

The Economy in Perspective

Predictions of the future are never anything but projections of present automatic processes and procedures, that is, of occurrences that are likely to come to pass if men do not act and if nothing unexpected happens; every action, for better or worse, and every accident necessarily destroys the whole pattern in whose frame the prediction moves and where it finds its evidence.

—Hannah Arendt, “On Violence,”
in *Crises of the Republic* (1972)

U.S. employment grew by only 32,000 jobs last month, dramatically fewer than the 240,000 jobs the pros had predicted. Moreover, the Bureau of Labor Statistics simultaneously revised down its prior estimates of net job gains for the months of May and June by roughly 60,000, more than negating July’s paltry gain.

The July labor report arrived at a pivotal point in the economic outlook cycle. Economic activity expanded at a 4 percent annual rate in the first quarter, but growth moderated to a 3 percent rate in the second quarter. Inflation rates escalated throughout the first half of the year, and recent energy price spikes have intensified concerns about price developments for the rest of 2004. Although there are many reasons to suspect that recent inflation patterns will prove to be transitory, elevated inflation rates could still have a significant impact on spending decisions before the pressures abate.

Analysts have been on the lookout for signs that growth in the second half of the year will return to a more vigorous path, including renewed strength in hiring, hours, and earnings. Besides being regarded as a growth harbinger, the July employment report was expected to trump the labor market weakness reported in June. That month, the Bureau of Labor Statistics indicated that payroll employment had risen by only 112,000 jobs, when analysts were looking for twice that number.

The weakness in the July employment report surprised many financial market participants, prompting them to alter their views on corporate earnings and interest rates. Overall, stocks declined and bond yields fell. Participants began to revise their thinking about monetary policy as well. As recently

as May, more than a few of them had conjectured that the Federal Open Market Committee might be “behind the curve” in raising rates; today some are suggesting that a flatter rate-hike trajectory might be a better idea.

Taken together, these circumstances highlight several “economic truths” that bear repeating. First, most macroeconomic data are derived from surveys, are variable from period to period, and are susceptible to revisions over time. What you see is not necessarily what you get. It could take a year’s worth of monthly reports to determine whether the data show a change of trend. Second, economic forecasting can be a treacherous business. Some economic time series have a lot of short-term volatility but revert back to an average over time, while others might have a lot of short-term persistence but long-term drift. Decisions generally are better informed when reasonable forecasts are employed, but reasonable forecasts do not guarantee correct decisions. A decisionmaker (such as a stock picker, currency trader, or policymaker) must always have a “Plan B.”

Context strongly affects how we interpret incoming information; we establish “frames” for viewing the data. For example, a soft labor market appears more anomalous in the midst of solid gains in orders, production, and income than it does in a weak overall economy. We expect to see certain economic relationships hold up because they have tended to do so over time. We are prone to think of alternative outcomes as deviations from normal. That is, doesn’t weak employment growth always mean that the economy is functioning poorly? Or might it be rational for employment gains to be slow during periods in which firms can achieve large gains in productivity but want to hire only people who can work effectively with new technology and business processes? How much weight should be given to the employment situation as an indicator of the economy’s current cyclical strength, regardless of stronger employment growth’s certain importance to longer-term economic health?

In other words, how much of what we infer comes from what we expect to see, or wish to see? When is it time to alter the frame?