Research Department
Federal Reserve
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FRBSF Weekly Letter

Forecasting Recessions

The long-awaited recession has finally arrived, it would appear, judging from the recent weakness of production and retail sales, as well as the obvious problems of key industries such as autos and housing. "The economy peaked in January and then began a slide into recession," the Commerce Department's chief economist Courtenay Slater said last week. Although she and others won't make it official until they see two consecutive quarters of declining real growth, the evidence they cite is somewhat stronger than during the preceding year or more of false alarms.

In late 1978, most forecasters expected a slow year in 1979, with either a "soft landing" or (more likely) an actual downturn in business activity. In those circumstances, they also expected the inflation rate to decelerate from the 7.3-percent increase recorded for 1978. As it turned out, real GNP rose 2.3 percent between 1978 and 1979, with only the second quarter of the year showing significant weakness. And inflation, rather than receding, accelerated during the year. Consequently, it may be useful to examine the unexpected strengths which developed in various sectors of the 1979 economy, and to compare them with the apparent weaknesses in the same sectors this year.

A mild recession seemed to be a logical forecast to make a year ago. The typical scenario included a substantial slowdown in employment, which had been increasing at a record peacetime rate since the early 1975 trough. Consumers seemed likely to reduce their spending, as a result of their heavy debt burdens and the inflation-caused erosion of their real after-tax incomes. With consumer spending dropping, businesses seemed likely to be forced into liquidating the inventories which they had involuntarily accumulated during the spending downturn. And with interest rates climbing, the funds-short housing industry seemed set for a substantial decline. All of these signs spelled out a classic script for at least a mild recession.

How '79 turned out

Interestingly enough, all of these signs actually appeared—at least to some extent—during 1979. Still, the economy forged ahead, with only one quarter of actual decline—and that resulted from an external shock, the cutoff of Iranian oil. Indeed, the cutback in two related expenditure items (autos and parts, and gasoline and oil) accounted for the entire second-quarter decline in consumption spending, which in turn accounted for four-fifths of the quarterly decline in real GNP.

Inventories behaved generally as expected in 1979, increasing almost by half during the second-quarter consumer-spending downturn, and increasing at a much slower pace during the remainder of the year. Business firms boosted their stocks at an $18.1-billion rate in the second quarter, but at only a $1.4-billion rate in the final quarter of the year. So although there was no actual liquidation, what had appeared to be a glut of inventories was reduced in orderly fashion by year-end. Many observers consequently saw little danger of inventories becoming a contractive force in 1980.

The home-construction sector also behaved somewhat as expected, with housing starts declining 24 percent in response to rapidly rising housing prices and tighter mortgage-credit conditions. Even so, real expenditures for housing dropped only 7 percent, partly because physical production lagged considerably behind the decline in starts, and partly because spending on alterations and remodeling remained high during the year. Meanwhile, business capital spending behaved somewhat better than anticipated. As a highly cyclical sector, it would be expected to decline in the weak business

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climate expected in 1979. Instead, capital spending outpaced the growth of the overall economy, despite some weakness toward the end of the year.

Strength in consumer spending
Nonetheless, consumer spending represented the most evident (and most unexpected) source of strength in the 1979 economy. Real consumer spending increased by 1.6 percent between the fourth quarter of 1978 and the fourth quarter of 1979, while real GNP increased by only 0.6 percent over that period. (Incidentally, all of the growth in household expenditures was concentrated in the second half of 1979, thereby accounting for the strength of the overall economy during that period.) But real after-tax income increased by only 0.2 percent over the year, so that consumers were able to expand their purchases only by cutting into savings and expanding their borrowings.

Consumers drastically reduced their saving rate, from a 1978-79 average of 5.0 percent (of disposable income) to a low of only 3.5 percent in the final quarter of 1979. At the same time, they boosted their debt, either by increasing their instalment credit or by borrowing against the inflation-enhanced equity in their homes. Estimates of borrowing against home equity ranged from $50 billion to $100 billion, equal to about 3 to 6 percent of disposable income. Whatever the exact figure, considerable amounts not arising from current income went into consumer purchases during 1979, thus giving an extra boost to total spending during the year.

The unexpected strength of consumer spending undoubtedly reflected the state of consumer psychology, which increasingly became dominated by the high and accelerating rate of inflation. Understandably, consumers spent more in anticipation of higher prices in the future. In such a frame of mind, consumers could be expected to boost spending for durable goods, since buying such long-lived items at 1979 prices should ensure considerable relative savings over an inflationary future. But surprisingly, durable-goods spending weakened in real terms during the year, and most of the strength (especially in the second half) occurred in the areas of services and nondurable goods, such as clothing. Still, the "buy now" psychology was an important spending stimulus in most consumer markets during the year.

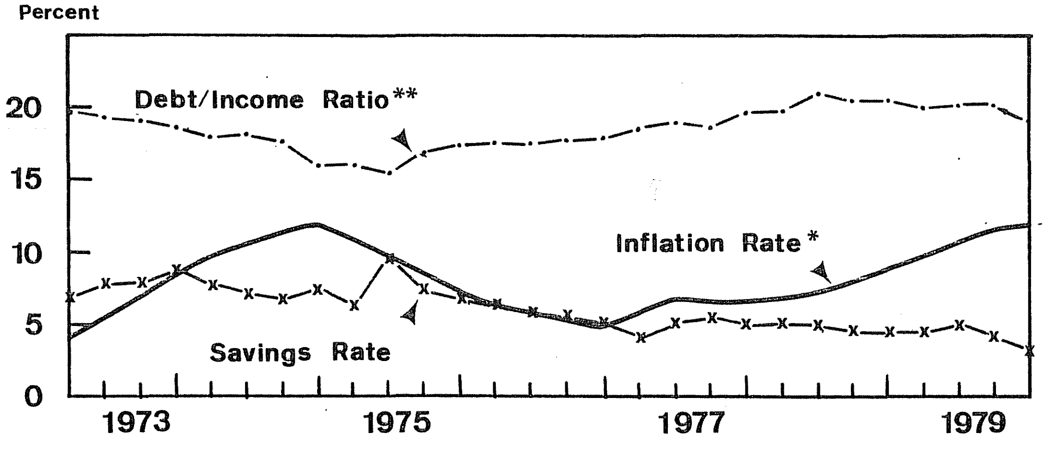
The consumer response to inflation in 1979 contrasted sharply with the response in 1973—a similar year of accelerating inflation at the end of a prolonged business expansion. In that earlier period, consumers reacted to rising prices by reducing spending and increasing savings, instead of doing the reverse as in 1979. This difference in response apparently reflected differing perceptions of the nature of the inflation faced by consumers. In 1973, consumers had two years of comparatively low and stable prices behind them, thanks to a program of wage and price controls, and hence they responded cautiously to the uncertainty imposed by an unanticipated rise in the inflation rate. Although real consumption spending increased at about the same pace in 1973 as in 1979 (1.7 percent), the increase in real disposable income was much greater in that earlier year (4.1 versus 0.2 percent). Thus in 1973, as compared with 1979, consumers responded to inflation by boosting their savings and reducing their burden of debt.

Forecasting 1980
On the basis of recent evidence, forecasters predicting a recession in early 1980 will be closer to the truth than those who predicted a recession a year ago. The basic source of weakness apparently is the consumer—the source of most of the strength in the 1979 economy. In the first quarter of 1980, real consumer spending for goods actually declined, and only spending for services increased. At the same time, real spending for residential construction dropped substantially, reflecting last year's decline in housing starts. The sharp tightening of credit, along with stagnant real incomes and a very low level of household savings, has made it

impossible for consumers to continue with their "buy now" spending behavior of 1979.

Other GNP sectors generally moved sideways in first-quarter 1980, in real terms. Business capital-goods spending increased modestly, and business inventories remained stable. Federal government spending meanwhile continued to strengthen, as it did in the latter part of 1979. But to repeat, the consumer seems to be the main reason why recession forecasters went wrong in 1979 and why they appear to be correct in 1980.

Herbert Runyon



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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 4/9/80	Change from 4/2/80	Change from year ago Dollar	Percent
Loans (gross, adjusted) and investments*	139,487	+ 345	+ 15,232	+ 12.3
Loans (gross, adjusted) — total#	117,689	+ 278	+ 16,251	+ 16.0
Commercial and industrial	33,890	− 142	+ 3,627	+ 12.0
Real estate	45,732	+ 189	+ 9,144	+ 25.0
Loans to individuals	24,394	− 93	+ 3,058	+ 14.3
Securities loans	1,007	− 216	− 485	− 32.5
U.S. Treasury securities*	6,525	+ 18	− 1,498	− 18.7
Other securities*	15,273	+ 49	+ 479	+ 3.2
Demand deposits — total#	45,147	−1,683	+ 1,315	+ 3.0
Demand deposits — adjusted	33,230	+ 956	+ 1,181	+ 3.7
Savings deposits — total	27,059	− 165	− 3,182	− 10.5
Time deposits — total#	62,951	+ 924	+ 12,976	+ 26.0
Individuals, part. & corp.	54,432	+ 849	+ 13,767	+ 33.9
(Large negotiable CD's)	22,462	+ 560	+ 4,900	+ 27.9

Weekly Averages of Daily Figures	Week ended 4/9/80	Week ended 4/2/80	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (−)	21	107	48
Borrowings	200	42	11
Net free reserves (+)/Net borrowed(−)	− 179	66	37

* Excludes trading account securities.
\# Includes items not shown separately.

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