

## *The Economy in Perspective*

*Imagine the possibilities...* The U.S. economy has come a long way since the 2001 recession. Despite terrorist attacks, an ongoing war, and a series of energy price shocks, economic activity has steadily advanced for four years and shows no sign of abating. In fact, the most recent news about the expansion has been very positive: Employment increased at a solid pace in July, and the prior estimates for May and June were each revised upward. Industrial production and capacity utilization continued to rise, and manufacturing orders have been strengthening. Although successive waves of energy price hikes might have made the public uneasy about future inflation, most households and financial market participants seem confident that it will be lower than current inflation.

The economy's performance has not been without its critics. The expansion, which followed a fairly short and shallow recession, got off to a slow start. The labor market's performance was so weak that the first part of the expansion was derisively labeled the "jobless recovery." Today, there are analysts who contend that the unemployment rate has declined to 5%, its long-term average, only because of an unusual pull-back in the labor force participation rate. The employment-to-population ratio has finally edged up to its 2002 level, but is still considerably below its record-high prerecession value. And after four years of growth, capacity utilization rates in a host of industries still lie below their long-term averages.

Tempting as it is to compare one business cycle with another, or with the average of many, the comparisons are not always apt. Business cycles often display some similar characteristics, but the forces driving the cycles—and the mediating channels through which those impulses travel—are usually different. This expansion differs from others partly because of the legacy of the prior cycle, which had its own idiosyncrasies, partly because of the war in Iraq and against terrorist forces elsewhere, and partly because of the continuing expansion of economic activity and trade around the world. There are enough differences from cycle to cycle to make caution advisable when diagnosing problems and prescribing solutions.

Such caution is needed now. Referring to benchmarks reached in other cycles, some analysts conclude that the current cycle has not yet fully taken up whatever resource slack exists. After all, in the last cycle the unemployment rate fell to 4% and some industries' capacity utilization rates were higher than they are today.

But students of previous business cycles have concluded that "idle capacity" is a questionable concept to begin with and notoriously difficult to estimate in any event. Many industries are experiencing wrenching transformations because of technological, regulatory, and competitive changes. In some cases, these changes are pressing against newly established conventional wisdom. For example, many people now believe that energy prices will remain at or above current levels for quite some time. Consequently, investors are willing to finance projects in the energy sector on a scale unthinkable only a few years ago. Coal mining regions cannot find qualified miners because an entire generation of working-age adults had been convinced that there was no future in mining.

Consider the connection between East Asia's ascendancy in the global economy, the U.S. housing boom, and rising energy prices. As East Asian countries integrate with the world trading order, their activities affect us and vice versa. An excess of savings abroad lowers the cost of capital to U.S. borrowers, which results in lower mortgage rates. At the same time, growing energy requirements in the developing nations, coupled with increased uncertainty about the reliability of the energy supply, has raised prices dramatically and attracted large-scale investment in energy sources.

Amidst these changes, other long-term forces are at work. Innovations in information technology and telecommunications are reshaping industry supply chains, financial transactions, and entertainment. Innovations in the life sciences are reshaping the potential of the entire health care industry. Each of these developments has implications for resource utilization in our economy today and in the future.

How much room do we have to grow? The possibilities are unimaginable.