

# ECONOMIC COMMENTARY

Federal Reserve Bank of Cleveland

## An Anemic Recovery?

by John J. Erceg and Lydia K. Leovic

The latest economic indicators are signaling an end to the recession that began last July. According to most forecasters, a recovery has already begun, or is about to begin shortly. Less certain are questions about the strength of the recovery and about Federal Reserve policy in the early stages of the upturn.

These issues were central to the mid-year meeting of the Fourth District Economists' Roundtable, held June 14 at the Federal Reserve Bank of Cleveland. The most current data available to the panel suggest that the 1990-91 recession, the ninth economic contraction of the post-World War II era, apparently ended in the spring months of 1991. If so, it would rank about average in duration compared with the previous eight recessions, which lasted an average of 11 months.

The 1990-91 downturn also represents one of the mildest of the postwar recessions in terms of GNP contraction, according to the Roundtable forecasters. The median of 24 forecasts shows a virtual standstill in real GNP in 1991:IIQ, following a 1 percent decline between 1990:IIIQ and 1991:IQ. This compares with an average real GNP contraction of 2.6 percent between peak and trough quarters of the previous eight recessions.

Why do most forecasters believe that the economy may be in or close to a recovery? A number of leading indicators that usually foreshadow economic recoveries by two to eight months advanced between February and April, suggesting to a Roundtable panelist that a business

trough occurred between May and July. His computed estimate of the probability of recovery grew to 98 percent in April. Moreover, the Commerce Department's composite index of leading economic indicators rose for four successive months between February and May. In the past, consecutive increases of that length have indicated that a trough occurred within the last two months or will be reached within the next six months, according to a study by the Federal Reserve Bank of Cleveland.<sup>1</sup>

Although forecasters uniformly agree that recovery in real GNP will get under way by 1991:IIIQ, there is disagreement about its strength, at least in the early months. In the first year of the seven recoveries since the mid-1950s, real GNP rose 5.7 percent (6.7 percent if the 1949-50 recovery is included). The median forecast of the Roundtable group anticipates only about a 2.8 percent increase in real GNP in the four quarters between 1991:IIQ and 1992:IIQ (see figure 1).

### ■ Two Recovery Scenarios

Estimating the strength of the early stage of expansions has often eluded forecasters, and divergent views about the outlook are not uncommon. The current episode is a good case in point. At least two scenarios of the economic outlook were presented at the Roundtable meeting, one calling for a relatively mild recovery and another indicating a somewhat stronger growth path for output. Both of these, however, fall short of the real GNP growth rate in the past recoveries.

Now that the economy appears to have climbed out of recession, what are the prospects for the early stages of expansion? Forecasters attending the most recent Fourth District Economists' Roundtable expressed divergent views about the strength of the recovery, but their consensus is for a subdued gain in real GNP through mid-1992. A critical factor will be the Federal Reserve's commitment to controlling inflation as the recovery unfolds.

The milder scenario is based on several possible constraints that are likely to inhibit the growth rate of the economy, according to one of the Roundtable members. These include a high level of private debt, tax increases that have taken place since last fall, relatively high interest rates going into recovery, a long-term downward adjustment in service-sector employment, and waning consumer confidence, all of which are likely to restrain real GNP growth to a 2.5 to 3 percent range at least through the end of 1992.

An alternative view is that the upturn will not be as weak as indicated by the median forecast. The brighter scenario expects that real GNP will grow at close to 4 percent in the first year of recovery. The business upswing will be supported by lower oil prices since late 1990, which have cut production costs and inflation; lower interest rates over the past year, which should encourage interest-rate-sensitive investment; a lower dollar

in exchange markets between mid-1989 and early 1991, which has encouraged net export growth; and a turnaround in corporate profits and cash flow, which will support increases in capital spending. Consequently, a comeback in the cyclically sensitive sectors, including consumer durable goods, inventories, business fixed investment, and residential construction, should boost total output at a faster rate than is expected in the slower recovery outlook.

#### ■ Constraints to Recovery

At the initial stage of economic recoveries, the largest thrust typically comes from consumer spending for durable goods, residential construction, and business investment. Most Roundtable economists, however, expect a lackluster recovery in each of these traditionally leading economic sectors.

**Consumption:** Following a severe contraction in consumer spending between 1990:IIIQ and 1991:IQ, a recovery is apparently under way, but it should proceed at a relatively subdued pace, according to two economists associated with consumer goods markets (see figure 2). The 1990–91 slump in consumer spending was one of the worst in recent recessions. Year-over-year growth in personal income fell from about 6 percent in mid-1990 to 3 percent by the spring of 1991, and real income performed weakly.

The panelists expect a less-than-typical rebound in consumer spending, at least during the early stages of recovery, because of slow expansion in consumer credit and in real disposable personal income. A demographic shift toward consumers who tend to spend less of their disposable incomes will be a drag on consumer spending over the next few years, according to one economist.

The main stimulus to a revival in this sector is lower prices for consumer goods. For example, price increases for retail apparel should remain below 2 percent because of high inventories and a strong dollar overseas. In addition, the recession has forced down housing prices. As demand for housing increases, the sale of consumer durable

goods, such as home appliances and furnishings, should step up.

The slump in auto sales and production during the 1990–91 recession was worse than typical, but the auto industry has been gradually recovering. New car and truck sales rose substantially in May and June from levels of previous months, and the industry is hopeful that these rates can be sustained. The consensus forecast for domestic auto and light-truck sales for 1991 is 12.8 million units; in 1992, sales are predicted to be about 14 million units. It was also noted that fleet sales have given a substantial boost to auto production schedules, but the growing popularity of these “nearly new” cars has had a dampening effect on new car sales.

**Housing:** Residential construction is expected to rebound in the first year of the 1991–92 recovery with only half the vitality of past upturns. Following each of the past seven recessions, residential construction increased in a range of 22 to 35 percent, except for the 1961–62 and 1980–81 expansions, which saw either a smaller revival or an outright decline. A housing economist pointed out several reasons for expecting a slower-than-typical rebound in housing.

The expected mild economic recovery, accompanied by slow income and wealth growth, of course, is one factor. The declining trend in the prime home-buying age bracket (ages 25 to 34) and the reduced pace of new household formations to a rate of about 1.3 million per year will also slow demand for housing. This economist also stated that the user cost of capital in housing has risen since the Tax Reform Act of 1986 was enacted. Moreover, the real interest rate for mortgages (the fixed mortgage rate less expected home price appreciation) has been climbing toward 7.5 percent, the highest rate since the mid-1980s, because of a decline in home price appreciation in recent years. Finally, there is an abundant supply of unsold single- and multiple-family units. In view of these conditions, total new housing starts are expected to rise

FIGURE 1 REAL GNP

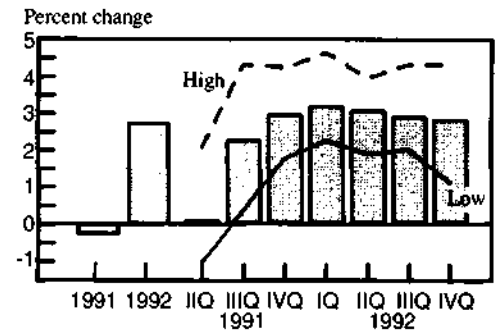
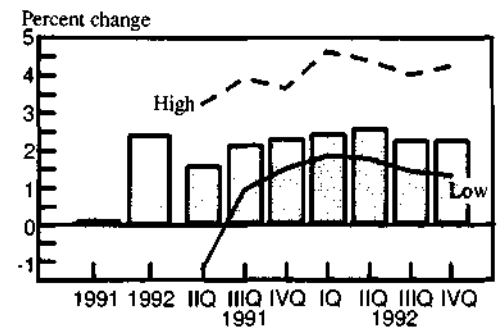


FIGURE 2 REAL PERSONAL CONSUMPTION EXPENDITURES



NOTE: All bars represent median forecasts. “High” and “low” are an average of the three highest and lowest forecasts, respectively.

SOURCE: Fourth District Economists’ Roundtable, June 14, 1991.

to about a 1.3 million to 1.4 million level over the next several quarters (see figure 3) and to remain there for much of the 1990s.

**Capital Goods:** The consensus view from capital goods producers is that the recovery in this sector will be slow, reflecting the high cost of capital compared with its levels in past economic upturns. Reduced tax incentives and steeper real rates of interest have contributed to a higher user cost, according to one economist.

The information processing industry, which accounts for nearly half of producers’ durable equipment, has not been insensitive to the 1990–91 recession. Historically, every recession in computer machinery has preceded a business downturn by approximately three

FIGURE 3 HOUSING STARTS

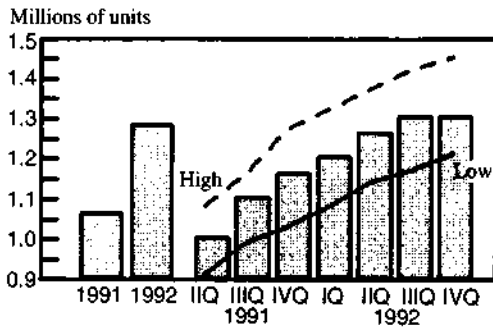
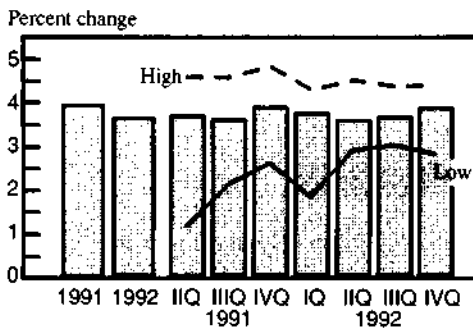


FIGURE 4 GNP IMPLICIT PRICE DEFLATOR



NOTE: All bars represent median forecasts. "High" and "low" are an average of the three highest and lowest forecasts, respectively.  
SOURCE: Fourth District Economists' Roundtable, June 14, 1991.

months. Although it was able to avoid the national recession in 1980, the industry experienced a contraction in 1984-86 and slipped into another recession before the officially announced business downturn in July 1990. Domestic demand for office equipment has shown virtually no growth for the last four to five years. However, some favorable developments have surfaced recently. New orders and shipments of electronic components used in the office machinery and computer industry have picked up, as has the ratio of new orders to shipments, suggesting a near-term revival in the computer industry.

#### ■ Credit Markets

Credit availability is perceived as a constraint to business recovery, according to some forecasters. Before the recession began last summer, public officials

and some economists expressed concern that tight credit market conditions could lead to a recession. A Fourth District panelist argued, however, that a so-called credit crunch did not cause the recession, nor will bank credit availability inhibit a recovery.

Bank lending (commercial and industrial loans) has been declining since mid-1990, but credit availability to business firms from other sources, including foreign banks, financial companies, and commercial paper, has been rising. Total credit, therefore, has continued to expand through at least mid-1991. Rather than reflecting a supply constraint, the reduction in bank loans indicates a longer-term downtrend in banks' market share of credit, reduced demand for credit in line with a weakening economy, and deterioration in credit quality, according to the panelist. He acknowledged that there could be "micro credit squeezes that are industry and region specific," but not a general *credit crunch*, which in the past was associated with regulatory policies that restricted the total supply of credit. Symptoms of a credit crunch include rising real rates of interest, an inverted yield curve, and declines in credit outstanding, which are just the opposite of conditions that have prevailed since 1989.

The same panelist asserted that a *credit squeeze* developed, however, because the Federal Reserve supplied virtually no growth in reserves, helping to slow economic growth since 1989 and in turn curtailing bank loan growth. At the same time, banks tightened credit standards for loans to some industries (such as real estate) and to some regions of the country (such as the East Coast). Nevertheless, the tightening and restructuring in banking will not inhibit the recovery, according to the panelist, because alternative sources of credit are available.

#### ■ Why So Little Progress on Inflation?

The underlying rate of inflation in the 1990-91 recession did not appear to be much improved from its prerecession rate (see figure 4). Little progress seems

to have been made toward reducing either inflation or expectations about inflation, despite a sustained moderate growth rate in money stock (M2), which has averaged about 4.5 percent annually for the last four years.

Several explanations were offered at the Roundtable meeting for this apparent lack of progress. The current price stickiness is not unexpected, according to one economist, because inflation usually lags a recession.

The persistence of high inflation and high yields on long-term bonds since early 1990 cannot be explained solely by money stock behavior, according to another Roundtable member. Moderate growth in M2 in recent years should have resulted in a 2 to 3 percent inflation rate, if prices responded only to money. However, in his money/price model, only about half of the variation in inflation can be explained. While inflation is a monetary phenomenon in the long run, he said, nonmonetary factors are important causes of short-term variances in the inflation rate. In 1990-91, those factors include an oil price shock, the long-run slide in the dollar, and a surge in unit labor costs. Another influence on price developments is Federal Reserve credibility, which affects expectations of wage and price setters when there is a discrepancy between the Fed's actual and anticipated actions. This economist predicts lower inflation if the uncertainty about inflation and the Fed's response are lessened.

Another panelist maintained that some improvement in the inflation outlook is yet to come. He expects the GNP implicit price deflator, the broadest price measure, to rise at nearly a 3.5 percent annual rate through the end this year, as shown in figure 4. This scenario assumes several constraints on inflation, including relatively weak economic growth and excess capacity, which should restrict wage and price increases; a continuation of the recent strengthening of the dollar in exchange markets; and an ongoing expansion in money stock in a 3 to 5 percent range.

## ■ The Importance of

### Federal Reserve Credibility

Discussion of appropriate monetary policy during recovery and of how the Federal Reserve System should respond to inflation raised concerns about the Fed's credibility. Some of the Roundtable members asserted that the steep yield curve and weakness in long-term bond prices can be tied to uncertainties about the Fed's commitment to reducing the inflation rate. Money stock and inflation usually increase during business recoveries, and bond market participants generally expect that the Fed will allow the same outcome in this expansion. Long-term investors are reported to be uneasy about the extent to which inflation might accelerate once the business recovery gets under way and about the Federal Reserve's response. The bond market may be more responsive to the inflation rates of recent years than to the steady and moderate money-stock growth in recent years. Long bond yields, therefore, will not decline until the inflation rate recedes. Market participants also seem uncertain about whether inflation or economic growth is the Fed's primary objective.

The Roundtable group saw several actions as being necessary for improving the Federal Reserve's credibility. An initial test of the System's anti-inflation resolve, according to one financial

economist, will likely come early in the recovery, when it may be necessary for the Fed to take tightening actions to keep M2 growth in line with its recent average annual increase of 4.5 percent. Such a bold move would raise credibility and lead to a bond market rally.

Also, the panelist prescribed an M2 target range for 1992 of 2.5 to 5.5 percent, which represents a full percentage-point reduction from the upper end of the 1991 target range. This narrowing would signal to financial markets that the System is serious about controlling money stock growth and inflation. If achieved, this midpoint would be consistent with the four-year trend rate of M2 growth.

## ■ Conclusion

The recession's end has shifted attention to economic recovery and inflation, and to how the Federal Reserve will reconcile those objectives. Most members of the Fourth District Roundtable expect that the upturn will be mild, marked by a rise in real GNP at about half the average rate of increase that occurred in the last seven recoveries.

Still, the expected growth path is not as weak as it appears, because it is close to the economy's long-term trend rate of output growth. Policymakers may be tempted to take actions to encourage

a higher GNP growth rate, but several economists at the Roundtable meeting urged the Federal Reserve to avoid repeating past behavior that generally added to inflation.

The specific policy prescriptions offered by some of the Roundtable members are not necessarily shared by the entire group. Their views highlight, however, the importance of the Federal Reserve System's credibility in altering inflation expectations as an effective anti-inflation policy strategy.

## ■ Footnote

1. See Gerald H. Anderson and John J. Erceg, "Forecasting Turning Points with Leading Indicators," Federal Reserve Bank of Cleveland, *Economic Commentary*, October 1, 1989.

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