

The Economy in Perspective

The error of our ways... The Bureau of Labor Statistics announced last week that the nation's unemployment rate, instead of edging back up in February after an unexpected January dip, declined further to 5.5 percent. Even January's decline surprised most economic forecasters, who have been projecting a slow recovery in the pace of economic activity and job creation. But the recent labor market reports seem consistent with other incoming data, which collectively depict an economic recovery that is coming together nicely.

It is a cliché that business cycles are broadly similar to one another, yet each exhibits its own special character. One reason for the similarity should be obvious: The experts who date business-cycle turning points look for a certain breadth, depth, and duration of weakness in economic activity before declaring that a recession has begun (the same goes for the strengthening in activity used to date a recovery). The idiosyncrasies arise because cycles originate in multiple disturbances and can be transmitted through different channels.

One unusual aspect of the current recession is the unofficial debate over identifying it as a recession in the first place. When the NBER's Business Cycle Dating Committee stated in November 2001 that a recession had begun in March, it indicated that a downturn might have been avoided except for the September terrorist attacks. However, we now know that the economy did not even contract in the fourth quarter of 2001. Consequently, as more analysts become confident that the recession has ended, some are beginning to suggest that it be annulled.

As a recession, how does the current one stack up? The previous nine post-World War II recessions have lasted between six and 16 months, with an average of 11, so this slump appears very conventional; the speed of its recovery, however, is often spoken of derisively because most observers project an unusually tepid rebound. The received wisdom holds that because consumer spending on durable goods and housing has been so strong during the recession, and business spending on capital goods is being restrained by a cautious high-tech sector, the expansion cannot gain momentum quickly. This view appeals to common sense, but its implications can easily be exaggerated.

The upturn following the 1990–91 recession, for example, was lamented by pundits at the time as a “jobless recovery” because employment grew more slowly than usual during the first several years. That recession, too, was mild and brief, but the expansion that followed proved remarkable in its length and strength. Ironically, that jobless recovery culminated in an unemployment rate so low that anyone who had dared to dream it would have been labeled delusional. And, in a double irony, even those dreamers probably would have condemned an unemployment rate of 4 percent for its inflationary potential, lest they be considered both addle-brained and heretical.

As economists have demonstrated time and again, they have only limited ability to forecast short-term movements in many aspects of economic activity, including production, spending, employment, and exchange rates. Errant forecasts mean little if little depends on them. However, if policymakers who put too much faith in forecasts try to follow a postulated output path representing the economy's growth potential, they risk creating trouble of their own. It is well known that most forecasters who used this construct underestimated the economy's growth potential in the second half of the 1990s. Had the FOMC been determined to resist a decline in the unemployment rate from 5.5 percent—a then-popular estimate of the economy's noninflationary rate of unemployment—a valuable opportunity might have been lost.

Predictions of the future abound, as they always will: Some prognosticators contend that we will have an anemic expansion; some say that the economy could slip into a double-dip recession; still others foretell a surge at year's end. Human nature leads most people, including policymakers, to be pessimistic about the outlook and then to hope for a pleasant surprise. But activist stabilization policies are not the fountainhead of economic growth. As we have become more resolved to achieve price stability, fiscal discipline, innovation, and more trade with the rest of the world, our nation has prospered. In the face of pessimistic forecasts, living well is the best revenge.