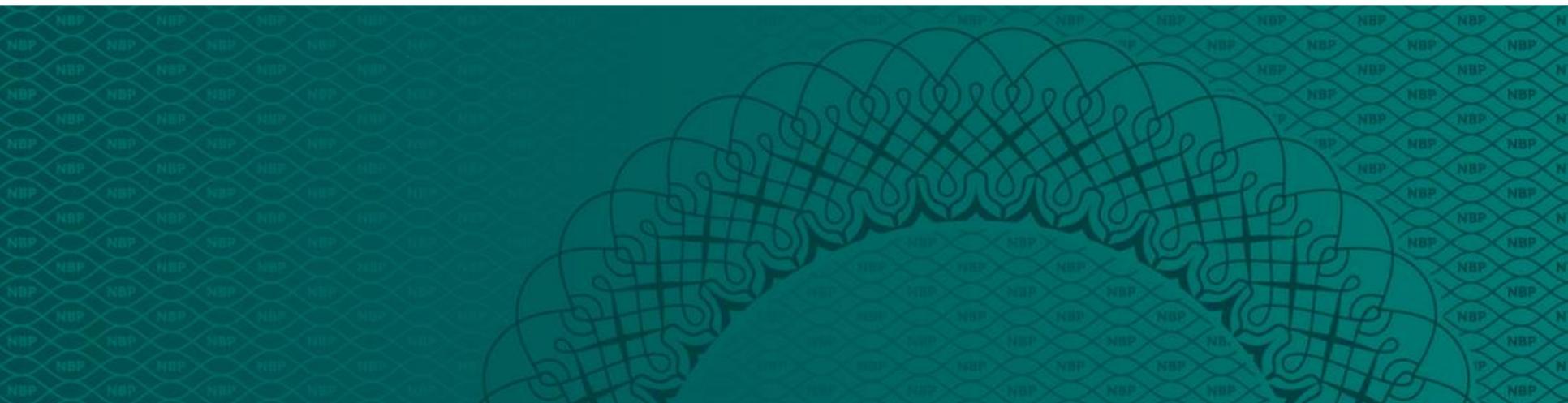


**NBP**

Narodowy Bank Polski

Paweł Skrzypczyński, Economic Advisor

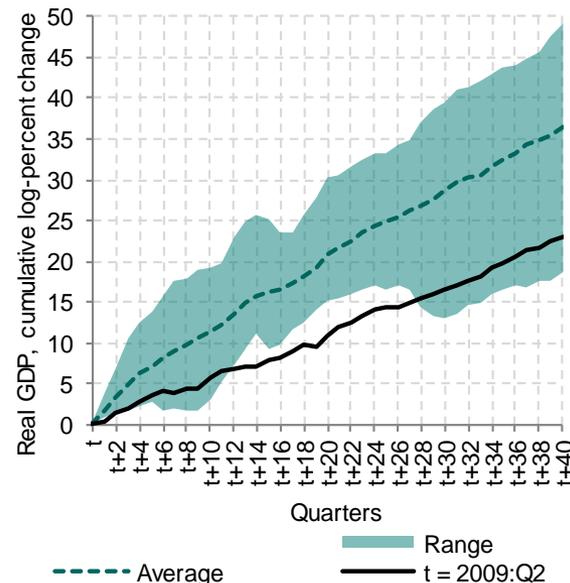
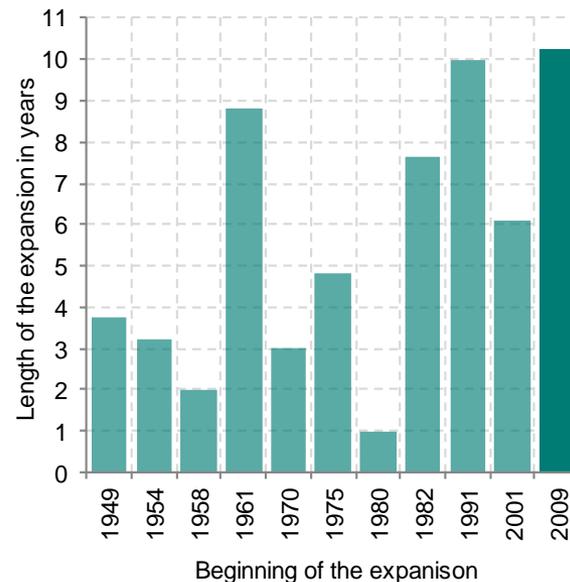
## Comments on U.S. recession probability



*„The opinions expressed herein are those of the author  
and do not represent the official view of the Narodowy Bank Polski.”*

# The longest post-war U.S. economic expansion

- The current economic expansion, at 123 months as of September 2019, became the longest on record in July 2019.
- A key reason the current recovery has been so long is that housing didn't contribute to economic activity for the first few years of the expansion.
- At the same time the current expansion has also been one of the slowest on record, among others due to sluggish housing recovery.
- Expansions don't die of old age... but as recently shown by Beaudry & Portier (2019) certain types of macroeconomic vulnerabilities may accumulate as the expansion ages causing the arrival of a recession to become more likely.

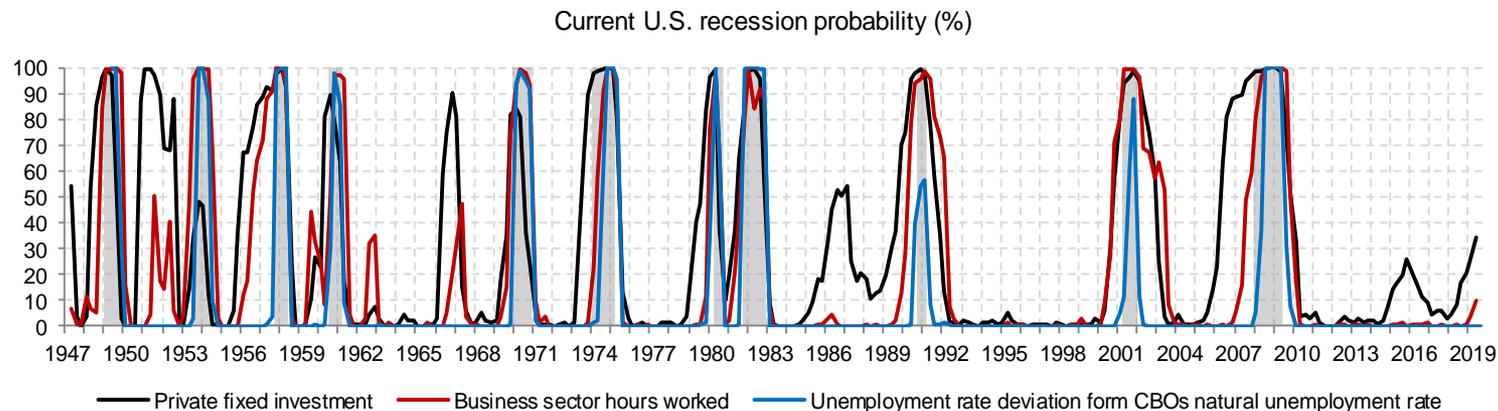


## Recent economic developments in the U.S.

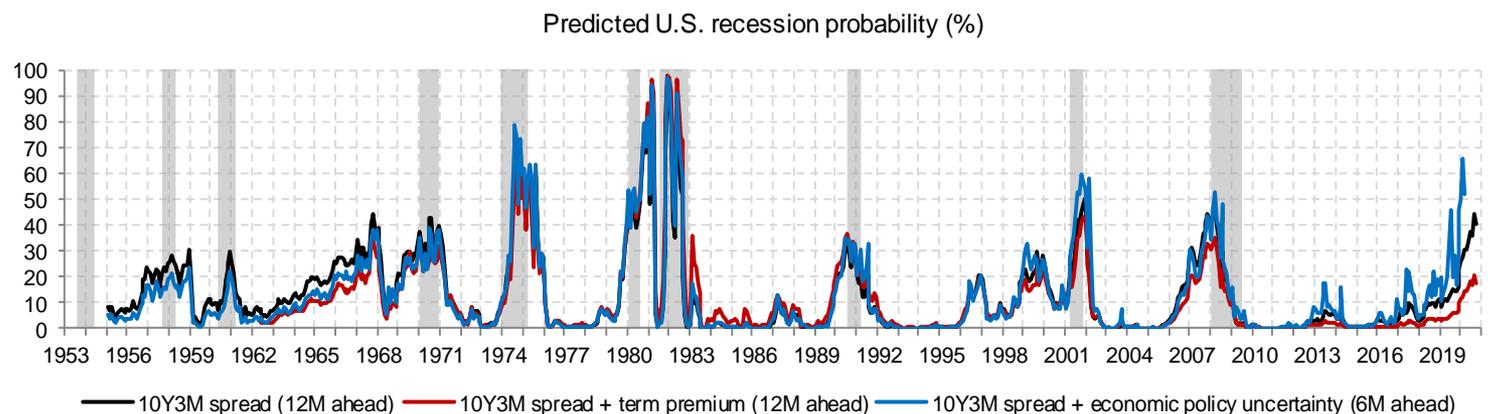
- In light of elevated trade policy uncertainty combined with softening overseas demand businesses have grown more cautious in terms of their capital expenditures. Among others these factors pushed the manufacturing sector into a downturn.
- Labour market remains tight with the unemployment rate visibly below natural level.
- With wages rising solidly and household balance sheets strong, the consumer spending is maintaining its momentum, despite rising tariffs on imported goods, providing some cushion from softening growth overseas.
- Significant drop of long-term bond yields is becoming a tailwind for housing activity.
- At the same time speculation about a possible recession is still on the agenda despite monetary policy easing delivered by the FOMC so far.
- Some economic data signals that the recession odds are on the rise.

# Current and predicted recession probabilities

- Probabilities of the U.S. economy being currently in a recession remain low mainly due to favourable labour market conditions, while those pointing to a recession in one year are elevated due to low term spread and heightened economic policy uncertainty.



Note: Probabilities estimated by Markov switching regressions in mean with dependent variables transformed to quarter-over-quarter growth rates (quarter-over-quarter changes in case of the unemployment rate deviation from CBO's natural unemployment rate).



Notes: Probabilities estimated by probit regressions with dependent 0-1 variable representing NBER dating of the U.S. business cycle. Out-of-sample forecasts refer to period October, 2019 – September, 2020.

# Forecasters ignore signals of rising recession odds at their own peril

- The track record in forecasting business cycle turning points by economists is poor as among others they do not want to take the cost of making a false call on a recession.
- At the same time forecasters appear to have generally placed too little weight on the term spread when projecting declines in the aggregate economy, however they have proved to be quite successful in identifying a recession at the time the economy has just entered one.
- Rudebusch & Williams (2008) showed that in case of the U.S. economy professional forecasters appear worse at predicting recessions a few quarters ahead than a simple real-time forecasting model that is based on the term spread.
- If this puzzle holds, this time will not be different and forecasters will again find the term spread as a hard to beat benchmark in predicting the peak of economic activity in the current expansion.
- Although this time around we are witnessing rising recession probabilities again, as implied by some economic data and especially the term spread, it would be premature to assume the recession is imminent.

# What does it mean for the U.S. economy?

- One-year-ahead U.S. recession probabilities implied by term spread models remain elevated despite interest rate cuts delivered by FOMC since July 2019.
- Downside risks to the U.S. economy persist and as the economy is slowing to trend, these risks leave it vulnerable to falling below it.
- Under these developments a monetary policy error may become a potential outcome at some point, especially if the FOMC doesn't warrant market participants the confidence they need on time.
- To enhance the odds of avoiding a recession, it seems reasonable for the FOMC to continue communicating readiness to act decisively if economic and financial conditions worsen abruptly, regardless of the origin of the shock leading to it.
- FOMC rhetoric implies we are witnessing a mid-cycle adjustment phase of monetary policy – i.e. at this stage the Fed is trying to engineer a soft landing for the U.S. economy.
- A broad view on economic data available up to date, beyond the yield curve itself, is indeed pointing to a soft landing scenario.

# What does it mean for EMEs?

- FOMC easing delivered so far seems to have reduced the downward pressure on some EMEs currencies.
- At the same time capital flows, equity markets and to some extent bond yields in some EMEs have also benefited from the change in U.S. monetary policy stance.
- The magnitude of U.S. growth slowdown and in general advanced economies growth slowdown seems to be crucial at this stage of the global business cycle.
- A more severe slowdown of the U.S. economy than the one anticipated will have a larger impact on EMEs in general, especially should the magnitude of the potential disruption be amplified by the collapse of risk appetite, which would be typical in a recessionary scenario.
- At the same time many EMEs have improved their fiscal and monetary policy frameworks since the GFC, being better insulated from external financial shocks as argued among others by Obstfeld et al. (2017).

# References

- Beaudry, P., Portier, F., 2019, Duration dependence in US expansions: A re-examination of the evidence, *Economics Letters*, Volume 183, October 2019, 108523.
- Obstfeld, M., Ostry, J. D., Qureshi, M. S., 2017, A Tie That Binds: Revisiting the Trilemma in Emerging Market Economies, Working Paper WP/17/130, International Monetary Fund.
- Rudebusch, G. D., Williams, J. C., 2008, Forecasting Recessions: The Puzzle of the Enduring Power of the Yield Curve, Working Paper 2007-16, Federal Reserve Bank of San Francisco.

*We protect the value of money*