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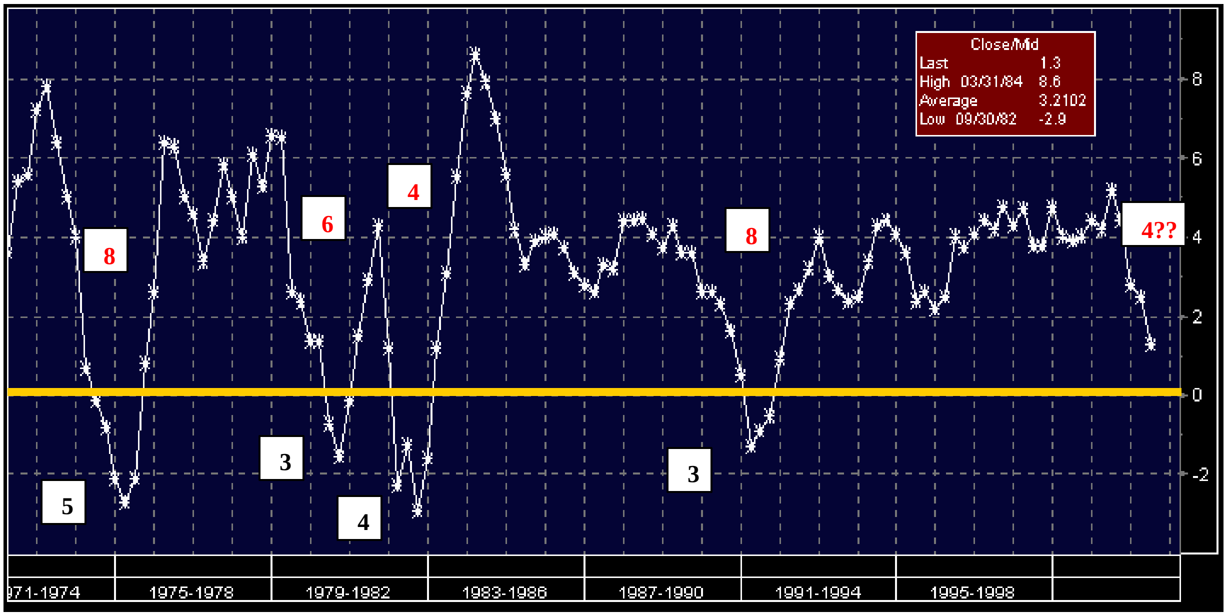
Benchmarking the Current Disturbance

Figure 1: Recession Duration and Negative Growth Quarters



Bloomberg data

Economic history is never perfectly repetitive, but during the past 30 years, the U.S. economy has experienced four recessions, 1974-75, 1979, 1982 and 1990-91. Each has had different characteristics and each disturbance may have had different causative factors. We look at these past recessions for hints as to how the current disturbance might play out if in fact the economy does not recover as the "consensus" now forecasts and instead slips into well-recognized recession. **Figure 1** shows year-on-year percentage changes in **Real GDP** for each quarter since 1972 Q1using the revised chain-linked data from the Department of Commerce. The red figures show the number of quarters from the prior cyclical peak to current cyclical trough, and the black numbers to the left of the respective troughs show the number of quarters during which a negative, year- on-year change in **Real GDP** was experienced. In terms of our simple metric for the duration of the disturbance, the current "disturbance" has a duration of **four quarters** (since the cyclical peak in the series at the end of 2000 Q2). Of course, we don't know how large that number will become.

The current 'consensus' appears to indicate that the duration of this disturbance will extend only four quarters, and **negative year-on-year growth will not occur**. (Zero growth is highlighted in the graph by a thick yellow line). The average duration from peak to trough was 6.5 quarters. The average number of negative growth quarters was 3.75 quarters. If this disturbance is "average," the economy will experience two negative quarters (QIII and QIV) and would 'bottom' by the end of 2001. **The next question for investors is to ask what the Market expects and how far wrong could that expectation be?**

A New Era Recession? This disturbance has been called the first "recession" of the globalization era because the intricately linked supply chains that now span manufacturing nodes around the world have quickly transmitted the upset in the U.S. manufacturing sector to many other countries. If this disturbance is ultimately christened a recession, it may differ from prior recessions in the degree of synchronization around the world. It may also be different in the sense that a production disturbance in the U.S. gets translated into similar production disturbances around the world without waiting for the traditional income transmission mechanism to operate. Finally, this disturbance may differ because it grew out of the long period during which the proportion of GDP devoted to investment grew far beyond prior historical norms, and excessive capital stocks were built.

This latter characteristic, the **investment boom collapse**, suggests to many observers that this disturbance will play out differently because of the large 'overhang' of investment goods that accumulated during the period of 'easy finance.' (We have termed this easy finance, the period of zero cost-of-capital). In this latter aspect, this disturbance looks much like the 'busts' of the 19th century and may have some similarity to the initial phases of the Great Depression. If it the economy experience real negative growth, we will hear much more about 'over-investment' theories of the business cycle, and the famous 1931 debate between Hayek and Keynes over the potency of monetary policy to offset this kind of disturbance.[1]

New Era Macro Policy—Will it make a difference? What is different about this disturbance is that the macro policy response has been strikingly clear in direction, large, and unusually early when judged by historical norms. The Fed has cut the Federal Funds rate 275 basis points since January 3, 2001. A significant fiscal stimulus is being applied through the tax cut and also through an expansion in government spending now underway. Still, there are skeptics who believe that the recession is inevitable and that monetary policy cannot stop the economy from experiencing several successive of quarters of negative growth.[2] The essence of their argument is two-fold: first, domestic investment will continue to slide as corporations attempt to trim their oversized capital stocks and inventories; second, the consumer will fade as mounting debt and future job losses erode confidence and consumer purchasing power. With no prospects of an immediate lift from exports, the economy will continue its downward course until these excessive stocks of capital are eliminated and the prospects for corporate profits are markedly improved. In that kind of environment, nominal interest rates will continue to fall until the real rate of interest drops low enough to re-invigorate investment and consumer durable expenditures.

John Makin, Senior Fellow at the **AEI,** has called for Congress to begin quick consideration of tax incentives for investment spending in order to deal with the currently negative prospects for investment spending. He also called on the other major central banks (the Bank of Japan and the ECB) to 'get busy.' For linguistic, cultural and political reasons, it would appear that the ECB may 'hear but not listen,' and the Bank of Japan is still waiting for an appropriate signal that the Koizumi reforms will actually occur. Makin's call is more likely to be heard on Capitol Hill and at the White House than in Frankfurt or Tokyo.

This pessimistic forecast may or may not be correct. Certainly, serious doubt has emerged as to the effectiveness of monetary and fiscal policy in producing a 'bottoming out' that does not involve successive quarters of negative growth. If the pessimists are correct, industrial production will continue to fall; capacity utilization rates will continue to fall; and unemployment will begin to rise in a fashion similar to past recessions. We would also expect to see further erosion in measures of consumer confidence as decreasing employment opportunities and heavier consumer debt loads take their toll on housing and consumer spending which are now the mainstays to a non-recession ending of this disturbance.

Can Benchmarking the Past Help? Benchmarking these data in terms of prior experience may help to gauge the duration and depth of this disturbance. It will produce some 'guidelines' of how deep the decline may become and for how long it will last. Stay tuned as we look further into the data.

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[1] A review of these "over-investment' theories as well as a discussion of Hayek's view of this kind of disturbance can be found in Gottfried Haberler's classic **Prosperity and Depression** written in 1937. See Chapter III (1939 edition).

[2] See John Makin, "Forget the Second-Half Recovery**,"** August 2001, **AEI Economic Outlook.** Makin was even more unequivocal in his TV commentary tonight seen on Nightly Business News. He unequivocally asserted that the Federal Reserve is powerless to prevent this recession from occurring.