US Special

Thinking about the next US recession

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Financial Markets Research

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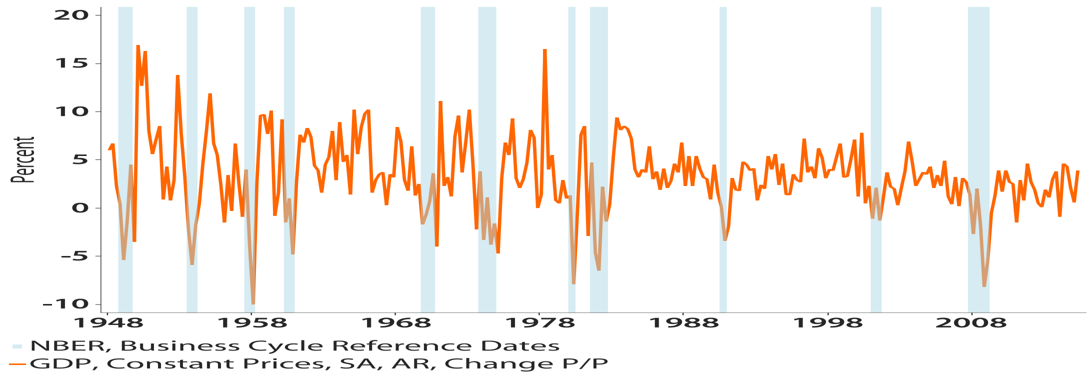
Summary

- *The US economy came out of the Great Recession in June 2009 and has seen an expansion that has lasted for 75 months (as of 2015Q3). With the average post WWII expansion lasting 58.4 months it could be argued that the next recession is long overdue.*
- *The large and domestically-oriented US economy should be strong enough to deal with external demand shocks, such as the slowdown in the Chinese and other emerging economies. Meanwhile, oil shocks may have a smaller impact now that the domestic shale oil industry has made the US less dependent on oil imports. In contrast, domestic shocks may pose a serious threat to the current expansion.*
- *First, fiscal policy remains characterized by threats of government shutdowns and defaults. While government shutdowns tend to be a modest drag on GDP growth, a stalemate on the debt ceiling might lead to a default that could spark a US sovereign debt crisis. Meanwhile, the November 2016 elections could lead to Republican control of both the White House and the Congress. If this would lead to aggressive cuts in government spending, the multiplier effects could derail the recovery.*
- *Second, monetary policy mistakes are easy to make. If the Fed hikes too early or at a pace that is too fast, the recovery could come to an end. An additional risk comes from the normalization of the Fed's balance sheet that has skyrocketed in recent years. There is also a possibility that in the process the Fed pops a bubble that was caused by its own policies.*
- *While the next US recession may still be years away, there is a substantial risk that it will happen earlier and in that case policy options may be limited.*

Introduction: recession overdue?

The US economy came out of the Great Recession in June 2009 and has seen an expansion that has lasted for 75 months (as of 2015Q3). While US GDP did contract in 2011Q1 and 2014Q1, it never did so for two quarters in a row, which would have led to a 'technical recession' in the sense that economists usually define a recession this way. Moreover, in the US recessions are 'officially' identified by the NBER, which takes into account a range of economic data, instead of a mechanical rule that only looks at GDP growth. **With the average post WWII expansion lasting 58.4 months it could be argued that the next recession is long overdue.** However, recessions do not occur because of the passing of time, but because the economy is dealing with a shock of some kind. What kind of shocks are usually seen as the causes of recessions? We can distinguish between various types of shocks[1]. The US economy could be hit from abroad by an external demand shock or an oil shock. At home, fiscal and monetary policy shocks could derail the recovery. The most severe recessions are usually associated with a financial crisis.

Figure 1: US recessions

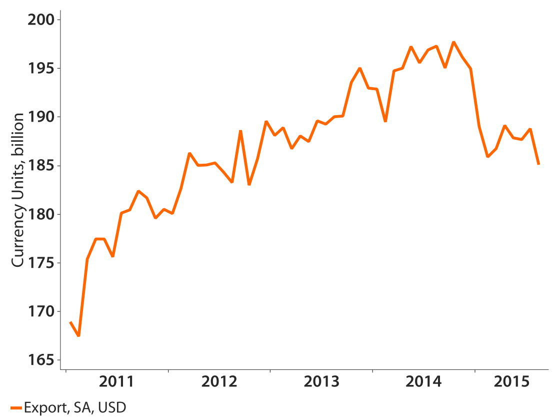


Sources: Macrobond

External demand shocks

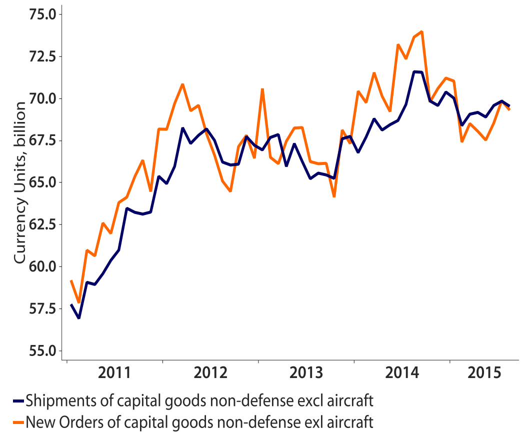
At present, the Chinese economic growth slowdown and its impact on other emerging economies appears to be slowing down the US economy. The export-oriented manufacturing industry is facing reduced demand from overseas, while it was already trying to deal with a stronger US dollar since the second half of last year. The reduced demand for commodities is also affecting the US commodities sector. The US shale oil boom had already come to an end after the steep decline in oil prices in the second half of 2014, and the recent developments are not helpful for the shale sector oil either. All'n all, the incentives to invest in the manufacturing and mining sector are under pressure again, having only recently recovered from the impact of the stronger dollar and the decline in the oil price in the second half of 2014. Nevertheless, **the large and domestically-oriented US economy should be strong enough to deal with external demand shocks, such as the slowdown in the Chinese and other emerging economies, without falling into a recession.** The US economy is less dependent on its commodities sector than some other economies, such as the Canadian for example. What's more, the large and inward-looking US economy is also less dependent on exports. While the manufacturing and mining sectors are feeling the headwinds from abroad, the services sector – where most of the jobs are created – is only feeling a small breeze and continues to thrive in a strong domestic economy. What's more, lower energy prices reduce the costs of businesses in the non-energy sectors and they boost the budget of consumers for non-energy items. In fact, none of the US recessions that have taken place since 1945 have been attributed to external demand shocks.

Figure 2: Exports



Source: Macrobond

Figure 3: Durable goods orders and shipments

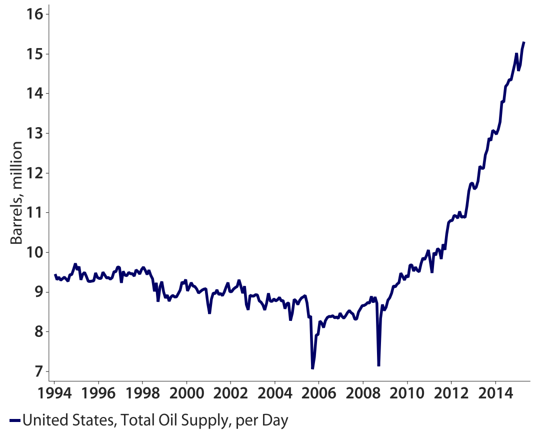


Source: Macrobond

Oil supply shocks

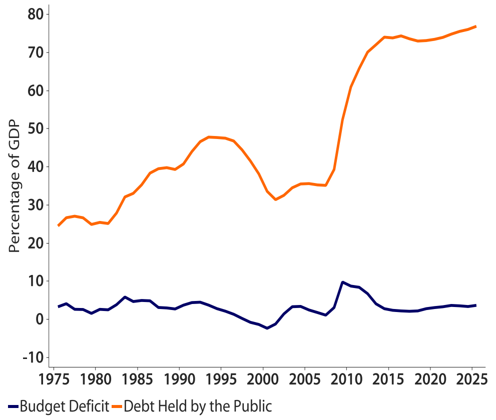
While global economic growth affects the demand for oil, pushing up oil prices if the world economy accelerates and reducing oil prices in case of a slowdown, the impact on the US economy is relatively modest. Historically, negative shocks in the supply of oil have had a more significant impact and are able to push the US economy into recession, as we saw in 1973-1975. **To a certain extent, the impact of oil supply shocks may be less of a problem now than in the past, as the domestic shale oil industry has made the US less dependent on oil imports.** It has become easier to expand supply in the short run, due to the shale oil fields that have already been developed and the improvement in technologies to find new oil fields and extract oil. What's more, since the oil crises of the 1970s the US has made efforts for consumption and production to become less oil-dependent. However, as a result of these efforts transportation is left as the main factor in US oil dependence, which has made total US demand for oil less elastic. On balance, while a major shock in the supply of oil is less likely to lead to a recession, it could still have a substantial impact on the US economy[2].

Figure 4: US oil supply



Source: Macrobond

Figure 5: Federal deficit and debt



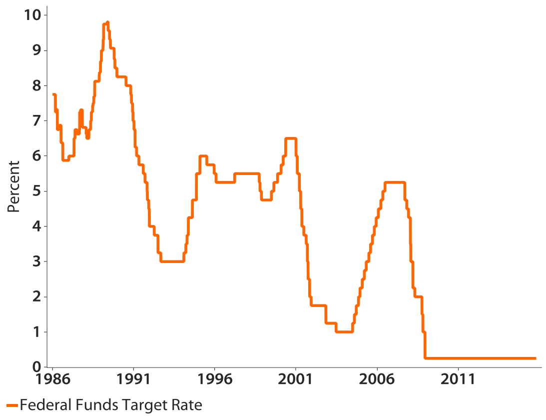
Source: Macrobond (CBO projections)

Fiscal policy shocks

US fiscal policy remains characterized by threats of government shutdowns and defaults. Since Republicans and Democrats find it difficult to agree on a formal budget, they go from one continuing resolution to another. Without a continuing resolution the federal government is not allowed to spend and has to shut down. Unfortunately, the political parties often play a game of chicken when the deadline for a continuing resolution comes in sight. If neither party blinks, the federal government has to shut down. Similar games are played near deadlines for raising the debt limit, which specifies the amount that the federal government is allowed to borrow. The latter games are the most dangerous for financial markets and the economy. **While government shutdowns tend to be a modest drag on GDP growth, a stalemate on the debt ceiling might lead to a government default that could spark a US sovereign debt crisis.** Note that a financial crisis usually makes a recession more severe. After this week's deal, the debt ceiling will become an issue again in March 2017.

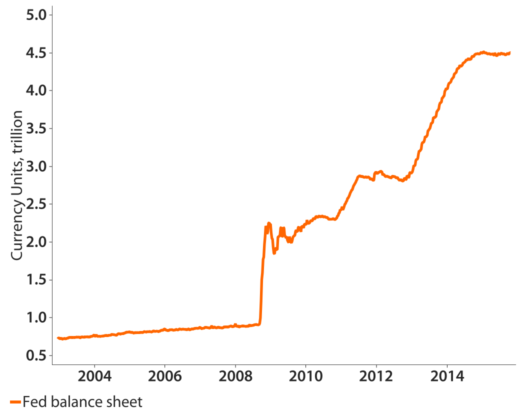
These games of chicken are possible because of 'divided government' between the White House, the Senate and the House and they reflect the wide differences between the two major political parties in the US. However, if one party were to get the upper hand in all three houses we could still face fiscal policy risks to the economic recovery. Generally speaking, the Democrats are less likely to reduce public debt and this could bring the US closer to a sovereign debt crisis, even without a stalemate on the debt ceiling. And even if they were to reduce debt, they are more likely to raise taxes to do so. This could stifle the economic recovery and in the worst case scenario cause a recession. In contrast, while Republicans are more likely to bring down public debt, which reduces the chance of a sovereign debt crisis, they are also more likely to cut government spending aggressively to achieve this. The multiplier effects from these spending cuts could derail the recovery and push the economy back into recession. If we look at the current situation, the most likely 'unified government' scenario is that the November 2016 elections lead to Republican control of both the White House and the Congress. This means that **a recession caused by government spending cuts is the most likely fiscal policy risk in case of unified government in the next couple of years**. Note that the new House Speaker, Paul Ryan, is known for his plans to make deep spending cuts. If we also get a Republican President who wants to cut spending abruptly, this scenario could unfold. The ability of fiscal policy to throw the economy into recession has been shown twice in the last 70 years. The recession of 1945 was caused by a decline in government spending after World War II had ended. A combination of fiscal tightening (after the Vietnam War) and monetary tightening caused the recession of 1969-1970.

Figure 6: Federal funds rate



Source: Macrobond

Figure 7: Fed's balance sheet

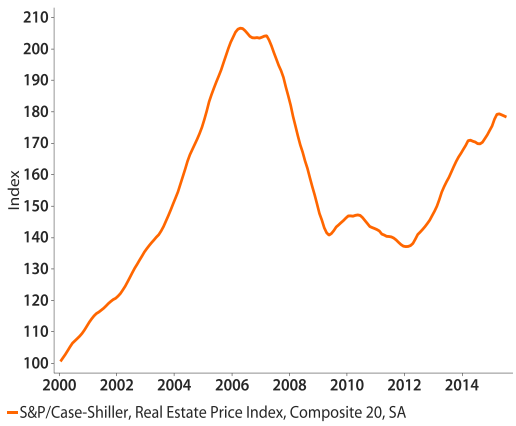


Source: Macrobond

Monetary policy shocks

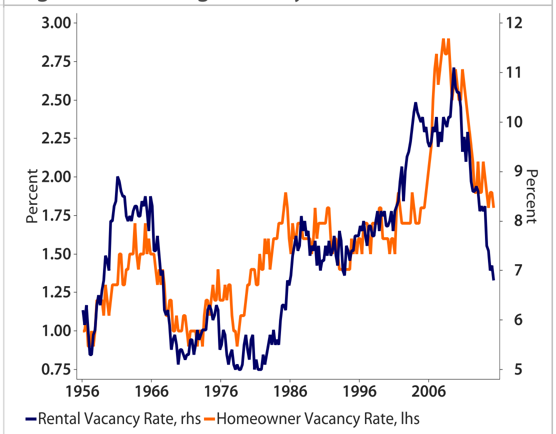
Even under normal circumstances, tightening monetary policy is a balancing act in which the central bank wants to raise rates to prevent excessive inflation without derailing the economic recovery. However, making monetary policy decisions in the current extraordinary circumstances may be an accident waiting to happen. Monetary policy is in uncharted waters with an economy that has been used to near-zero policy rates for 7 years and a central bank balance sheet that has skyrocketed. What's more, these very policies may have created bubbles that could pop during the Fed's tightening cycle. Monetary policy tightening does not only comprise of raising the policy rate anymore, but the Fed will also have to make decisions about how to bring the Fed's balance sheet back to normal levels. In fact, monetary tightening has played a role in most recessions since 1945. It was seen as the main culprit behind the recessions of 1953, 1958, 1960-1961, 1980, and 1981-1982, while it also contributed to the recessions of 1949, 1969-1970, and 1990-1991. In fact, monetary policy has by far been the most important cause of US recessions since 1945. And this was under normal circumstances, without near-zero policy rates and an excessive central balance sheet. **In the current circumstances monetary policy mistakes are even easier to make**. If the Fed hikes too early or at a pace that is too fast, the recovery could come to an end. There is also a possibility that in the process the Fed pops a bubble that was caused by its own policies. If this were to lead to a financial crisis, it would make the recession more severe.

Figure 8: House prices



Source: Macrobond

Figure 9: Housing vacancy rates

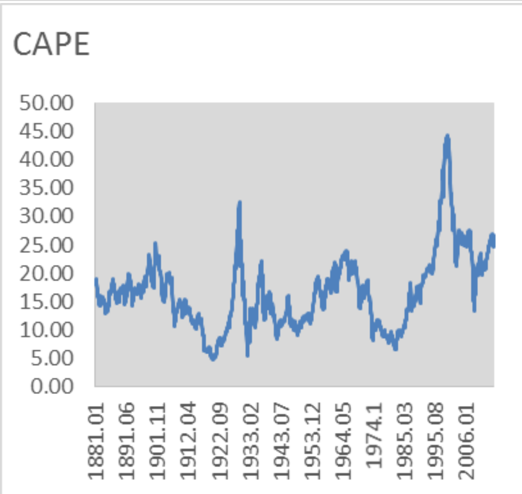


Source: Macrobond

Bubbles that could be popped

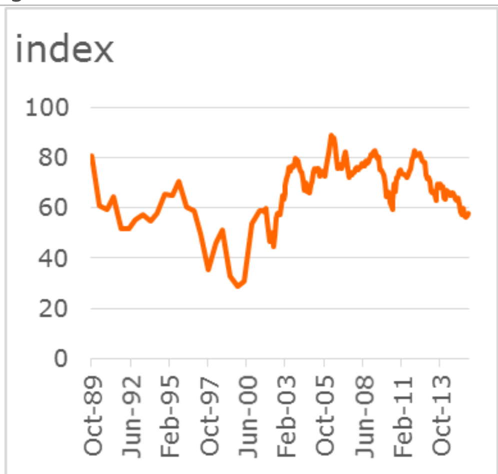
Years of extremely loose monetary policy may have led to the formation of bubbles in asset markets. For the US economy to fall into recession, bubbles in domestic markets are the most relevant. Two asset markets that play an important role in the economy are the housing market and the stock market. A large decline in house prices or stock prices will cut deep into the wealth of consumers, damage their confidence and undermine their spending. The housing market played a crucial role in the Great Recession and should therefore be monitored closely for any signs of renewed excess supply. House prices have recovered but are still well below their 2006 peak. More importantly, vacancy rates are still falling, which does not seem to suggest any kind of bubble formation in the housing market. Let's turn to the stock market. The dotcom bubble that started in the late 1990s is often seen as one of the causes of the recession of 2001. With extremely low interest rates and quantitative easing aimed at boosting risky assets, it seems obvious to look at the stock market for bubble formation. In fact, the stock market may be closer to the bubble phase than the housing market. Recently, Robert Shiller updated his CAPE and it stood at 24.78 in October, well above the long term average of 16.64. In combination with a decline in the confidence of institutional investors in the valuation of the stock market, according to a Yale School of Management survey, Shiller warned that the US stock market looks 'a bit like a bubble again.' Of course, bubbles could also have emerged in other markets, at home or abroad. However, the domestic housing and stock markets are likely to have the most severe impact on the US economy.

Figure 10: Cyclically-adjusted price-earnings ratio



Source: Robert Shiller (2015)

Figure 11: Stock Market Valuation Confidence



Source: Yale School of Management (2015)

Conclusion

While external demand shocks and oil shocks could cause substantial headwinds for the US economy, a recession would most likely be caused by domestic policy mistakes or bubbles. Fiscal policy errors could lie in abrupt cuts in government spending or a game of chicken on the debt ceiling that goes wrong and lead to a government default or a sovereign debt crisis. The normalization of monetary policy from extremely low policy rates and excessive central bank balances could also pose a threat to the economic recovery if the Fed moves too fast, in particular if a bubble gets popped along the way. What happens if the US falls back into a recession? With policy rates at extremely low levels, a substantial rate cut to boost the economy is not possible. Only if the recession occurs at a progressed stage of the hiking cycle will the Fed be able to make significant rate cuts. If the next recession happens at an early stage, the Fed will have to resort to QE4. With only limited options for monetary policy, the need for fiscal policy measures will rise, although it may be difficult to get anything through Congress. While the next US recession may still be years away, there is a substantial risk that it will happen earlier and in that case policy options may be limited.

Endnotes

1) *From recession to recovery: How soon and how strong*, Prakash Kannan, Alasdair Scott, Marco E. Terrones, IMF World Economic Outlook, April 2009, Chapter 3.

2) *The outlook for US oil dependence*, David L. Greene, Donald W. Jones, Paul N. Leiby, Energy Policy, Vol. 26, No. 1, pp. 55-69, 1998.

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