

Outlook for 2002

Lawrence S. Davidson

Professor of Business
Economics and Public Policy,
Kelley School of Business,
Indiana University,
Bloomington

The year 2001 was supposed to be the 10th year of the long economic expansion that began in the second quarter of 1992. Instead, it will be recorded as part of the 2001-2002 recession. This is the third consecutive decade that started in recession—the 1980s opened with two recessions (two quarters in 1980 and five quarters spanning 1981 and 1982) and the 1990s began with a recession covering three quarters of 1990 and 1991. The U.S. economy doesn't seem to start decades well, but it clearly recovered each time and did very well through much of the 1980s and 1990s.

Not all recessions are alike, however. Between 1979 and 1982, the unemployment rate rose from 5.8 percent to almost 9.7 percent. In December of 1982 it was nearly 11 percent. It wasn't until 1988 that the rate for the year had fallen back to below 5.8 percent. Contrast that performance with the unemployment rate in the 1990s. From 1989 to 1991 the unemployment rate rose from 5.3 percent to 6.8 percent. The rate rose again in 1992, but averaged 5.4 percent by 1996. Clearly, in terms of unemployment, the short recession of 1990–1991 had a much less pronounced and briefer impact.

We believe the current recession will be more like the one in the 1990s. It will have started in mid-2001 and should be over by early to mid 2002. While two or more quarters of that time period will register a contraction in GDP, each year will show a year-over-year positive rate of growth, in the neighborhood of 1 percent. The unemployment rate should rise from a low of 3.9 percent in 2000 to a peak of about 6.4 percent in 2002. Within two to four years, the rate should be back to around 4 percent.

It is debatable whether or not we would have entered a recession in 2001 had it not been for the attack on the United States on September 11th. The economy had already been slowing and GDP growth was barely on the positive side during the first two quarters of the year. The unemployment rate had risen from 3.9 percent in September of 2000 to 4.9 percent in August of 2001. The Federal Reserve began aggressively lowering interest rates early in 2001, attempting to stabilize the economy against the impacts from lower profits, declining business investment, slowing export sales, and decreasing consumer spending. Since September, the Federal Reserve continued this policy and it appears that the federal government will do its own part to resuscitate spending through its own spending increases, industry subsidies, and tax decreases. Central banks in many

countries have joined the U.S. Federal Reserve in a concerted effort to provide liquidity in distressing times.

We predict a short and shallow recession because we believe that these policy responses will be measured and adequate. Because the country's growth was slowing in the first half of 2001, some of the previous imbalances were starting to be corrected before the September attack. The last five years revealed a strong engine of growth for the U.S. that should resurface once imbalances are worked off, the direct impact of the September attack recedes, and confidence returns to realistic levels. Some of the highlights of our 2002 forecast include:

- GDP growth of 1.0 percent and an economic recovery phase in late winter
- GDP inflation of 1.6 percent
- Unemployment rate averaging 6.3 percent
- Historically low short-term rates; Prime Rate of 5 percent
- Housing starts of 1.5 million units
- A trade deficit of approximately 4 percent of GDP
- A declining value of the dollar
- Indiana employment falling by 90,000 jobs
- Modest growth in Indiana exports

The U.S. Economy: The Great Expansion Ends

R. Jeffery Green

Professor of Business Economics and Public Policy,
Kelley School of Business, Indiana University,
Bloomington

As we look at the economy in late 2001, after the terrible shock of September 11th, it is easy to see signs of a significant downturn. The National Bureau of Economic Research (NBER) has recently announced that a recession began in March of 2001. How deep will it be? How long will it last?

The dates associated with economic recessions and recoveries are determined by the National Bureau of Economic Research. A recession begins when the NBER decides the economy has reached a peak and ends when the economy reaches a trough. The

duration of the recession is the length of time, in months, between the peak and trough. The NBER recently decided that the peak was reached in March 2001. However, this was a difficult choice since different parts of the economy were behaving in very different ways.

Figure 1

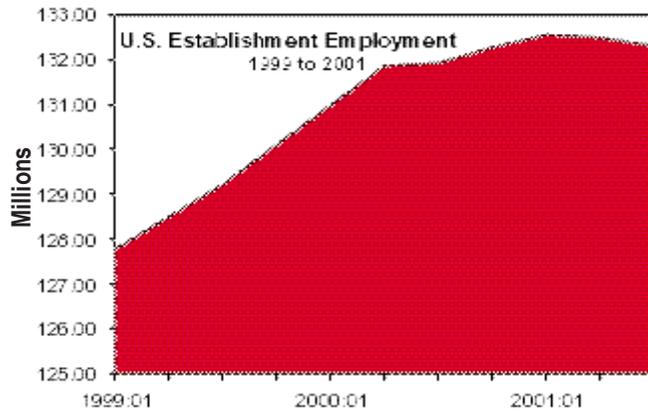


Figure 2

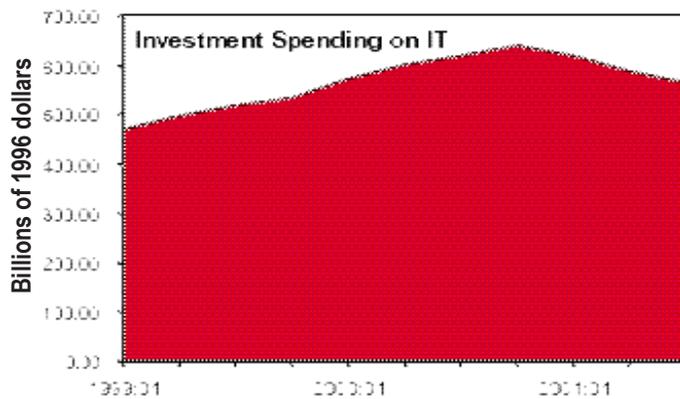
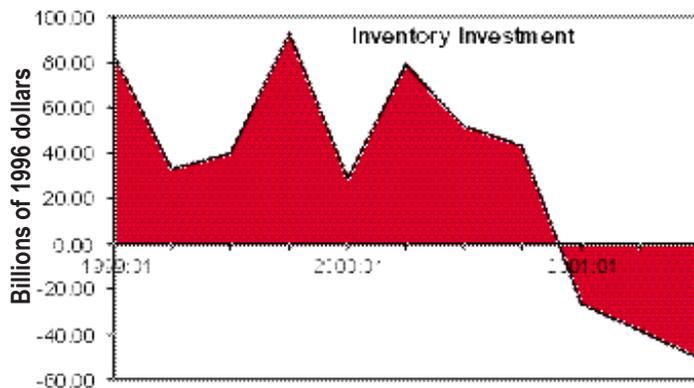


Figure 3



An early sign of trouble in the economy was the bursting of the Internet bubble in March 2000. The Internet and technology-heavy NASDAQ reached a peak on March 10 before beginning a dizzying fall. As Internet companies began to suffer, spending on new technology slowed and then declined. Growth in real GDP slowed significantly, from 4.2 percent over the four quarters ending in the first quarter of 2000, to 2.5 percent over the four quarters ending in the first quarter of 2001. The Index of Industrial Production peaked in September 2000 and declined by 5.8 percent over the following twelve months. Real investment spending on communication and information processing equipment peaked in the fourth quarter of 2000. Also, as the high tech sector unraveled, employment gains slowed and then stopped. Establishment employment peaked in March 2001 while the unemployment rate reached a low of 3.9 percent in September and October of 2000. Firms also began to trim inventories in the first quarter of 2001 (see Figures 1, 2 and 3).

Despite all these signs of weakness, other parts of the economy continued to show some small gains. Real GDP continued to grow through the second quarter of 2001, and real consumer expenditures and real disposable personal income continued to increase through August 2001. Considering all these indicators, by September 11th the economy was either in a recession or was barely avoiding one.

Because of the complex movements of the economy any date between September 2000 and September 2001 was a candidate for selection as the beginning of the recession. The NBER considers depth, duration, and dispersion when deciding whether a recession has occurred and the dates of the associated peak and trough. Depth and dispersion are particularly important in assigning a date to the peak.

The strongest case for a September 2000 peak centers on the sharp declines in financial markets, the peak in industrial production, and the trough in the unemployment rate. The most telling argument against that date is that real GDP continued to increase, albeit slowly, for another year. The March 2001 date is supported by a peak in establishment employment, a series that the NBER considers an important indicator. September 2001 could be considered the peak if one thinks the economy had slowed but not stalled prior to September 11th. My view is that September 2000 is the most persuasive choice for the peak, but ultimately the choice is made

by a committee at the NBER and committees often make compromises. March 2001 was the logical compromise.

Evidence is beginning to accumulate that the economy weakened sharply after September 11th. For example, new orders for durable goods declined at an annual rate of 8.5 percent in September, and consumer confidence, as measured by the Conference Board, declined 12 percent in September. Real disposable personal income fell 0.6 percent in September and real consumer spending dropped 1.3 percent. The very weak September performance led to a decline of 0.4 percent in real GDP for the third quarter.

When will the trough be reached and recovery begin? Our latest forecast indicates the economy will likely reach the bottom and begin to recover by late winter of 2002. If the trough occurs in March 2002, the duration of the recession will be 12 months if the peak was March 2001 and 18 months if the peak was in September 2000. In comparison, the average duration of the last six recessions since 1960 has been 11 months.

One of the reasons we expect the recession to end in early 2002 is that the economy underwent considerable adjustment prior to the onset of the recession. As mentioned earlier, the decline in financial markets started in early 2000 and the drop in investment spending began shortly thereafter. The inventory adjustment began in early 2001. Thus, if the recession is judged to have begun in March 2001,

or even September 2000, many necessary structural adjustments were well underway before the economy peaked.

Strong policy moves toward expansion are the other reason we expect the recession to end soon. The Federal Reserve cut interest rates nine times between January and early October of 2001. The reductions lowered the Federal Funds rate from 6.5 percent to 2.5 percent. Fiscal policy, partly as a result of the Bush tax policy and partly as a result of the response to the September 11th tragedies, eased significantly. In fact, the Federal surplus will likely disappear by 2002. While not a policy move, the decline in world energy prices during 2001 will stimulate the economy as well. By October 2001, average OPEC crude petroleum prices were 8.9 percent below their level in January 2001 and 14.1 percent below their level in January 2000.

Our latest forecast indicates the recession will be moderate in depth. The average decline in real GDP, from peak to trough, in the last six recessions has been 2.1 percent. If we eliminate those recessions with sharp increases in energy prices, the average decline is only 1.4 percent. We expect a decline from peak to trough of about that magnitude (see **Figure 4**).

We have already been through a sharp falloff in investment spending and in exports. We have also seen a sharp inventory correction. We expect the rest of the recession, lasting through the winter, to be characterized by weaker consumer spending and a continuation of export and investment problems. Government spending will create a stimulus to the economy, and tax relief, combined with low energy prices and low interest rates, will moderate the decline in consumer spending. We expect both investment spending and consumer spending to be increasing by spring, bringing an end to the recession. By the second half of 2002, economic growth should be in the two to three percent range. Higher growth rates must wait for the recovery of the international economy, and that could take longer.

Figure 4

