

The Economy in Perspective

Spring is here. Why doesn't my heart go dancing?

—Lorenz Hart, U.S. songwriter

According to the National Bureau of Economic Research, an independent organization that dates U.S. business cycle peaks and troughs, economic activity peaked in March 2001 and declined until November 2001. By that account, more than two years have passed since the recession's trough, and three years since the previous cycle's peak. How has the business cycle progressed?

As measured by real GDP, the March-to-November recession was fairly typical in length, but mild in severity. Real GDP declined less than 1 percent from peak to trough. In the two years following the fourth quarter of 2001, it expanded by roughly 7%, and most analysts expect it to advance another percent in the current quarter. Historically, that is also a mild expansion.

Households have been spending actively during the past two years, spurred on by unusually low interest rates. Consumers have also been able to augment their purchasing power by refinancing their debts and tapping into their housing equity. A rebound in stock prices and, more recently, an apparent halt to the deterioration in labor market conditions, have bolstered consumer confidence. Consumer spending and housing purchases accounted for roughly 5 percentage points out of the total GDP growth of 7 percentage points during the two years ending in 2003:IVQ. Federal government purchases accounted for nearly all of the rest.

Business investment spending has not contributed appreciably to spending, nor has production fully regained its footing. More than two years into the recovery, the Federal Reserve's industrial production index has yet to return to its March 2001 level. Consumer goods production has finally regained—but not yet surpassed—its pre-recession peak, while most capital goods production remains in the doldrums. Capacity utilization rates in the goods-producing sector are fairly low, especially for capital goods, and have not shown much upward movement in the past two years.

These relatively low capacity utilization rates are hardly surprising, considering the delirious capital spending that occurred during the last several years of the prior economic expansion. Capital spending increased at double-digit rates for a considerable period of time in a wide range of industries during

the second half of the 1990s, in a boom that not only proved unsustainable but also left a considerable overhang needing to be worked down.

Is it possible that labor markets also became distended during the frenzy leading to the March 2001 business cycle peak? That is, with help-wanted signs posted everywhere, firms paying hiring bonuses, and compensation soaring, is it reasonable to think that many people who otherwise would not have entered the labor force in the latter portion of the last expansion did so because the financial rewards finally became tempting enough?

Economywide labor force participation rates have been rising for many decades, primarily because of the strong, steady advance in adult women's participation, even though the participation rates of adult men have been slowly declining. Teenagers' participation rates generally rose during the 1970s and 1980s before beginning a long decline. Total labor force participation reached a record high at the peak of the last expansion, but since then every group's participation rate has declined—sharply so in the case of teenagers.

Roughly 10 million jobs were filled in the four years leading up to the March 2001 peak, with the employment-to-population ratio hitting an all-time high and the unemployment rate falling to a 30-year low. Now that labor demand pressures have abated, large numbers of people who otherwise might have been in the labor force have decided not to participate. This elasticity of supply helps to explain why, even as the employment-to-population ratio has receded, the unemployment rate still hovers just above 5½ percent today. Not long ago, many economists would have regarded this rate as being consistent with full employment, or nearly so.

Capacity utilization rates have been edging up and the unemployment rate has been edging down, but progress has been languid despite a period of very supportive monetary and fiscal policies. Finally, however, initial unemployment insurance claims have dropped. Capital spending appears to be regaining vigor. And businesses seem far more optimistic about new orders and hiring than they have in quite some time. As the previous business cycle taught us, even from a bleak start a robust expansion can emerge.

Men must walk, at least, before they dance.

—Alexander Pope