February 1, 1991

ECONOMIC COMMENTARY

Federal Reserve Bank of Cleveland

1991 Outlook: Mild Recession, Mild Recovery

by John J. Erceg

The U.S. economy has been buffeted in the past few months by uncertainties surrounding the Persian Gulf War and its effects on crude oil supplies and by a strained financial sector domestically. Though these factors can make short-term economic forecasts highly unpredictable, members of the Fourth District Economists' Roundtable, who met January 18 at the Federal Reserve Bank of Cleveland, project that the current contraction will be brief and that economic growth will resume by mid-year.

The Roundtable economists acknowledge that a contraction in economic activity began in the fourth quarter of 1990, but have different views on what caused the decline. They concur, however, that a brief war in the Middle East is not expected to either deepen or prolong the present economic downturn, as long as crude oil supplies are not disrupted. The economists also predict that a mild recovery will ensue by the second half of 1991, against a backdrop of a gradual reduction in interest rates and a lower inflation rate.

■ The Oil Price Enigma

Some of the Roundtable economists assert that the oil price shock last August is the prime culprit in the current economic decline, as it led to severe erosion in consumer and business confidence and spending. Another explanation is that concern about the prospects of war in the Middle East was a primary factor that generated spending cutbacks, and that consumer and business outlays will revive as some of the uncertainties are resolved. According to one economist, the shock to consumer confidence was similar to that of early 1980, when the announcement of credit controls resulted in a sudden and sharp cutback in spending and real GNP. Confidence was restored when credit controls were lifted in mid-1980, spending subsequently rebounded, and the brief six-month recession ended.

The Roundtable panel apparently believes that a short war in the Persian Gulf is unlikely to have much of a negative effect on the economy, assuming that oil supplies, particularly from Saudi Arabia, are not disrupted. In this event, the price of crude oil would likely hover around its long-run price of about $20 per barrel, according to one economist. Supplies are judged to be plentiful because of higher output by Saudi Arabia and other oil producers that more than compensates for the embargo on oil exports from Iraq and Kuwait.

If oil supplies do become disrupted, however, the economists predict that crude oil prices and inflation would surge and that consumer spending and eventually business investment would decline, serving to deepen the contraction. It is the fear of future supply disruptions that accounts for last year's wide swings in the spot and futures prices. As that fear waned, crude oil prices fell to a recent average of about $20 per barrel, from an average high of about $40 per barrel early last fall.

Forecasters who attended the Fourth District Economists' Roundtable meeting two days after the outbreak of war in the Persian Gulf last month were generally optimistic about the potential economic effects of the conflict. The economists believe that as long as oil supplies remain adequate, a brief war should have minimal impact on the current economic contraction, and predict that mild growth in output should resume in the second half of the year.

■ Contraction and Recovery

Members of the Roundtable believe that the worst of the contraction in real GNP was in 1990:IVQ and that after a mild decline in 1991:IQ, growth of the economy will resume by mid-year. Real GNP was estimated to have declined at a 2.6 percent annual rate last quarter, according to the median of 27 forecasters at the meeting (table 1).[1] Another decline at a 1.5 percent annual rate is expected for this quarter, and after a flat 1991:IIQ, real GNP growth is predicted to rebound to a 2.7 percent annual rate in the second half of the year and to nearly a 3 percent rate in the first half of 1992.

ISSN 0428-1276

According to the median projection of the group, the current contraction is expected to be one of the mildest and briefest in the postwar period. The average decline in real GNP in the eight recessions since 1948 was 2.5 percent, and the average length of the downturns was 11 months. In contrast, Fourth District forecasters expect that real GNP will drop only about 1.1 percent between 1990:IIIQ and 1991:IIQ.

Similarly, the recovery anticipated by the Roundtable group would also rank as one of the mildest in postwar experience. In the first four quarters of the average recovery since 1948, real GNP rose 5.7 percent. For the four-quarter economic upturn that is expected to begin by mid-1991, the Roundtable forecasters anticipate a 3.2 percent increase in output.

One economist offered his explanations for this atypically shallow contraction and shallow recovery. To begin with, economic growth had been slowing gradually for two years before the presumed peak in 1990:IIIQ. Consequently, business firms were able to adjust production to a gradually slower product demand and avoid an inventory overhang that has typically steepened declines in economic activity. Moreover, he pointed out, a long-term shift in the mix of the economy has been taking place, contributing to different patterns of economic behavior by industry and by region.

Consumption, residential investment, and government purchases have been declining as shares of GNP, while exports have been rising. Manufacturing industries are likely to outperform service-producing industries because restructuring in manufacturing in the 1980s led to lower production costs, while service-producing industries that usually do well in recessions, such as financial services and retail trade, will be underperformers, resulting in potentially large layoffs.

Why is a milder-than-typical recovery expected? Obviously, some of the downward adjustments from the changing mix of the economy are not yet complete, so that real estate, financial services, and retail trade will continue to underperform the rest of the economy. Problems in those industries are not expected to spread unless final demand in the economy declines. Moreover, the Roundtable panelists believe that the Federal Reserve System is likely to continue a disinflationary policy, unlike its posture during past recoveries that were stimulated by rapid expansion of money and credit.

Alternative scenarios for both the contraction and recovery stages were apparent at the Roundtable meeting. A few panelists expect that economic growth will revive in 1991:IQ, following only a one-quarter decline. Another forecaster expects a double-dip recession in 1990-91 and in 1992. In his view, the present contraction was triggered by the fear of a Middle East war. Another dip in economic activity could occur in early 1992 in response to the oil price shock last summer, unless the price of crude oil were to drop to a sustained level of about $15 per barrel.

■ Inflation

The trend rate of inflation in the post-World War II period has averaged about 4 percent annually, with considerable oscillation around that figure. Most private and public forecasters have projected a 4 percent inflation rate well into the mid-1990s, apparently because of a perception that the Federal Reserve and the public are willing to accept that rate.

Inflation expectations now appear to be slowly adjusting downward, at least for the short term, despite the flare-up in price pressures last year. The Roundtable consensus is that the GNP implicit price deflator, the broadest price measure, reached a recent peak rate of 4.8 percent last quarter and will recede to a 3.9 percent annual rate this half. Between 1991:IIIQ and 1992:IIQ, the forecasters anticipate an annual average rate of increase of 3.3 percent, about matching the 1985-87 average. This figure is slightly more optimistic than the 4 percent rate the group had forecast for 1991 last fall.

■ Financial Market Conditions

Analysts have expressed considerable concern about whether financial problems in the economy might worsen the recession and constrain the recovery. Some maintain that the availability of funds from bank and nonbank sources has already been curtailed more severely than during the troughs of some past recessions. Discussants at the Roundtable, while acknowledging more restrictive credit extension by banks, do not believe that the economy is in a so-called credit crunch, or that credit restraint has been much of a factor in the economic downturn. They believe that nonbank sources of funds have been picking up the slack in bank lending.

One financial economist asserted that much of the decline in credit growth owes to weak demand for credit from both private and public sectors of the economy. Commercial and industrial loans, which track closely with industrial production, were growing slowly even before the oil price shock. Moreover, bank credit has been losing market share in credit markets since the early 1980s, well before the tighter regulatory supervision of recent years.

Growth of nonfinancial corporate debt slackened sharply in 1990, along with bank lending. However, bank credit as a share of total credit has been declining for the last several years, while the shares of nonbank sources of credit—especially life insurance companies, mortgage pools, households, and foreign capital—have been rising. Finance companies are one of the nonbank intermediaries that have been increasing their share of nonfinancial debt outstanding. Portfolios of some of the diversified finance companies include commercial and real estate loans, which have led to increases in nonperforming loans and reserves for loan losses.

Another economist asserted that financial problems may extend beyond commercial banks. Even insurance companies have experienced rising foreclosure and delinquency rates for commercial and single-family properties, especially in New England and the West North

TABLE 1 MEDIAN FORECAST OF CHANGE IN GNP AND RELATED ITEMS
Change in levels, billions of dollars, seasonally adjusted

			1990		1991				1992	
	1990	1991	IIIQ	IVQ	IQ	IIQ	IIIQ	IVQ	IQ	IIQ
GNP in constant (1982) dollars	36.8	-7.1	14.9	-27.7	-15.6	0.5	25.5	29.2	29.7	30.5
Personal consumption expenditures	25.9	-0.4	18.0	-18.8	-8.6	0.4	11.3	13.4	16.7	16.4
Nonresidential fixed investment	7.2	-10.0	10.9	-9.3	-7.0	-3.0	2.0	4.0	5.0	6.0
Residential construction	-9.5	-14.1	-9.8	-7.2	-4.4	-0.8	2.0	3.7	4.2	3.8
Change in business inventories	-20.5	-2.5	-4.8	-3.7	-4.9	1.9	3.5	5.0	3.5	2.0
Net exports	11.7	14.6	-1.9	3.5	5.0	3.8	4.0	2.0	2.0	0.0
Government purchases	21.0	5.3	2.5	3.0	0.4	0.0	-0.2	-0.4	-1.0	-0.1
	Percent change, annual rate									
GNP in current dollars	5.1	4.1	5.3	1.5	2.4	3.8	6.1	6.4	6.3	6.3
GNP implicit price deflator	4.2	4.1	3.7	4.8	4.3	3.5	3.4	3.4	3.3	3.3
GNP in constant (1982) dollars	0.9	-0.2	1.4	-2.6	-1.5	0.0	2.5	2.9	2.9	2.9
FRB index of industrial production	0.9	-1.3	3.7	-7.9	-4.0	-0.8	2.7	3.4	3.9	3.9

SOURCES: Fourth District Economists' Roundtable, Federal Reserve Bank of Cleveland, January 18, 1991; and U.S. Department of Commerce, Bureau of Economic Analysis.

Central states. Finance companies, according to one panelist, drastically cut the number and volume of new commercial real estate loans in 1990 and apparently plan no lending for commercial real estate in 1991. Similarly, both banks and nonbanks substantially cut highly leveraged transaction loans last year, and many finance companies reportedly plan to curtail that type of lending further in 1991. An economist emphasized, however, that funds are available and are rising for other kinds of loans.

A finance company that specializes in consumer credit reports that its problem loans lessened between 1989 and 1990, except for some auto dealer loans for inventory. The company's lending policies did not change in 1990, and the volume of lending fell only because of reduced demand for credit, especially for cars.

■ Outlooks for Key Manufacturing Industries

For most of the period between 1986:IQ and 1990:IIIQ, growth of industrial production was stronger than growth of real GNP, especially because of the rising volume of exports and double-digit growth in capital spending. The slump in production last quarter was more severe than for real GNP, and the Roundtable group expects another deep cutback in industrial output for 1991:IQ, though less than last quarter. A pattern of mild recovery in industrial production is anticipated beginning after mid-1991, and the pace of expected growth is again somewhat stronger than for real GNP.

The automotive industry, which is vital to the economy of the Fourth District, has felt the brunt of the slowdown in consumer spending. It now appears that the worst of the slump in auto output occurred in 1990:IVQ, when production fell to an annual rate of 5.6 million units, accounting for a major part of the quarter's decline in industrial production and in real GNP. An expected pickup in output should have a slightly positive effect on real GNP growth this quarter, however.

New car sales have been jarred by uncertainties about the economy and the Persian Gulf situation since the middle of last year. Some industry analysts are cautious about prospects for the upcoming spring months because of a likely increase in cars previously delivered to rental agencies that now will be resold to dealers and will compete with new cars. The prospective shallow economic recovery after mid-1991 implies no strong revival in the auto industry later this year and early in 1992.

In the capital goods industry, also critical to the Fourth District, the Roundtable group gave two different outlooks. An optimistic view, based on an economic recovery that is stronger than the group's median forecast, shows that business spending for producers' durable equipment declined last quarter by much less than is typical during a recession, and will revive in the second half of 1991. Much of the expected strength is in high-tech industries, especially office and computer machinery, but strong gains are also anticipated in transportation equipment (especially aircraft) and agricultural machinery. Longer-run prospects for producers' equipment are favorable because the aging of capital stock relative to that of our major trading partners will require strong growth in traditional capital goods. A less optimistic outlook for office and computer machinery goods this year stems from weakness in domestic purchases that more than offsets the continued growth in exports.

Monetary Policy

Some Roundtable members expressed concern about the sluggish growth of monetary and reserve aggregates during 1990, and about whether their sustained slow growth might prolong a recession and dampen recovery. For 1990, the Federal Reserve set a target range for M2 of 3 to 7 percent. Actual growth was about 3.7 percent, although growth in the last half of the year amounted to a 2.4 percent annual rate.

Some financial economists urged that the Federal Reserve move to step up the growth rate of monetary aggregates to the midpoints of their ranges. They noted that the three-year trend growth of M2 is about 4.5 percent, well above its actual growth since mid-1990. Moreover, nominal money balances have been flat since last September, and real balances have declined.

The Federal Reserve has taken several actions in recent months, including reductions in the federal funds rate, in the discount rate, and in reserve requirements, to accelerate the pace of growth in monetary and reserve aggregates. Further cuts in short-term interest rates may be necessary until money and credit growth strengthens, according to financial economists at the Roundtable meeting. In their view, a gradual reduction in interest rates would not be inconsistent with the long-run policy of reducing the inflation rate.

Last July, the Federal Reserve set a tentative 1991 target range for M2 growth of 2½ to 6 ½ percent. One financial economist prefers a 3 to 6 percent target range, leaving the lower end of the range unchanged from 1990. He believes that money stock growth has already been too slow, but that the upper band should be lowered because it is too far above the recent trend growth of M2.

Conclusion

The dual effects of the Persian Gulf War and oil price unpredictability make near-term forecasts more uncertain than usual. What is known to forecasters, however, suggests a mild, brief contraction in economic activity and a mild recovery later this year.

The Roundtable group acknowledges financial strains in the economy, but believes that some of these are structural changes that are affecting the mix of credit sources rather than the total supply. They generally do not believe that credit is a serious constraint on the economy or that it will hamper a recovery later this year because of the rising importance of nonbank intermediaries that are still making credit available, except for real estate and leveraged buyouts.

Footnote

1. Since the January Roundtable meeting, the U.S. Department of Commerce has released its advance estimate of a 2.1 percent annual rate of decline in real GNP for 1990:IVQ.

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