THE NEW ECONOMY RECESSION: ECONOMIC SCORECARD 2001

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Now that it is officially acknowledged that a recession has begun, most economists are predicting that it will soon be over. This assessment should not be accepted uncritically. The vast majority of these economists failed to anticipate the onset of the recession, primarily because they refused to recognize the problems posed by a stock market bubble of unprecedented size.

An economic recovery must be driven by some component(s) of demand growing rapidly. It is not clear which sector can drive the economy forward in the near future. Both consumption and investment, which drove the late nineties boom, are likely to remain weak for the foreseeable future. State and local government spending will be a drag on the economy, as these governments are forced to cut spending to keep in line with falling tax revenue. The best near term prospect for growth is an increase in net exports, which in turn would depend on a fall in the dollar. A decline in the dollar at some point is inevitable, the sooner it occurs, the better it will be for the economy. It will be important that the Federal Reserve Board not attempt to prevent such a decline, or offset its impact with higher interest rates.

The Economy in 2002

After 5 years of rapid growth the economy sank into a recession, for the first time in more than a decade, in 2001. The economy added an average of almost 3 million jobs annually in the last five years. It lost close to 1 million jobs in 2001.This job loss has pushed the unemployment rate up from 4.0 percent in 2000, to close to 6.0 percent at the end of 2001.

This downturn came as a surprise to many economists. For example, in July of 2000, the Congressional Budget Office (CBO) forecast growth of 3.1 percent for 2001. As recently as January it still projected real GDP growth of 2.4 percent. The Office of Management and Budget projected 3.3 percent growth in January of 2001. Most private forecasters gave similar projections. While we don't have the 4th quarter numbers in yet, GDP growth for the whole year will be flirting with zero.

While the exact timing of the downturn was not predictable, the fact that a downturn was imminent should have been apparent. The economy in 2000 was being driven by an investment boom in the information technology (IT) sector, and by surging consumption. These two phenomena were in turn driven by a booming stock market. At its peak in March of 2000, the market as a whole was valued at more than 33 times corporate earnings. This was more than twice the historic average price to earnings ratio of 14.5 to 1. Since the share of output going to corporate profits was already at an extraordinarily high level, and unlikely to rise further, market valuations were especially out of line. In fact CBO predicted in January 2000 that real (inflation adjusted) corporate profits would actually fall over the next ten years, because it seemed likely that the profit share of output would shrink.

Since it was virtually impossible to construct a plausible scenario that made sense of the peak stock prices of 2000, a large downturn in the market was inevitable. And a downturn in the market would bring an end to the two major forces driving the rapid growth of the late nineties—booming IT investment and surging consumption. The market bubble had already begun to deflate by the end of 2000, so economists making projections at that time should have foreseen the weakness in these two sectors that hit home in 2001.

The table below compares the growth rate of GDP, consumption, and investment in equipment and software in the 4 quarters from the third quarter of 1999 to the third quarter of 2000, with the growth rate from the third quarter of 2000 to the third quarter of 2001.

Table 1—Real Growth (3rd quarter to 3rd quarter)

	1999-2000	2000-2001
GDP	4.4%	0.6%
Consumption	4.9	2.5
Investment (equipment and software)	10.3	-7.6
Net Domestic Product	4.2	-1.1

The wealth effect from the run-up in the stock market had pushed savings rates almost to zero. With the market falling back from its peak levels, it was virtually certain that savings rates would rise somewhat, as households adjusted both to the lower current value of their stock holdings and reduced expectations for the future increase in stock prices. Those families with significant stock holdings realized that they would have to save more money in order to accumulate enough to pay for such things as their children’s education or their own retirement. And, by definition, saving more means consuming less.

The collapse of the tech bubble in the stock market meant that it was no longer possible for companies earning little or no profit to raise billions of dollars of capital by issuing new shares of stock. The Federal Reserve Board also reports that banks have significantly tightened lending standards over the last two years. With investors demanding to see at least some evidence of profitability, many tech companies had to sharply curtail their investment plans and a large number have gone bankrupt in the last year.

Is Recovery Around the Corner?

Many of the economists who were surprised by the recession are now predicting a rapid turnaround. These predictions should be viewed with caution, since the basis for this optimism is rather dubious.

For example, many analysts have noted that the average post-war recession has lasted 11 months. If this is an average recession, it would imply that recovery will begin in February, since the recession began in March. But this recession does not appear to be average. Prior recessions were brought on by the Federal Reserve Board raising interest rates in an effort to slow growth and inflation. Higher interest rates would choke off housing and new car purchases. Although the Fed's six interest rates hikes in 1999-2000 may have contributed to the onset of the downturn, the main factor behind this recession has been the collapse of investment and slower consumption growth attributable to a declining stock market. Housing and car sales have actually remained reasonably strong thus far. The relative strength of these two sectors means that there is no pent up consumer demand that can jump-start a recovery.

The other basis for optimism that is generally cited is the recent rise in the stock market. But at this point it should be apparent that the stock market is a very imperfect predictor of anything. It is often driven by completely irrational forces—the economy does not follow the stock market in any regular pattern. To give an extreme case, Japan's Nikkei index hit 40,000 in 1989. Twelve years later, after a decade of slow growth with four recessions, it stands at less than one third this level.

Economic recovery will have to be grounded in the growth of the actual components of GDP, not wishful thinking. At this point, it is not clear where this growth will take place. As always, consumption is the most important component, since it accounts for just under 70 percent of GDP. It is difficult to see the basis for strong consumption growth in the near future. The economy has been losing jobs since March, with the pace of job loss accelerating sharply in the wake of September 11th. With the decline in jobs being accompanied by a decline in hours for those still working, and slowing nominal wage growth, real wage income has been falling since June. Job losses are likely to continue for the immediate future, even in optimistic scenarios. It is therefore unlikely that there will be a significant uptick in wage income any time soon. In fact, since many companies are cutting back on year-end bonuses, the income numbers are likely to be especially bad in December and January.

Weak wage growth will not be the only factor dampening consumption. The ratio of household debt to disposable income is at an extraordinarily high level. Non-mortgage debt is now more than 23 percent of disposable income; by comparison it peaked in 1990, at the top of the previous expansion, at 18.4 percent of disposable income. Lower interest rates reduce the burden of this debt load, but it doesn't change the fact that many households are reaching the limits of their ability to borrow.

In fact, one effect of the low interest rates of recent months—which did keep the economy from weakening further—will be a dampening of any turn around next year. The flood of new car purchases sparked by zero interest financing will come largely at the expense of car purchases in the first half of 2002. The extraordinary financing offer undoubtedly did bring some new buyers into the market, but the larger impact was to get consumers to move their purchases forward. Similarly, the surge in home refinancing in the fall will limit the extent to which maintaining low mortgage rates will benefit homeowners next year.

With little or no growth in wage income, high levels of indebtedness, and a relatively saturated car market, there seems little prospect for strong consumption growth, at least for the first half of 2002.

The picture for investment does not look much better. Capacity utilization rates have fallen below 75 percent, and are not far above their low points of the 1974-5 and 1981-2 recessions. Firms are not likely to feel a need to expand their capacity any time soon. This is especially the case in the tech sector where there continues to be enormous overcapacity in the semi-conductor and computer industries.

In addition, with profits down nearly 20 percent from year-ago levels, and many firms experiencing a downgrading of their creditworthiness, financing could pose an obstacle to new investment for many firms. Investment spending may stop falling in the next two quarters, but there is little reason to expect a significant turn around in the immediate future.

The state and local government sector, which accounts for more than 11 percent of GDP, is likely to be a substantial drag on the economy in the next year. Revenue has fallen sharply below expectations due to the slowing economy. As a result, most of these governments are finding it necessary to cut spending and jobs as they seek to balance their budgets.

Housing has remained relatively strong, as low interest rates have helped to sustain demand. But even here, future prospects are not bright. Housing prices had been rising rapidly into the first half of 2001. The median price of a new home sold in October (the most recent month available) was down 6.1 percent from the peak hit in June. The average price of a new home was down 5.1 percent from its year ago level. The monthly data for home prices are erratic, but the decline has continued long enough that it seems clear that housing prices have reversed direction. This indicates both a weakening sales market, and a reduced ability for homeowners to borrow against equity in their home.

The prospects for commercial construction are especially bleak as noted in a recent report by the Federal Deposit Insurance Corporation (FDIC).[1] There appears to have been widespread overbuilding of office space, retail space, and of hotel rooms. The FDIC made this assessment before September 11th.

[1] Regional Outlook: Third Quarter, 2001, (http://www.fdic.gov/bank/analytical/regional/ro20013q/na/t3q2001.pdf).

The international sector could offer the best hope for growth, but also the greatest risk. With the economic slowdown hitting worldwide, the United States is unlikely to experience a surge in exports due to strong growth elsewhere. However, the strong dollar is leading to large and unsustainable trade deficits. At some point, it will have to fall. This will lead to a substantial reduction in the trade deficit, since a lower dollar makes U.S. goods more competitive, both domestically and internationally. A drop in the trade deficit could provide a substantial boost to the economy. However, it will also lead to more inflationary pressures, perhaps adding as much as 2.0 percentage points to the rate of inflation. If the Federal Reserve Board raises interest rates to combat this inflation, it could offset the simulative effects of a lower dollar.

Since current account deficits of 4.5 percent of GDP (the present level) are not sustainable, it is certain that the dollar will fall, but just as with the stock market bubble, the actual timing of the decline is unpredictable. At this point, a sharp decline in the dollar may be the economy's best prospect for renewed growth, in the absence of government stimulus.

Fiscal stimulus can give the economy a boost, but there are serious political obstacles to an effective package gaining approval. It is worth noting that fiscal stimulus will require very different attitudes towards government deficits than Congress has recently displayed. It is not clear that Congress will be willing to support substantial spending increases or tax cuts, when the baseline budget is already showing a deficit. It is also worth noting that the deficits may prove significantly larger than even recent forecasts have indicated. Last year's budget projections assumed more than $100 billion a year in capital gains tax revenue. (The projection for the 2002 fiscal year was $125 billion.) These estimates seem very high in light of the stock market's recent downturn.

In summary, there does not seem to be any firm basis for the view that a recovery is imminent. With job losses and large debt continuing to check the growth of consumption, and excess capacity and financing problems restraining investment, the main engines of economic growth will be sidelined for the immediate future. The best prospects for a turn around lie in either a sharp drop in the dollar, which will spur net exports, or a strong dose of fiscal stimulus from the federal government.