

FOCUS

CAN U.S. GROWTH CONTINUE AS OIL PRICE SPIKES UP?

Never in this expansion have the leading indicators been so close to forecasting a recession. Luckily, underlying inflationary pressures have already turned down.

A Broadbased Predictor

Leading indicators usually move in rough unison, though they rarely speak with one voice; but generally, their overall message is clear enough. However, a more precise interpretation is sometimes critical, because it may spell the difference between a forecast of a slowdown and a recession. This is one of those times.

An important insight from business cycle research is that the pace of an expansion is closely tied to its scope. This insight may be extended to leading indicators of the business cycle. For example, the more pervasive the weakness in a set of leading indicators, the slower the future pace of growth is likely to be.

A useful way to consolidate the evidence from ECRI's many leading indexes is to combine all their components into one U.S. Leading Diffusion Index (USLDI), last examined in this publication six months ago (Vol. V, No. 3, March 2000). It is expected that cyclical turns in the USLDI would anticipate cyclical turning points in the growth rate of the U.S. economy.

In fact, as Chart 1a shows, the USLDI reliably anticipates growth rate cycle turning points, which correspond roughly to the growth rate of the U.S. Coincident Index. The USLDI typically leads growth rate cycle peaks by about half a year, whether or not the downturn that follows results in a recession. However, at troughs, the median lead (-) of the USLDI is much greater (nine months) for non-recessionary slowdowns than it is (three months) for recessionary slowdowns (Table 1a).

Slowdown Ahead

In July, the USLDI plunged to its lowest level in the current expansion. In August, it rose above that low, but remained in a sharp downtrend. Given its behavior patterns at growth

Table 1a: Lead/Lag of USLDI at Troughs: Recessionary and Nonrecessionary Slowdowns

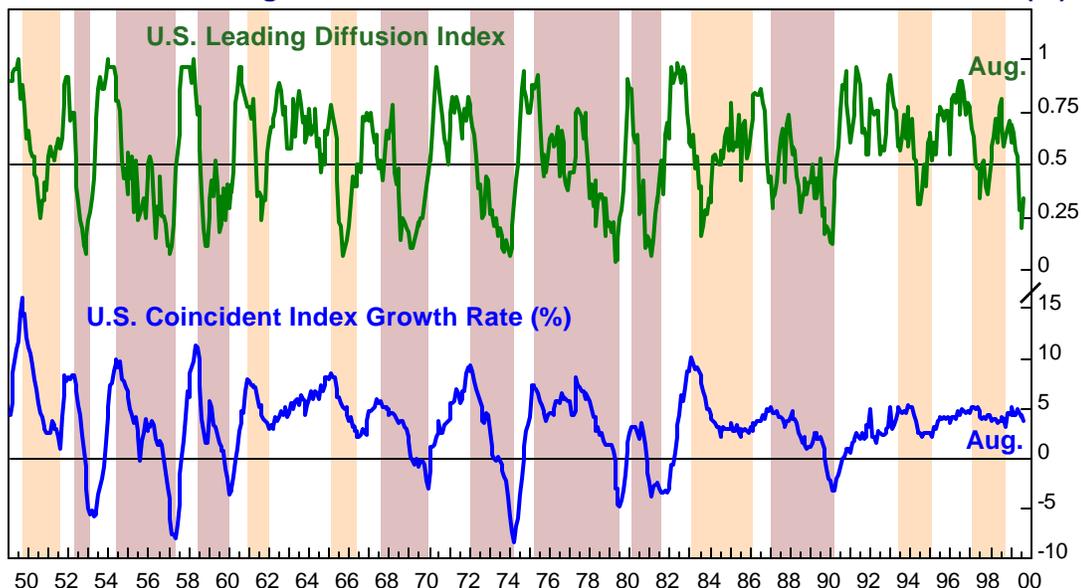
Growth Rate Cycle Trough Dates		USLDI Trough Dates		Lead (-) in Months	
Recession	No Recession	Recession	No Recession	Recession	No Recession
	7/1952		7/1951		-12
1/1954		10/1953		-3	
4/1958		1/1958		-3	
12/1960		11/1959		-13	
	12/1962		8/1962		-4
	5/1967		8/1966		-9
11/1970		2/1970		-9	
3/1975		12/1974		-3	
6/1980		3/1980		-3	
7/1982		1/1982		-6	
	1/1987		7/1984		-30
2/1991		1/1991		-1	
	1/1996		6/1995		-7
		Average Lead		-5	-12
		Median Lead		-3	-9

rate troughs, the next few months should provide a vital clue as to the prospects for a soft landing.

If the USLDI recovers promptly and clearly, that would follow the pattern in non-recessionary slowdowns or soft landings, with growth slowing through early next year and then recovering. Alternatively, if it remains depressed or plunges lower still, this would be consistent with the historical pattern in recessionary slowdowns.

It is not yet clear which scenario is more likely. However, it may be noted that in eight out of the ten instances since

Chart 1a: U.S. Leading Diffusion Index & U.S. Coincident Index Growth Rate (%)



Brown shaded areas represent U.S. growth rate cycle downturns that were followed by recessions and orange shaded areas represent those that were not followed by recessions.

1950 in which the USLDI dipped this low, a recession followed. On the other hand, for the past decade, monetary policy has moved preemptively when the USLDI faltered.

The Effect of Oil Prices

U.S. economic growth peaked last January, following the June 1999 peak in the USLDI. With the index plunging in recent months, a more serious slowdown now looks likely. However, whether oil price spikes will disrupt the expected soft landing is still an open question.

As discussed in this publication two months ago (Vol. V, No. 7, July 2000), when consumers encounter an unexpected jump in prices, consumption falls and precautionary savings rise. This is known as the Katona effect, which intensifies if the higher prices involve nondiscretionary spending like food or energy, which reduces the money left over for discretionary spending.

Price level volatility is already around a nine-year high, and could rise further this fall or winter if energy prices spike higher. The larger the spike, the stronger the check on consumer spending growth, in which some moderation was already expected due to the lagged effect of the Fed's interest rate hikes. It is conceivable that large and sustained oil price spikes could actually trigger a recessionary drop in consumer spending, which could be particularly damaging in the upcoming holiday shopping season.

Room For Maneuver

Fortunately, a recession is far from inevitable at this point, given both the uncertainties about future movements in oil prices and the leeway for preemptive actions. Such actions include those that could be taken at an administrative level, including the timely use of strategic petroleum reserves.

If energy price inflation does spike up to the extent where there is a serious threat to consumer confidence, the direction of short term interest rates may become critical. As Chart 1b shows, recessionary slowdowns are typified by long lags between the onset of a slowdown and downturns in the Federal Funds rate, while non-recessionary slowdowns involve shorter lags between the starts of slowdowns and interest rate cuts. In some of these cases (1968-70, 1973-75 and 1976-80), it may have been more difficult to ease promptly, since underlying inflationary pressures, as measured by the U.S. Future Inflation Gauge (USFIG), continued to rise well into the slowdowns.

Table 1b: Lead/Lag of USFIG & Fed Funds Rate at Peaks: Recessionary and Nonrecessionary Slowdowns

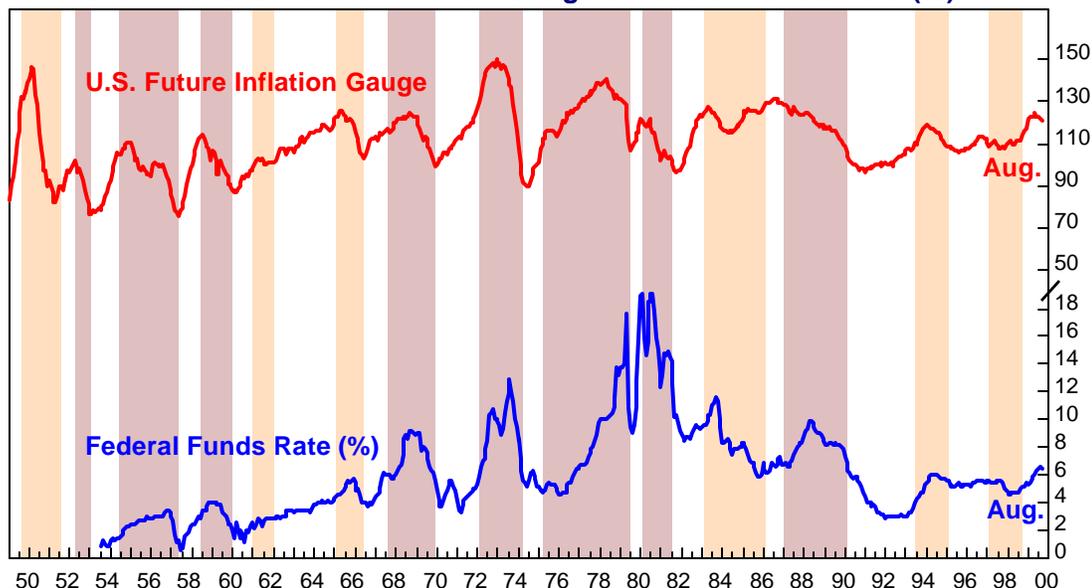
USFIG Peak Dates		Fed Funds Rate Peak Dates		Lag (+) in Months	
Recession	No Recession	Recession	No Recession	Recession	No Recession
12/1955		10/1957		+22	
6/1959		11/1959		+5	
	3/1966		11/1966		+8
8/1969		8/1969		0	
11/1973		7/1974		+8	
4/1979		6/1981		+26	
	3/1984		8/1984		+5
7/1987		3/1989		+20	
	12/1994		4/1995		+4
	7/1997		8/1998		+13
Average Lead				+14	+8
Median Lead				+14	+6.5

In other cases, where the drop in the USFIG started before or soon after the slowdowns began, there may have been more leeway for the Fed Funds rate to have declined sooner, but it continued to rise (1955-58, 1959-60 and 1988-91), and recessions followed.

As Table 1b shows, the median lag (+) between the USFIG and the Fed Funds rate at peaks is 6.5 months in non-recessionary slowdowns, but as long as 14 months in recessionary ones. The latter figure may actually be understated because in 1959-60 and 1968-70, the Fed Funds rate remained high for months after it technically peaked. Thus, long lags between peaks in the USFIG and the Federal Funds rate are associated with recessionary slowdowns. The difficulties are worse when the USFIG does not peak until long after growth has peaked.

Currently, however, while U.S. growth peaked early this year (around January), the USFIG followed suit in April and is now clearly easing. Therefore, unlike the 1970s, when the USFIG kept rising well after growth turned down, there is room for the Fed Funds rate to come down if a recessionary drop in confidence occurs in the coming months. Hopefully, such options will allow any potential recession to be averted.

Chart 1b: U.S. Future Inflation Gauge & Federal Funds Rate (%)



Brown shaded areas represent U.S. growth rate cycle downturns that were followed by recessions and orange shaded areas represent those that were not followed by recessions.