"Big Picture" Measures May Confuse Us; Everyday Experience Really Matters

By Edgar R. Fiedler

Almost anyway you slice it, the US economy appears to have performed superbly in the 1990s. Everything we want more of—employment, wages, incomes, consumption, investment, profits, and stock prices—has increased. Everything we want less of—unemployment and inflation—has gone down. It's a Goldilock's economy—not too hot, not too cold, but just right. And (if you'll permit me to mix metaphors) we can also say that Murphy's law has been working in reverse: everything that could go right, has.

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The contrast to Western Europe, Japan, and Russia is particularly striking. At various times in recent decades, each seemed destined to overtake America in the economic race. First it was Western Europe, when its strong recovery from World War II continued through the 1950s and 1960s. The Soviet Union followed, especially around the time of Sputnik; when Khrushchev said, "We will bury you" [economically] many Americans were afraid he was right. Then it was the Japanese who appeared to us to be 10 feet tall and poised to devastate our major manufacturing industries.

Well, things didn't work out that way. Instead, all three overseas areas are now wallowing in economic troubles—Europe with double-digit unemployment, Russia in a messy and grindingly painful transition toward a market economy, and Japan in a decade-long recession. The contrast to the near ideal economic conditions in the United States is dramatic.

Before we choke on our own congratulations, however, we should heed Kipling's advice to treat triumph as an imposter. A careful look at the US economy reveals that our performance during the 1990s, as good as it was, still falls well short of perfection. Furthermore, a broader examination of American society reminds us that economics is not the single, overriding dimension on which to judge how well we are doing.

Measuring From the Bottom

To put the US economy of the 1990s into proper perspective, we need to focus on two developments that are often omitted from the analysis. The first is the business cycle. The 1990s began with a recession, a mild recession to be sure, but even so when you start at the bottom and measure changes upward, you're sure to get excessively favorable comparisons.

Since 1990-91, we've had seven consecutive years of cyclical recovery. In itself, that prolonged expansion is a remarkable achievement, one of the three longest on record and, who knows, it could well establish a new record for longevity.

To be fair, however, economic performance should not be measured starting from a down year; instead, the measurement should be across business cycles, via a fitted trend, or from cyclical peak to cyclical peak.[1] On that basis, the 1990s still look very good, although not quite as spectacular as when they are measured starting from the bottom of the recession.

Productivity's Lackluster Growth

The second, more serious qualification is the continued mediocre growth of productivity during the 1990s.[2] As the primary source of gains in living standards for Americans, productivity growth is a crucial—but too often ignored—indicator of economic performance.

During the 1950s and 1960s, productivity advanced at a vigorous pace, more than 3% per year. Subsequently, however, the trend slowed markedly —to about 1 1/4% per year during the 1970s and 1980s, and the 1990s have continued this lackluster growth rate.

We can best understand the importance of this slowdown, perhaps, by calculating what would have happened, hypothetically, if the slowdown that started in the late 1960s had instead continued on the faster trend of the earlier post-war decades. If such stronger growth had taken place, Americans today would be as much as 75% better off. That is, the typical household today would be enjoying a level of real income 75% higher than it actually does now. And at the low end of the income distribution, it would have meant an enormous drop in the poverty population. Clearly, productivity is extremely important. And by this standard, the 1990s have not been a great success.[3]

The Economy Isn't Everything

Beyond these serious qualifications to our very good economic performance of the 1990s, it is important to remember the economy isn't everything. Oh, yes, it's true that economic principles *affect* everything, since every decision each of us makes is based on cost-benefit analysis, a core principle of economics, including decisions such as where to attend college and the size of our family—decisions we wouldn't ordinarily think of as *economic* choices. But all these decisions are based, consciously or unconsciously, on a comparison of the benefits and costs of the alternatives.

When I say that "economics isn't everything" what I have in mind is macroeconomics—unemployment, inflation, and other aspects of the economy as a whole. To many of us—economists, journalists, senior government officials, and others who watch "the big picture" closely—things like economic growth and the business cycle seem not just important but crucial. By contrast, most Americans are little interested in the economy as a whole.

Perhaps you remember the old story about Paul's arrangement with his wife, Betty. "It's an ideal marriage," he would explain. "I make all the important decisions, such as whether we should bomb Iraq, and when the Fed should raise interest rates to fight inflation. And I leave to her the unimportant decisions, like where we live and what job I take."

Ideal marriage or not, there are few Pauls in this world who focus mainly on the macroeconomic issues. Most of us are like Betty: We give top priority to matters that are closer to home—our health, how well we are getting along with our spouses and friends, whether the neighborhood streets are safe to walk after dark, and whether to watch TV or go to the movies tonight. For most of us, whether unemployment is 5% or 7% and whether inflation is accelerating or slowing are questions of minor interest compared to important worries such as how well the kids are progressing at school.

That is, of course, not true for everybody. At the margin, macroeconomic conditions are almost always important and often are the most crucial element in people's lives. Consider, for example, a retiree whose only income is from a fixed (unindexed) pension. If inflation had averaged, say, 7% throughout the 1990s instead of the 3% we've actually experienced, she would now be living under very strained circumstances. The purchasing power of her pension would have been slashed by one fourth. Similarly, more than 2 million more Americans, mostly low-skilled, low-paid workers, would be without a job today if unemployment had remained at the 1991 rate of almost 7% instead of falling to below 5% in 1997.

This decline in the importance of macroeconomics has been going on for many years. One manifestation of this change is the way we economists, as comic Rodney Dangerfield quips, "just don't get no respect." Twenty years ago it was rare when an industry convention or corporate meeting didn't begin with a speech devoted to the business outlook.

Correspondingly, back in the 1960s, almost every major corporation had its own economics department, fully staffed, in some cases with as many as 15-20 professional economists. No longer! Many of those departments have been abandoned in their entirety, and most of the others have been sharply downsized.

In similar fashion, the work that economists do in business has also changed substantially. There may be as many employed in business today as 20-30 years ago, but most are employed quite differently. Today they are much more likely to be forecasting sales or researching transfer pricing or engaged on other microeconomic tasks rather than analyzing the business cycle outlook or other aspects of the big picture. These changes also tell the story of the declining importance of macroeconomics.

For the public, back in the 1970s and early 1980s when inflation burst out of control and unemployment approached 10%, macroeconomic conditions were a common worry. Since then, with economic instability greatly reduced, most Americans have turned their attention to more personal issues. Today, except for the stock market, the economy is rarely a topic of conversation.

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The Media and the President Care

In addition to people at the margin of the economy, there are two other areas where macroeconomics remains as important as ever: one is the media coverage devoted to short-run economic statistics, which has proliferated in recent decades. The reason for this must be the growth in the financial markets, and especially the long, seldom-interrupted rise in common stock prices over the past 15 years.

I'm always astonished (despite the endless repetition) when reporters tell us that "the markets are anxiously awaiting tomorrow's unemployment statistics" or when they explain that yesterday's movements in securities prices occurred because last month the consumer price index increased two-tenths of an index point rather than the one-tenth economists had forecast. Now, unless you're a nincompoop or a daytrader (no, they're not identical groups!) you know both that forecasts of monthly movements in most economic statistics are nothing but guesswork and that those month-to-month economic changes have almost no real meaning for the values behind securities prices. (Longer term, of course, the relationship between the economy and securities values is very substantial.)

Why are the day-traders interested? Evidently, it's because others are and their business is to outguess the others. The day-traders are not interested in the economy itself, only in whether economic statistics might cause others to buy or sell.

What this boils down to, I believe, is that most of what you hear about daily movements in the financial markets being caused by economic events is garbage. The main function of the daily reports about this month's economic statistics is, as best I can guess, merely to give brokers and others involved in the markets something to talk about, that is, something that at a superficial level *sounds* legitimate.

The second exception to the declining importance of macroeconomics is presidential approval ratings, where macroeconomic conditions appear as important as ever. Economic conditions remain important to presidential approval ratings *not* because the survey respondents have heard that unemployment is 4.7% this month and that the consumer price index increased only 1.7% over the past year. To most Americans, macroeconomic statistics have no real meaning.

What works for most of us, instead, is our everyday experience. When we stop hearing stories about the guy who lives down the block getting laid off, and when the bill we pay at the supermarket holds pretty stable week after week, then we feel a higher degree of comfort about our own lives. In public opinion polls, that improved comfort translates directly into higher presidential approval. In other words, it's the personal economic impact that counts—*micro*economics—rather than the *macro*economic statistics.

Microeconomics Matter Most

These exceptions notwithstanding, the importance of the big-picture economy has declined substantially over the past two decades. For the overwhelming majority of the population, the main focus of their lives will remain on their families and friends, their health, their jobs, and outside interests such as civic matters, music, sports, and other hobbies. Macroeconomic conditions will be far down their list of concerns.

The economic performance of the 1990s has been pretty darn good. But it was not great. Even more significant, except for the poor, it has not mattered all that much to most Americans. They know that economics isn't everything. Yes, the macroeconomy matters. Indeed, it is important. But it's not nearly as important as we once believed.

Endnotes:

[1] To be precise, the cyclical contraction ran from the peak month of July 1990 to a trough in March 1991. Thus for peak-to-peak comparisons of monthly data, the proper starting point would be July 1990. For annual series, a logical starting point would be 1989, although in many cases using 1990 will not skew the comparison seriously (except for year-end data). The distortion is most pronounced when a comparison starts in 1991.

[2] Some analysts will be disappointed that I haven't added a third development to this list of negatives of the 1990s—the widening disparity of incomes among American households. As explained elsewhere, however, I am less troubled by this development than are many other analysts. See "The Brouhaha About Rich and Poor," *Economic Times*, May 1996, and "A Few Kind Words About Instability, Insecurity, and Inequality," *NABE News*, March 1998.

[3] Not all economists agree that a 1 1/4% per year trend in productivity growth should be considered "mediocre" or "lackluster," as I have labeled it here. Some feel that the two decades following World War II were very unusual, representing an unsustainable catching up in productivity growth after the disruptions of the Great Depression and the War. To this way of thinking, the productivity trend of the most recent 30 years is more comparable to the trend (as best it can be measured) from the mid-19th to the mid-20th centuries. See Robert E. Lipsey and Irving B. Kravis, *Saving and Economic Growth: Is The United States Really Falling Behind?*, a study jointly sponsored by the American Council of Life Insurance and The Conference Board (Conference Board Report No. 901, 1987). Nevertheless, even if that is the correct way to look at it, the fact that the 1990s did not produce any improvement in the trend growth of living standards means that the economic performance of the 1990s should be regarded as ordinary or normal, rather than as an unusually good performance.

The active debate about the accuracy of our price indexes is also relevant here. If, as many believe, our price indexes overstate inflation then output and productivity are correspondingly understated. The slowdown in the productivity trend discussed above, however, would only be called into question if by chance the mismeasurement of inflation happened to have begun at the same time the productivity trend slowed, and to have been of approximately the same magnitude which would be an extraordinary coincidence. A reasonable conclusion is that, although the productivity growth trend may have been faster all along, it did indeed slow substantially somewhere around 1970.

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