U.S. Economy in Recession

"Despite the contractions in early 1991, we expect that a recovery will begin later in the year and that year-over-year growth will resume by the fourth quarter."

The U.S. economy entered a recession in the fourth quarter of 1990, and we expect economic declines to continue in the first and second quarters of 1991. Despite the contractions in early 1991, we expect that a recovery will begin later in the year and that year-over-year growth will resume by the fourth quarter. Even though oil-price shocks triggered the current recession, the U.S. economy had been weakening for some time, and the characteristics of the pre-recession softness offer a useful perspective on the probable characteristics of a 1991 recovery.

Chart 1
Real GNP Growth

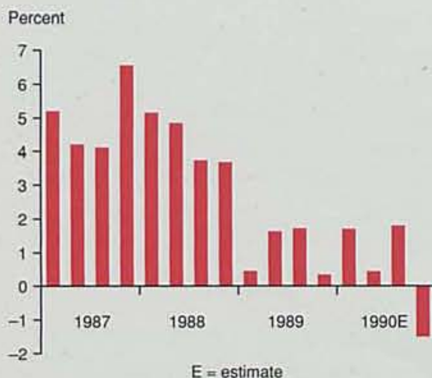
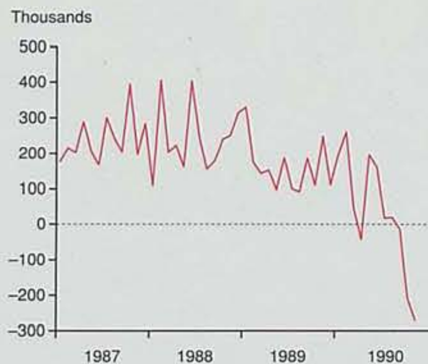


Chart 2
Growth in Private Nonagricultural Employment



The U.S. Economy in 1990

Before oil prices increased in the wake of the Middle East crisis, economic activity had been slowing. As Chart 1 shows, real gross national product (GNP) had grown at less than a 2-percent annual rate for six consecutive quarters. In the third quarter as oil prices were increasing, GNP grew 1.4 percent, according to revised estimates. The third-quarter strength in GNP resulted largely from increased consumer spending on services and nondurable goods. When fourth-quarter data become available, however, they probably will reveal that consumer spending was not a source of strength. In October, real consumption expenditures dropped 0.7 percent, the largest month-over-month decline in three years. The widespread decline in economic activity will probably cause real GNP to decline at a 1.5-percent annual rate in the fourth quarter of 1990.

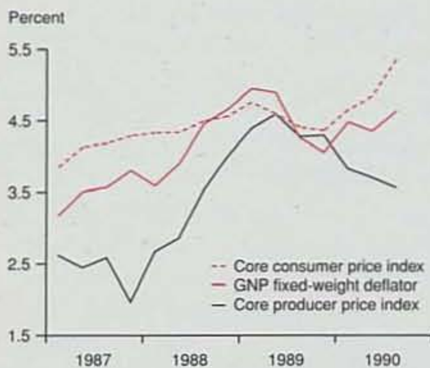
The economic slowdown before the oil-price shock was broad-based. The growth rate of the goods-producing sector had fallen steadily since 1987. Growth in the service sector averaged more than 3.5 percent in 1987 and 1988 but dropped to about 2.5 percent in 1989 and 1990. These sectors together account for 90 percent of GNP. The output of the construction sector, which accounts for the other 10 percent of GNP, has declined every year since 1987.

Sluggish expansion of output led to a major slowdown in the growth of private nonagricultural employment *(Chart 2)*. Since the beginning of 1989, the manufacturing sector has lost nearly three-quarters of a million jobs. The average number of jobs lost each month in this sector more than doubled from 16,000 in 1989 to about 50,000 in 1990. Growth in total private service-sector employment slowed from about 200,000 jobs per month in 1987–88 to fewer than 100,000 jobs per month in 1990. One employment report available in December indicated that about 60,000 private service-sector jobs were lost in October and November.

By the third quarter, job growth began to fall below the pace of labor force expansion, and the unemployment rate began to rise accordingly. After hovering around 5.3 percent from the fourth quarter of 1988 through the second quarter of 1990 *(Chart 3)*, the unemployment rate began to increase steadily and reached 6.1 percent in early January. Nevertheless, the slowdown in employment growth was slow to translate into increases in unemployment because labor force growth had also been slowing. The slowdown in expansion of the labor force stems from two factors that have reduced the number of people entering the job market each year: the aging of the U.S. population and the leveling off of female labor force participation rates.

Chart 3
Unemployment Rate

Chart 4
Inflation Rates



What caused the slowdown that occurred before the oil-price shock? An important contributor was restrictive monetary policy, which contributed to an increase of 300 basis points in the federal funds rate between 1988 and 1989. This monetary restrictiveness was a response to incipient inflationary pressures, which were believed at the time to have been caused by unsustainably high rates of GNP growth. Chart 4 depicts the recent behavior of three standard measures of inflation. Core producer price inflation (movements in producer prices less food and energy prices) showed the most dramatic increase between 1987 and 1989. Tighter monetary policy began to take effect in 1989 and was clearly having some success in bringing inflation rates down. Had there been no energy-price shock in 1990, the inflation rate would have continued to fall or at least would have stabilized.

The increased restrictiveness of monetary policy put the economy on a course for a soft landing. Based on actual GNP growth in the first three quarters of 1990 and preshock expectations of fourth-quarter performance, GNP would probably have grown about 1.3 percent in 1990 had there been no oil-price shock.

Oil Prices and the Recession

The increase in oil prices *(Chart 5)* transformed the potential soft landing into an economic downturn. Since the Middle East crisis of 1990, movements in oil prices have reflected expectations about the *future* availability of oil supplies and cannot be attributed simply to a crisis-induced shortage of oil. Nevertheless, even when higher oil prices do not reflect a supply shortage, they have a disruptive effect on economic activity in oil-importing nations.

The near doubling of oil prices alone could have disrupted economic activity, but a rolling real estate recession and federal fiscal problems compounded the influence of higher oil prices. This combination of factors contributed to drastic declines in consumer confidence that began late in the third quarter and continued into the fourth quarter of 1990.

As one analyst observed, "a concerned consumer is a cautious consumer," and eroding consumer confidence could trigger lower consumer spending. A large drop in spending would have potentially severe consequences for aggregate economic performance because consumer spending accounts for about two-thirds of all economic activity. Recent reports indicate that consumer spending began to decline in October. Confidence, while at recession levels, will not remain low for very long unless validated by a deterioration in real economic conditions. In other words, uncertainty about how the Middle East crisis will be resolved is contributing to low consumer confidence, but a real shortage of oil would have to occur to maintain this confidence level.

Consumers are not alone in their concern. Movements in the Treasury yield curve since July suggest that investors have been moving into relatively low-risk, short-term government securities. In an uncertain economic environment, investors will prefer short-term over long-term securities. They will also put a premium on safety.

Some observers believe that a credit crunch is exacerbating the current downturn. Lending to businesses and real estate in 1990 slowed noticeably. A contraction of credit occurred in response to earlier lending practices and was a necessary adjustment to past mistakes. Also, in a highly uncertain economic environment, lenders become more reluctant to lend to every class of borrower. Uncertainty about future oil prices has increased the perceived risks associated with investment projects. A prompt resolution of the Middle East crisis or, more specifically, greater certainty about future oil prices would eliminate this source of credit shortage.

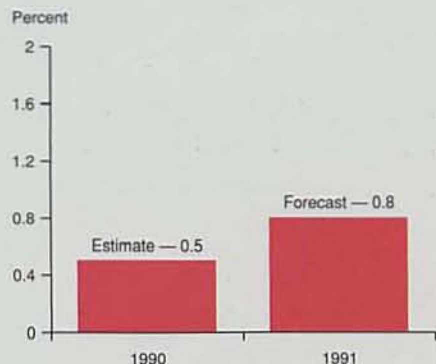
Chart 5
Price of West Texas Intermediate Crude

The adverse effects of the oil-price shock in the third and fourth quarters of 1990 shaved almost 1 percentage point off GNP growth for the year. GNP will probably grow by only 0.5 percent in 1990, instead of the 1.3-percent increase predicted had there been no oil-price shock.

Outlook for 1991

Real GNP will grow less than 1 percent between the fourth quarter of 1990 and the fourth quarter of 1991 *(Chart 6)*. This forecast is

Chart 6
Real GNP Growth in 1990 and 1991



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predicated on two quarters of negative GNP growth in the first half of 1991. We predict that the second half of the year will show improvement because we expect that the Middle East crisis will have been resolved by that time. Underlying this forecast are assumptions that oil prices will fall steadily in 1991 and that monetary policy will remain somewhat less restrictive than in 1990. The engine of growth in 1991 will be export demand, which is expected to grow 6.7 percent during the year. Exports should benefit from continued economic growth abroad.

We forecast inflation rates of 4.1 percent in 1991 and 3.6 percent in 1992. The surge in oil prices in the second half of 1990 will feed through to prices in the rest of the economy during the winter months. Additional pressure will come from new excise taxes on alcohol, cigarettes and gasoline. We expect the inflationary pressure from oil prices to be reversed sometime in the first half of 1991, and this, in turn, will impart some negative momentum to consumer prices later in the year.

Several factors could affect the accuracy of this forecast. We based our expectation of a recovery in 1991 on three key assumptions: a decline in oil prices sometime in the first half of the year following a resolution of the Middle East crisis, continued economic growth abroad that will sustain demand for U.S. exports, and no major decline in credit availability. No one knows with certainty how and when the Middle East crisis will be resolved. As for the prospects for continued growth abroad, we note that the leading indicators of economic activity for most major U.S. trading partners have shown weakness in recent months and may signal a downturn in global economic activity. Finally, the credit situation could deteriorate if widespread loan defaults weaken banks' capital positions.

Summary

The economy was headed for a soft landing before oil prices increased in the second half of 1990. As a result of the oil-price shock, we predict a brief recession that will not last beyond the second quarter of 1991. Real GNP will grow 0.5 percent in 1990 and 0.8 percent in 1991. Inflation will fall from 4.8 percent in 1990 to 4.1 percent in 1991.

Uncertainty about future oil prices greatly increases the risk in this forecast. A sustained increase in oil prices would prolong the recession by adversely affecting both domestic and foreign output growth. If oil prices do not fall sometime in 1991, inflationary pressures will not subside. Finally, widespread financial distress could follow a slowdown in economic activity and a deteriorating real estate market. Consequences of this distress, while difficult to quantify, could prevent a recovery that otherwise would accompany lower oil prices and strong export growth.

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