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PROSPERITY WASN'T JUST AROUND THE CORNER

Signs indicate weakening economic performance before September 11 attacks

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Some observers of the economy, notably Federal Reserve Chairman Alan Greenspan and former Treasury Secretary Robert Rubin, have argued recently that the terrorist attacks in Washington, D.C. and New York interrupted an economic recovery that was already underway. Commenting on the state of the economy, Greenspan concluded in his testimony to the Senate Banking Committee on September 20 that signs prior to the terrorist attacks were "tentative, but encouraging," suggesting that the economy had turned a corner in July or August.

Perhaps Greenspan and Rubin based their cautious optimism on preliminary indicators, but the data on consumer spending, investment outlays, trade, and overall economic activity for July and August show just the opposite to be true. In fact, most indicators show the economy was going from bad to worse—and was most likely in recession—before the attacks on the Pentagon and the World Trade Center even took place. Even now, several indicators suggest that the slowdown will continue past the third quarter and into the fourth.

Most of the evidence shows that the economy had slowed down even further in July and August compared to prior months, with unemployment in August at its highest level in almost four years (**Table 1**). Unemployment is only likely to continue its rise, as a result of both the adverse shock to the economy from the terrorist attacks and the economic trends already in motion beforehand. In fact, at the end of September, new claims for unemployment benefits rose to their highest level in nine years.

These rising unemployment levels contribute to weakening consumer confidence, which had been on the decline since July. As households lost their appetite for spending, retail sales declined four weeks in a row in late

TABLE 1
Evidence of a downturn, summer 2001

	July 2001 compared to:		August 2001 compared to:	
	Previous month	Year ago	Previous month	Year ago
Economy overall				
Industrial production	-3.3	-0.1	-0.8	-4.8
Manufacturing output	0.0	-4.0	-1.0	-5.5
Capacity utilization (percentage-point difference)	-0.2	-5.4	-0.7	-6.3
Unemployment (percentage-point difference)	0.0	0.5	0.4	0.8
Consumption and household expenditures				
Consumer confidence	-2.4	-18.9	-1.7	-19.1
Retail sales (Census)	0.3	3.2	0.2	3.5
Consumer goods products	0.4	-0.7	-0.8	-2.1
Consumer durables	2.1	-0.6	-1.5	-2.9
Travel expenditures	-1.5	-2.4	n/a	n/a
New housing starts	0.4	10.2	-6.9	-0.2
New building permits	-1.8	1.5	-0.7	1.0
Investment				
Business equipment manufacturing	-0.3	-4.0	-1.6	-6.9
Information processing equipment	-1.6	-0.8	-0.5	-3.9
Computers and related equipment	-0.8	4.7	-0.5	0.3
Trade				
Export	-2.6	-6.7	n/a	n/a
Imports	-2.1	-8.0	n/a	n/a
Trade balance	1.0	-21.9	n/a	n/a

Notes: Monthly rates are not annualized.

Sources: Conference Board, Consumer Confidence Index; Travel Business Roundtable, TBR Index; U.S. Census Bureau, New Residential Construction; U.S. Census Bureau, Advance Monthly Sales for Retail and Food Services; U.S. Census Bureau, FT-900 U.S. International Trade in Goods and Services; Board of Governors of the Federal Reserve System, Release G.17 Industrial Production and Capacity Utilization; and Bureau of Labor Statistics, Employment Situation.

August and early September, according to reports from the investment banks UBS-Warburg and Bank Tokyo-Mitsubishi. Such reports suggest that the advance August numbers from the Bureau of the Census (see Table 1) are likely overstating actual consumer activity. As would be expected, retail sales substantially declined in the two weeks following the terrorist attacks, but some key sectors—for instance total travel activity, which declined by 1.5% in July—had shown sure signs of weakening much earlier. Completing this picture was the decline in consumer goods output, which dropped 0.8% in August, more than eliminating the previous month's small gains.

Clearly, most signs point to reduced consumer spending in the third quarter. Since consumption has been responsible for about two-thirds of gross domestic product growth, each percentage-point decline in consumption in the third quarter means that the economy loses more than $17 billion in output. Thus, a contraction in consumer spending would be particularly worrisome.

Other sectors, such as housing, exports, and investment, have also declined. The housing sector, which had thus far remained resilient to the economic slowdown, began to show clear signs of weakness in August. New housing starts declined by 6.9% in August, and the issuance of new housing permits declined by 1.8% in July and 0.7% in August. These trends suggest that, in the near future, housing construction will continue to decline. As for U.S. products in overseas markets, exports declined by 2.6% to their lowest (non-inflation adjusted) level since November 1999. With consumers in the United States and abroad reluctant to spend, there is little reason for businesses to invest. Business equipment output fell in August for the ninth month in a row, reaching its lowest level since January 2000. Moreover, two categories often associated with the investment boom of the late 1990s—information-processing equipment and computers—fell for seven and eight consecutive months, respectively.

Since the downturn affects all sectors, the third quarter most likely marks the beginning of a recession that is likely to continue into the fourth quarter. This outcome is also reflected in data for the economy as a whole. Capacity utilization fell to its lowest level since October 1982; industrial production, especially in manufacturing, fell in July and August, and manufacturing output in August was down by 5.5% compared to a year ago. Furthermore, durable goods orders, which provide a glimpse into the future of manufacturing, fell for the third month in a row in August by 0.3%, only deepening July's 1.1% decline.

So far, the United States has relied predominantly on monetary policy to get the economy growing again. But despite short-term interest rate cuts by the Fed, long-term interest rates remain static. Mortgage rates, for instance, are still above their level at the end of 2000. In an economy suffering from low consumer confidence and rising unemployment, providing businesses with cheap money will do little, if anything, to push the economy out of recession. Sales have to increase before businesses will begin investing, regardless of how low interest rates are.

Consequently, only a fiscal stimulus can generate the faster growth the economy needs. To stave off a sharp and prolonged recession, the government needs to increase its spending substantially in the next two years since, under current circumstances, faster growth will likely not occur in the next few quarters. The federal government is expected to have surpluses of $176 billion for fiscal year 2002 and $172 billion in fiscal year 2003, allowing for the increased government spending needed to jumpstart growth in the economy.

At a minimum, government spending needs to be high enough to prevent rising unemployment in the near term. If we assume that productivity continues to grow at about 2% and that wage growth, growth in hours, and labor force growth total to an additional 1% in the coming year, then output will have to grow at least 3% to prevent rising unemployment. In other words, with growth at or slightly above 3%, unemployment is likely to remain at least constant, and the threat of a vicious cycle in which rising unemployment and declining consumer confidence feed on each other could be contained. Getting the economy to grow again at 3% will require large government expenditure increases. A proposal to meet this goal is described in Scott and Weller (2001). It calls for additional spending of $137.8-187.8 billion in FY 2002.

This estimate assumes, however, that consumer spending and investment spending increase by an average of at least 1% over the next 12 months. This may be a heroic assumption, considering that consumer confidence is low and, as unemployment increases, will likely fall further during the course of the recession. Without increases in consumption, though, investment is unlikely to increase. There are already signs that both household and

business expenditures will decline in at least the beginning of the fourth quarter. Domestic private spending, consumption, and investment will consequently take several quarters to recover, which makes a quick fiscal stimulus in the form of increased government spending even more important.

The government has already begun to increase its spending, but not by enough.[1] An increase in spending of an additional $45 billion has been approved in the wake of the terrorist attacks. To reach the goal of $200 billion in the next 12 months, an extra $155 billion or so is needed. It makes the most sense to invest this money in existing programs that reach households quickly and have a substantial impact on economic growth.

Endnote

1. In the third quarter, households received a tax rebate of close to $40 billion, or less than 2% of third quarter GDP. Considering that the U.S. economy had to withstand the dual impact of a recession before the terrorist attacks and the fallout of the terrorist attacks themselves, this stimulus had almost no impact.

References

Scott, Robert E., and Christian E. Weller. 2001. *Addressing the Nation's Needs: A Plan for Emergency Relief and Economic Stimulus.* Briefing Paper. Washington, D.C.: Economic Policy Institute.