How 9-11 Helped End the Recession

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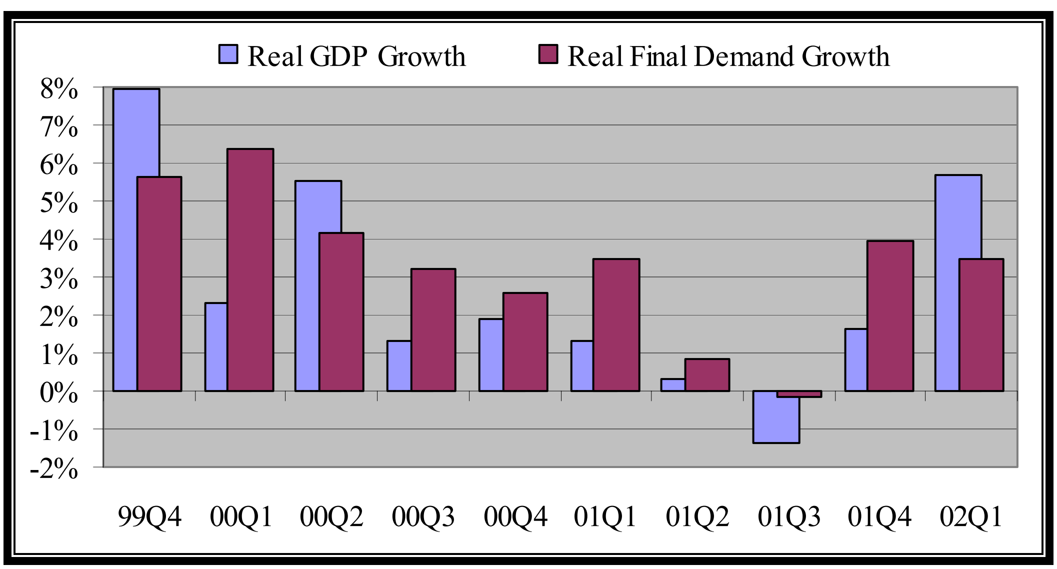
The first release of quarterly GDP statistics is subject to substantial revisions by the BEA as their analysis deepens and becomes more accurate. Nonetheless, the initial release for the first quarter of 2002 was a surprise to most economists, and especially for those of us who have been very bearish on the economy. The annualized real growth rate of GDP was 5.8%, a strong indication that the recession is finished and recovery is on the way. If so, then this has been one of the mildest recessions in the past 50 years, both in length as well as in the fact that we saw almost no decline in real output.

	2001Q4	2002Q1	Change	% Change
Real Gross domestic product	9348.6	9482.1	133.5	5.8%
				Contribution
Personal consumption expenditures	6540.3	6597.5	57.2	2.53%
Gross private domestic investment	1515.5	1594.6	79.1	3.1%
Fixed investment	1621.9	1621.3	-0.6	-0.01%
Change in private inventories	-119.3	-36.2	83.1	3.1%
Net exports of goods and services.	-412.7	-448.5	-35.8	-1.22%
Government consumption	1663.9	1695.8	31.9	1.43%

Yet despite this seemingly good news, the financial markets did not respond well, Alan Greenspan seemed to become more pessimistic, and many economists discounted the entire report as some sort of statistical fluke. One reason for this was that a significant portion of the growth in real GDP came from one source—changes in private inventories. According to the BEA, the increase in the change in private inventories accounted for about 3.2% of the 5.8% growth in overall GDP, well over 50% of the total. The confusion is understandable. It's not as if the economy has been *adding* to inventory. Rather, there was just a slowdown in the decline of it, from -$120 billion in the fourth quarter of last year to a -$36 billion this quarter. It seems odd to think that a negative number becoming a smaller negative number can contribute positively to the economy.

But before we can dismiss this number so quickly, we need to understand what changes in inventory imply a little better. Remember that Real Gross Domestic Product (GDP) represents the sum total of goods that are *produced* within the borders of the United States in any given period. This needs to be distinguished from what the BEA calls ‘Final Sales to Domestic Purchasers’ and the New York Federal Reserve Bank calls ‘Real Domestic Final Demand’ (DFD), which is functionally the sum total of all goods *consumed* within the United States in any given period. The DFD can be defined as the sum of Personal Consumption, Government Consumption and also Fixed Investments since these also involve the consumption of produced goods albeit for investment rather than final consumption.

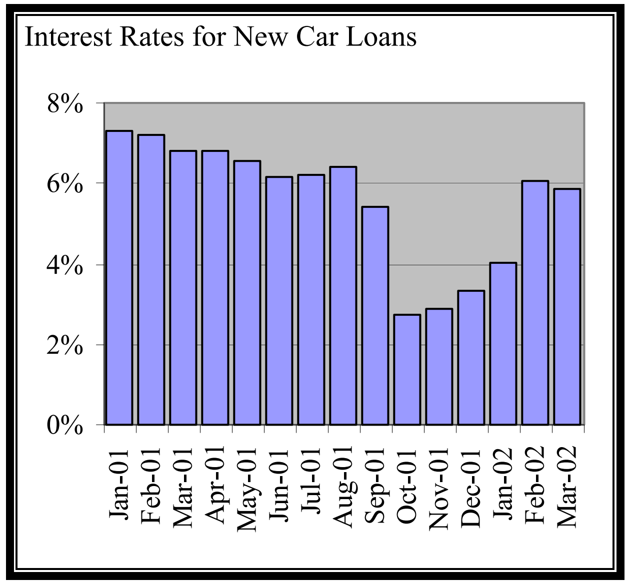
Gross Domestic Product is necessarily equal to Gross Domestic Income, since the earnings from production accrue to workers or owners, but GDP and DFD do not necessarily need to balance in the same manner. Production can be greater than Final Demand and the excess can either be shipped abroad or stored domestically as inventory. We would register the former as a trade surplus, when exports are larger than imports, since more output would be leaving the country than coming in. In the latter case we would see an increase in the outstanding stock of inventory in the economy—what the BEA records as ‘changes in private inventories’. Alternatively, if final demand is larger than production the additional consumption must be imported from abroad (a trade deficit) or taken from the stock of available inventory (a negative change in inventory in the NIPA accounts).



The substantial negative change in private inventory in the fourth quarter of last year occurred because there was a large surge in final demand in the United States, and this increase was *not* offset with increased production. Final demand grew by nearly 4% (annualized), where increases in domestic production were slightly less than 2%. The difference between the two had to be made up from some other source—in this case from an increase in the rate of inventory depletion. This gap between final demand and production is certainly not unusual. Indeed, similar differences occurred in the first quarter of 2000 (6.3% and 2.3% respectively) and in the first quarter of 2001 (3.4% and 1.3%). What is unusual about this period relative to previous ones is that a larger portion of the gap was filled in from the consumption of domestic inventories rather than from an increase in the trade deficit as in previous quarters.

With this in mind, we can then see that the drop-off in the rate of inventory depletion for the first quarter of this year actually tells us that national production is moving to catch up with national final demand. Output increased by 5.8% relative to 3.8% for final demand. This still wasn't enough, since inventories are still declining and the US is still running an extremely large trade deficit. Nevertheless, it is a good start. A nation cannot indefinitely consume more than it produces. Eventually our neighbors will refuse to loan us any more consumption (and may even begin to request some back) and our inventories will simply run out. To prevent either of these two eventualities, either final demand must shrink or production must increase. The latter is clearly a preferable option, and that is what we saw in the first quarter of this year. This is good news.

We can take this intuition one step further and state that this quarter's strong results in production are a direct result of the surge of final demand in the last quarter of last year and the subsequent rapid drop in inventories. Firms want to keep a minimum amount of inventory on hand to handle natural fluctuations in demand. When inventories run low they begin to ramp up operations to restock their depleted inventory as well as in anticipation of larger future sales. Indeed, if we look at predictors of current real GDP growth, we find that last quarter's growth of real final demand has a very strong predictive value, more so even than real GDP growth overall in the previous period. Remember that a recession is characterized by some market failure that creates a large amount of unemployed resources or production. A recession, once begun, often spirals down into a deeper trough—a vicious cycle where weak demand for goods leads to lay-offs and a lack of hiring and therefore to even weaker demand. Hence the strong ramping up in demand in the final quarter has likely shortened the recession or at least has sped up the rate of recovery by positively interfering in this vicious cycle.



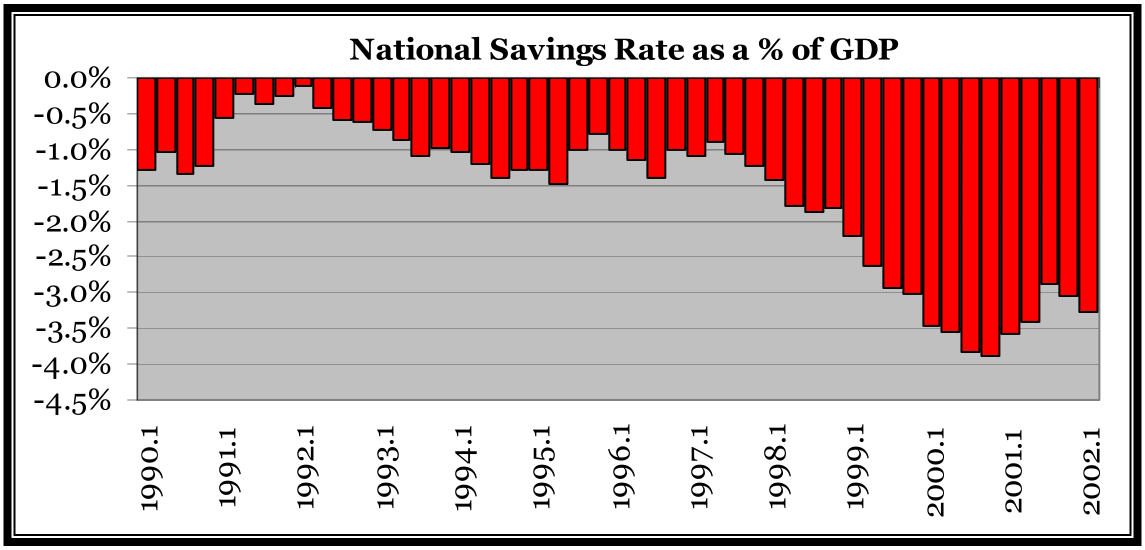
So what spurred the sudden surge in final demand in the fourth quarter of last year? The answer can be found by first looking to where these changes occurred. If we break down the change in national final demand for the fourth quarter of last year, the two largest components in the increase were in government consumption and consumer durables, increasing 9.6% and a whopping 33% respectively. Consumption of non-durables and services also increased strongly. The overall increase in final demand would have been larger except that fixed investment fell by 12%, somewhat offsetting the gains elsewhere. The increase in government consumption was due to the military action in the Middle East and the increased security investments here at home.

The increase in durable goods sales came from the fact that durable manufacturing firms, especially automobile corporations, largely bought into the myth that the tragedy of September 11th was going to have a substantial negative effect on personal consumption, and therefore had a fire sale. These firms radically slashed the interest rates they charged on consumer loans—a good way of increasing both current sales and current revenues by passing off the lower prices into the future. Financing for autos, for example, fell from over 6% in August to slightly over 2% in October. Many firms were offering 0% loans for certain models. While autos definitely represent a large portion of the sales, other industries followed suit and all durable goods posted strong increases in sales. The surge clearly caught these manufacturers by surprise, since we saw the largest quarterly drop in private inventories ever.

When we consider the causes of the surge in output, we suddenly must come to a very uncomfortable conclusion: *that the September 11th event may have actually helped the US pull out of the recession at a quicker pace than it may have otherwise*. Interest rates are a lever that Alan Greenspan often pulls to try and move the economy one way or the other. But his control is relatively indirect and slow acting. There would be little room for him to create the type of interest rate drops we saw in the immediate wake of 9-11, and the surge in sales in all consumer goods especially in autos. Similarly, the rapid run up in government consumption is clearly a direct result of September 11th, and the increases so far are larger than the tax rebate and more able to have a direct impact since it represents direct government purchases rather than a consumer's choice to save or spend.

Of course, September 11th is not the only reason this recession has been shallow. There are plenty of other reasons as well. The labor markets responded slowly to the current downturn. Layoffs didn't start in any significant way until long after the nation saw its first major declines in industrial production and investment. This is partly due to the fact that many of our investment goods are now physically produced overseas (we have in essence exported our recession) and the fact that many firms were labor hording, likely an outgrowth of the tight labor markets experienced in the late eighties. Another major reason is that an important cyclical component of previous recessions—housing—did not exhibit the same boom-bust cycle in this downturn. This is due to a lack of run-up in investment in residential housing in the late nineties and the aggressive rate cutting activities of the Fed that kept mortgage rates low.

Does this mean that we at the Anderson Forecast are now bullish on the economy? Unfortunately not. While the short-run spike in final demand is a good way to break the vicious cycle of recessions, it was at best a one quarter event. And at the same time it has pushed US national savings rates, already dangerously low, even farther into the red. With a growing current account deficit and a threatened federal government deficit for the coming year, consumers are eventually going to have to slow down their profligate ways in order to balance the national books. This implies weak personal consumption growth in the future, along with a weak US dollar to rebalance the external accounts.



Fixed investment—another important drive of long-run growth—remains flat, and it seems highly unlikely that we will see another surge like we saw in the late 90s between the continued abysmal corporate profits and the lack of any new general technologies in the pipeline. And finally, the overall shallowness of the recession and the lack of a substantial employment have the perverse effect of limiting the strength of the rebound as well. Economies often receive a surge after downturns as the idled resources of production get back to work. With so few idled resources, the economy will not have this ricochet effect to pad this year's numbers.