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Economy in 2002: Climbing back up the slope

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The National Bureau of Economic Research made it official on November 26, 2001: The U.S. economy entered a recession in March 2001. This ended the longest economic expansion in U.S. history, exactly ten years after it began. The September 11 attacks played a significant role in turning what had been viewed as an economic slowdown into a recession. However, this downturn has not been as large as past recessions, more like a bunny ski slope than a black-diamond run, and there are other striking differences from previous recessions. While overall economic growth has been slow since the second quarter of 2000, the consumer sector has done very well. Light vehicle sales set a record in 2000, at 17.2 million units, and sales for the first 11 months of 2001 are challenging that record at 17.1 million units. Housing starts through the first ten months of 2001 were 1.8% higher than the comparable period a year ago.

This recession has been led by the business sector. Since peaking in September 2000, manufacturing output has fallen by 7.6% over the subsequent 13 months. This is far greater than the decline experienced during the 1990–91 recession, when manufacturing output fell 5.1% over seven months. Businesses have also been extremely aggressive at trimming inventories. Against this backdrop, the Federal Reserve Bank of Chicago held its fifteenth annual Economic Outlook Symposium on November 30, 2001. More than 70 economists and analysts from business, academia, and government attended the conference. This *Chicago Fed Letter* reviews last year's forecasts for 2001 and summarizes the presentations at this year's conference.

1. Median forecast of GDP and related items

	2000	2001	2002
	(percent, unless stated otherwise)		
Real GDP, chained dollars[a]	4.1	1.1	1.3
Personal consumption expenditures[a]	4.8	2.7	1.4
Business fixed investment[a]	9.9	–3.7	–6.0
Residential investment[a]	0.8	1.2	–1.0
Change in private inventories[b]	$50.6	–$39.4	$9.7
Net exports of goods and services[b]	–$399.1	–$401.5	–$410.2
Government consumption expenditures and gross investment[a]	2.7	3.4	3.6
Industrial production[a]	5.6	–3.3	–0.8
Car & light truck sales[c]	17.2	16.8	15.6
Housing starts[c]	1.57	1.59	1.54
Oil price (West Texas Intermediate)[d]	$30.30	$26.00	$23.48
Unemployment rate[e]	4.0	4.8	6.0
Inflation rate (Consumer Price Index)[a]	3.38	2.90	1.90
Treasury constant maturity 1-year rate[e]	6.11	3.50	2.69
Treasury constant maturity 10-year rate[e]	6.0	4.9	4.7
J. P. Morgan trade-weighted OECD dollar[a]	4.1	3.1	0.6

[a]percent change from a year ago
[b]billions of constant dollars
[c]millions of units
[d]dollars per barrel
[e]percent
Notes: Actual data for 2000; forecast data for 2001 (fourth quarter not known) and 2002. Data as of November 19, 2001.

Looking back up the hill

Last year, symposium participants expected real gross domestic product (GDP) to increase by 3.5% during the first three quarters of 2001. In fact, growth was a much slower 1.5%. The –1.3% growth rate of business fixed investment for the first three quarters was substantially weaker than the 8.9% forecast. Change in private inventories was forecast to rise by $50.5 billion over the first three quarters but contracted by $38.6 billion. The –2.0% growth rate of industrial production for the first three quarters was significantly less than the 3.5% rate forecast. The forecast group was closer to the mark in the consumer sector. Consumer spending was forecast to rise by 3.5%, just a bit more than the 3.1% realized. Light vehicle sales were forecast to slow from 2000's 17.2 million units record pace to 16.4, a bit lower than the 16.6 million units recorded. Housing starts were expected to moderate to 1.51 million units after a very strong year in 2000. Instead housing starts for the first three quarters of 2001 averaged 1.61 million units. An underestimation of 0.3 percentage points occurred for the unemployment rate, which averaged 4.5% for the first three quarters. Inflation was expected to fall from 3.4% in 2000 to 2.6% for the first three quarters of 2001, but with energy prices remaining high, inflation was at 3.2%. The forecasters expected

the one-year interest rate to remain at just over 6%, but in response to aggressive Fed rate reductions, it declined by 221 basis points to 3.89%. The ten-year rate forecast was overestimated by 87 basis points. So, overall, economic growth was lower and inflation and unemployment rates were higher than the forecasts.

Taking the chair-lift back up the hill

Since the economy is experiencing a modest downturn, the outlook for the recovery is restrained. The forecasters expect the duration of the current recession to be roughly in line with the average—11 months. The trough quarter is anticipated to occur in the fourth quarter of 2001, with real GDP down 2.0%. Real GDP is then expected to rise by 1.0% in the first quarter of 2002, with growth rates increasing to 4.1% by the final quarter of the year.

The typical forecaster expects 2001 real GDP growth to be 1.1% and 2002 real GDP growth to be 1.3% (see figure 1). Personal consumption expenditures, business fixed investment, and residential construction are forecast to slow in 2002. Change in business inventories is expected to reverse its $39.4 billion decline in 2001 by rising $9.7 billion in 2002, a change of nearly $50 billion. Net exports are forecast to decline from –$401.5 billion in 2001 to –$410.2 billion in 2002.

The forecasters expect industrial production growth to fall by a smaller amount in 2002—0.8% compared with a drop of 3.3% in 2001. After three very strong years, the light vehicle market is expected to sell 1.2 million fewer units in 2002. Housing starts are forecast to moderate to a still robust 1.54 million units. The unemployment rate is expected to average 6.0% with a peak of 6.2% in the second quarter. Oil prices are anticipated to remain low, averaging $23.48 per barrel, $2.50 lower than in 2001. The 2002 rate of inflation is forecast to fall to 1.9%, a full percentage point lower than in 2001.

Consumer and banking

According to the senior vice president and director of Treasury research, consumer spending should continue to grow at a reasonably healthy rate over the near term and lead the economy out of its current recession. Credit conditions are better than in 1990–91.

However, consumers clearly are spending less and are searching for value. Retail sales (excluding autos) growth slowed from around 9% in early 2000 to around 1.5% at the end of 2001. Housing markets have held up remarkably well, relative to other recessions, though activity on the high end of the market has dropped off considerably. The speaker was hopeful that the housing sector—and its carry-over effect into the durable goods market—could be strong enough to contribute to an economic recovery. While the terrorist attacks of September 11 and the ensuing military conflict set this recession apart, the speaker said the current situation is better than in 1990 because interest rates have been on the way down since the initial deterioration in confidence, energy prices are falling, and there are no lingering problems from failed savings and loans.

There are many signs that suggest consumer finances are not burdensome: consumers appear to have become more savvy about managing debt, competition has held down credit card interest rates, and debt service payments as a share of disposable income are not at an onerous level, despite rising steadily over the past seven years. Mortgage refinancing has been strong, but the incremental wealth effect has been smaller than in the refinancing boom of 1998. The wealth effect from the stock market may still be strong, despite recent declines in stock prices. One study said that only 4 cents of every dollar increase in stock wealth has been spent, which leaves room for some more spending.

There are mixed signals coming from credit markets. Banks have tightened credit standards since 2000—more so for commercial than consumer loans—but that is a natural response to economic conditions as well as regulatory pressures. Loan chargeoffs as a share of total loans have risen, but only to levels similar to those seen in the 1990–91 recession. Bank deposit growth has slowed significantly, but low interest rates make it hard for banks to stimulate deposits in the face of competition from mutual funds. The speaker expressed some concern about mutual funds, which are insured privately and regulated differently from banks, noting that this is the first recession to really test these investments. However, financial institutions are better capitalized than in 1990 and reserves are rising, though they have not kept pace with loan growth.

Vehicle sales

The executive director for global market and industry analysis for one of the Big Three automakers presented the outlook for vehicle sales. Sales had been slowing for the first nine months of 2001, due to deteriorating macroeconomic conditions. Following the events of September 11, sales would have probably slowed more significantly, along with other sectors of the economy, if manufacturers had not stepped in with new incentive programs. Consumers reacted well to the automakers' 0% financing programs and, as a result, vehicle sales surged in October and November. The effect is a double-edged sword: Sales increase now but mostly at the expense of future sales. It is likely the 0% incentive program pulled 600,000 to 700,000 units of sales from 2002. However, the spike was not consistent with the incremental price change associated with the program, a sign that consumers might be more resilient then many analysts presume.

On top of the pull-ahead effect, sales are poised to slow further in 2002. Falling employment levels, stagnant stock markets, slowing income growth, and tighter credit conditions are likely to continue to make consumers more hesitant about vehicle purchases, even in the face of high affordability. Assuming that the economy continues to be sluggish through the middle of 2002 and then recovers soon after, total vehicle sales (including about 300,000 units of heavy trucks) should total 15.0 million to 15.5 million units next year. Industry inventories are very lean and are expected to finish the year down about 30% from the end

of 2000. As a result, if sales are much stronger than forecast, automakers will have to boost production to meet demand, which could drive a stronger recovery than forecasted.

The main challenge for the domestic automakers is to profitably stabilize their market share. Since early 1998, the non-Big-Three share of the retail market has steadily grown from 30% to 40%. The foreign makers have benefited from a strong dollar and have made significant gains in the light truck market. To answer the challenge, the Big Three have to improve productivity, product quality, and pricing, as well as introducing innovative new products.

Heavy equipment

The manager of business economics from a major equipment maker discussed the outlook for construction, mining, and other types of heavy equipment. During the second half of 2001, the construction sector remained strong, led by housing starts and infrastructure and utility building. The mining sector was mixed, with metal mining weak and oil and gas and coal mining strong. However, capital spending in those industries was stagnant. Unit volume was down about 15% and inventory reductions continued into the fourth quarter.

Anecdotally, distributors are very negative about the outlook, but the speaker took a somewhat more positive view. There is a large amount of monetary and fiscal policy stimulus poised to invigorate economic growth. In 2002, GDP growth for the year should average between 1.5% and 2%, but the fourth quarter of 2002 should be up between 3% and 3.5% from 2001. The outlook for construction activity is mixed. Housing starts and nonresidential building will likely be flat. Commercial and industrial construction will probably be down, while institutional building will be up. Assuming an appropriations bill passes, public infrastructure building—highways, urban transit, railroads, and airports—will be up slightly. Mining will be flat to down, with metal mining and oil and gas extraction down, but coal mining up. Assuming retroactively accelerated depreciation of at least 20%, average annual growth of machinery capital spending will be flat and the fourth quarter of 2002 will be up moderately from 2001.

High-tech industries

The chief economist from a local high-tech manufacturer pointed out that conditions were very bleak for high-tech companies prior to September 11. The turning point for the industry was the so-called dot-com meltdown and the precipitous decline in the NASDAQ starting in early 2000. But, it was not until October of last year that many high-tech CEOs realized just how badly orders were drying up. Semiconductor sales plummeted, falling to as low as 40% below year-ago levels, the worst declines in the industry's history. Communication equipment capital expenditures, which correlate very well with changes in the NASDAQ, fell off the charts. Exacerbating the problem was that in 1999 and 2000, concerns about Y2K computer glitches had boosted high-tech spending around $50 billion.

Late in the summer of 2001, there were some scattered signs that the high-tech sector was bottoming. But, then the events of September 11 further shook executive confidence—one of the key drivers of high-tech spending. Currently, the speaker noted that there is "unprecedented uncertainty" in the economy. As a result, many investment projects are on hold, and few companies are willing to take a chance on new ventures.

There are still some preliminary signs that the sector may be bottoming, however. The ISI tech company sales survey has been generally flat for the past three months. A renewed interest in security issues has cushioned some of the declines in the wireless equipment markets. The speaker cautioned that forecasting in the current environment is difficult because there is no previous period in history from which to draw comparisons, but he offered two alternative scenarios. One is the modest decline, which assumes that the U.S. military campaign is a low key event, there are no further terrorist attacks on U.S. soil, September 11 is a one-time event, and the U.S. economy recovers by mid-2002. The other is the precipitous decline, which assumes that the U.S. engages in a large-scale, global war on terrorism, there are additional attacks on U.S. soil, and those attacks lead to an abnormal reaction by already skittish businesses and consumers. Under the modest decline scenario, U.S. GDP grows 1.2% in 2002 and world GDP grows 1.8%. In the precipitous decline scenario, U.S. GDP shrinks 1.7% and world GDP grows 0.7%; the main effect of the precipitous decline scenario is to push economic recovery back into late 2002 or early 2003.

What these two scenarios imply for the high-tech industry varies by sector. For semiconductors, sales are poised to recover under the modest decline scenario: Year-over-year declines would bottom at around –30% in the fourth quarter of 2001 and then steadily rise until sales are increasing at double-digit rates by early 2003. However, under the precipitous decline, the recovery is pushed back two quarters. Sales would not bottom until early 2002, and growth would reach around 5% to 7% by early 2003. For communication equipment, world

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telecommunication capital expenditures would fall about 7% under the modest decline scenario, or fall 15% under the precipitous decline. In either scenario, the declines in spending on wireless equipment are less than the declines in spending on wireline equipment. Overall, though, the long-term fundamentals for the industry remain strong, and U.S. high-tech spending should return to its trend growth rate—about 15%—in the not too distant future.

Trends in tourism

Though tourism was slowing prior to September 11, the events of that day led to a remarkable change in travel patterns across the country. The vice chair of a district state travel and tourism association discussed the economic impact of the tourism industry and the impact of September 11 on tourism.

The U.S. tourism industry employs one out of seven people and generates nearly $100 billion in state, local, and federal tax revenue. In 2000, 51 million international tourists spent $103 billion in the U.S., $14 billion more than U.S. tourists spent abroad. There are two segments to the industry: business, including corporate travel, group meetings, and sporting events; and leisure, including individual and group travel. The most important aspect of travel is overnight stays, which generate the biggest return on investment for local areas. While the industry has taken a significant hit after September 11, cutbacks in business travel prior to then had created weak conditions. Domestic travel was already down 3.5%, domestic travel expenditures were down 7%, 453,000 jobs had been lost, and the travel sentiment index had dropped to its lowest level in history. The September 11 effects were different in each area of the tourism industry. The restaurant industry reported a $1 billion sales shortfall and 85,000 job cuts in September and October. But, since sales were still up 4.5% year-to-date, there were not many effects beyond job losses. Hotels were harder hit. Occupancy rates were down significantly and one trade group forecasts that they will fall to 60.5%, lower than during the Gulf War. Another trade group reports that total revenue per available room is down 17.5% from 2000, with segment results ranging from a 23.9% decline for upper-scale rooms to a 9.5% decline for mid-scale rooms. As a result, hotels have cut workers, heavily discounted rooms, and cut back on capital expenditures. Canceled conventions after September 11 resulted in $1 billion in lost bookings, but that has now abated and many have been rebooked. Large conventions continued as scheduled, but attendance was down 20%.

The consensus tourism industry outlook for 2002 is that there will be gains over 2001, but activity will be far below 2000—a very strong year for the industry—and individual segments will vary greatly. Two large hotel chains offered different outlooks for their companies in 2002 and beyond. One, with a lot of high-end business, said there should be some sense of recovery by mid-year, but the industry will continue to be volatile for the next few years. The other chain, which focuses more on the mid-scale market, expects business to be poor throughout 2002.

Conclusion

The trough of the recession is expected to occur sometime near the end of 2001 or early 2002, with a gradual improvement in economic growth as we move through 2002. The forecasters anticipate that the expansion will be largely due to a reversal of the inventory contraction that has taken place since early 2001. The unemployment rate is forecast to peak in the second quarter of 2002 at 6.2%, and then ease to 5.8% by the fourth quarter. With weaker oil prices, 2002 inflation is expected to be 1.9%. While the forecast does not call for a significant rebound in economic activity, by the second half of the year the economy is forecast to be on a solid path of growth.

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