HOW BAD WILL IT BE?

TRACKING THE ECONOMIC STORM

How does the puzzling "recession of 1979" compare with the last few recessions? Where will the worst downturns come? Past patterns provide clues to what will happen this time, and suggest why the Southeast will likely fare better than the rest of the nation.

This article is based on material contributed by Federal Reserve Bank of Atlanta economists William N. Cox, John M. Godfrey, Charles J. Haulk, and Gene D. Sullivan.

Predicting the course of a recession is something like predicting the path of a hurricane. There will always be surprises. Most forecasters were surprised by the Federal Reserve announcements of October 6, for example. The policies announced there for the purpose of curbing inflation have caused most forecasters to lower their predictions of economic growth. Yet even with such surprises, there is still a good deal to be learned by tracking this economic storm against its predecessors.

The signs are mixed this time, but they suggest that the 1979 recession will be milder nationally than the 1973-74 experience and that the Southeast will fare better—partly because the construction situation is not nearly so vulnerable this time and partly because the slowdown is superimposed on the longer run shift to the Sun Belt.

To track the probable course of the storm, we examined three major categories of economic activity (economic indicators, inflation, and financial data) and compared their recent behavior with the pattern of the last four recessions. After several indicators took "recession-like" downturns in 1979's second quarter, some indicators rebounded strongly in the third quarter. As a result, there is no consensus among economists as to exactly when the recession began. For the purpose of this article, however, it is assumed to have started in the second quarter of 1979. This comparison should provide a basis for some tentative conclusions about the direction of the recession.

OBSERVING THE STORM FROM THREE ANGLES

Some economic indicators look worse than usual. In past recessions, housing has been one of the first sectors to turn down. Chart 1 shows that the decline in residential investment typically begins four quarters before the "official" start of the

All charts in this article *assume* that the recession of 1979 began in the second quarter. Although some recent evidence shows an atypical rebound in 1979's third quarter, these charts still reveal useful comparisons with past recessionary patterns. Since some charts are, by necessity, drawn to different scales, the reader should compare the current experience with past recessions within each chart, ignoring differences in scale between charts. The vertical gray band represents the onset of recession. The left of the band shows conditions in quarters or months preceding the onset. To the right is what happened in successive quarters or months "into" the recession.

The solid black line in each chart shows the composite pattern of either three or four previous recessions (since 1957) in either index (Charts 1-5, 13, and 14) or percentage (Charts 6-12) form. The red line represents movements for the 1979 experience.

recession and drops 12 percent in that pre-recession year. This time, housing peaked only two quarters before the onset of the recession. This could mean either that (1) the housing decline could be more shallow than usual or (2) it could be comparable to other recessions but later than usual. In either case, housing could be a retardant to growth for several quarters.

The second indicator—consumer durable goods expenditures in real terms—typically peaks three quarters prior to the recession start. Chart 2 shows that this time the lead was only two quarters. If this recession follows the historical pattern, durable goods sales will continue to fall for several quarters, significantly suppressing total economic activity. On the other hand, since the decline *has been sharper than usual,* much of the total adjustment may have already occurred. Third quarter strength tends to confirm a rebound.

The black line in Chart 3—the ratio of manufacturing and trade inventories to sales (measured in 1972 dollars)—describes the typical rise of this ratio in the year preceding the recession and a continued rise (based on declining sales, not additional inventory accumulation) for at least another three quarters. This pattern appears to be holding true for the current recession, so we can expect a continued rise in inventories to sales until production cutbacks begin to halt further accumulation.

Consumer confidence, our fourth indicator, has fallen rapidly this time, much more steeply than the composite pattern (Chart 4). If the confidence index (derived from a survey of consumers' buying plans and attitudes toward business conditions) is any guide at all to future consumer behavior, we can look for a great deal of retrenching by consumers.

The weak picture for consumer confidence is reinforced by the personal savings rate ("savings" is what is not spent out of current income) in Chart 5. In a typical recession, the savings rate would remain above the level existing when the recession began. The 1979 third quarter 25-percent drop diverges radically from the historical precedent, but it is consistent with the abnormal rise in durable goods expenditures.

Housing, consumer confidence, and personal savings are behaving somewhat abnormally. Housing, which has been supported by rapid money growth and financial innovations, may not be able to avoid a substantial downward adjustment (in line with previous recessions). Consumer confidence, already dropping fast, could fall even further. The precipitous drop in personal savings is probably due to expectations of continued inflation. People are buying instead of saving. But if consumers begin to fear recession more than inflation, we should see a substantial upward movement in the savings rate, which means a sharp decline in consumer purchasing. Through the third quarter, however, that has not yet happened.

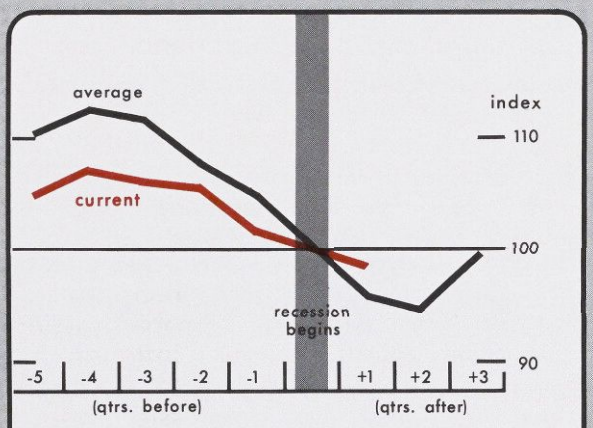
These two divergences from the historical pattern make the course of this recession difficult to predict, but their combined impact could make for a recession at least as bad as the average recession since 1957.

Will the recession help reduce inflation? Eventually, yes. Usually, when the economy goes into a recession, some workers begin to lose their jobs, others have cutbacks in working hours, and new labor force entrants have greater difficulty in finding employment. The combined effect is a reduction in the growth rate, if

economic indicators

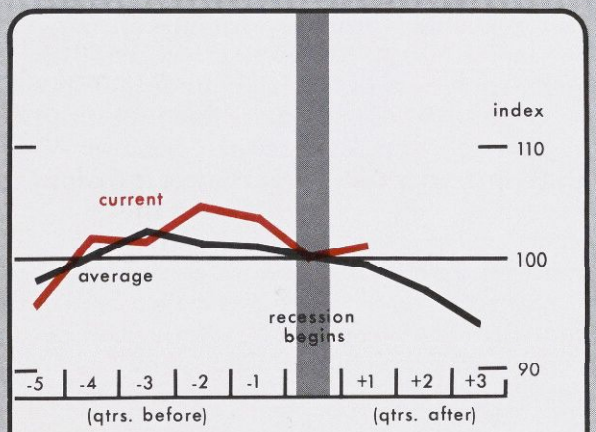
Black line indicates average of last four recessionary periods (1957-58, 1960-61, 1970, 1973-75).

1. RESIDENTIAL FIXED INVESTMENT



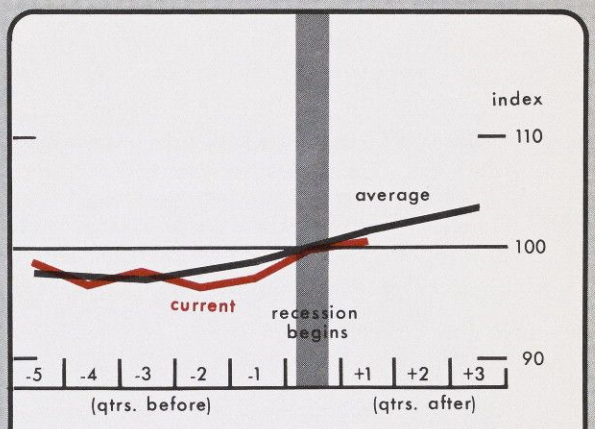
Housing slowing later than usual.

2. CONSUMER DURABLE GOODS EXPENDITURES



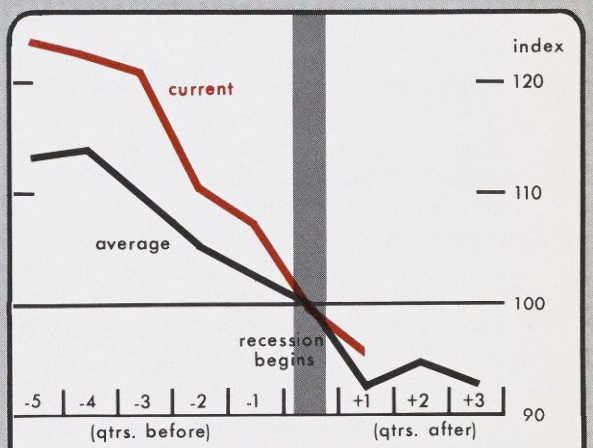
Consumer durable goods expenditures rebound after belated fall.

3. RATIO OF INVENTORIES TO SALES, MANUFACTURING AND TRADE



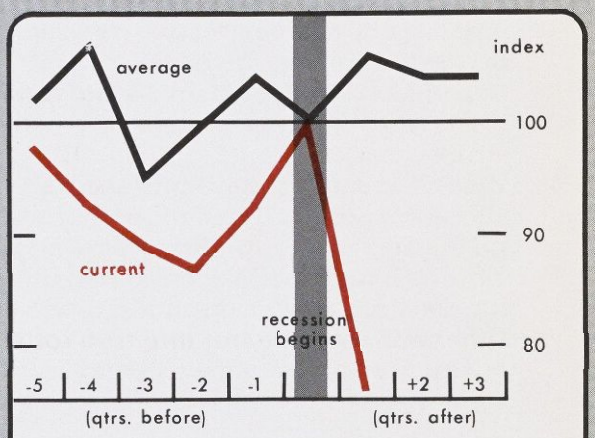
Inventories-to-sales ratio typical.

4. CONSUMER CONFIDENCE



Consumer confidence dropping sharply.

5. PERSONAL SAVINGS RATE



Personal savings rate plunging after typical gain.

not the actual level, of personal income. Consumers, increasingly cautious during these periods, reduce their demand for goods and services. This reduced demand may cause prices to fall as sellers offer discounts in attempts to stimulate faltering sales (not unlike what has happened to markets for large cars). Therefore, it is reasonable to expect a recession to be accompanied by some progress in the battle against inflation. Some people, in fact, view recession as the "bitter medicine" that is necessary to bring inflation under control.

How much inflation relief have past recessions actually produced? And how soon did those improvements appear after the recession began? Chart 6 answers these questions and also provides graphic evidence of the abrupt increase in the inflation rate during the 1973-75 period and the even sharper climb in 1979. The chart shows that price increases have generally slowed within two or three quarters after the onset of recessionary periods. Prices themselves have not declined, of course, only their rate of increase. The chart's bottom line, depicting the average of three earlier recessions, shows some abatement in the rate of price increases two quarters prior to the recession, but the rate does not drop off decidedly until the third quarter after the onset of recession.

An unsettling exception to the pattern appeared during the 1973-75 recession. Unlike the three previous experiences, prices continued to rise at an increasingly rapid rate until the first quarter following the recession's onset and did not begin to abate until four quarters later. By the sixth quarter following the onset, the rate began to stabilize at a much higher level than had been experienced following previous recessions.

The top line in Chart 6, showing the 1979 experience, begins from a sustained high level of inflation that followed the 1973-75 recession. The rapid rise during the fourth quarter before the onset was stimulated by the jump in food costs following the crop-damaging freezes in early 1978. The renewed rise in the rate of increase in the quarter immediately preceding the recession was primarily due to the mid-1979 upsurge in meat and gasoline prices.

The encouraging news is that preliminary data for 1979's third quarter indicate that a flattening in the rate of price increases may be occurring. If we continue to follow the pattern of the last recession, however, it will be another three quarters, or well into 1980, before the rate of increase subsides appreciably.

If inflation finally slows down, where will the decline be most pronounced? Four major sectors (food, lumber, textiles, and fuels) have paced the slowdown in prices in the past. This time around, that slowdown is coming later than usual (more like the 1973-75 recession). Chart 7 shows that food price increases were among the first to let up in past recessions. In our current experience, they have trended downward, but the movements have been more erratic than usual.

Producers' prices of lumber and wood products (Chart 8) actually declined in the third quarter prior to previous recessions; they were a source of substantial price relief four quarters after the onset in 1973-75.[1] In 1979, the pattern is not so encouraging. The rate of increase has been stable from fourth quarter 1978 through second quarter 1979, but recent data indicate that some abatement of inflation in lumber prices may be on the way. If construction does not falter as badly as it did in 1973-75, lumber prices are likely to chart a new course during the current recession.

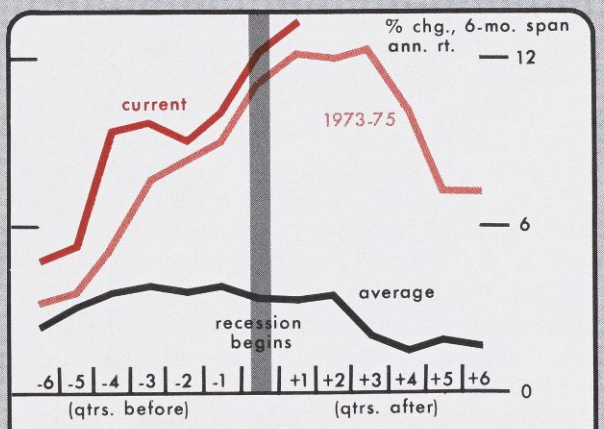
Chart 9, textile products and apparel, is inconclusive. Typically, the rate of increase begins to abate by the quarter just prior to the recession's onset and goes on to register actual price declines. Last time around, this price downturn did not occur until one year following the recession's

[1]Chart 8 shifts from consumer prices to producers' prices because of the prices for particular product groupings that were available at the producer level. Price changes at the producer level generally lead consumer price changes by one to two months.

inflation

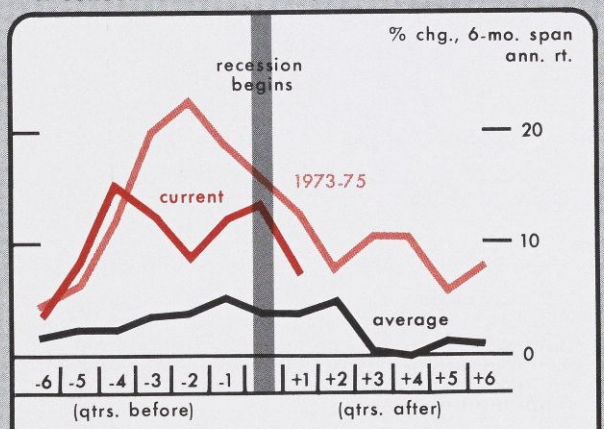
Black line indicates average of three recessionary periods (1957-58, 1960-61, 1970).

6. CONSUMER PRICE INDEX, ALL ITEMS



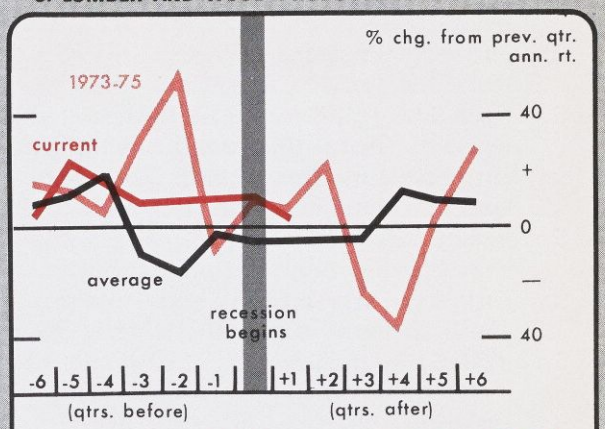
Consumer price index following '73-'75 pattern, suggesting a slowing rise four quarters after onset of recession.

7. CONSUMER PRICE INDEX, FOOD



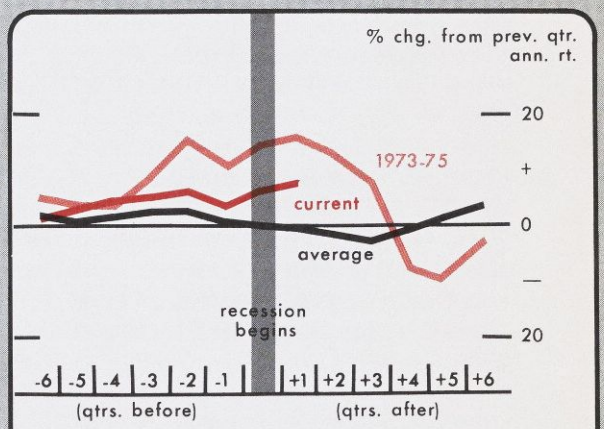
Food price increases slowing, but unlikely to drop to the level of typical recessions.

8. LUMBER AND WOOD PRODUCTS PRICES



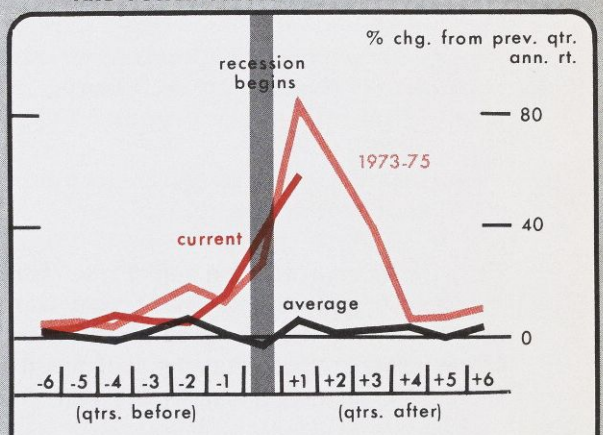
Wood products behaving more typically than '73-'75 although not yet negative.

9. TEXTILE PRODUCTS AND APPAREL PRICES



Textiles tracking '73-'75 course.

10. FUELS AND RELATED PRODUCTS AND POWER PRICES



Sharp fuel climb resembles '73-'75 so far.

onset. Some slackening has occurred in 1979, but it is too early to tell whether this sector will follow the 1973-75 pattern.

The oil embargo during 1973-75 produced vastly atypical performances for fuels and related products (Chart 10). Price increases approached an annual rate of 90 percent at the peak. Thus far in 1979, fuel price behavior has been uncomfortably like the early 1973-75 experience. In the recession's first quarter this time, prices were still rising with increasing rapidity. Even if the rate of gain slows a bit in the fourth quarter of 1979, recent price increases by OPEC countries raise doubts about hopes for stable oil prices in coming months.

Charts 6-10 show that, in the past, recessions usually have helped to reduce inflation. Actual price downturns, to be sure, have been limited to a few major products—some foods, lumber, and textiles. So far in 1979, however, our experience continues to resemble the 1973-74 period, which suggests that, if recent trends hold, we can expect some reduction in inflation but not before the middle of 1980.

Tracking a storm from different vantage points can produce different outlooks, and the financial statistics diverge slightly from the track suggested by the economic indicators. Chart 11 shows the M_1 definition of the money supply (bank demand deposits and currency) in terms of annual percentage rate changes. In the last four recessions, the growth rate of M_1, on average, has declined for four quarters prior to the onset of the recession.

During the five quarters preceding the current recession, the money supply has also declined but, uncharacteristically, has rebounded sharply. In fact, Chart 11 shows that money supply growth for the quarter following the onset of the recession (in this case, the third quarter of 1979) reached 9.5 percent.

The M_1 pattern, however, is somewhat deceptive. The sharp drop in the quarter immediately preceding the recession should be adjusted upward for the November 1 introduction of the automatic transfer of funds from savings to checking accounts and the introduction of NOW accounts in New York. These adjustments would increase the growth in the fourth quarter of 1978 and in the quarter preceding the recession. Still, however, it is clear that M_1 grew much more rapidly in the *third quarter* of 1979 than it did during the average of the past recessions. The implication is that, to the extent that money supply growth determines future inflation rates, the strong growth in the second and third quarters of 1979 may limit the relief from inflation which typically occurs as the economy moves into a recession.

The M_2 definition of the money supply (M_1 plus bank time and savings deposits, except for large-denomination CDs) exhibits much the same pattern as the M_1. Chart 12 reveals a noticeable slowdown in the average growth of this aggregate prior to the beginning of the average recession. In addition to this decline, banks have typically suffered substantial disintermediation (shifts of consumer funds from banks to higher yielding open market securities) during past recessions. The current trend also shows a sharp slowdown in the growth of M_2 but a strong rebound in the recession quarter and the following quarter. Like the growth in M_1, this aggregate may be signaling only a mild recession, with little relief from inflationary pressures.

Another key financial variable which may shed light on the current recession is total bank loans (Chart 13). The thick black line in Chart 13 describes the average trend of bank loans for the year preceding the recession and the year following the recession. The total at the onset of each recession equals 100 percent on this chart. Typically, bank loans have risen about 10 percent in the year immediately preceding the recession, shown very little growth as the economy has moved into the recession, and then risen about 5 percent in the year after the onset.

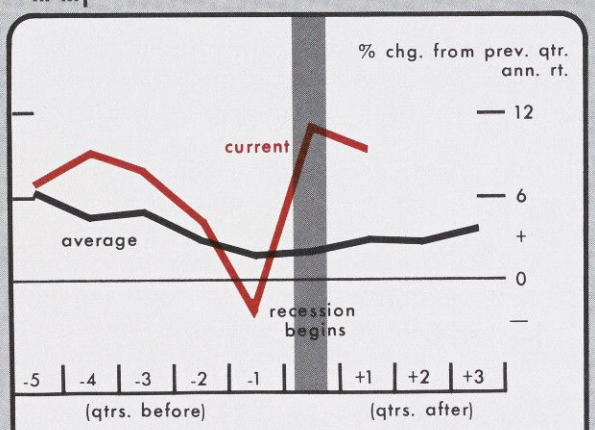
In 1973, however, this pattern changed significantly. Total bank loans rose some 15 percent in the year preceding the onset of the recession (November 1973) and continued to rise strongly for almost a

financial data

Black line indicates average of two recessionary periods (1960-61, 1970).

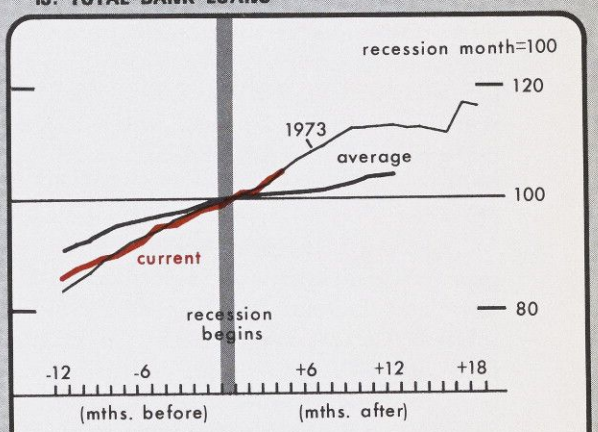
Black line indicates average of last four recessionary periods (1957-58, 1960-61, 1970, 1973-75).

11. M_1



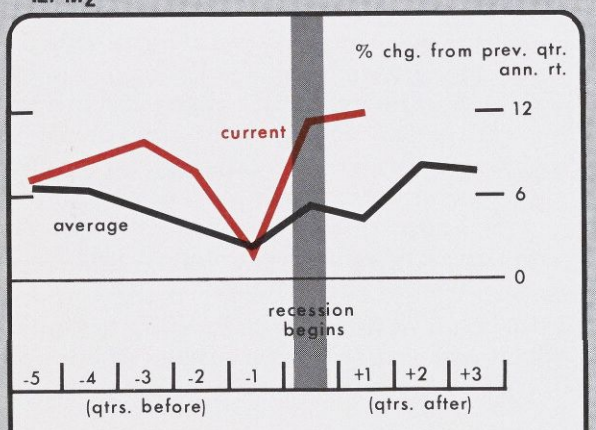
M_1 shows stronger-than-usual rise.

13. TOTAL BANK LOANS



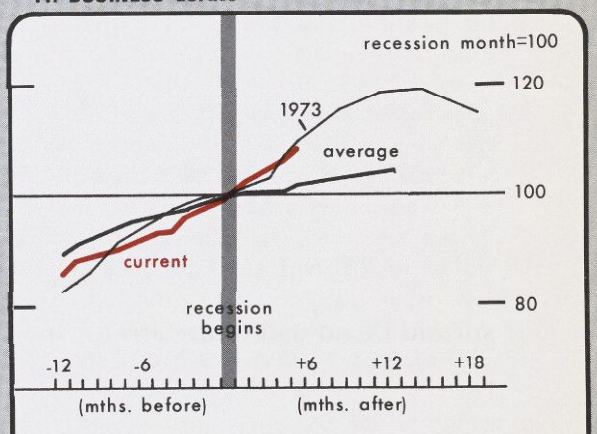
Total bank loans paralleling rapid '73 advance.

12. M_2



M_2 growth faster than average.

14. BUSINESS LOANS



Business loans also tracking '73 experience.

year thereafter, when they finally began to slow down. This atypical pattern was probably the result of consumers and businesses having to finance purchases and inventories at higher prices, which meant that even to finance the same volume of real goods would require more bank credit. As you can see, the 1979 pattern approximates 1973 more than it does the typical recession.

One reason for this continued expansion of loans is that banks have increased options in obtaining deposits and other funds. Their ability to issue large denomination certificates of deposit free of interest rate ceilings has attracted sizable amounts of funds. Since May 1978, money market certificates and other financial innovations have enabled banks to attract funds and, hence, to continue lending under conditions that previously would have caused them to curtail new loans.

Business loans followed much the same pattern as total bank loans. Again, 1973 was an exception to this pattern, as business loans advanced nearly 17 percent preceding the recession and another 20 percent after the onset. Not until early 1975, 13 months into the recession, did business lending slump sharply. The unusual continued strength of business borrowings in 1973-74 was partly because businessmen were forced to finance (often unwanted) inventories at increasingly higher prices and thus needed more and more credit. Chart 14 shows that the 1979 pattern is much closer to that of 1973 than to earlier periods. As unwanted inventories pile up, businessmen typically turn to banks and banks make more business loans as long as funds are available.

At present, the financial data, like the inflation charts, suggest a milder downturn than do our other economic indicators. If the monetary aggregates continue to expand rapidly, the slowdown may be milder than many people expect, with correspondingly little relief from inflationary pressures. However, in light of the Federal Reserve's October 6 policy changes, reduced monetary growth seems much more likely.

ADDING IT ALL UP

As happens so often with hurricanes and economics, our storm track stations do not all see the same signs. Some of the economic indicators, especially consumer confidence and consumer savings, suggest that we are in for a worse-than-average recession. Others—construction and durable goods sales—indicate an average downturn, only later than usual. Inflation is not following the typical pattern. So far, it more resembles the 1973 recession, when inflation relief came eventually but somewhat later and less substantially than usual. The most recent financial information—monetary aggregates and bank loans—indicated a milder-than-usual downturn prior to October 6, with a correspondingly small slowdown in inflation.

The Federal Reserve's October 6 policies, and the concerns evidenced by them, point to reduced money and loan growth and, hence, to reduced economic growth, reduced inflation, and a stronger dollar.

Taking all the indicators together, we can discern four central characteristics of the situation. First, recent movements in economic variables *generally* resemble the patterns of previous recessions. Second, the recession probably will produce some inflation relief but not until 1980. Third, the typical recessionary slowdown in the monetary aggregates has not yet materialized (as of mid-October). Fourth, a typical recession sees a rapid increase in bank loans, and the 1979 pattern is no exception.

Whatever the storm's degree of severity, we can expect the Southeast to get off easier than other parts of the country. Since World War II, the Southeast has usually had much lighter recessions than the nation as a whole , sometimes not even noticeable ones. The biggest single factor in our "umbrella" has been the mix of jobs and production, especially our low proportion of heavy industry—a large component of recessionary swings.

In 1974-75, however, our umbrella collapsed and the Southeast got soaked—thanks to faster growth which led to a

higher proportion of construction, overbuilding, and financial overextension. This time, we appear to be better prepared. The energy crisis has pushed migration to the warmer climates even faster, thus fueling the District's economy. There is little evidence of financial overextension by builders and not much speculative building. Commercial building in some areas of the Southeast continues strong. But a strong commercial construction sector now could easily lead to a slower recovery. No large inventories of unsold homes exist in 1979. Even Florida, where building activity has been torrid, will probably suffer little damage from the recession because of low home inventories. The percentage of construction workers in the labor force is also lower in Florida than last time. The usury ceilings, which are slowing housing in some southeastern states, should have only temporary influence as floating rates adjust themselves to the post-October 6 environment. Although the recession's impact on the Southeast depends on the precise distribution of the drop among the sectors of the economy, the evidence suggests that this storm will strike the rest of the nation harder than it does the Southeast. ■