

# ECONOMIC COMMENTARY

Federal Reserve Bank of Cleveland

## The Outlook After the Oil Shock: Between Iraq and a Soft Place

by John J. Erceg  
and Lydia K. Leovic

**T**he effect of August's oil price shock on the U.S. economy was the main focus of attention at the latest meeting of the Fourth District Economists' Roundtable, held September 14 at the Federal Reserve Bank of Cleveland. The price shock came at a time when the growth rate of the economy was already sluggish and, according to some analysts, moving toward a recession. The 27 forecasters, representing manufacturing, trade, and financial institutions, predict sustained economic growth through 1991, but they also anticipate that higher oil prices will cause a further slowdown over the next few quarters. Participants also expect that the inflation bubble that began in the third quarter of 1990 will extend at least into the first quarter of 1991.

A majority of the panelists believe that the price of crude oil will average between \$25 and \$30 per barrel through the balance of this year, but revert to \$20 to \$25 per barrel in 1991. Some expressed the cautiously optimistic view that no oil shortage will occur during the fourth quarter. These participants believe that reduced demand coupled with increased production by some OPEC nations will compensate for the net loss caused by the Iraqi/Kuwaiti oil embargo. Additionally, no shortage of petroleum products, including gasoline and distillate fuels, is expected this year. That outcome assumes, of course, that there will be no

further disruption in the supply of crude oil, especially from Saudi Arabia.

### ■ A Pre-Oil Shock Recession?

The first issue confronted by Roundtable participants was whether the U.S. economy was in a recession even before the August invasion of Kuwait. Total U.S. output (real GNP) has been rising at an average annual rate of only 1.5 percent since the spring of 1989, which is less than one-half the average annual growth rate attained over the first six years of the current expansion. A variety of other data for June and July suggested to some business analysts that the economy was indeed bordering on a recession by early August.

What is a recession? According to one business-cycle expert and Roundtable panelist, it is a persistent and pervasive contraction in economic activity. It is not, as some commonly assume, simply two consecutive quarterly declines in real GNP. For example, the breadth and depth of the economic contraction during the first six months of 1980 were sufficient to warrant a declaration of recession by the National Bureau of Economic Research (NBER), although the decline in real GNP lasted only one quarter.<sup>1</sup> On the other hand, real GNP decreased in the second quarter of 1986, and yet that episode (along with several others that occurred during the 1960s

**The Fourth District Economists' Roundtable met last month to discuss the economic outlook in the wake of the Iraqi invasion of Kuwait. The panelists expect a weaker economy and more inflation for several quarters, followed by a return to more normal economic conditions. Participants also discussed possible monetary policy responses to the risks of recession and higher inflation.**

and 1970s) was not judged by the NBER as constituting a recession.

Are current economic indicators signaling a recession? According to Roundtable participants, the answer is not yet, although it is admittedly difficult to distinguish between an economic slowdown and a recession until well after the fact.

The Composite Index of Leading Indicators has remained relatively flat in recent months, evidence of a continued downturn in economic growth but not of a classical recession, since no clear decline has occurred.<sup>2</sup> In addition, the Diffusion Index of Leading Indicators has been hovering around zero (rather than below zero, as it does in recessions), while the Composite Index of Coincident Indicators is still positive, at least through June. However, a slight decline in the latter index occurred in July (the latest month for which data are available). The Long-Leading Index, which correlates highly with GNP and confirms the more commonly used leading index, did not suggest that the economy was in a recession during the pre-oil shock period.

From these somewhat ambiguous indicators, participants drew at least one firm conclusion: The probability of a recession has increased as a result of the oil price shock.

#### ■ The Overall Outlook

Roundtable forecasters anticipate that the effects of the oil shock may be only transitory and predict that, although real GNP will show no increase this half, it will rise at a 1 percent annual rate during the first half of 1991, followed by a step-up in growth to 2 percent during the second half of the year. The total 1990 increase in real GNP is projected to be less than 1 percent, but between 1990:IVQ and 1991:IVQ, the growth rate should accelerate to 1.9 percent. These anticipated growth rates represent a downward revision of the respective 2.2 percent and 2.7 percent increases predicted by Roundtable panelists last May.

Unlike other recent Roundtable meetings, this one did not produce a strong consensus regarding prospects for U.S. economic growth. The spread around the group's median GNP forecast is much wider now than around the May forecast. At least six of the participants expect two to three consecutive quarterly declines in real GNP, generally beginning in 1990:IVQ and ending in 1991:IQ. About half of the analysts anticipate a decline in real GNP in 1990:IVQ, when the median forecast is for total output to decline one-half of one percentage point.

An alternative scenario calls for sustained 2 percent growth in real GNP during the last half of 1990, followed by a 1.5 percent increase during the first half of 1991 and a 1 percent rise during the second half of 1991. A panelist who expressed this view believes that the oil shock's effect on output will occur with a lag of about four quarters, as businesses cut back investment in response to energy price hikes. The inflation effects, however, will be seen immediately. Consumer prices and the GNP implicit price deflator (IPD) are expected to surge between the last half of 1990 and the first half of 1991, before settling down in the second half of 1991 to a rate only slightly higher than preinvasion predictions.

#### ■ The Inflation Bubble

Roundtable participants widely agreed that the effect of the oil price shock on inflation will be sizable and immediate. They were less certain about whether those effects will be transitory or longer term.

A bulge in the inflation rate is projected to begin in 1990:IIIQ and to run its course by next spring. The group's median inflation forecast predicts an increase in the IPD of about 4.6 percent (annual rate) during the last half of 1990, which should continue into early 1991. However, as was the case with output predictions, the inflation forecasts reflected more than the usual degree of uncertainty. For the 1990:IIIQ-1991:IQ period, the average quarterly spread between the high and low

forecasts was 564 basis points. Forecasts of both consumer prices and the IPD are considerably higher than predictions made last May, partly as a result of the oil shock, but also because of an inflation rate that was rising even before the August invasion.

From the spring quarter through at least the balance of 1991, the median Roundtable forecast is for an average inflation rate of about 4 percent (IPD basis), which is slightly higher than the May 1990 projection. This upward revision suggests that the effects of the oil shock on inflation may not be entirely transitory.

#### ■ Consumer Outlook

How might the oil price shock affect consumer spending? Even before the Persian Gulf episode, real consumer spending had been sluggish for several quarters. One Roundtable panelist asserted that the retail industry has been in a mild recession since the spring of 1990. The immediate effect of the oil shock was to jar consumer confidence, but nonetheless, consumer spending has remained at about preinvasion levels.

Retail sales in August were little changed from the previous month. Without relying on unusually large incentive programs, domestic new car sales held steady during August and early September, nearly equaling the January through July average. The short-term outlook for non-auto retail sales is cautiously optimistic, according to one representative of that industry; however, he noted that consumer income, wealth, and confidence have been buffeted by a variety of developments over the past several quarters. Still, consumer confidence is expected to rebound in time for the holiday shopping season, and consumer spending should follow suit. Retail profits and profit margins also are expected to improve in 1990:IVQ.

## ■ Manufacturing

In the two quarters preceding the onset of the oil shock, manufacturing was beginning to recover from a virtual no-growth phase between the spring of 1989 and year's end. Because of rising energy costs, panelists' views about the short-term prospects for manufacturing were mixed. The more optimistic outlook is that a sizable pickup in industrial production will occur by next spring if the price of crude oil settles at around \$25 per barrel.

Roundtable panelists cited several economic indicators that contribute to their optimism. Going into this period of high uncertainty, manufacturers have kept inventories low relative to sales, unlike during the 1980-82 oil shock episode. Also, capital goods output should be strong, supported by the transportation and high-tech industries. Commercial aircraft will be another major contributor to manufacturing growth, judging by the industry's \$2 billion order backlog. Heavy-duty truck orders, perhaps spurred by the higher fuel-emissions standards mandated for 1991, have been recovering gradually from a trough in late 1989 and early 1990. August orders were better than anticipated, despite soaring fuel costs. In addition, public construction (particularly for highways and airports) and mining are still pockets of steady growth.

Another cause for optimism is the volume of exports, which is expected to grow between 6 percent and 8 percent in real terms through the end of 1991. The declining value of the U.S. dollar against most major foreign currencies has stimulated profitability in the export market. The gap between the value of merchandise exports and imports (excluding oil) has virtually closed in the last several quarters. In addition, the trade-weighted value of the U.S. dollar has settled to a low near the level attained during the second half of 1980.

Less optimism about the prospects for U.S. manufacturing was expressed by other panelists. Foreign trading partners are experiencing slower economic growth, raising the potential for simultaneous worldwide recessions. Reduced economic growth in the United States and abroad would severely dampen capital spending, which is expected to languish for the next several quarters, according to another Roundtable analyst. He noted a sizable, broad-based weakening of export orders in August. Overseas sales are still strong, however, particularly throughout the Pacific Rim nations, which are experiencing a continuing economic boom. Latin American business is improving as well.

Participants also voiced concern about waning growth in the information-processing-equipment industry during the first half of 1990. This drop-off, evidenced by a weakened demand for parts, is likely to parallel the downturn in the overall economy. Exports of office and computing equipment are good, but domestic demand is increasingly being satisfied by imported goods. Employment in the information-processing-equipment industry has fallen, but this slide has been offset by a rise in employment among office-product distributors.

## ■ Monetary Policy Response

Roundtable analysts debated whether the Federal Reserve should sustain its anti-inflation policy goal in light of the heightened risks of recession and accelerating inflation caused by rising energy costs.

One financial economist spoke in favor of the Federal Reserve maintaining a disinflation policy. In his view, the long-term objective of the Federal Reserve should be to keep prices stable, which he sees as a precondition for maximizing long-run economic growth. He acknowledged that the economy is weak, but believes that the core rate of inflation, which he defined as unit labor cost, is "poised to decline" if the Federal Reserve does not accommodate the oil price shock. In his view, the core rate of inflation should soon decelerate because the growth rate of

domestic demand has been lower than the "potential" growth rate of the overall economy.

This panelist was also guardedly optimistic that the possibility for controlling inflation is more favorable now than during the two oil shock episodes of the 1970s. Even if the price of crude oil increases to \$30 per barrel (on a sustained basis) from its pre-oil shock average of about \$18 per barrel, he believes that the inflation effects should be transitory and should not become embedded in expectations unless accommodated by the Federal Reserve. Consequently, he recommends no monetary easing, since such a policy would only halt the disinflation process. Moreover, even if the economy entered an oil-induced recession, output could not be revived quickly because of the lag between policy actions and economic activity.

Another panelist urged that money stock (M2) growth be increased rapidly enough to result in a 4.5 percent to 5.0 percent growth rate by the end of this year. That would be about the midpoint of the 1990 M2 target range, and would be consistent with the average growth rate since 1987. In his view, a slower rate of increase over the next six to 12 months, coupled with the effects of the oil shock, would risk a recession. The Federal Reserve would then be pressured to take countercyclical actions to revive output growth, even at the risk of compromising its goal of price stability.

Other participants also raised concerns about whether the Federal Reserve System should attempt to sustain an anti-inflation policy in light of the recession risk. Some cautioned that a recession would have serious consequences for the Federal Reserve and questioned whether the System would be forced to monetize the resulting enlarged federal deficit. Others noted that a recession would interrupt progress toward disinflation because economic recovery would supplant price stability as the main policy priority of the Federal Reserve.

Two other concerns about monetary policy were also cited. The continued rapid pace of price increases in the service industry raised questions about whether this sector of the economy is insensitive to anti-inflation policies. It was pointed out, however, that the process of disinflation in this area is underway, as illustrated by the industry's drop-off in employment in recent months. This decline should both improve productivity and effect a slowdown in wage growth, unit labor costs, and, eventually, prices.

Some economists claimed that it is difficult to negotiate labor contracts that do not reflect higher inflation rates, but others argued that inflation-compatible contracts would be unnecessary if wage and price setters could reasonably expect stable prices. Some participants complained about labor and institutional rigidities — supported by government programs and legislation — that they believe should be dismantled, prompting others to agree that the federal government has a legitimate role to play in the effort to reduce the costs of disinflation.

#### ■ Summary

Before the oil price shock, Roundtable panelists had already concluded that economic conditions had been worsening since their last meeting in May. Although the Persian Gulf situation widened the range of both output and inflation forecasts, on average the participants expect the oil shock's effects to be transitory. And despite the deterioration in the short-term outlook, several important sectors of the economy should hold up reasonably well.

The oil price shock, hitting as it did when the U.S. economy was already weakening, has added a new dimension to the outlook for output and prices. If the Roundtable forecasts prove to be accurate, that is, if output growth is stronger in 1991 than in 1990, there would be little reason to ease monetary policy, even if following such a course would have the expected positive short-run effect on output. Acknowledging the lesson of the 1970s, many Roundtable participants are concerned that if the Federal Reserve were to ease monetary policy, it would risk allowing the oil price shock to spread more generally throughout the economy in the form of accelerated inflation.

#### ■ Footnotes

1. The National Bureau of Economic Research (NBER) is the official arbiter of expansions and contractions in the U.S. economy. NBER bases its determination of a recession on contractions in many economic series—both financial and nonfinancial—that occur at about the same time. Analysts there have long rejected the sole use of GNP to determine the dates of peaks and troughs (expansions and contractions), even though the NBER's designated dates often coincide with GNP declines. See Victor Zarnowitz, "On the Dating of Business Cycles," *Journal of Business*, vol. 36, no. 2 (April 1963), pp. 179-99; and Geoffrey H. Moore, "What is a Recession?" *American Statistician*, vol. 21, no. 4 (October 1967), pp. 16-19.

2. For a discussion of the usefulness of leading indicators, see Gerald H. Anderson and John J. Erceg, "Forecasting Turning Points With Leading Indicators," *Economic Commentary*, Federal Reserve Bank of Cleveland, October 1, 1989.

*John J. Erceg is an assistant vice president and economist and Lydia K. Leovic is a research assistant at the Federal Reserve Bank of Cleveland. The authors would like to thank Gerald H. Anderson for helpful comments on earlier drafts.*

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Federal Reserve Bank of Cleveland  
Research Department  
P.O. Box 6387  
Cleveland, OH 44101

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