U.S. Economy in Recovery, Although Rural Areas Still Affected by Recession

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The longest U.S. economic expansion on record ended in 2001, and rural areas were disproportionately affected even as the recovery began. The recession began in March 2001 despite a proactive loosening of monetary policy beginning in January 2001. Although the National Bureau of Economic Research has not yet declared the recession over, most forecasters think that by late February 2002, the recovery had begun.

Investment Spending Spurs Productivity Growth

The business fixed-investment boom of 1995-2000, concentrated in the high-tech computing and telecommunications sectors, was unsustainable. Five years of Gross Domestic Product (GDP) growth at more than 4 percent annually, above long-term growth potential, had been stimulated by the double-digit spending growth in business equipment, particularly in computers and software. However, spending on capital equipment stalled in the fourth quarter of 2000, presaging the impending drop in GDP.

The major funding sources of plant and equipment spending are new corporate equities, retained earnings, new corporate bonds, and bank lending. All of these funding sources were plentiful during the investment-spending boom of 1995-2000. With the stock market rising rapidly, a company issuing new stock was able to do so under very favorable terms. Financing through new stock issues was very cheap for dot-com startups as well as old blue chip corporations. Retained earnings were growing, as the investment proved profitable. The banking system provided the financing for small businesses to modernize by upgrading computer equipment. Each year's profits increased through the cost savings from the prior year's capital improvement, making bank loans available at favorable rates. More conservative companies joined the new equipment bandwagon. As a result, business equipment and software spending grew at above 11 percent per year in every year from 1993 to 2000—the longest streak of equipment spending growth since World War II.

Manufacturing in Recession Since Late 2000

The increasing capacity in high technology generated lower product prices and large cost savings, as embodied in the strong productivity growth throughout the 1990s expansion. The capacity to absorb new technology was eventually reached and worldwide demand matured, resulting in lower corporate earnings. Although the bull market in technology stocks collapsed in March 2000, the equipment investment boom, fueled by initial public offerings, continued into early 2001. At the same time, credit conditions tightened and medium and small businesses struggled to obtain credit. The recession in business fixed investment and manufacturing began in the late summer of 2000, triggered by a decline in earnings and credit availability. Since nonmetro areas have a larger share of small businesses than metro areas, they were more likely affected by these tightened credit conditions.

The manufacturing recession had spread to the rest of the economy by March of 2001. The industrial production index—a broad-gauge index of output from U.S. factories, mines, and gas and electric utilities—fell for six quarters in a row for the first time since the Great Depression (fig. 1). This industrial decline, starting in the third quarter of 2000 and continuing through 2001, was concentrated in the high-tech sector as business computer equipment production dropped 10 percent in September 2001 from its peak in November 2000. Manufacturing employment declined 7.2 percent from spring 2000 to the end of 2001, a loss of 1.3 million jobs (fig. 2).

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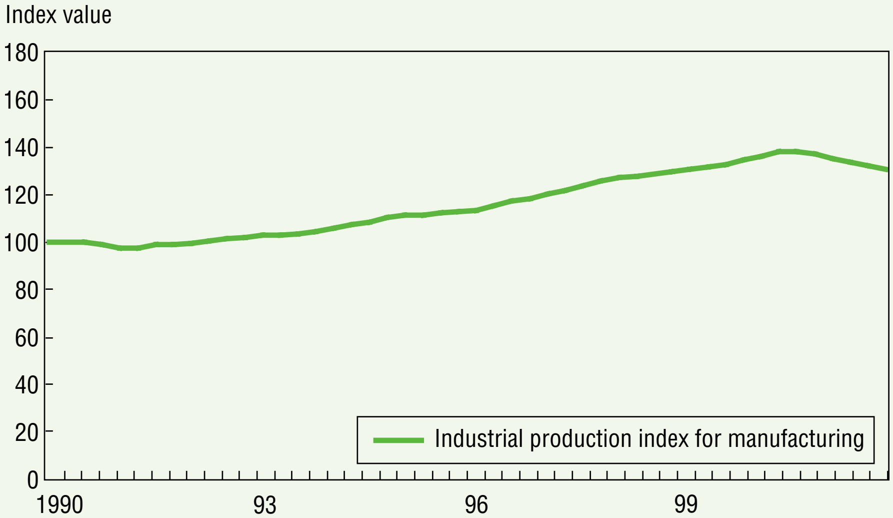
Figure 1
Industrial production index for manufacturing, 1990-2001
Index peaked in the third quarter of 2000



Source: Federal Reserve Board.

Asian Economic Slowdown Drives Dollar Up

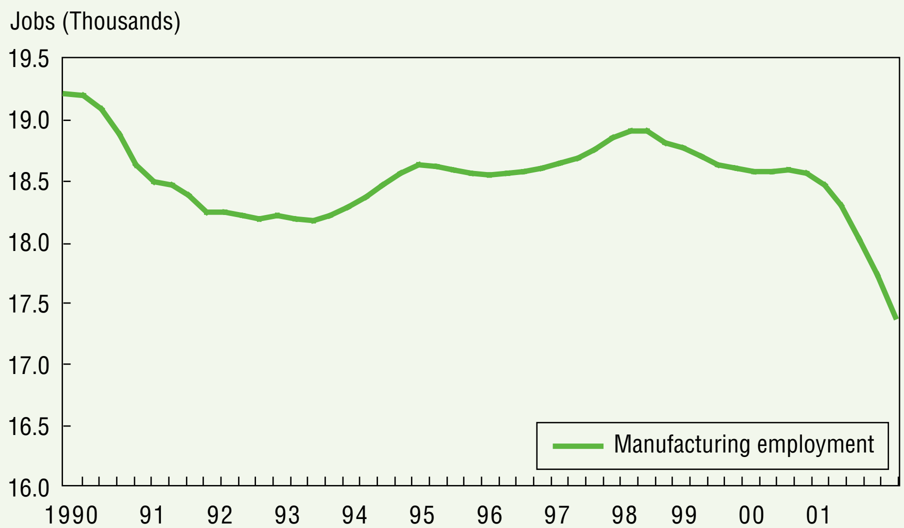
The concentration of the manufacturing recession in the technology sector contributed to a sharp slowdown in the economies of Asia, and particularly East Asia. Japan's recession of 2001, coupled with the slowdown in U.S. computer equipment demand, affected Asia nearly as much as the 1997-98 Asian financial crisis. Exports to Asia in goods, such as machine tools, dropped. U.S. machine tool production dropped in early 2001 to less than half the production level a year before. Many analysts expect the current Asian economic slowdown to be more protracted than in 1997-98.

A strong dollar exacerbated the recession in goods production. The dollar had been expected to fall in value versus the yen and European monetary unit (EMU) during 2001, but it appreciated instead. Japan, which had been expected to recover in 2001, went into a full-fledged recession, causing the yen to fall in value relative to the dollar. Similarly, when European Union growth fell below expectations, the EMU declined in value. The net result was a 5-percent appreciation of the dollar in the exact opposite direction needed to lower the more than $500-billion U.S. trade deficit. As a consequence, real goods exports dropped $122 billion in the fourth quarter of 2001 from a peak of $865 billion in the third quarter of 2000. As employment in nonmetro areas is more export dependent, the decline in goods exports likely has had a greater impact on rural economies. Since exchange rate movements take several quarters to fully make their impact, nonmetro employment will likely be affected by these developments into 2002.

Strong Consumer Spending Postponed Start of Recession

Robust consumer spending kept the U.S. economy out of recession despite the weak industrial sector through early 2001. Continuous housing appreciation and rising real wages drove this spending. Growth in real compensation, even as job growth slowed,

Figure 2
Manufacturing jobs, 1990-2001
Over 1.5 million manufacturing jobs have been lost since 1998

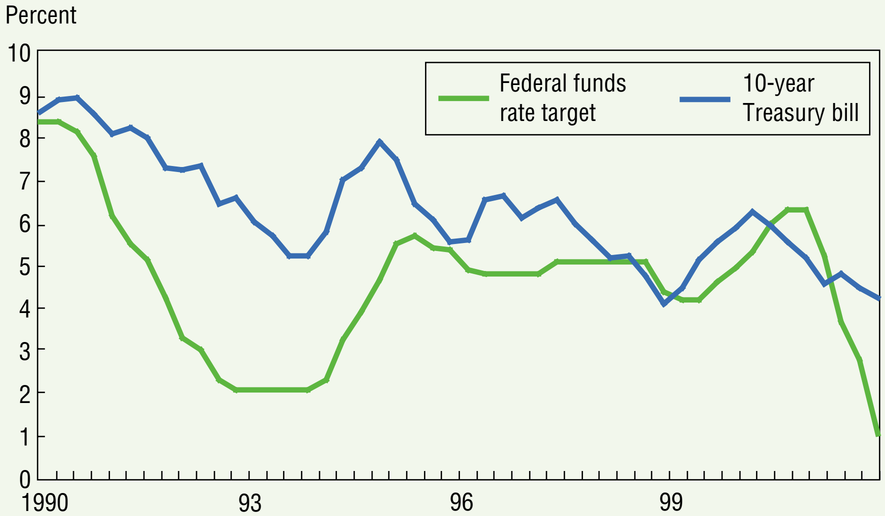


Source: Bureau of Labor Statistics.

Figure 3

Monetary policy over 1990-2001

Treasury bill rates tend to fall as the Federal Reserve lowers the Federal funds rate



Source: Federal Reserve Board.

further boosted consumer spending through the first half of 2001.

Real estate price escalation allowed the richest households to fund spending in excess of household income, taking on more real estate debt even as stock values plummeted. The weakened stock market reduced household financial wealth in 2000 but was partly offset by rising real estate values. The wealthiest 10 percent of households increased their spending by more than their personal income grew, mainly by refinancing their mortgages. Less wealthy consumers also spent freely into early 2001 as real wages continued rising in the tight labor market. The strength in consumer household income and balance sheets also supported home sales and housing starts during this period. As usual, consumer services spending rose with rising personal income.

The Bursting Bubble

The bubble burst in three stages. First, in March 2000, the U.S. equities began their bear market in the NASDAQ, the stock market where most technology stocks trade. The bear market erupted in fall 2001 when the Dow Jones Industrial index fell more than 35 percent from its peak value of 11,582.4 in January 13, 2000.

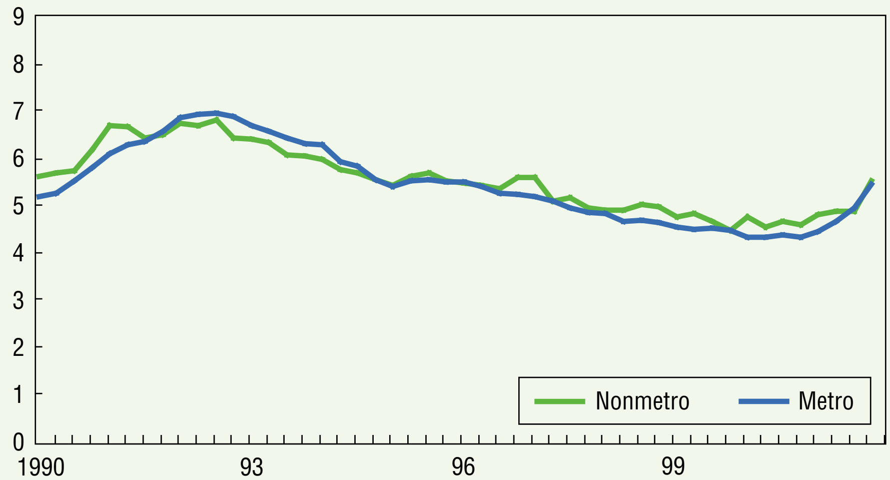
Second, in late 2000 the manufacturing recession worsened. Layoffs made it harder to get jobs, especially in geographically concentrated industries. As manufacturing profits and capital exports to Asia fell, production dropped. In addition, increased goods imports due to the dollar's strength weakened demand for domestically produced goods.

Finally, the manufacturing and stock market recession spread to the rest of the economy. By March 2001, the large wave of manufacturing layoffs and world events hurt consumer confidence. Weakened consumer confidence, coupled with slowed growth in wage earnings, brought consumer spending growth to a crawl. As real estate appreciation slowed and stock market values stagnated, spending on housing and luxury goods declined as well. Services spending was stagnant as well.

Aggressive lowering of short-term interest rates could not overcome slumping business plant and equipment prospects from lower earnings and declining availability of investment funds, nor did it buoy sluggish retail sales. Normally, a sharp drop in short-tem interest rates generates a noticeable drop in long-term interest rates. But, as of October 2001, a 400-basis-point drop in the Federal funds rate (the rate at which banks lend each other money to cover reserve requirements) translated to a meager 66-basis-point drop in the 10-year Treasury note rate. (fig. 3).

As a result of these events, GDP growth in the last half of 2001 was soft. Despite the recent weakened state of the economy, there were several mitigating factors. Interest rates and inflation were both low and likely to fall. Also, oil (fig. 4) and commodity prices had fallen from the very high levels seen in 2000 (however, with the world economic recovery in 2002, crude oil and gasoline prices are rising sharply.) Natural gas prices, which had risen higher than oil prices in 2000, are likely to rise less sharply than oil prices through 2002, aiding the recovery. These factors have mitigated the recession's impact on household income and helped spur spending growth in early 2002, helping the economic recovery. A bright spot even during the recession was the continued increase in productivity, which historically falls during a recession. This will likely provide the wherewithal for higher wages and corporate profits by late 2002.

Figure 5
Nonmetro and metro unemployment rates
Unemployment rates rose sharply in 2001

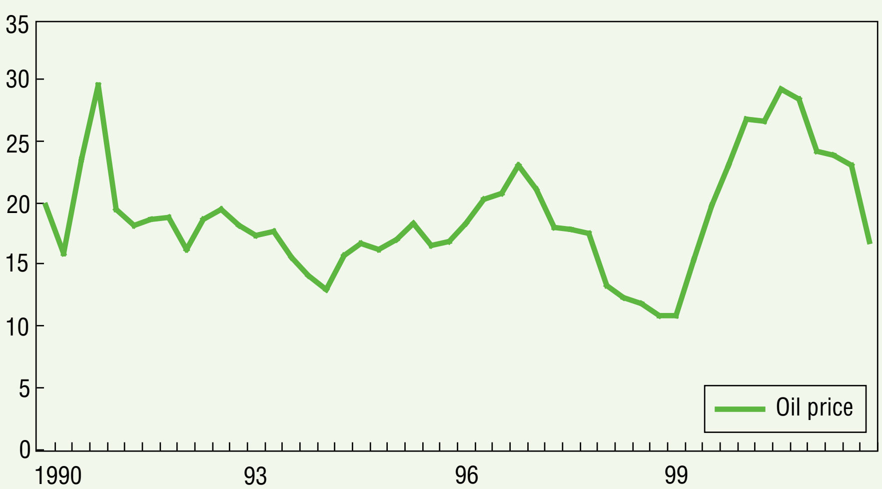


Source: ERS calculations from Bureau of Labor Statistics Current Population Survey data.

Outlook for 2002

Although the economy appears to be in recovery, three impediments loom. First, employment is likely to grow slowly until late 2002. Because the labor market lags the rest of the economy in recovery, relatively high rates of unemployment are expected for at least several quarters. Employers are reluctant to hire new employees until they are confident that the recovery will last. Second, corporate profitability is likely to stay weak for 2002 as a whole. The weak corporate balance sheet will likely lead to more layoffs from company downsizings and reorganizations at least for the first half of 2002. Also, weak corporate profits will affect household wealth, as the stock market will likely stagnate until earnings rise in late 2002. Last, petroleum prices are expected to rise sharply over the next year, reducing spending on non-energy household goods and services and dampening the strength of the recovery for the first half of 2002.

Figure 4
Oil prices, 1990-2001
Oil prices dropped from their recent heights



Source: U.S. Department of Energy.

Household income and wealth are expected to show strength in early 2003 as the economic recovery picks up steam.

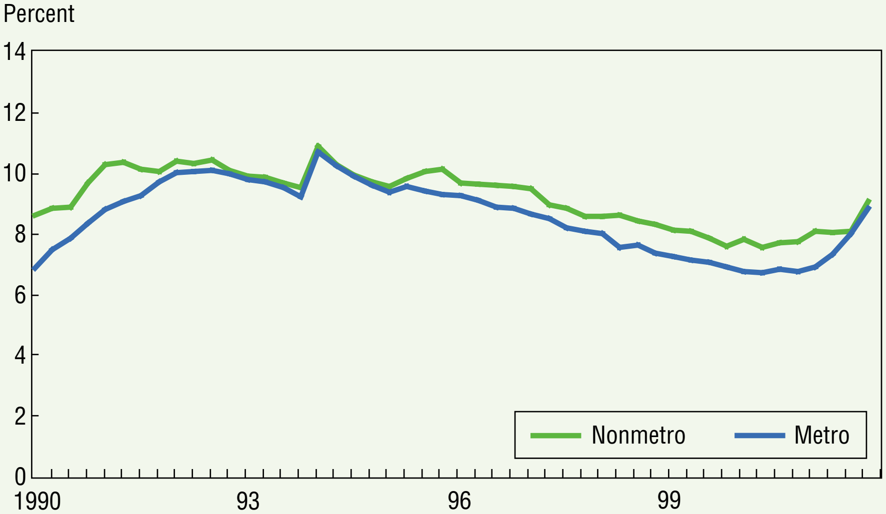
Implications for the Rural Economy

The steadily worsening manufacturing recession over 2000-2001, exacerbated by a decline in the overall economy, caused disproportionate job losses in nonmetro counties. Nonmetro areas had already been experiencing unemployment rates higher than those in metro areas since 1995 (fig. 5). Over 2000-01, nonmetro employment declined by 600,000 workers, while metro areas gained about the same number. An easy explanation of these events would be that the 600,000 nonmetro workers moved

Figure 6

Nonmetro and metro adjusted unemployment rates

The nonmetro adjusted rate continues to be above the metro rate



Source: ERS calculations from Bureau of Labor Statistics Current Population Survey data.

to metro areas and obtained jobs there. However, the nonmetro labor force stayed about the same while the metro labor force grew. This indicates that the 600,000 workers who lost their jobs in nonmetro areas either became unemployed or dropped out of the labor force. That the unemployment rates for the two areas ended 2001 at about the same rate, 5.6 percent for nonmetro versus 5.5 percent for metro, masks the change in the relative employment situation.

Similarly, the adjusted unemployment rate—a more comprehensive measure of labor market slackness that includes those working part time who would rather work full time, and also those who desire work but believe that no jobs are available and so have stopped job hunting—was about the same for both metro (9.3 percent) and nonmetro (9.6 percent). However, nonmetro areas had a high adjusted unemployment rate over all of 2000-01 (fig. 6), indicating labor market slackness due to more than just the recession.

Increases in compensation—wages and salaries plus benefits—ended 2001 with nonmetro areas experiencing only a 3.5-percent increase in the final quarter versus 4.2 percent for metro (fig. 7). However, over the last 2 years, the cumulative increase in compensation was 11.0 percent for nonmetro workers and only 10.5 percent for metro workers. Over 1990-2001, the cumulative increases were about the same.

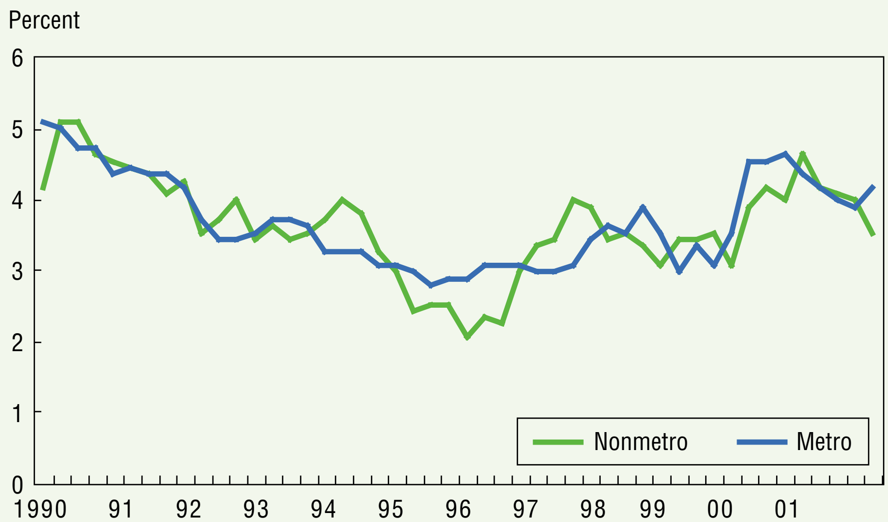
Farm households have seen farm income suffer from low commodity prices due to slow world growth and a strong dollar. In addition, as these international factors have weakened the manufacturing sector, it has become harder for farm families to keep off-farm jobs.

The weak U.S. economy and the softening of trade partners' income is expected to affect nonmetro areas disproportionately. First, rural areas are more export-dependent than urban areas and thus would be more hurt by the expected stagnation in goods exports. Second, softening consumer demand has affected the textile and apparel industries in particular, and production has declined 20 percent over the last 2

Figure 7

Nonmetro and metro employment cost Index, total compensation

Nonmetro compensation gains lagged metro gains over 2000-2001



Source: Bureau of Labor Statistics.

Photo courtesy, Economic Research Service, USDA.

years. These industries had already suffered extensive layoffs over the 1990s. Since textile/apparel plants are concentrated in nonmetro counties of the Southeast, rural labor markets there could be hard pressed to absorb workers.

Other areas hurt by layoffs over the past several years are the Pacific Northwest and the North Atlantic States. Layoffs in the Pacific Northwest were mostly in the lumber and wood products industries, plus some in the electric industry. The North Atlantic States had a mixed group of industries with layoffs—the electric industry and various manufacturing industries, including textiles/apparel, leather/leather goods, toys, paper products, metal products, machinery, and electrical equipment. Smaller areas that have experienced high concentrations of layoffs are New Mexico/Texas, Kansas, and North Dakota/Montana, all in mining or mining-related industries. The recovery's soft labor market is likely to affect these areas especially, as they saw so many layoffs during the 1990s expansion. *[Data as of April 4, 2002.]* RA