty to the conclusion of the Uruguay Round of world trade talks to the G-7 jobs summit in Detroit. Leadership in key countries like America, Germany, and France will be essential to effective management of this issue.

Whether structural or political, obstacles to expanding production will certainly arise in both the developed and the developing worlds; the question is whether they will be severe enough to derail continued growth. The expansion of capital markets has rendered capital insufficiency much less of a concern than just a few years ago. Energy shortages are surely possible, and a severe and lasting oil shock would be a serious problem. But oil shocks seem increasingly unlikely, given

both the state of the market and the slowly improving political situation in the Middle East. A gradual, moderate rise in energy costs reflecting increased demand would be manageable and arguably even good for a number of reasons, including the environment. Indeed, the environment seems the most likely obstacle to expansion, and thus to future growth. Although no sign of large-scale environmental disaster looms, the possibility cannot be dismissed.

Finally, security problems have the potential to wreak havoc with any scenario. The next decade will witness sharp changes in the location and concentration of economic power around the world. As in previous eras, race, religion, and ideology are overlaid on shifting wealth. Cooperation among the G-7 on a range of issues, more likely in a world with diminished business cycles, is important, but will it be decisive enough to manage the larger challenges? Relations with China and Russia and other unresolved situations lurk in the background and will likely provide a dose of nervous uncertainty. As still-developing countries, however, their prospects for stabilization should improve just as they will for other developing countries—indeed, for all countries—that benefit from a world with dampened business cycles.

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