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2002 Economic Outlook - General Trends National and North Carolina

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The National Economy: A Recession Begins

According to the National Bureau of Economic Research, the U.S. economy entered a recession in March, 2001. This marked the start of the first recession in ten years. As 2001 came to a close, the most important questions were how severe would the recession be and how long would it last?

The movement to a recession is clearly evident in the aggregate statistics. Real gross domestic product, the broadest measure of economic activity, increased 4.1% in 2000. In the first quarter of 2001, the GDP increased 1.3%; in the second quarter, it increased 0.3%; but in the third quarter, real gross domestic product *declined* by 1.4%. It is widely expected the decline will continue in the fourth quarter of 2001 and possibly the first quarter of 2002.

To date, the 2001 recession has been different than other recent recessions. The 2001 recession has primarily affected the business sector. Although unemployment has increased, consumers have fared better than businesses.

Industrial production fell 2% in 2001, and business investment disappeared. Corporate profits were negative, and one million manufacturing jobs were cut during the year. The troubles in the business sector were reflected in a declining stock market in the first half of 2001.

In contrast, consumers weathered the economic storm rather well. Although the jobless rate did jump from 4.2% to 5.7% during 2001, the unemployment rate was still significantly lower than in previous recessions. Wages rose at an annual rate of 3.5%, and both inflation-adjusted disposable income and consumer spending rose. In previous recessions, consumer income and spending either did not increase or fell.

Impact of September 11

The strength of the consumer and non-manufacturing sectors of the economy in the spring and summer of 2001 has led many economists to believe the economy would have escaped an official recession had it not been for the terrorist attacks of September 11. The economic aftershocks of the attacks were strong enough to cause the economy to decline in the third quarter and likely again in the fourth quarter.

Admittedly, it is difficult to estimate the economic impact of 9/11. However, one estimate from two University of Chicago economists puts the annual reduction in national income as a result of the attacks at $250 billion or 2.5% of gross domestic product.

Mr. Greenspan's Medicine

Well before the recession was "officially" declared, the Federal Reserve (the "Fed") was using its power over monetary policy to stimulate the economy. During 2001, the Fed reduced its key short-term interest rate (the federal funds rate) eleven times, from 6.5% to

1.75%. The Fed's goal was to reduce the cost of borrowing in order to encourage increased borrowing and spending by both businesses and consumers.

There is little evidence the Fed's medicine worked for the business sector in 2001. However, lower interest rates certainly motivated consumers to purchase homes, refinance mortgages, and buy vehicles during the year. The full impact of the Fed's cheap money policy are likely yet to be felt though. Typically it takes one year to eighteen months for Fed interest rate reductions to have their full impact on the economy.

When Will the Recession End?

The consensus among economists is that the recession will end in the second quarter of 2002. If correct, the 2001-2002 recession will be average in length for post-World War II recessions.

It is important to understand what an end to the recession means and doesn't mean. An end to the recession *doesn't* mean the U.S. economy will suddenly be back to where it was two years ago, with a 4% unemployment rate and all the lost jobs recovered. Instead, an end to the recession means the economy will begin to *improve.* The "economic bleeding" will stop and the "patient" will start to recover. Firms will begin re-hiring and increasing production, and aggregate economic activity will increase. But the economy will *not* be back to running full-speed. This will take time.

There are three major reasons for optimism that the current recession will be relatively short-lived. First, the Fed's interest rate cuts began early and have been very aggressive, pushing short-term interest rates to below the inflation rate. This is providing a strong inducement for future borrowing and spending.

Second, energy prices have been falling. Oil prices have dropped by one-third, and natural gas prices have fallen by one-half since the beginning of 2001. These price reductions are saving billions of dollars in energy costs for both businesses and consumers.

Third, the economy is naturally self-correcting. During a recession, businesses reduce the production of new goods as they sell from inventories. In the first nine months of 2001, businesses reduced inventories by over $125 billion. Eventually, inventories will be depleted to such a level as to require businesses to increase production and hiring.

In summary, it appears the 2001-2002 recession will be of average duration but less severe than the recessions in the post-World War II period. But this also means the recovery will likely be less robust than previous recoveries. Consumer spending accounts for almost two-thirds of all spending in the economy. Since consumer spending has remained relatively strong during the recession, there won't be the usual surge in consumer spending once the economic recovery begins.

North Carolina: A Deeper Recession

Due to North Carolina's greater reliance on manufacturing, the recession has impacted North Carolina more than the nation. Manufacturing accounts for 23% of North Carolina's income compared to 16% for the nation. Recessions always hurt manufacturing more because consumers and businesses can postpone purchasing manufactured products until the economy improves.

The impact of the recession on North Carolina's economy can been seen in the labor market. In October 2000, North Carolina's unemployment rate was less than the national unemployment rate (3.9% compared to 4.1%). One year later, in October 2001, North Carolina's unemployment rate had moved above the national unemployment rate (5.5% compard to 5.4%). In the first ten months of 2001, the number of unemployed persons increased 33% in North Carolina compared to an increase of 30% for the nation.

The big job losses in North Carolina have been in manufacturing, as would be expected. During the year spanning September 2000 to September 2001, traditional manufacturing industries in North Carolina (tobacco, textiles, apparel, and furniture) cut over 25,000 jobs, and other manufacturing firms cut 27,000 jobs. In contrast, the service sector and government (including teachers) added 58,000 jobs.

This is the bad news. The good news is, despite the terrorist attacks of September 11, the North Carolina economy is forecasted to recover in 2002. The state's unemployment rate is expected to peak at 6.6% in the first quarter of 2002 and decline thereafter. However, at the end of 2002, the statewide unemployment rate is still projected to be above 5.5%.

The events of September 11 will delay, but not prevent, the economic recovery in North Carolina. However, although no terrorist attacks occurred in North Carolina, the state will still suffer costs from the aftermath of the attacks. For example, it is expected that retail sales in North Carolina will be $1 billion *less* in 2002 as a result of the attacks.

Although the North Carolina economy is expected to improve beginning in the second quarter of 2002, structural change will continue in the state. Most of the 25,000 jobs lost during the last year in traditional manufacturing will not come back. In particular, job losses will continue in textiles and apparel as these industries move to more mechanized production with fewer workers.

Most of the jobs lost in "other" or "non-traditional" manufacturing in North Carolina will eventually return. For example, in the first year after the 1990-1991 recession, all of the jobs lost in non-traditional manufacturing in North Carolina were recovered. However, because the economic recovery is expected to be slower after the 2001-2002 recession, it will likely take much longer than a year for non-traditional manufacturing employment in North Carolina to return to its pre-recession levels.

Looking Back and Ahead

The current recessionary cycle was prompted by a desire by the Federal Reserve to temper the strong economic growth rates of the late 1990s. Consequently, the Fed *increased* interest rates in 1999 and 2000. These rate hikes set the stage for the slowdown in the economy in 2001.

Clearly, the Fed didn't want to cause an outright recession in 2001. The Fed's goal was to *slow* economic growth, not to cause economic growth to go into reverse. It looked as if the Fed had achieved its goal of slower growth, without a recession, until the terrorist attacks of September 11.

Of course, this issue is now academic. The economy is now in a recession, and the Fed has been actively fighting it. But as expectations increase for an economic recovery in 2002, eyes are turning to the nature of the economy in 2002 and beyond and potential threats to the economy.

Certainly one threat is future terrorist attacks. Terrorist attacks not only cost lives and wealth today, but they also increase risk. Greater risk increases the cost of economic activity and reduces investment and commerce. Hopefully, the current military and security efforts to confront terrorism will reduce this threat in the future.

Another threat that always arises when an economic recovery occurs is the threat of faster increases in prices - that is, higher future inflation rates. Current data indicate inflation is low now. In fact, in some markets deflation (falling prices) is occurring. But some economists are worried that the tremendous monetary stimulus provided by the Fed, combined with a likely *fiscal* stimulus (increased spending and reduced taxes) from the federal government, will provide such a boost to the economy in 2002 that production won't be able to keep pace with desired purchases. In such an environment, prices rise at faster rates.

Balanced against these threats is the assessment that the country's economic fundamentals are good. The annual inflation rate is, and will likely remain, in the low single digits. Government debt relative to the size of the economy has been falling. Productivity (output per input) has been rising even during the recession. Household net wealth is higher than a decade ago. The economic future still looks bright!

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