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U.S. CYCLICAL OUTLOOK

ECONOMIC EXPANSION NOT IN DANGER

A Shock-Resistant Economy

During the economic boom that led up to the 2001 recession, the U.S. economy's resilience to external shocks became a general article of faith. But after the trauma of the contraction highlighted the economy's vulnerability, that faith was shattered. In the years since, the economy has survived a number of false alarms about renewed recession.

In fact, as oil prices soared over the past year while the Federal Reserve kept raising interest rates, some prominent analysts predicted a sharp slowdown, if not a new recession, in the second half of this year. Yet the economy has maintained a healthy pace of growth, confounding the prophets of doom.

In the past, oil price spikes of such magnitude, even in inflation-adjusted terms, had proved to be recessionary, as had rising interest rates. This was true even five years ago when the U.S. economy, about as energy-intensive as it is today, was hit by a smaller demand-driven oil shock. What, then, accounts for the economy's newfound ability to withstand the interest rate and oil price shocks, and what implications does that have for its likely reaction to the aftermath of Hurricane Katrina?

Despite a near-term hit to consumer spending, the economy is unlikely to be tipped into a new recession.

As we discuss later (pages 3 to 4), recessions in modern market economies are sparked not by shocks alone, but by a combination of endogenous cyclical forces and external shocks. When those endogenous forces – basic drivers of business cycles such as profits and inventories – are aligned in certain ways, as reflected in recessionary downturns in reliable leading indexes, the economy is vulnerable to any significant shock. It is as if the dominoes are then lined up to all fall down as the shock propagates easily through the economy, causing a recession. This was the case in the months leading up to each of the last five recessions, all of which were set off by spikes in oil prices and interest rates.

Alternatively, those endogenous cyclical forces may be aligned to impede the transmission of a shock through the economy. This is signaled by cyclical upswings in leading indexes, which make it difficult for even major shocks to precipitate a contraction. Examples include the attack on Pearl Harbor and the stock market crash of 1987, neither of which triggered even a brief recession.

Because ECRI's leading indexes of economic growth have now been in clear cyclical upswings for many months, it was evident that the economy was fairly impervious to shocks. That is why it was able to keep growing steadily even as oil prices and interest rates climbed this year, and why it has been able to withstand the devastation of Hurricane Katrina.

It is in that context that one might interpret Katrina's impact as a "near-term setback" rather than a "persistent threat," to quote from the Federal Open Market Committee's statement this week. The point is that, if Katrina's aftereffects were set to cascade through the economy in a recessionary fashion, this week's interest rate hike would have been risky at best. Instead, it is a valid vote of confidence in the resilience of the expansion.

Waiting for Data

There is a belief in some quarters that all pre-Katrina data are now irrelevant and post-Katrina data are too distorted to be usable, making it necessary for policy makers to wait for clearer signals from the economy. But in fact, because they reflect the state of the economic cycle leading up to Katrina's advent and thus bear on the economy's vulnerability to shocks, pre-Katrina data on economic growth are quite relevant and contain actionable information for decision makers.

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__Future Inflation Gauge__: Climbed to a five-year high in August, suggesting that pipeline inflation pressures are advancing steadily.

__Leading Home Price Index:__ Slipped further in August, but not enough to predict a cyclical downturn in home prices.

__Leading Employment Index__: Rose further though its growth rate slipped, suggesting that the job growth outlook was modestly positive before Hurricane Katrina.

__Long Leading Index__: Growth edged up in August, suggesting that the expansion was poised to withstand any upcoming shocks.

__Short Leading Index__: Growth rose for the third straight month, suggesting that near-term growth prospects were improving before Katrina.

__Leading Services Index__: Growth eased from a 22-year high, but the outlook remains fairly bright.

__Leading Financial Services Index__: Growth dipped slightly, suggesting that financial sector growth may begin to moderate.

__Leading Nonfinancial Services Index__: Growth ticked down but remained healthy, indicating a positive outlook for nonfinancial services.

__Leading Manufacturing Index__: Growth edged up further, indicating a somewhat less gloomy outlook for the sector.

__Leading Construction Index__: Growth weakened, pointing to fading growth prospects.

Focus:

Shocks and Recessions

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CONSUMER SPENDING TO TAKE A HIT

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This is also true of measures of underlying inflationary pressures such as ECRI's U.S. Future Inflation Gauge (USFIG), which climbed in August to a five-year high. While longer-term secular deflationary forces related to technology and globalization keep a lid on overall inflation, the cyclical direction of inflation pressures is clearly upward. Because Katrina has helped to exacerbate shorter-term inflation pressures through the creation of capacity shortages, it has scarcely altered the fundamental direction of inflation.

This is also the message from the weekly version of the USFIG, which already reflects post-Katrina data. While some post-Katrina data may be distorted, much are not. In any case, changes in the cyclical direction of the economy or inflation can be signaled only by fairly pervasive directional changes in leading index components, only some of which are subject to distortion. Thus, a proper reading of ECRI's leading indexes should already be able to shed some light on the likely direction of the economy and inflation.

Taxing Consumers

It is appropriate to think of an oil price increase as a tax on consumers, likely to hurt consumer spending. But in addition, there is a link between price level volatility and consumer spending growth called the Katona Effect, after the late George Katona of the University of Michigan, who found in his surveys that when consumers encountered an unexpected jump in prices, consumption fell and savings rose.

If we proxy the component of inflation that surprises consumers by a 12-month standard deviation of the Consumer Price Index (price level), there appears a long-lasting *inverted* relationship (Chart 1) between consumer spending growth and the volatility in the price level. This measure of price volatility tends to anticipate cyclical turns in consumer spending growth, with a median lead of two months at peaks and 3.5 months at troughs.

In terms of consumer psychology, the Katona effect works through the real side of the economy. When price volatility increases, so does inflation uncertainty, inducing the consumer to build up precautionary savings balances. Moreover, a rapid pickup in the CPI – especially when driven by higher energy or food prices, as in the current instance – reduces discretionary spending since more of the consumer's budget must go to nondiscretionary purchases. Thus, discretionary spending on deferrable items suffers, ultimately hurting overall consumer spending.

With the CPI surging in August, there has already been a sharp increase in price level volatility (shown inverted in Chart 1, thick line), but it is probable that it will increase further in September in the wake of Katrina. Because price level volatility, in inverted form, leads consumer spending growth by a couple of months, this could hurt consumer spending growth during this holiday season.

Clearly, none of ECRI's leading indexes of economic growth is pointing to a new recession. The growth rates of those indexes, however, present a mixed picture, with growth in the U.S. Long Leading and Short Leading Indexes of the overall economy having recovered only modestly from their spring lows. Growth in the Leading Services Index has eased from July's 22-year high but remains robust, but growth in the Leading Construction Index is already flagging from lackluster readings. Meanwhile, growth in the Leading Manufacturing Index has recovered only slightly following a major downswing.

Thus, as of August, the economy was poised to see lopsided growth, focused mostly on services. But it is now plausible that the Katona effect, by hurting consumer spending, will help trigger renewed downturns in the growth rates of these indexes. That is not yet a given, but these leading indexes deserve to be watched closely for any emerging signs of directional change.

In any case, a new recession is quite unlikely until ECRI's leading indexes exhibit recessionary weakness. If that happens, the economy will once again be vulnerable to external shocks that could trigger a fresh recession. But that is far from the current state of affairs.

In sum, the drivers of the U.S. business cycle remain configured in a way that makes it difficult for Katrina or other near-term shocks to trigger a new recession. However, growth in consumer spending is likely to take a hit this year, causing at least a near-term dip in growth, but that is likely to be followed by a boost from the rebuilding of the Gulf Coast. Meanwhile, pipeline inflationary pressures, which were already climbing before Katrina hit, continued to creep up in its immediate aftermath, making it important to remain vigilant on the inflation front.

Chart 1: The Katona Effect and U.S. Consumer Spending