We have been telling you for a long time that the 2001 downturn was highly unusual. Its unusual nature makes forecasting the future more difficult; history is an imperfect guide for what comes next. But with that 8.2% growth rate in the third quarter of this year, things got stranger and stranger. This is starting to feel like a Twilight Zone episode.

The recessions with which we are familiar have been “consumer cycles,” not “business cycles.” In such “familiar” recessions, the first economic measure to turn down is consumer spending on homes, followed by spending on consumer durables. Businesses react to that bad news and reduce their spending, first on inventories and equipment, later on structures. This temporal ordering—homes, cars, machines, and buildings—is echoed over a “familiar” recovery, with spending first rising on homes, then cars, then machines, and finally buildings.

In contrast, the 2001 event was all on the business side. Logically, there cannot be a recovery this time, because there is nothing for the consumer to recover from. Similarly, business spending cannot be expected to fully “recover” unless the Internet Rush gets going again, which is highly unlikely.

Thus, we have been projecting a return to normal business spending, with no strong recovery intervening between recession and normalcy. If all components of GDP were making their normal contribution, we would have relatively steady, 3.3%...
growth, not the 5% spurt typical of normal recoveries. However, there is reason to expect weaker growth than normal, because of the inevitable spending pullback by state and local governments and the probable pullback by consumers, who have already bought enough cars and homes to last them quite a while. Consumers’ need to begin to repair their own troubled balance sheets will also exert a drag on the economy.

The atypical nature of the recession and the precarious state of state/local government and consumer finances thus point to early-expansion economic growth in the 2.5% to 3% range. Though GDP growth in the last four quarters (4.0, 1.4, 1.4, 3.3) has averaged in the expected range, there was much happening that was hard to understand, including surprising weak labor markets and a highly troubled manufacturing sector which has continued to slough off jobs and has generated hardly any growth in industrial output.

But then along comes third quarter of 2003: not modest, normal growth, but an 8.2% explosion? And still no growth in jobs or industrial output.

You are traveling in another dimension…

At the signpost up ahead, you’re next stop … is the Twilight Zone

For the last two years, products have been appearing magically on our doorsteps. No one has been making them and no one has been delivering them.

Figure 1 illustrates the path of employment and real GDP since 1946, including the ten intervening recessions. (Remember that the double-dip event of 1980-82 counts as two recessions.) Normal growth takes the economy in the northeasterly direction in these diagrams, with higher GDP and more employment. In all of the recessions shown, both employment and GDP decline, southwesterly movements in the charts. Then, most of the time, the economy’s rebound resumes northeasterly movement, tracing out a path like the squiggle at the right.

GDP, But No Jobs

This is very clear for the 1948, 1953, and 1957 recessions in the upper left panel of Figure 1. The 1960 and the 1969 episodes illustrated in the upper right panel are more mild, but still take the same shape, as do the 1973 and the 1980/81 episodes in the lower left.

In contrast, the “jobless” recovery of 1990 was a little slow to generate job growth. However, the present episode, in the aftermath of the 2001 downturn, is completely different. We are now moving in a strictly vertical direction: more output, but not more employment.

GDP, But No Factory Production

Since humans don’t seem to be making all this stuff, you are probably thinking that it is being made by aliens from outer space working secretly in our factories during the graveyard shifts. You might think that, but you would be wrong. In fact, just as there is no job growth in this recovery, there is also not much growth in manufacturing, as you can see in Figure 2 which compares real GDP and industrial production in the same fashion as Figure 1 compares real GDP and employment.
Figure 1  Paths of Employment and Real GDP

How Odd is That?
Cycles in Employment and Real GDP
Figure 2 shows the same general northeasterly movement during expansions as Figure 1. At each recession, the variables take a step backward, a bit more rapidly in industrial production than in real GDP, before resuming the northeasterly movement with the recovery. However, this has not been the case in the aftermath of the 2001 recession. We’ve had more GDP, but not more industrial production from factories, mines, and utilities.

We are not making it in our factories, and we are not delivering it either. Figure 3 shows that the employment in transportation and warehousing continues to decline, and Figure 4 shows that air cargo has recovered from the 9/11 effect but has turned in a mixed performance in 2003, with a weak first half and a stronger third quarter.

Notice with all these illustrations that the extremely robust growth of third quarter 2003 did not feature a departure from the patterns of 2002 and early-2003. Even the spectacular Q3 GDP growth was not accompanied by comparable gains in total employment, industrial production, transportation/warehousing jobs, or cargo activity.

**GDP, But Hardly Any Services**

So if the GDP growth has not come from “stuff,” surely it must have come from “services.” After all, we are a service economy, right? Sorry, that explanation doesn’t hold water either. If anything, the service sectors have shown abnormally weak growth throughout the “recovery” and even more so in third quarter.

Figure 5 shows the contributions to normal economic growth of each of the components of GDP. In a normal, 3.3% growth quarter, services would typically contribute 1.2% points to that growth. Now, Figure 6 illustrates the differences in growth in Q3 2003 from the normal pattern in Figure 5. Thus, a zero means the contribution is the same as the normal contribution in Figure 5.

Notice in Figure 6 that services turned in a below-normal performance in Q3, contributing 0.2% points less than it typically would in a normal, 3.3% growth quarter. This was due to softness in both consumer and government services spending. And if the Q3 service-sector performance was not enough to power even normal growth, it was nowhere nearly enough to power the explosive growth reported for Q3.

This was not a new development specific to Q3. Service-sector growth has been weak throughout the last two years of “recovery.” Real consumer spending on services has grown as weakly during the past two years of recovery as it ever has during the “typical” recession of the last thirty years. As shown in Figure 7, only the recession-recovery episodes of 1948-following and 1959-following featured services
The Twilight Zone Economy

Figure 3  Employment in Transportation and Warehousing

Figure 4  Air cargo
Figure 5  Growth Profile

Normal Growth: 3.3%

Figure 6  2003 Q2 Difference from Normal
consumption growth as weak as is currently being seen.

What’s more, whatever services consumption growth is occurring is all on medical care services and on homeowners’ shelter, a non-cash expenditure item that the Commerce Department imputes to consumer spending. (a “Twilight Zone” indicator, if ever there was one). Net of these components, real services consumption has shown zero-change for three years of recession of 1980-82.

What was unusually strong about 2003 Q3? As seen in Figure 6, the strength was in consumer durables, consumer nondurables, and business equipment – all material stuff! Factory workers aren’t making them, the factory sector isn’t producing them, and delivery men aren’t bringing them, but the goods are nevertheless ending up at your doorstep and in GDP.

It’s the Twilight Zone economy.

Forecast: Greater Uncertainty

Our basic story remains in place. Expect next year to be OK, but not great. Expect some employment growth, but not enough to drive down the rate of unemployment. Expect the Federal Reserve to hold on desperately to the Fed Funds rate until there is very substantial improvement in the job market and/or the depreciation of the value of the dollar causes enough inflation to force the Fed’s hand.

But that 8.2% growth is startling and further supports the optimistic view that the US trend rate of GDP growth may really have been affected by all those New Economy investments. What that 8.2% number surely does to increase the error bands around any forecast. This increased uncertainty has important implications for most business decisions that do not depend on the central tendencies of the forecast possibilities, but rather on the possibilities of extreme outcomes. For inventory decisions, the greater uncertainty calls for higher stocking levels to limit the chance of a stock outage. For spending plans, the greater uncertainty calls for lower revenue forecasts to limit the chance that spending commitments are made that cannot be lived up to.
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Additional Recession Comparison Figures

GDP

The downturn of 2001 was very mild as far as GDP is concerned, but growth thereafter has been weak, unlike the 4.5% to 5.5% numbers often racked up in recoveries. The 8.2% growth in 2003 Q3 was an exception.
Payroll Employment

Although the maximum percentage loss of jobs has not been as great as those long-ago recessions, 1948, 1953 and 1957, the persistence of lost jobs 11 quarters since the last cycle peak is completely extraordinary. We are still down almost 3% in private payroll employment. Even the so-called jobless recovery following the 1990 recession had returned payroll jobs to the previous peak level by the 11th quarter.
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Household Employment

The household employment numbers are not great but are not as bad as the payroll numbers. The gap between the household numbers and the payroll numbers is very large, larger even than the 1990 event.
Industrial Production

Industrial production is only bouncing along the bottom, having declined by about 5%. Parallel with industrial production, capacity utilization is bouncing along the bottom at a very troubling level of 74%.
Employment in Manufacturing

Meanwhile, we are producing the same amount of stuff with fewer and fewer workers working long hours. Employment in manufacturing is down by about 16%. Weekly hours of production workers had been at a very high level and are now down but still high.
Fiscal and Monetary Policy

Big Time Fiscal Stimulus but more typical monetary stimulus

Federal Income Tax / GDP During Recessions
Displayed Until Return to Previous Peak Employment Level

Interest Rate on 3-month Treasuries During Recessions
Displayed Until Return to Previous Peak Employment Level