North Carolina Cooperative Extension Service

NC STATE UNIVERSITY

COLLEGE OF AGRICULTURE & LIFE SCIENCES

NC State Economist

Agricultural and Resource Economics • January/February 2003

2003 Economic Outlook: Is the Recovery For Real?

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The National Economy: A Recovery Begins (We Think!)

The economy entered a recession in early 2001. To date, the committee that determines the beginnings and ends of recessions has not identified when the 2001 recession ended. However, it is widely believed the recession will officially be dated as ending in the final months of 2001.

A recession means the economy's output of goods and services shrinks. Indeed, in the first three quarters of 2001 the economy's output did drop by 1%. Yet, a strong rebound in 2001's fourth quarter production brought total economic growth for the year to be a slight 0.25% (Table 1).

The economic recovery continued in 2002. It is estimated that the total output of goods and services grew 2.7% during 2002 and fully recovered the output that was lost in 2001.

An Unusual Recession ....

We now know the 2001 recession was unusual in several ways. Like all recessions, the business sector was hard hit. Corporate profits fell and business investment in new technology and equipment shrank. Industrial production dropped 2.6% in 2001, a decline much sharper than during the previous recession of 1990-91. These changes are typical as recessions dim the prospects for businesses and make companies reluctant to invest in the future.

The labor market also deteriorated during the recessionary year of 2001. Employment declined by over 1%, and the national unemployment rate jumped almost 2 percentage points (Table 1).

One unique aspect of the 2001 recession was its devastating effect on one segment of the business sector, the "high-tech" or information-technology industry. This emerging industry grew rapidly in the 1990s, and prospects of continuing high growth rates became imbedded in the industry's forecasts and stock values. Then, when the industry's growth halted and receded in 2000 and 2001, the industry was left with serious over-capacity and inflated stock values. Massive layoffs, bankruptcies, and a rupturing of stock prices resulted. The virtual free-fall of high-tech stock value pulled the entire stock market down in 2001and early 2002.

Yet a positive feature of the 2001 recession was the performance of consumers. Usually during recessions consumers "batten down the hatches" and moderate their spending, especially on "big-ticket" durable goods purchases. But prompted by the aggressive lowering of interest rates by the Federal Reserve, the continued growth in real (inflation-adjusted) household income, and moderate retail price increases, consumer spending was surprisingly robust in 2001. Consumer purchases of houses and vehicles actually set records by some measures.

Government policymakers quickly recognized the onset of the 2001 recession and enacted textbook policies to combat it. The Federal Reserve reduced short-term interest rates to generation-low levels, and the President and Congress enacted tax cuts and boosted federal spending in 2001.

.... And An Unusual Recovery

The 2002 recovery from the recession also appears to be unusual, but in a negative way - in its tepidness. The economy did grow in 2002 at an estimated rate of 2.7%. While good, this growth rate was only two-thirds as great as the average first-year recovery growth rate after the previous three recessions. Job growth was also non-existent in 2002, and the national unemployment rate continued to climb during the year (Table 1).

Economic growth was moderate in 2002 due to continued weakness in the industrial sector. Industrial production declined another 1.6% in 2002. Consumers, however, continued their contrarian behavior by actually accelerating retail purchases. Real (inflation-adjusted) retail sales, excluding vehicles, jumped 1.5% in 2002 after rising 0.6% in 2001.

What's Ahead in 2003?

The slow economic recovery is expected to continue in 2003, but for different reasons than in 2002. Buoyed by a full year of general economic growth and prodded by low interest rates and favorable input prices, the industrial sector should stage a turnaround, and industrial output will increase by about 3.5%. The labor market will also improve, with the job base increasing by over 1% and the unemployment rate falling by 0.3 percentage points. Businesses will resume purchases of new equipment and technology.

Yet the flip side of the relatively strong performance by consumers in 2002 will be the moderating effect their spending will have on the economy in 2003. Consumers will not have a "pent-up" demand for durable good purchases due to their continued buying of these products in 2001 and 2002. Consumer debt loads also didn't drop in 2001 and 2002 as in previous recessions. Continued consumer spending generated by borrowing is thus constrained. Therefore, a moderate increase in consumer spending in 2003 will act to keep overall economic growth near 2%.

Continued moderation in inflation and economic growth will work to keep any interest rate increases in 2003 relatively minor. Short-term interest rates are expected to increase by 0.4 percentage points, and long-term rates are projected to rise by 0.3 percentage point. Most of these increases will occur in the second half of 2003.

Table 1. Key U.S. Economic Measures

	2001	2002[a]	2003[b]
Real U.S. GDP (% Chg.)	0.25	2.7	2.0
Employment (% Chg.)	-1.1	-0.01[c]	1.2[c]
Unemployment Chg. (% Points)	1.8	-0.01[c]	-0.3[c]
Industrial Production (% Chg.)	-2.6	-1.6	3.5
Real Household Income (%Chg.)	0.5	0.2	2.5
Chg. in Household Debt-Service Pymts. as % Disposable Income (% Points)	0.47	-0.12[c]	-0.10[c]
Real Retail Sales (% Chg.)	0.9	0.9	0.6
Real Retail Sales excl. vehicles (% Chg.)	0.6	1.5	0.8
Consumer Price Index (% Chg.)	2.8	2.0	2.3
Chg. in 3-mon. T-bill interest rate (% Points)	-4.23	-.47[c]	0.4[c]
Chg. in 10 yr. T-note interest rate (% Points)	-0.15	-1.04[c]	0.3[c]
S & P 500 Stock Price Index (% Chg.)	-16.1[c]	-20.4[c]	7.0[c]

[a]Annualized rates based on performance for available months and forecasts for remaining months
[b]Forecast
[c] Year-end to year-end comparisons
Sources: U.S. Dept. of Commerce, Federal Reserve System

The North Carolina Economy: Faster Down, and (Hopefully) Faster Up

The 2001 recession was deeper in North Carolina than the nation as a whole. Real household income grew more slowly and employment fell more in North Carolina compared to the nation in 2001 (Table 2). The major reason for this is the North Carolina economy's heavier reliance on manufacturing as an income source. Manufacturing accounts for 23% of North Carolina's income compared to 16% for the nation. The manufacturing sector has traditionally been more volatile than the service sector, and manufacturing declines more during recessions.

The North Carolina economy has been in transition. For example, during the growth years of the 1990s, 20% of North Carolina's traditional manufacturing (tobacco, textiles, apparel, and furniture) jobs were lost, but other manufacturing jobs increased 9% and non-manufacturing jobs jumped 30%. Although this change did not help every North Carolinian, it did result in a 22% increase in real per capita personal income over the decade, and it moved North Carolina's average personal income closer to the national average.

But during the period 1999-2001, the state was hit by the continuing job losses in traditional manufacturing plus losses in other sectors due to the national recession. From 1999 to 2001, the state lost another 11% in traditional manufacturing jobs and lost 7% of other manufacturing jobs, many of these in the high-tech sector that grew so rapidly in the 1990s. Non-manufacturing jobs did grow, but only by a modest 1%.

The bleeding appears to have stabilized in 2002. Real household income in North Carolina grew slightly faster than in the nation. Although the number of jobs shrank, the state unemployment rate did fall.

Looking ahead to 2003, North Carolina's economy should register positive measures. Real household income and employment should both increase slightly faster than national rates. The unemployment rate will drop by approximately one-half percentage point. However, a drag on the state economy will be the slow recovery in the high-tech sector. Also, the long-term reduction in traditional manufacturing jobs will continue.

Risks

All economic forecasts must contend with the uncertainties caused by unforeseen events that render the forecasts incorrect. At the end of 2002, it appears three uncertainties confront economic decision-makers.

One is the continuing threat from international terrorism. Terrorism has already imposed costs on the economy related to the destruction on 9/11/01. Terrorism continues to impose costs on the economy related to additional expenditures for security in travel and protection of personal and real property. Without the threat of terrorism, these are expenditures that would have been available for productivity-enhancing endeavors, such as capital investment and educational training.

One estimate suggests the threat of international

Table 2. Key North Carolina Economic Measures

	2001	2002[a]	2003[b]
Real Household Income (% Chg.)	0.3	0.3	2.7
Employment (% Chg.)	-1.5	-1.2[c]	1.5[c]
Change in Unemployment rate (% Points)	2.3	-0.5[c]	-0.5[c]

[a]Annualized rates based on performance for available months and forecasts for remaining months
[b]Forecast
[c] Year-end to year-end comparisons
Sources: U.S. Dept. of Commerce, Security Commission of North Carolina

terrorism is reducing national GDP growth by 0.5 percentage points. These costs will rise, and GDP growth will slow if another major terrorist attack occurs on U.S. territory.

A second uncertainty centers on the continuing confrontation with Iraq. It is widely expected a military conflict between the United States and Iraq will proceed quickly and strongly in favor of the U.S. However, this doesn't eliminate the possibility that such a conflict could adversely affect world oil supplies and substantially increase oil prices, if only for a relatively short period of time. A sharp spike in oil prices could derail economic expansion in 2003.

Finally, with a relatively weak economic recovery and with restructuring occurring in many markets, the possibility of major corporate bankruptcies will persist in 2003. Such bankruptcies could wreak havoc on markets, and the resulting restructuring could slow economic growth and increase unemployment.

Yet with all the economic gloom of the past two years and the uncertainties present for 2003, there is reason to be optimistic based on one key economic factor - productivity. Worker productivity increased over 5% in 2002, the highest annual rate in 35 years. This is significant because in the years during and following a recession, productivity growth usually slows and often turns negative.

Ultimately, our standard of living is based on improvements in worker productivity. The fact that strong gains continue in worker productivity is a good sign for the long run strength of our economy and improvement in our living standards.

N.C. State Economist

Published bi-monthly by the Department of Agriculture and Resource Economics and the Cooperative Extension Service. Address correspondence to:

The Editor, N.C. State Economist
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