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By

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**We Are In A Recession! It's About To Be
Official!**

By
Kenneth T. Rosen
Daniel T. Van Dyke
Jeanine Kranitz

The October 2000 paper released by Rosen Consulting Group entitled "Recession Risk Rising," identified ten reasons why the U.S. economy was likely to slip into a recession in 2001. We think the recession started during the second quarter of 2001, and that revisions to the second quarter GDP growth number, to be released on August 29, will show that economic activity indeed did decline during the second quarter. How deep will the recession be, and how long will it last? These are questions that affect general business planning, the demand side of the real estate market, and interest rates and prices, including asset prices, with generalized implications throughout the economy. Our view is that the downturn will extend into the middle of 2002, and that it will be deeper and longer than current consensus expectations.

It is clear that economic growth has slowed, with a preliminary second quarter 2001 real GDP growth of 0.7% posted in July. Job growth has turned negative in three of the past four months. The unemployment rate has edged upward as announcements of mass layoffs, business bankruptcy filings and news of lower, or more negative, corporate profits have become common in newspaper headlines. Most economists, nine out of ten in the last blue chip poll, believe the aggressive interest rate cuts by the Fed administrators and the tax rebates, will reverse the negative conditions now plaguing the economy and will spare the country from recession. **While we all hope that this rosy scenario is correct, we think the most likely outcome is that a recession has been underway for six months already and will probably last until mid or late-2002.**

Expansionary monetary and fiscal policies have been implemented to jumpstart the U.S. economy. The Federal Reserve has responded to weaker economic conditions and lowered interest rates seven times during the first eight months of 2001, bringing the federal funds rate down to 3.5%, the lowest since April 1994. The most recent 25 basis-point drop was announced on August 21, 2001. Tax rebates are being sent out which should inject the economy with a small jolt of increased consumer spending. Although government statistics have not yet confirmed that the domestic economy contracted during the second and third quarters, several indicators lead us to believe that economic activity is now declining.

Second Quarter GDP Growth Will Be Revised Downward

We believe that revisions to the second quarter data will primarily come in the inventory sector. Weak demand and declining business sales have resulted in a sharp and rapid inventory correction that is not over. Further, the inventory correction in the second quarter was steeper than assumed in the second quarter advance GDP release of a month ago. The second quarter GDP data were based on inventory assumptions that turned out to be too optimistic. The -0.2% revision in the May inventory data and the -0.4% decline in June inventories will provide a \$10 billion to \$12 billion decline in GDP, enough to knock about 0.5% off the GDP growth rate. We anticipate that other revisions, notably in the consumer sector, will wipe out the remaining positive gain, and will push GDP into decline in the second quarter. The downward revision will make it official that the U.S. economy is in decline for the first time in a decade, and that the conventional

wisdom of a soft landing is fast becoming a fading dream.

Third Quarter GDP Growth Likely to be Negative

The recession in the United States is gaining momentum. The housing sector and consumer sector have prevented an outright steep decline in production so far, but the evidence is that consumer spending may be based on a house of cards. Throughout the corporate sector the economy has all the characteristics of a recession and the red ink on the corporate bottom line will have a spreading effect as we move through the third and fourth quarters. This is especially true in the beleaguered manufacturing sector and the high tech sector. In addition, we can expect no help from the rest of the globe. Major portions of the world are also entering recession, reinforcing the economic downdraft in the United States.

Manufacturing Recession

The manufacturing sector is in a recession and has been since late 1998. National employment statistics have shown job contraction in this sector since the fourth quarter of 1998, and areas with higher concentration of manufacturing employment have suffered from weakness in the industry for several quarters. And the situation is not poised to improve. As we have indicated above, inventories are slipping away, but business sales are declining even faster, pushing up the inventory-to-sales ratio. This implies to us that the inventory correction—despite being substantial—is not yet over, and, as a result, manufacturing output still has further to fall. Recent cutbacks announced by domestic auto-producers will exacerbate this downdraft. Capacity utilization is already lower than the early 1990s recession.

Technology and Telecom are in a Depression

It is no secret by now that the high tech bubble has burst. Spending on Internet and telecommunications accounted for approximately one-third of GDP growth during the late 1990s. Since then, IT spending has dropped significantly and businesses laid off employees. Orders for boxes, communications gear, networking devices, and telecommunications services not only came to a standstill in the dot.com graveyard, but the very collapse of the sector created an immense overhang of used equipment that is now weighing on the market.

Not only were non-profitable start-ups affected, but established, profitable companies that provide the infrastructure for the Internet and telecommunication services were affected. Cisco, for example, announced in March that it would be laying off as much as 11% of its workforce during the fiscal year. Through the end of June Cisco had already slashed its workforce by 8,500, 15% of its employees. The tech slowdown had penetrated blue chip high tech companies. Daily news continues to be littered with layoffs, cutbacks and news of large losses.

Most Internet companies are now making no money from operations, and the flow of

venture capital to these companies that funded their extravagant and risky ventures has slowed from a waterfall to a trickle. Venture capital spending fell to \$8.2 billion during the second quarter of 2001, down from \$24.2 billion during the second quarter of 2000, a 66% decline over the year. So far, hundreds of tech companies have gone bankrupt. We expect that following this shakeout, only a handful of companies will survive. In another blow to the high-tech industry, *The Industry Standard*, the magazine that documented the rise of the new economy now shares the fate of its subject, declaring bankruptcy on August 17, 2001.

The collapse of the high tech industry now involves not only start-ups but also established names in the industry, including Cisco, AMD, and Lucent Technologies. The severity of this downturn is unprecedented and the problems in this industry will spread to other sectors of the economy as layoffs persist. Not only are immediate suppliers and infrastructure providers to the dot.com sector affected, but as the stock price collapse and layoffs affect the broader economy, the involvement will become more widespread throughout the general economy.

NASDAQ in Free-Fall; All Stock Prices Will Decline

As high tech companies have declined, so have their stock prices. Accordingly, the NASDAQ Index has now fallen more than 50% since its peak. The over-exuberance for telecommunications and the Internet "revolution" led to dreams of fast wealth creation. But unsustainable rates of growth, and expectations of continued growth at those unsustainable rates, came collapsing down as first one dot.com and then the next failed to deliver profitability. Stock prices still incorporate a growth premium that is not likely to be realized this year or even in 2002. Consequently, we expect that this growth premium will evaporate as investors come to believe that this high tech downturn is indeed the worst yet seen.

The broader market indexes also have some adjusting to do. The PE ratio for the S&P500 has risen to the low 30s as earnings have declined and prices have been unchanged. This situation is not likely to persist. We view a general decline in the broad market index as highly probable as investors eventually come to realize the poor earnings prospects for the next year. It has never been the case that a recession is accompanied by PE ratios at or near their historic high.

The Consumer Cannot Sustain Spending Levels

It is clear that stock prices will decline further with weak fundamentals, including near-record high PE ratios, underscoring the need for further price correction. The expected stock price correction will dramatically affect the consumer because it will directly target the net household worth of consumers. Nearly half of all households are now investing in the stock market, the highest level in history. Net worth, which has already showed dramatic decline, turned negative during the first quarter of 2001 and will be eroded further as stock prices fall. While rising housing prices have somewhat cushioned the impact of the decline in stock prices in the past year, it is our view that they will also

succumb to the economic weakness. With lower levels of net worth, consumer confidence will deteriorate and consumer spending will decline. The consumer confidence numbers released for August show new weakness.

Retail sales have already slowed somewhat, but growth remains positive. Auto sales, however are already manifesting the symptoms of weaker economic conditions with a 3.6% decline during the second quarter in the year-over-year growth rate. Retail and auto sales will be impacted by the decline in net worth that will dampen consumer confidence. With a more bleak outlook for the future, consumers will delay making unnecessary purchases and increase their savings rate.

Lowered corporate profits will also result in additional layoffs after the summer vacation. Although increases in the unemployment rate have been modest so far, corporations will be forced to cut their workforces until profits improve. With more people out of work and unable to find new jobs, the unemployment rate will increase, further chiseling away at consumer confidence. Even under mild recessionary conditions, the unemployment rate will climb to the 5.5% to 6.0%. If the economic downturn is more severe, we expect the unemployment rate to climb to the 6.0% to 7.0% range. Consumers still believe that the United States can avoid a full-blown recession. When signals of the recession reach consumers, they will respond by reigning in their spending.

World-wide Economic Slowdown

Reports of economic weakness around the world are further aggravating shaky domestic conditions. GDP figures from Asian, European and Latin American countries have revealed that the economic slowdown has spread to nearly every continent. In Asia, Singapore's second quarter GDP turned negative. While second quarter numbers have not been released for Taiwan, Japan and the Philippines, weak first quarter growth prompts us to expect growth in these areas to be lower or negative during the second quarter. Declining consumer demand in Germany and Italy resulted in flat and contracting economic growth, respectively, during the second quarter of 2001. Latin America continues to be plagued by economic weakness as Argentina's negative first quarter GDP indicates. Argentina's economy has been in recession for three years and much of Latin America is softening. Mexico reported declining GDP for the third consecutive quarter, resulting in flat year-over-year growth in the second quarter of 2001. Teetering global conditions increase the risk of a long and deep recession in the United States. Domestic demand will decline during a national recession and a synchronized world recession will result in lower demand in foreign markets as well. Import and export activity will decline domestically and abroad making the recovery slower and more painful.

Some Segments Still Remain Strong

The housing market has fared extremely well during the first half of 2001, with strong sales in both the new and existing home markets. The seven cuts announced this year to the Federal Funds Rate have resulted in lower mortgage rates for home-buyers. Lower

mortgage rates increased demand for homes in an otherwise weakening economy. Many believe that the continued strength of the single-family market indicates that the economy remains relatively healthy. We feel that demand in the single-family market is no longer a leading indicator. Instead, it will lag the economic slowdown. To date, the consumer has not responded to the corporate and high tech slowdown. When the unemployment rate rises and net worth deteriorates further, we expect the single family housing market to soften.

In addition, monetary stimulus and the tax cuts should eventually provide a boost to the economy. However, in the near term, it is unclear whether tax cuts will be used to make purchases or to repay debt, thereby repairing the badly out-balance household balance sheets. We think that more of the tax cut than is generally thought will go into repaying debt. Lower interest rates will also eventually have a positive impact on the economy. However, in the near term, that impact will be definitely muted. The spending declines in the manufacturing, capital goods, high tech, and the telecommunications sectors were not caused by high interest rates, so lower interest rates will not provide an immediate stimulus. Over capacity is the problem today in much of the global economy. The housing sector will benefit from lower interest rates, but if rising unemployment cuts income growth, damages perceptions of job security, and lowers consumer confidence, the pace of housing activity will start to falter as the consumer sector becomes more involved in the downturn. Many segments of the economy were overheated with speculative spending and unrealistic exuberance fueling overproduction and overspending from both households and corporations. Once these factors are corrected, growth will be able to re-start on a more sustainable course. At that time, expansionary fiscal and monetary policies will facilitate recovery.

How Long and How Deep Will the Recession Be?

Domestic imbalances and the international slowdown dramatically increase the risk of a global recession. The deterioration of corporate profits, an over-valued stock market, the manufacturing recession, the technology and telecommunications depression, and the almost inevitable decline in consumer spending on the horizon will, in all likelihood, bring about a domestic recession. First and second quarter GDP growth figures from all around the world indicate that the groundwork is also being laid for a global slowdown. We have developed a mild and a deep recession scenario to examine the probable impacts of a synchronized global recession. We assign the mild recession scenario a 60% probability and the deep recession a 30% probability. Our base scenario is the same as our forecast a year ago, however we have lowered the probability of a soft landing and raised the probability of a more protracted recession.

Mild Recession (60%)

Under the mild recession scenario, expansionary monetary and fiscal policies will stimulate economic growth domestically and abroad, enabling the global economies to slowly recover from recession in the second half of 2002. Tax reductions in the United States and various countries of Europe provide enough of a prop, together with lower

interest rates, that the United States skates through a mild recession before starting on the road to recovery.

For two to three quarters, corporate profits will be weak, causing a stock market correction. Corporations will cut additional employees in an effort to scale back costs and improve the bottom line. The unemployment rate will increase to 5.5% to 6.0%. Consumers will feel the decline in corporate profits, both from the deterioration of their net worth as they experience falling stock prices and as the unemployment rate climbs making it more difficult for out-of-work individuals to find new jobs. Consumer spending will decline, especially for big-ticket items like automobiles. Consumer spending will rebound slowly as corporate profits and stock prices recover. The housing market will stay fairly stable with moderate price and sales volume declines near the trough of the recession. As conditions improve, the domestic economy will return to slow but better growth during the second half of 2002. Growth is expected to be lower than before the recession as the United States returns to a sustainable level of growth of 2.5% to 3.0% in the second half of 2002 and in the 2003 to 2005 period.

Deep Recession (30%)

We believe that a synchronized global deep recession is 30% likely to occur where fiscal and monetary policies are unable to quickly remedy world economic malaise. The beginnings of a global recession are already in place with early GDP releases showing a spreading world slowdown. With much of the globe already infected, it will be difficult to stop the spread of recession. Once the recession spreads it will gain momentum creating a self-perpetuating malady which, unfortunately, will have to bottom out before it can be reversed.

Domestically, the consumer will be deeply affected by falling stock prices and high unemployment rates. With weaker demand domestically and globally, it will take longer for corporations to return to strong growth. Feedback from other countries reinforces the downturn, as a lack of export markets feeds the U.S. manufacturing sector decline. Conversely, lack of demand from the United States further weakens other countries. Fiscal policy measures are weakly successful as much of the windfall income is used to repair balance sheets. Additionally, lowered interest rates will not be useful in enabling companies to make new investments and return to strong profitability because the weakness was not caused by costly debt, deterring borrowing from the commencement of the recession. Consumer spending will stay low for a sustained period, and the unemployment rate will climb to the 6% to 7%-range. The housing market will finally be affected as demand for housing falls, pushing sales prices down. Economic weakness will also cause mortgage delinquency rates to rise substantially. The U.S. dollar will decline relative to the Euro as demand for U.S. exports decline, the profit outlook in the United States will weaken. In the long run, a dollar correction would help boost manufacturing, making goods relatively less expensive and therefore competitive. In the meantime, a weaker dollar would mean less capital inflow to the United States, affecting the financial sector and investment, placing these sectors under further duress.

Internationally, lower demand for exports will put pressure on foreign currencies. The same feedback response will plague international economies as weaker demand for exports everywhere will further soften economic conditions across the globe. In Japan and Argentina, where weakness has persisted for several years, currency devaluation could lead to a version of the Asian financial crisis of 1997. As one regional currency is affected, other currencies will weaken as well. Debt held in U.S. dollars would be more difficult to repay as foreign currencies weaken against the dollar. Additionally, fear of currency devaluation will cause a capital flight, putting further stress on the currency. As the currency declines, imported goods are relatively more expensive, creating inflationary pressure in the economy and severely contracting domestic growth. Eventually the currency devaluation will benefit the country as goods produced domestically become comparatively inexpensive to the rest of the world, making them more competitive. However, this recovery will follow a period of stagflation and possible financial crisis. Interest rates in this scenario are pushed even lower by the Fed, with short-term Treasury rates in the 2-3% range.

A synchronized global recession is contagious, and the weakness gets passed among countries and re-infects economies until they undergo a painful restructuring or currency correction. A deep global recession will take two years for a significant recovery. Once the momentum of a global recession takes hold, monetary and fiscal policy will become less effective at curing economic ailments, especially in high debt, low interest rate economies.

Soft Landing-No Recession (10%)

Recovery in the second half of 2001 is the Holy Grail that 90% of economists still expect. We think these are false expectations based on a misplaced faith in traditional policy tools.

Conclusion

We believe that the onset of the recession of 2001 will be dated to the second quarter of 2001. We expect contraction to continue in the third quarter of 2001, and these two consecutive quarters will mark the 2001 recession. Several factors point to a year-long recession including:

- The manufacturing recession will persist as inventory levels adjust further to meet decreased demand domestically and for U.S. exports.
- The continuing depression in the high tech and telecommunications sectors.
- Declining stock prices which will cause household net worth to decline further weakening consumer spending.

Additionally, weakness striking major portions of the globe could worsen economic conditions and lead to a deep and painful recession lasting two years. With global

synchronization, the 2001 recession has the potential to be longer and deeper than is commonly believed.