

Macroeconomics Analysis: Questions and Answers

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1. Are you a pessimist or optimist with respect to the future of business cycles in the United States? Do you think recessions in the future will be shorter or longer than in the past?

Perceptions about how well the economy is performing are even more volatile than the economy itself. This has never been more evident than recently. Seven years ago, most discussions about the U.S. economy focused on the debate regarding whether there was a “New Economy” and whether the United States was entering a new era of greater prosperity characterized by permanently higher output growth and increased macroeconomic stability. Incredible advances in information and communication technology, remarkably strong productivity growth, a booming stock market, and outstanding real wage growth within both the richest and the poorest segments of the population fueled these enthusiastic forecasts. Now, things have changed. Economic discussions in the twenty-first century are characterized by phrases such as “double dip” recession, “jobless” recovery, deflation, and depression. These gloomy conditions have been driven not only by the weak performance of the U.S. economy, but also by the increasingly turbulent political environment America faces abroad and the problems that this creates domestically.

The 1990s were a very good decade for the U.S. economy. After a short recession in 1990-1991, the United States experienced its longest peacetime economic expansion in history, beginning in March of 1991 and lasting until April of 2001, an amazing 121 consecutive months. Compared to the 1970s and 1980s, both unemployment and inflation were significantly lower in the 1990s and real output growth was just as strong. One of the more surprising aspects of the 1990s was that economic performance actually got stronger as the expansion went on. During the second half of the 1990s, there was a dramatic improvement in all three

macroeconomic indicators compared to the two previous decades. In fact, the unemployment rate reached a 40-year low by 2000.

Then the recession of the 2000s came. Many individuals began asking themselves questions, “Which is the deviation, the remarkable growth of the 1990s or the slowdown of the 2000s?” The answer to this question will largely be determined by what one believes was the driving force behind the New Economy of the 1990s. The optimists believe that the IT revolution has had and will continue to have a strong impact on productivity and output growth for the foreseeable future. The slowdown of the 2000s will purge the excesses of the 1990s (such as an overvalued stock market) and set the stage for a resumption of prosperity based on the sound fundamentals of the U.S. economy. In the words of Martin Bailey, the U.S. economy is now prepared to catch its “second wind” (23).

The pessimists believe that the New Economy was primarily a bubble economy built on over-enthusiasm, over-investment, over-building, and over-spending. The 2000s are when the bill has come due, and there is no reason to expect an exceptionally strong recovery, especially since the recession itself was so mild that many of the excesses have yet to be fully driven from the economy. For example, the stock market continues to look overvalued to many observers based on price-to-earnings ratios that remain high relative to historical levels. Robert Gordon states that the New Economy has meant little to the 88 percent of the economy outside of durable manufacturing; in that part of the economy, trend growth in multifactor productivity has actually decelerated, despite a massive investment boom in computers and related equipment (52).

The fundamental limitation on the contribution to productivity of computers in general and the Internet in particular occurs because of the tension between rapid

exponential growth in computer speed and memory on the one hand and the fixed endowment of human time. Most of the initial applications of mainframe and personal computers have encountered the rapid onset of diminishing returns. Much of the use of the Internet represents a substitution from one type of entertainment or information-gathering for another.

Overall, business cycles in the US have been more stable recently, primarily in terms of longer expansions and less frequent recessions. Although the 1990s and 2000s have been too short a period of time on which to base reliable predictions of the future, it appears that this trend toward output and duration stabilization has gotten much stronger during the last twenty years.

Some would argue that the relative stability of the U.S. economy in the 1980s and 1990s indicates that policymakers are learning from their past mistakes and are figuring out how to more effectively manage stabilization policy, better balancing the tradeoff between output stabilization and inflation. It does appear that Federal Reserve policymakers have been more cautious in their policy actions. For instance, the Federal Reserve changed their monetary stance only one time between 1994 and 1998.

On the other hand, during good economic times—times when productivity and aggregate supply are expanding—it is a lot easier to make good macroeconomic policy decisions than during bad times. Monetary policy is responsible for 25 percent of the postwar decline in output volatility (Gordon, 53). However, the other 75 percent is due to fewer external shocks (oil prices, etc.) and good luck. It is better to be lucky than good, and the Fed appears to have been both during the 1990s.

There are two ways to view the frequent business cycles and 2001-2003 growth recession. “The glass is half full” view is that things could have been much

worse given the dramatic and destabilizing events of the early 2000s. Consider the events that have impacted the U.S. economy since 2001. First, the terrorist attacks of 9/11 occurred, which struck directly at the heart of the nation's financial system. Markets re-opened only a week later and stayed open as nearly \$1 trillion in wealth disappeared (Romer, 25-28). The financial system continued to operate, and no significant financial panics or failures occurred despite these financial losses, which were on top of stock market losses that had been accumulating since 2000.

Production and consumption dropped dramatically during September, but many of these declines were offset by a strong bounce-back in production and consumption in October.

“The glass is half empty” view of the U.S. economy is that given the Keynesian nature of this slowdown, the inability of macroeconomic policy to decisively end it is troubling. Despite the aggressive use of monetary and fiscal policy, the economy has continued to limp along, and analysts have used phrases like double-dip recession to describe persistently weak employment and output growth. The continued weakness in the U.S. economy is most evident in the labor market. While growth was a remarkable 8.2 percent in the third quarter of 2003, only 1,000 jobs were created during that same time (Romer, 25-28).

The length of the business cycles along with the economy itself are still subject to unsustainable expansions, recessions, and, potentially, depressions. Only time will tell if the optimists or the pessimists are right, and the answer will undoubtedly influence the way economists think about business cycles in the future.

2. What major trends in the present economy will have the biggest impact on the business cycle?

Modern researchers argue that economies inherently go through long cycles of booms and busts that are driven by changes in technology. New technologies increase productivity, often quite dramatically, but not at first because of the costs of switching to this new technology. After this transition has occurred, productivity can grow very rapidly, but eventually the growth benefits of a new technology wanes as diminishing marginal returns set in. Technological revolutions only last until the next technology coup; then some new technology comes along that initially reduces productivity because of switching costs but eventually increases productivity growth once the technology has been fully adopted.

There is empirical support for this idea that the 1990s were a good period of time. The New Economy of the last half of the 1990s looks a lot like the old economy of the 1960s. The 1960s were a period of remarkable advances in petrochemicals, electronics, aviation, and pharmaceuticals. However, the boom times of the 1960s were followed by the volatile 1970s, a decade characterized by painful periods of stagflation.

At the same time, Robert Gordon argues that the impact of the IT revolution is much more limited than past technological revolutions, for a number of reasons (55-56). First, according to Gordon, most of the increases in productivity that took place during the 1990s were in computer hardware, which directly affects only 12 percent of the economy. In the other 88 percent of the economy, productivity growth actually decelerated. Gordon argues that this is because jobs that could be automated by computers were automated long ago (63). As a result, future advances in productivity from IT appear limited within most industries.

Second, because computer hardware is a relatively minor part of any production process, diminishing returns to new computer technologies set in very quickly. As a result, doubling the megahertz of a computer does not make that computer twice as productive. For example, consider the time spent by a student writing a paper. Faster computer speeds and the invention of word-processing software reduced the amount of time spent writing papers quite dramatically at first. Today, however, faster computers and new software lead to little reduction in the time spent on writing a paper. The primary constraints are human ones: how fast a student can think and communicate (or type) ideas. Better computer hardware cannot eliminate these restrictions.

Finally, it can be argued that many of the technologies most closely associated with the IT revolution, such as the Internet and cellular phones, have not significantly altered production. Instead, they are better thought of as entertainment media, more akin to the television than the combustible engine. Many of the markets created by the Internet are duplicative, meaning they exist in similar forms elsewhere, such as the Web services provided by previously existing retailers (the primary exception to this is eBay). Their main advantage is not one of productive efficiency but of convenience for the consumer. This does not mean that these communication technologies are worthless; it only means that most of the benefits come in the form of utility to consumers and not higher productivity to firms. As a result, compared to other technological revolutions such as electricity, the combustible engine, chemicals and plastics, and plumbing sanitation, IT has not changed things as much as those who are myopic to the history of technology might think.

Works Cited

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