ECRI
ECONOMIC CYCLE RESEARCH INSTITUTE

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Founded by Geoffrey H. Moore

U.S. CYCLICAL OUTLOOK

RECESSION

Recession No Longer Avoidable
The cyclical leading indicators monitored by ECRI are now collectively pointing to a business cycle recession in the U.S. economy, making it very unlikely that the economy will avoid a recession this year.

Six months ago, we noted in this publication *(Vol. V, No. 9, September 2000)*, "Never in this expansion have the leading indicators been so close to predicting a recession. Luckily, underlying inflationary pressures have already turned down." In other words, the economy had entered a window of vulnerability. However, with inflation no longer a risk, a timely drop in short term interest rates could help avert a recession.

By last September, it was already clear that the spike in energy prices posed a serious threat to growth. As we noted, "large and sustained oil price spikes could actually trigger a recessionary drop in consumer spending." By late last year, unexpectedly frigid temperatures and an unusual election were also conspiring to disrupt economic activity.

Rising unemployment will damage confidence, hurting services growth and causing a recesssion.

A Fork in the Road
Early this year, with the leading indicators dangerously weak, the economy was approaching a fork in the road. If the leading indicators weakened further, a recession would be the clear outcome. If they rebounded soon, it would still be possible to avert a recession, and achieve a softer landing for the economy.

With manufacturing activity already contracting, it was resilient service sector growth that was preventing an overall recession. The key to continued services growth was consumer and investor confidence, the critical question being whether policy measures would be effective in keeping confidence from plunging.

Four months after we warned of the risks to growth, the Federal Reserve took aggressive action to shore up confidence by slashing interest rates by 100 basis points in January. After an initial rebound, stock prices resumed their decline, as did investor confidence. Consumer confidence also plunged before stabilizing in early March. This week, the Fed lowered interest rates by another 50 points, but stock prices continued their slide, further damaging confidence.

It is now clear from the pattern of movements in our large array of leading indexes that the economy has passed the fork in the road and veered towards a recession. This is the message from the Long Leading Index, the Short Leading Index and the Weekly Leading Index of economic activity. The movements of the Leading Manufacturing Index and the Leading Construction Index are also pointing clearly to a recession. Only the Leading Services Index remains ambiguous, with its movements consistent with either a recession or a slowdown. This leading index, above all others, is most sensitive to consumer confidence.

Ominously, growth in the Leading Employment Index has just plunged to a 19-year low, below the worst readings seen in the last recession. It is evident that the jobless rate will rise significantly in the next few months.

Nothing can undermine confidence as much as the serious increase in joblessness that is now imminent. Not surprisingly, cyclical downturns in the growth rate of the Leading Employment Index lead cyclical declines in consumer expectations by six months on average. Under the circumstances, the recent stabilization of consumer confidence is small comfort, since the decline is likely to resume in earnest as unemployment starts to rise.

Once confidence starts to plunge afresh, it is unlikely that service sector growth will continue to hold up. If it does hold up, a recession can still be averted, and that increasingly remote possibility is the major risk to our recession forecast.

Conflicting Signals from Stock Prices
In the short term, with labor markets likely to worsen, the only available route to a revival of consumer confidence is a

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rebound in investor confidence. With the major averages entering bear market territory, however, investor confidence has plunged instead.

Yet not every important stock price index has plummeted. It is notable that through February, the New York Stock Exchange (NYSE) Composite Index, which is not as heavily weighted towards technology stocks as more widely followed stock indexes, had not experienced a serious decline. It is only in recent days, especially following the Fed's latest move, that the NYSE index has begun to drop more quickly.

Since there has never been a recession without a cyclical decline in the NYSE index, which covers a broad range of corporations, a prompt rebound in this index would imply that a recession will be averted. In that case, we must also see quick revivals in the array of ECRI leading indexes that are now pointing to a recession.

That appears to be an unlikely prospect at this stage. Instead, it is more likely that the NYSE index will experience a cyclical downswing in the near future.

The Leading Indicators' Consensus

When we first warned of the recession danger six months ago, one of the key measures that we used was the U.S. Leading Diffusion Index (USLDI), which is the proportion of the components of ECRI's array of leading indexes that are more favorable than they were six months earlier. The USLDI takes advantage of the insight from business cycle research that the pace of an expansion is closely tied to its scope, and that the future pace of an expansion should be closely linked to the pervasiveness of the improvement in the leading indicators. By last summer, the USLDI had dropped to its lowest level in the long expansion.

As we noted subsequently in this publication *(Vol. V, No. 12, December 2000)*, when the USLDI does not fall below about one-sixth (horizontal line at 0.167, upper panel, Chart 1), recessions never follow. When the USLDI stays below that threshold for at least two months, a recession always follows. The only exception to this rule is the "mini-recession" of 1966-67, when the USLDI stayed below that threshold for exactly two months.

The latest reading shows the USLDI at 0.27 in February, above the recessionary threshold. However, a close examination of the USLDI components suggests that once all the data become available, it could easily drop below the threshold in March.

Equally worrisome is the U.S. Coincident Index (USCI) growth rate, shown in the lower panel in Chart 1. The USCI is not a predictor of economic activity – it is a measure of current economic activity, and moves in step with the US economy. Preliminary February estimates show that USCI growth has fallen to just 0.5%. USCI growth has never dropped this low in its history without a recession.

The Point of No Return

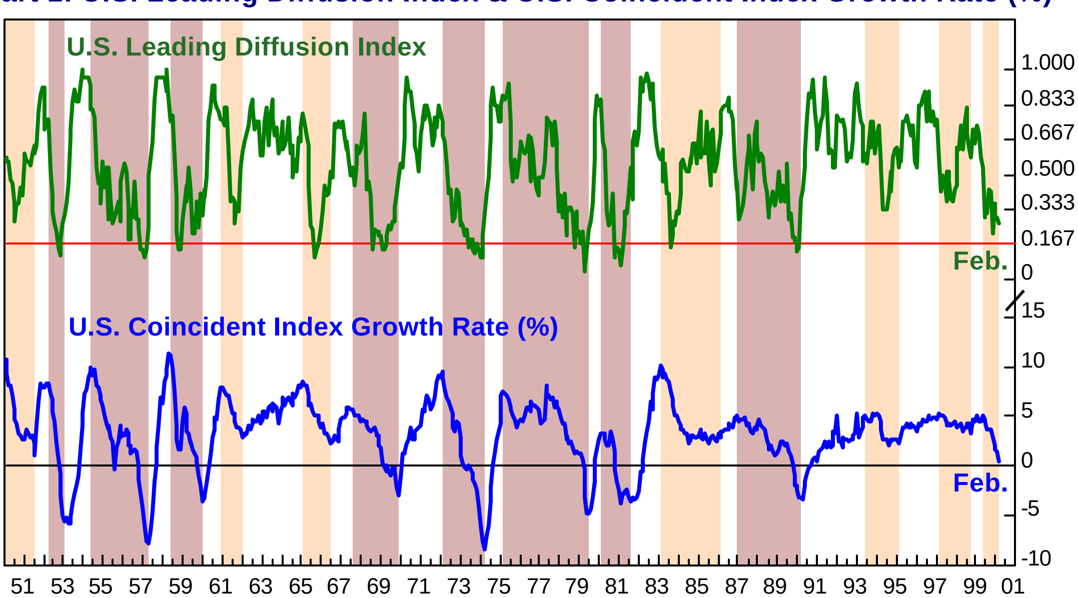
The U.S. economy has been in danger of falling into a recession since last summer, but until now a recession was not a foregone conclusion. Unfortunately, we have now run out of time.

At this point, every one of ECRI's leading indexes, excluding the Leading Services Index (LSI), is pointing to a recession. The LSI is likely to follow suit if confidence drops further as joblessness increases substantially, in line with the Leading Employment Index's forecast. The economy has passed the point of no return, beyond which it is not possible to shift away from the recession track. Of course, the economy will eventually recover from this recession, but that cyclical upturn is not yet in sight, and may not begin until next year.

The U.S. downturn is bad news for Asia, especially Japan, Korea and Taiwan, which are heavily dependent on exports to the U.S. and are likely to plunge into renewed recessions. The European economies are also slowing as a synchronous global slowdown intensifies. As a result, there is no locomotive anywhere in the world to help pull the U.S. economy out of recession. This global backdrop will tend to prolong and deepen the U.S. recession.

For a decade, recession in the U.S. was kept at bay by a combination of luck and skill. But in market economies, recessions cannot be postponed indefinitely. As imbalances build, they demand the catharsis of a recession, which lays the foundation for the subsequent recovery. Thus, while a recession can bring hard times for many, it is part and parcel of a free market economy, and is integral to its growth. Fortunately, the persistent downswing in the Future Inflation Gauge permits substantial leeway for a continued decline in short term interest rates, which can help mitigate the severity of the contraction.

Chart 1: 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.