

THE BENEFITS OF RECESSION-
WHAT WE SHOULD BUT OFTEN FAIL TO LEARN

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Abstract

This short article deals with one of the most "emotionally loaded" but misunderstood economic terms in the public vocabulary. Mention the word, "Recession," and virtually everyone experiences a knee-jerk negative reaction. Most economists would admit to the necessity for a business cycle (specifically for a recession) due to the unpredictability of supply and demand, but few would criticize attempts to eradicate it. The problem is that manipulation of the business cycle (especially attempts to prevent recessions) can have both short-term and long-term negative unforeseen consequences. This is not to say that recessions should be allowed to "run their own courses" completely unimpeded (what many perceive to be the position of classical economics), but that the present paranoia whenever the "R-word" is mentioned fails to recognize the disciplinary benefits of recessions. Today we know more than ever before about how to measure business cycles and influence them through monetary and fiscal policies. Yet, *knowledge does not always beget wisdom; and short-term results do not always lead to long run effectiveness (especially when there are significant unforeseen negative consequences).*

This article will elaborate on the disciplinary benefits of recessions in order to generate discussion on how these benefits can be better realized. In addition, a general Biblical framework for dealing with recessions will be introduced. This framework has as its foundation the phrase, "in God we trust," and contains three phases: Discipline (where God reveals mistakes, shortcomings, etc. in the business/household); (2) Repentance (where the believer responds by changing the behavior of the business/household); and (3) Restoration (where God restores the business/household so that it honors Him).

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INTRODUCTION

This short article deals with one of the most "emotionally loaded" but misunderstood economic terms in the public vocabulary. Mention the word "Recession" and virtually everyone experiences a knee-jerk negative reaction. Most economists would admit to the necessity for a business cycle (specifically for a recession) due to the unpredictability of supply and demand, but few would criticize attempts to eradicate it. The problem is that manipulation of the business cycle (especially attempts to prevent recessions) can have both short-term and long-term negative unforeseen consequences. This is not to say that recessions should be allowed to "run their own courses" completely unimpeded (what many perceive to be the position of classical economics), but that the present paranoia whenever the "R-word" is mentioned fails to recognize the disciplinary benefits of recessions. Today we know more about how to measure business cycles and influence them through monetary and fiscal policies than ever before. Yet, *knowledge does not always beget wisdom; and short-term results do not always lead to long run effectiveness (especially when there are significant unforeseen negative consequences)*. This article will elaborate on the disciplinary benefits of recessions in order to generate discussion on how these benefits can be better realized. In addition, we will put forth a general Biblical framework for dealing with recessions. In preparation for looking at these benefits and the Biblical framework, we will briefly define and look at the historical causes of recessions in order to better understand them.

RECESSION - DEFINITION AND CAUSES

The official technical definition of a recession, according to the National Bureau of Economic Research, is two successive quarters of decline in real Gross Domestic Product (GDP) so that the minimum length for a recession is by definition only six months. This definition does not indicate anything about the magnitude of the decline in real output. (The fall in real output from August 1929 to March 1933 (43 months) represented a 32.6% decline; while the recession from July 1981 to November 1982 (16 months) represented only a 3% decline.) From January 1920 through March 2001, recessions have averaged 24 months in length with an average fall in real GDP of 6.2%¹. If we eliminate the 1929-33 recession, the average length is only 11.6 months; and since World War II, the average length falls to 10.2 months.² All recessions are temporary in that their lives are limited, and a trough (lower turning point) will sooner or later occur after which a rebound and an increase in real output will follow. In addition, the economic characteristics of each recession are unique. For example, although the most recent recession (2001) has been over for almost three years, employment has been unusually slow to recover. Employment usually lags the upturn in real output because decisions to increase employment are not made until there is sufficient evidence to confirm that sales are definitely on an upward trend. Although no two recessions are exactly alike, there are generally common causes. These

¹ Michael Parkin, *Macroeconomics*, 6th Ed., Addison Wesley, Table 5.1, p. 109. These statistics originally came from the National Bureau of Economic Research

² A standard Introductory Macroeconomics text defines a recession as, "a decline in real Gross Domestic Product of at least two consecutive quarters." Roger Arnold, *Macroeconomics*, 6th Ed., p.17)

causes can be seen in the different business cycle theories, which have developed over the years. One of the most popular groups of business cycle theories is the group labeled "inventory theories" where periodic excesses or shortages in inventories lead to periodic contractions and expansions of production. Another closely related group, "lack of adequate demand," was championed by one of the most influential economists of the twentieth century, John Maynard Keynes, who based his recommendations of government intervention on the assumption that aggregate demand would periodically fall short of output which would necessitate government pumping up aggregate demand through increased spending.

The above-mentioned groups come under the category of endogenous theories. Another group of business cycle theorists looked to factors external to the economy (exogenous). Joseph Schumpeter stressed cycles of innovation. New innovations would stimulate economic (GDP) growth and keep output rising until the benefited industries had "milked" the technology to its limit; then the recession would set in until the next wave of innovations appeared. (The remedy for recessions here is to encourage innovation.) Other exogenous theories focused on "supply shocks" which by their very nature were generally temporary. These supply shocks (such as a war) could generate increased economic activity after which a recession usually occurred or could spawn a recession (such as a middle-eastern oil crisis) after which an expansion usually occurred.

Wesley C. Mitchell, writing for the National Bureau of Economic Research in his classic 1923 article "Business Cycles" commented,

Differences among business cycles arise from the fact that the business situation at any given moment is the net result of complex forces among which the rhythm of business activity is only one. Harvest conditions, domestic politics, changes in monetary and banking systems, international relations, the making of war or of peace, the discovery of new industrial methods or resources, and a thousand other matters all affect the prospects of profits favorably or adversely and therefore tend to quicken or to slacken the pace of business...To give a sketch of the business cycle which will be applicable to future cases, it is necessary of course to put aside the complicating effects of the various special conditions which at any given time are influencing profits, and to concentrate attention upon the tendency of the modern business system to develop alternate periods of activity and sluggishness.³

RECESSION-RELATED PROBLEMS AND BENEFITS

Since World War II, the federal government has taken an increasingly active role in attempting to stabilize the business cycle. This has coincided with the "Keynesian Revolution" or perhaps this IS the "Keynesian Revolution." Recessions since World War II have tended to be milder and shorter. In the last two decades, the U.S. economy has not experienced a significant recession in either magnitude or length. Output fell only 1.2% in the 6-month 1990-91 recession and only 1.9% in the 6- month 2001 recession.⁴ Statistics indicate a decline in the volatility of the business

³ Readings in Business Cycle Theory, Richard D. Irwin, Inc., (1951) pp. 44-45. This quote appeals to the examination of endogenous factors over exogenous ones although the latter often influences the former.

⁴ U.S. Department of Commerce, *Statistical Abstract of the United States-1993*, Section 14, p.437. St. Louis Federal Reserve Bank, *National Economic Trends*, November, 2003, p.22.

cycle in recent years. An article, written by James Stock and Mark Watson, calculates that "the standard deviation of the growth rate of GDP averaged over four quarters was one-third less during 1984- 2002 than it was during 1960 to 1983."⁵

Classical economists recognized the beneficial effects of recessions much more than economists today. In fact, the classical economic system saw no need for the government to become involved in attempting to soften or eliminate recessions (*laissez-faire*). Government's role was more micro-oriented (encourage factor mobility and productivity, and maintain competition). We should also point out that the technological tools, theoretical principles, and amount of information were not as developed during the eighteenth, nineteenth, and early twentieth centuries as they are at present. Today "the government believes it has to maintain public confidence in the economy in order to build and sustain prosperity."⁶

This paper focuses on developing a list of benefits that result from the "corrective effects" of recessions. These benefits do not necessarily imply that we should allow recessions to follow their natural courses, but that we should be careful in our attempts to lessen the effects of recessions in order to avoid preventing the proper corrective effects from occurring. What are these benefits; and how can we provide the necessary support (be compassionate) to those who are "legitimately hurt" during a recession without destroying the corrective mechanism of the recession and even without generating counter-productive habits (often unforeseen) which are stimulated by the support?

In order to get a better handle on these benefits, we should consider the problems that lead to or are the result of recessions. The following list is not meant to be exhaustive but is designed to lead into a discussion of the corrective effects (BENEFITS) that recessions should bring.

Problem Number One: A product (good or service) that is no longer generating the value it once did for consumers is usually one of the first to feel the effects of a recession. This problem can result from a number of factors ranging from increased competition whose product(s) are a better value to consumers to products that are in the later maturity or even declining stages of their product life cycles (for example video and audio tapes).

Benefit Number One: ACCELERATED EXAMINATION OF PRODUCTS TO CREATE MORE VALUE to the Consumer is a product of recessions which force companies to work harder to attract the consumer's dollar either by lowering prices, improving service, or improving product quality.

Problem Number Two: Increasing Indebtedness across all sectors of the economy (households, businesses, government). "Uncontrolled spending" is certainly a characteristic of the U.S. economy over the last fifty years. This spending has been fueled by a number of factors including expansive fiscal and monetary policy which has put more liquidity into the U.S.

⁵ James H. Stock and Mark W. Watson, "Has the Business Cycle Changed? Evidence and Explanations, *Monetary Policy and Uncertainty: Adapting to a Changing Economy*, Federal Reserve Bank of Kansas City, p.9.

⁶ Austrian Economics Newsletter, Summer 2003, Ludwig Von Mises Institute, interview with Dr. Morgan O. Reynolds.

economy; the lure of advertising and its ally materialistic hedonism; and the lack of concern over mounting indebtedness, and the pressures and changes in lifestyle this generates.

Benefit Number Two: Reminder of the Importance of KEEPING ACCOUNTS CURRENT and KEEPING SPENDING AND SAVING in the PROPER BALANCE: The recession reminds individuals of the necessity of keeping accounts current and of keeping spending and saving in proper balance. Unfortunately, many learn this lesson the hard way by declaring bankruptcy. Interest expense is a fixed cost that remains unaffected by output and thus does not decrease during recessions, as do variable expenses. Recessions also force investors to evaluate more carefully their purchases and often produce necessary stock price adjustments such as the recent dot-com/technology stock bust.

Problem Number Three: A fall in overall productivity that has caused costs to increase to the point where the seller is no longer cost competitive. (For example, U.S. auto manufacturers took longer to produce a vehicle in the 1980's compared to their Japanese counterparts). When the economy is in the expansion (prosperity) phase, there is a tendency to become complacent and even overly optimistic with regard to factors that affect productivity. When the bottom line (profits) begins to slide, the behavior is more reactive to the slide rather than proactive.

Benefit Number Three: REEXAMINATION OF THE PRODUCTION PROCESS and the IMPROVEMENT OF PRODUCTIVITY: Recessions always transmit warnings in the form of falling or slowing sales, or falling productivity with its attendant rising costs, and it is these warnings that should motivate the seller to reexamine the production process and ferret-out inefficient, unproductive resources and production methods. (This has led to a significant amount of outsourcing in the last ten years.) Ideally, this reexamination should occur continuously but the pressure is greater during a recession.

Problem Number Four: Poor upper level management choices have put the company's resources at risk either by overproduction in certain products or unwise entry into new markets. As was the case in Problem Two, the optimism attending an expansion period permeates upper level management resulting in "excessive" risk taking (A good example of this was the diversified expansion of former WorldCom into new unrelated markets.)

Benefit Number Four: REASSESSMENT of STRATEGIES and POLICIES and a THOROUGH INVESTIGATION OF THE USE OF the COMPANY'S RESOURCES: The onset of a recession should be a catalyst for a careful examination of strategies and policies by upper level management, and the threat of recession should act as a positive constraint on the risk-taking decisions of the board and firm's executive officers. Thus both the threat of and occurrence of recession act as a positive tool in promoting responsibility through sound strategies and policies within the ranks of upper-level management.

Problem Number Five: An artificial inflating of the economy by macroeconomic policies, which have "run their course." This artificial inflating may occur for political reasons or because of good intentions of the FED and other government officials. The inflation is not limited to monetary policy but would also include government spending such as agricultural price supports. The problem is that the artificial effect is only temporary and will automatically trigger forces to

bring about an adjustment (for example the expansion in the later 1990's followed by the recession of 2001). A thorough investigation of the proper involvement of the federal government in recessions is a topic for books and is too great for us to handle here.

Benefit Number Five: WARNING AGAINST ARTIFICIAL METHODS OF INFLATING SPENDING which have negative unforeseen consequences: This benefit has repercussions for households, corporations, and even governments. The sooner these three institutions realize that income (receipts) should be saved (invested) as well as spent and that financial planning is important at all levels, the quicker society's resources will be more efficiently allocated. In addition, prices will more accurately serve as indicators of consumer satisfaction and economic efficiency.

Problem Number Six: Increasing Corporate Ethics Violations: There is evidence in addition to logic, that ethical violations tend to be exposed during recessions. As a practical matter, boards of directors, managers, and others in position of authority in business firms should be extra vigilant regarding ethical compromises during recessions (The Enron, Tyco, and WorldCom scandals were uncovered shortly after the end of the most recent recession.)

Benefit Number Six: BELT-TIGHTENING EXPOSES ETHICAL VIOLATIONS AND LEADS TO IMPROVED SELF-POLICING WITHIN INDUSTRY AND FIRMS: Recessions tend to expose unethical behavior in business and reinforce the need for vigilance in providing an internal self-policing mechanism. The economic problems that occur during recessions breed the kind of examination that should be on going but often is not.

Problem Number Seven: Increasing Burdens to U.S. business of regulations, which reduce their global competitiveness. Government regulation in the areas of environment, occupational safety, and product safety has grown considerably over the last 35 years. Most of these regulations are beneficial in dealing with areas where self-policing is ineffective or areas where there are significant economic externalities. However, they do put U.S. corporations at a disadvantage when competing against foreign countries where no such regulations exist.

Benefit Number Seven: REDUCTION OF THE BURDEN OF U.S. REGULATIONS and INCREASING OF U.S. COMPETITIVENESS in International Markets: Recessions act to encourage U.S. corporations to become more competitive in international markets. One of the methods for improving competitiveness is to reduce "unduly burdensome" rules and regulations, which put U.S. firms at a competitive disadvantage.

To summarize, we have indicated seven general economically-related areas (micro and macro) where economic problems are dealt with in a positive manner by the self correcting forces generated during recessions. Like a forest fire that purges the forest of "dead wood," the recession (while painful) can be beneficial to new growth, both to the economy and to individual households and firms that comprise the economy. The key is to PROPERLY CONTROL the recession, much more dialogue needs to occur regarding how we should properly control recessions in order to reap the natural blessings. The Bible's famous example of recession is the story of Joseph's interpretation of Pharaoh's dream found in Genesis 41 and his proactive behavior to minimize the negative effect of the coming lean years (recession). The seven

plentiful years were used to prepare for the seven lean years so that Egypt was in a position to weather the years of famine. This example provides both a warning and a classic lesson about handling economic adversity.

THE BASIC BIBLICAL FRAMEWORK FOR HANDLING RECESSIONS

The basic Biblical framework for dealing with recessions has as its foundation the phrase, IN GOD WE TRUST. This is trust in God's sovereignty to discipline His children (Hebrews 12: 6-11) (Ecclesiastes 7:14) and to always work for the good of His children (Romans 8:28). This trust leads to patience in the true sense of the word, not the lazy, laid back variety according to the world's definition; but the active, focused behavior constrained by God's laws, which does not take unethical shortcuts to "hurry up the process." The Biblical framework has three phases: (1) Discipline (where God reveals mistakes, shortcomings, etc. in the business); (2) Repentance (where the believer responds by changing the behavior of the business); and (3) Restoration (where God restores the business so that it honors Him).

The Discipline phase generates proactive behavior which sees the recession as a form of performance review and holds itself responsible for vigilance in satisfying the consumer, providing for the employee, treating suppliers and creditors properly, and in general being an exemplary corporate citizen. "Commit your works to the Lord, and your plans will be established." (Proverbs 16:3) (See also Proverbs 3:11- 12 and I Timothy 4:7-8.)

The Repentance phase requires the proper response to problems/weaknesses/strengths so that God is glorified. Ethical shortcuts/compromises are not permitted; hard decisions are made in the light of God's Word rather than expediency. The first, but not final, step in repentance is acknowledging errors (II Samuel 12:13); but perhaps even more important is turning toward Jesus Christ or purposing not to continue but to properly rectify wrong policies and/or decisions. "Better is a little with righteousness than great income with injustice." (Proverbs 16:8)

In the Repentance phase, pride must be dealt with and this presents a golden opportunity to build and rebuild relationships within the corporate family. In short, this phase represents an ideal time to transform the workplace into what it should be, a place where 1) honesty is honored and becomes the hallmark of the business; 2) authority is respected and handled responsibly from both the dispenser and the receiver; 3) efforts are made to resolve conflicts as a habit; 4) sexual fidelity is promoted inside and outside the workplace; and 5) members of the corporate community can be trusted to keep their word and fulfill their responsibilities.⁷

The Restoration phase occurs when God restores the firm (household) that has followed Him and taken steps to rectify its mistakes/shortcomings. Restoration is in God's timing and it is critical that the firm (household) trust in God's perfect timing and not attempt an improper restoration through unethical shortcuts or foolish behavior. Remember the costly ramifications of Abram's and Sarah's foolish attempts to help God fulfill His promise by providing heirs to Abram through

⁷ An excellent description of Biblical principles which would transform the workplace are found in the NAVPRESS book, "Keeping Your Ethical Edge Sharp", by Doug Sherman and William Hendricks.

Sarah's maid, Hagar, The unforeseen consequences of this attempt to preempt God's perfect timing are being felt even today.⁸

THE NEXT STEP – WHERE DO WE GO FROM HERE?

This study was designed to raise the issue of, "What can we learn from recessions?" A recession can and should serve as a performance review to help the overall economy as well as individual companies improve. A more in-depth look at these problem/benefit areas and further development of the Biblical framework for dealing with recessions are certainly in order. In addition, we would like to survey key executives and compile a list of valuable lessons learned during or in reaction to recessions. Discipline is usually a difficult pill to swallow and the market can be a "cruel taskmaster." Nevertheless, if we do not learn from history (or from our mistakes), we will tend to repeat it (them). Most of the important lessons we learn are revealed during times of adversity, trial, or difficulty. This principle is as valid to the economy as it is to the firm and the household.⁹

⁸ See Genesis 16. The origin of the hostility between the Arabs and Jews can be traced back to this event.

⁹ I would like to thank faculty members of the School of Business, Belhaven College; Mr. Chris Cullname, Belhaven Librarian; Mr. James Brinkley, Chairman, Legg Mason Inc.; and Mr. Craig Robinson, President, Consumer National Bank for helpful comments.