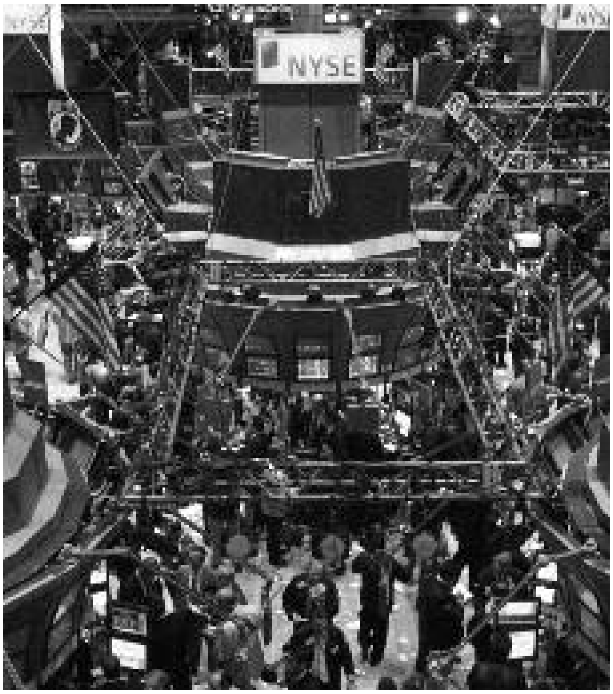
How the U.S. Economy Looks from Here

Elaine Levine*



Chip East/Reuters

On more than one occasion over the past few months, after President Bush insisted publicly that the U.S. economy is well on the road to recovery, the stock market has responded with a significant drop the following day, as if to prove him wrong. In mid-July, *Washington Post* staff writers noted, "For the second time in as many weeks, President Bush offered reassuring words today about the nation's economy. And for the second time investors drove stock prices steeply down just after his address."[1] Throughout the spring and summer the White House tried to convey optimism about the course of the nation's economy. Some over-enthusiasts in Washington went so far as to doubt that a recession had even occurred since, according to initial data, the gross domestic product (GDP) had only contracted for a single trimester in 2001. Near the end of July, Treasury Secretary Paul H. O'Neil said on NBC-TV's *Meet the Press*, "If people count as a recession one quarter of negative growth, God bless them. I don't care."[2]

In early June, the National Bureau of Economic Research (NBER) pinpointed "sometime in March" 2001 as the peak of the economic expansion that began in March 1991, and hence the beginning of a recession. They cited four key indicators for determining whether or not "a significant decline in activity" —their definition of a recession— has taken place: 1) employment; 2) industrial production; 3) manufacturing and wholesale-retail sales volumes; and 4) real personal income minus transfers. "Most of the recessions identified by our procedures do consist of two or more quarters of declining real GDP, but not all of them," the NBER affirmed, adding, "The present recession may be an example that lacks two quarters of decline."[3] At that time the bureau did not identify a trough date, i.e., a turn-

* Researcher at CISAN.

ing point that would indicate the end of the recession. In fact, as they themselves stated, the bureau's Business Cycle Dating Committee "waits for many months after an apparent trough to make its decision, because of data revisions and the possibility that the contraction would resume."[4]

Data revisions released at the end of July did indeed raise new uncertainties about the current and future course of the U.S. economy. They also dispelled any doubts about whether or not a recession had occurred. The Commerce Department "revised its GDP data back to the start of 1999, revealing that national economic output contracted for three straight quarters during the first nine months of 2001, handily surpassing a rule-of-thumb definition that two quarters or more of declining output is a recession."[5] Although first quarter growth —originally reported at 5.8 percent and subsequently 6.1 percent— was revised downward to 5.0 percent, surely the most disappointing news was that in the second quarter of this year output only grew at a 1.1 percent seasonally adjusted annual rate —that is, "half the 2.2 percent rate estimated by Wall Street economists."[6]

It now seems that the decline in economic activity was a bit longer and deeper than originally estimated (a decrease of 0.8 percent rather that a rise of merely 0.1 percent) and yet mild when compared to other downturns. In spite of all the time and energy spent making predictions and all the paper and ink used to print them, the questions remaining unanswered thus far are: "Is it over?" "How bad was it, really?" and "What long term effects will it have?"

Although economics has made enormous strides since the days of Adam Smith, the business cycle, while seemingly still inevitable, is nonetheless a highly unpredictable phenomenon in terms of its precise timing, exact magnitude and overall impact. Only the advantage of hindsight allows us to fully explain the often erratic behavior of certain economic indicators and even then experts do not always agree in their interpretations of the economic events observed and their underlying causes.

The 2001 recession is an excellent example of how difficult it is at times for economists to make reliable predictions in spite of all the information to which they now have almost instantaneous access.

While the experience of the past two decades may indicate that the cycle has been tamed somewhat —judging by the magnitude of the fluctuations in GDP– it definitely has not been eliminated. Furthermore, the ostensibly mild recession in 1990-91, for example, had a much stronger and longer lasting impact than initially expected. According to David Brauer the subsequent recovery and expansion's lack of momentum, after the recession trough was reached, is without precedent in the entire postwar period. Both GDP and industrial output took over two years to reach their previous peaks. Private sector employment fell continuously for 19 months (until February 1992) and as late as July 1993 had not recuperated its pre-recession level.[7]

Nevertheless, the long lingering effects of that recession were finally dimmed by the economy's surprisingly strong performance during the second half of the 1990s. In spite of the president's public and private scandals, which cast their shadows over Clinton's White House years, and the numerous defeats he suffered in Congress, the Clinton administration can claim several important accomplishments in the economic domain, such as lowering unemployment, eliminating the fiscal deficit and sustaining GDP growth for eight years. After the first trimester of 1998, the unemployment level reached a 28-year low. The fiscal deficit was eliminated more rapidly than expected and, for the first time in 30 years, there was a budget surplus in 1999.

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Midway into Clinton's second term his Council of Economic Advisers assured that there were no indications the existing economic expansion was in danger of winding down yet.

They pointed out that there were no inflationary pressures, nor build-up of inventories and no evidence of financial disequilibrium.

They highlighted the fact that investment had been growing since 1993 and productivity and salaries had been on the rise since 1996. However they also recognized that personal savings were extremely low and household debt continued to climb. They showed caution in warning that "the recent achievements do not mean an end to inflation or that the cycle has been defeated nor a permanent reversal of the secular tendencies of low productivity growth and increasing inequality in the income distribution."[8] Continuously high growth rates in GDP and productivity from 1996 to 2000 surpassed even the most optimistic projections. The favorable coincidence of low unemployment rates, low inflation and high rates of growth achieved during those years was just as surprising as the reverse phenomena of high inflation rates, high unemployment rates and almost negligable growth rates for output and productivity —referred to then as "stagflation"— which had caused so much concern at the end of the 1970s. According to the Clinton administration, this favorable combination of circumstances was due to the positive interaction of 1) great progress in information technology and telecomunications that in turn had an impact on many other sectors; 2) changes in business organization and practices that enhanced competitiveness; and 3) public policies which created a favorable climate for innovations and investment —particularly fiscal discipline to convert the deficit into a surplus, thereby allowing for lower interest rates, which encouraged private investment.[9]

In spite of all the Clinton administration's rhetoric about the "new economy," the spectre of a recession had been haunting the horizon for quite some time before September 11. Investment growth proceeded at a much slower pace after 1998 and actually began to wane in the third quarter of 2000, continuing to do so throughout 2001. Manufacturing employment began slipping in the second semester of 2000 as did employment in general after March 2001. Nevertheless the "r" word was not openly or widely used until after the terrorist attacks. Up to that point, the Bush administration had been hoping that Fed chairman Alan Greenspan would be able to commandeer a "soft landing."

As is to be expected, the White House was reluctant to admit that a recession was underway and a bit hasty, perhaps, in proclaiming it over. Once the initial shock effects of September 11 had subsided, consumers responded quite well to all the overt exhortations —many assert that there were subliminal ones also— that it was their patriotic duty to go out and spend. It was mainly consumer spending that got the economy back on track in the fourth quarter of 2001 and fueled its surge at the beginning of 2002. Later on it seems that the patriotic spending impulse was severely dampened by all the news of corporate scandals that plagued the economy throughout the spring and summer months.

The revised data released at the end of July and the continuously erratic behavior of the stock market have belied the administration's upbeat discourse. The president now finds himself faced with the dilemma of either appearing to be absurdly overly optimistic —and thus not sufficiently concerned about the immediate future of the economy and those most affected by hard times— or too pessimistic — possibly setting into motion a self-fulfilling prophecy of imminent further decline. With an eye to the upcoming midterm elections the Republicans are hoping to strike a proper balance. Around the middle of August, about a week after the economic forum he convened in Texas, Bush announced to the press that he was in the process of considering additional measures to help stimulate the economy. "That's one of the things that came out of the meeting, that some have urged us to think about additional measures to help growth, so I'm thinking about it," the president said.[10]

Just a few days before Bush's statement about considering a package of new steps to help out the economy, the Federal Reserve decided to leave interest rates unchanged. At the same time, it "downgraded its view of the economy and signaled that it would consider cutting rates if the recovery from last year's recession continued to lose steam."[11] By mid-August both the Fed and the President were sounding less optimistic than they had only a month earlier. Another ominous sign is that even though the twin towers have not been replaced yet, the twin deficits —the trade deficit and the fiscal deficit— have reappeared.

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Currently a V-shaped recession —a brusk dip followed by a quick upswing— seems much less likely that it did some months ago. It now appears much more likely that the recession has assumed a U shape —an apparently mild decline followed by a rather slow, sluggish recovery. However it is still too soon to discard the possibility of a W-shaped, or double-dip, recession. Regardless of the form the U.S. recession assumes, the only thing certain for the Mexican economy is that the negative impact will probably be even stronger and last even longer here than in the U.S. It has been shown time and time again that in terms of economic health, when the U.S. sneezes, Mexico gets a cold, and if the U.S. gets a cold, Mexico comes down with pneumonia. VM

NOTES

[1] "Market Ignores Bush's Bullishness," *The Washington Post*, 15 July 2002, http://www.washingtonpost.com/ac2/wp-dyn/A10058-2002Jul15

[2] "O'Neil, Lindsay Laud Strength of Economy," *The Washington Post*, 29 July 2002, http://www.washingtonpost.com/ac2/wp-dyn/A13926-2002Jul28

[3] Business Cycle Dating Committee, "The NBER's Business-Cycle Dating Procedure," National Bureau of Economic Research, 7 June 2002, www.nber.org/cycles/recessions.html.

[4] Ibid.

[5] "Economy Grew Only 1.1% in 2nd Quarter, Less Than Expected," *The New York Times on the web*, 31 July 2002.

[6] Ibid.

[7] David Brauer, "A Historical Perspective on the 1989-92 Slow Growth Period," *Federal Reserve Bank of New York Quarterly Review* (summer 1993), pp. 3-5.

[8] *Economic Report of the President 1997* (Washington, D.C.: United States Government Printing Office 1997) Chapters 1 and 2; *Economic Report of the President 1998* (Washington, D. C.: USGPO, 1998), Chapters 1 and 2 and p. 42.

[9] *Economic Report of the President 2001* (Washington, D.C.: United States Government Printing Office, 2001).

[10] "Bush Considers New Measures in a Bid to Boost the Economy," *The New York Times*, 17 August 2002, wysiwyg://38/http://www.nytimes.com/2002

[11] "No Cut in Rates as Fed Lowers Its Assessment of the Economy," *The New York Times*, 14 August 2002, wysiwyg://37/ http://www.nytimes.com/2002