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US recession puts us to the test

Justin Wolfers*

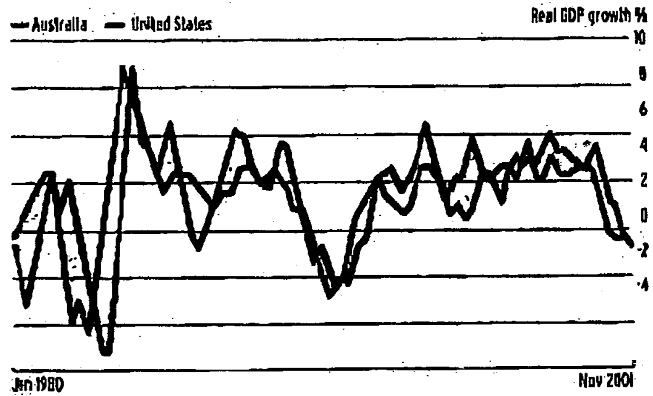
It's now official: the US economy is in recession.

Indeed, boffins at the National Bureau of Economic Research tell us that the US has been in a recession since March. And, of course, while the attacks on September 11 could not have been responsible for this slowdown, these economists argue that the "attacks clearly deepened the contraction and may have been an important factor in turning the episode into a recession"

Long regarded as the official scorekeeper of the US business cycle, the NBER eschews the much-cited definition of a recession as two consecutive quarters of negative growth. Instead, the economists opt for a more fine-grained assessment, poring over a range of economic indicators, including employment, income, sales and industrial production.

And what struck these economists most was the fact that employment has declined by 0.7 per cent over the past seven months. This decline is already about two-thirds that expected in typical recession.

THE GDP TWO-STEP



After a 10-year expansion – the longest expansion in the 32 business cycles since the 1850s – the boom is dead. While this is an unwelcome development for our American friends, it may be even worse news at home.

As the accompanying chart shows, when the US economy sneezes, Australia catches a cold. Indeed, Reserve Bank research shows the US economy to be the single best predictor of Australia's prospects.

But how bad a cold should we expect to catch? Historically, the average US downturn has lasted 18 months, and we are already eight months into this one. And while one might expect a record expansion to lead to a large offsetting correction, slumps have historically been shorter in the wake of a long boom.

Yet with the effects of the September 11 attacks on the economy presenting a major unknown, it seems that history may be a poor guide. Most analysts agree that the direct effects of the attacks are fairly minor. Far more damaging are the effects on consumer confidence and the prospect of an open-ended war. It does seem likely, however, that these effects will be felt most directly in the US.

While the Australian economy appears to be in better shape than the US, this should not be overstated: US unemployment is up 1.5 percentage points since its trough, while ours is up 1.1 percentage points.

Moreover, the US economy is unwinding after experiencing the lowest unemployment rate in

Continued Page 24

Recession in US puts us to the test

From Page 23

a generation, while the same is hardly true in Australia.

The prospects for averting the worst of these recessionary forces depend on monetary policy settings. US Federal Reserve Board chairman Dr Alan Greenspan has the pedal to the metal, pushing real interest rates below zero, while Reserve Bank of Australia governor Ian Macfarlane has domestic settings barely out of neutral.

The US Fed has responded aggressively to the first signs of a slowing economy, cutting interest rates 10 times this year for a total decline of 4 per cent, while our own central bank has been far more tentative, lowering rates four times, and by only 1 per cent.

Perhaps the more useful history is to be found in our most recent skirmish with an external shock – the Asian financial crisis in the late 1990s.

Australia managed to avoid the most of the recessionary fall out from that shock.

To some, this episode confirmed the importance of the strong US economy as an engine of growth. To others, this was an example of the resilience of our reformed economy. It seems that the Reserve Bank is punting on the latter.

With the US now joining Japan and much of Europe in recession, the coming months will surely test just how recession-proof the modernised Australian economy really is.

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