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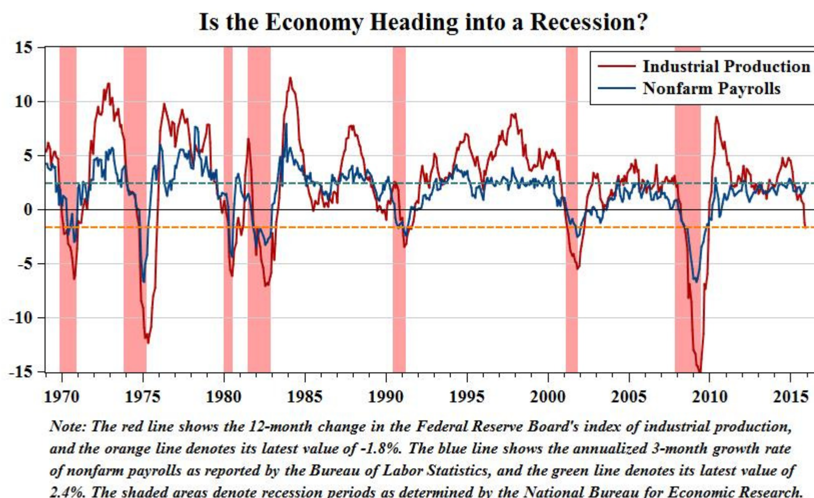
Recent Economic Data and the Risk of a Recession

Economic downturns are notoriously difficult to predict. In fact, a recession may not be obvious even when it's already underway. For example, the National Bureau of Economic Research has determined that the last recession began in December 2007. But even as of mid-September 2008—several days after Lehman's bankruptcy--the Federal Reserve continued referring to a temporary slowdown and retained its medium-term outlook of "moderate economic growth." The minutes of that Fed meeting do not mention the word "recession," and the meeting transcript indicates that Chairman Bernanke was the only person at the table who recognized the economy was already in the midst of a recession.

Unfortunately, the latest economic data underscore the risk that the economy may now be heading into another recession. Last Friday, the Federal Reserve Board reported that its index of industrial production sank further in December and was down 1.8% from a year earlier. Indeed, as shown in the accompanying chart, this pace of contraction has *only* occurred during prior recessionary periods. In some instances, the fall in industrial output was a harbinger at the onset of a recession. In other episodes, the industrial sector had been booming previously and turned downward after a recession was already underway. But since 1970 there has *never* been a case where the industrial sector shrank nearly 2 percent on a 12-month basis and the broader economy was left unscathed.



Note: The red line shows the 12-month change in the Federal Reserve Board's index of industrial production, and the orange line denotes its latest value of -1.8%. The blue line shows the annualized 3-month growth rate of nonfarm payrolls as reported by the Bureau of Labor Statistics, and the green line denotes its latest value of 2.4%. The shaded areas denote recession periods as determined by the National Bureau for Economic Research.

These developments should not be dismissed as simply reflecting ongoing structural trends or transitory factors. Indeed, the latest release of the New York Fed's Empire State Manufacturing Survey suggests that the downturn has been accelerating over recent weeks. The level of -19.8 in that survey hasn't been seen since the depths of the last recession in early 2009.

Moreover, the drop-off in economic activity has not been limited to the industrial sector. Core retail sales (that is, excluding autos, gasoline, and building materials) turned downward in December, consistent with a flatlining of broader measures of real personal consumption expenditures. And that development was not merely a one-month blip: The annualized 3-month growth rate for overall retail sales slowed from

about 3% last summer to just 1.1% during autumn. In effect, despite lower gasoline prices and unseasonably warm weather, American households have been pinching their pocketbooks very tightly.

Meanwhile, other recent data has pointed to significant contractions in core capital goods shipments and private non-residential construction, indicating that American businesses have been scaling back their spending on new equipment and structures. Consequently, it looks increasingly likely that real GDP was essentially flat during the final quarter of last year.

On a positive note, the labor market has proven remarkably resilient in recent months. The chart above shows that last quarter's annualized 3-month growth rate of 2.4% for nonfarm payrolls was very similar to its average pace during prior expansions. In effect, employment growth has been diverging recently from other measures of economic activity. Of course, that divergence may be resolved by a pickup in consumer and business spending that facilitates a continuation of robust payroll gains. However, a less rosy scenario is that businesses will soon be slashing their hiring plans or initiating involuntary layoffs, consistent with the usual pattern of declining payrolls seen in prior economic downturns.

Evidently, the prospect that the economy is now heading into a recession poses a much more significant risk than the prospect of economic overheating. These downside risks reinforce the case for Fed officials to refrain from any further monetary tightening in coming months and, instead, refocus on formulating and communicating their contingency planning for scenarios in which such risks materialize.

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