

THE DETERMINANTS OF UK BUSINESS CYCLES

Output fluctuations over the business cycle can occur for two reasons, according to **Allison Holland** and Professor **Andrew Scott**, writing in the latest issue of the Economic Journal - increases in employment and investment lead to higher production or output/productivity increases without changes in employment and investment. The researchers examine which of these two factors is most important in explaining UK business cycles and try and draw implications for what causes UK business cycles.

They find that around 80% of changes in GDP over the business cycle are associated with productivity changes rather than employment increases. Further, they find that this part of GDP growth is largely unpredictable - in other words, a very large amount of GDP fluctuations cannot be easily forecast. This finding is consistent with a substantial role for supply shocks in driving the business cycle, which in turn suggests that early stages of a business cycle expansion will be characterised by strong output growth and low inflation.

While this favourable combination lasts, monetary policy faces a dilemma - raising interest rates will lower demand and output growth but will push inflation yet lower. The combination also suggests that as the economy slows down, inflation will be rising and so monetary policy faces the opposite dilemma - raising interest rates will help stabilise inflation but will push output down even further.

While the majority of output fluctuations are unpredictable, the researchers find that around 20% of output fluctuations can be explained by variations in employment. In contrast to changes in productivity, they find that the part of output fluctuations caused by variations in employment is predictable and that monetary aggregates contain predictive power. This suggests that the impact that monetary policy has on the economy is felt most keenly through the labour market.

Note: 'The Determinants of UK Business Cycles' by Allison Holland and Andrew Scott is published in the July 1998 issue of the Economic Journal. Holland is at the Bank of England; Scott is Professor of Economics at London Business School.

For Further information: contact Andrew Scott on 0171-706-6780; or RES Media Consultant Romesh Vaitilingam on 0117-983-9770 or mobile 0468-661095 (email: romesh@compuserve.com).