Economic Scene | Leonard Silk

The Case Offered By the Optimists

THE Government's report that the American economy expanded at an annual rate of 1.8 percent in the third quarter startled economists who have been saying a recession has already started or soon will.

Many doubting economists said the official numbers must be wrong, because the Commerce Department had underestimated the rate of inflation and therefore overestimated the rate of real economic growth. They rejected the data, saying, "Wait for the next revision!"

But is it possible that the third-quarter G.N.P. data are telling a correct story and that the economy is stronger than most economists, business people and consumers believe?

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Not all economists found the new numbers incredible. One who was not at all surprised was Gail Fosler, chief economist of the Conference Board, who predicted a month ago that third-quarter G.N.P. would rise at a rate of 1.8 percent, precisely as the Commerce Department says it did. She also forecast that real G.N.P. would slow to a 1.1 percent annual rate in the fourth quarter but would increase by 1.6 percent in 1991 and 2.5 percent in 1992. These days when a wave of pessimism is sweeping the country, Ms. Fosler is being called the most optimistic of forecasters.

Nevertheless, she regards what she calls the "recession discounting" by business as a source of economic stability. Many businesses, she said, "are already operating as though they were in a recession, holding down operating rates and employment levels, slowing investment plans, cutting costs to raise margins and profitability." As a result, order backlogs are stable and delivery times are lengthening.

She sees little danger of a huge lurch toward inventory-cutting, which is the usual trigger of a recession. For, despite the gloomy mood of consumers, as measured by surveys, consumer spending has been holding up. The Commerce report showed consumer spending, corrected for inflation, rising at an annual rate of 3.6 percent in the third quarter, as consumers cut their savings rate.

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Ms. Fosler is by no means the last of the optimists. Some economists who focus on financial assets, especially the spread between interest rates on short-term and long-term assets — the yield curve — see no recession ahead.

Campbell R. Harvey of the Fuqua School of Business at Duke University is holding to his forecast that the economy will grow 2.2 percent between the third quarter of 1990 and the third quarter of 1991. Well aware of all the bearish talk in business circles, he says, "talk is one thing and action is another."

And he maintains that financial indicators reflect business actions affecting turning points in the business cycle far more accurately than surveys of expectations. Over the last 25 years, a flattening or inversion of the yield curve has correctly called all the major turning points in the United States business cycle but that is not what is happening now.

Using data similar to Professor Harvey's, the Experimental Index of Leading Indicators, developed by James Stock and Mark Watson for the National Bureau of Economic Research, is forecasting strong economic growth of nearly 4 percent in the next several months, with only a minuscule probability of 3 percent that the economy will be in recession by next February.

The Stock-Watson index derives its prediction of such strong growth mainly from the spread between interest rates on 10-year and one-year Treasury securities and between six-month commercial paper and six-month Treasury bills.

Despite the historic correlation between these financial indicators and business-cycle turning points, could they be misleading now? George R. Perry of the Brookings Institution says they could. He suggests that the long-short spread might be giving off a false signal now because the Federal Reserve, to avoid the risk of causing a recession, is not raising short-term interest rates to check inflation. And he contends that long-term interest rates may be kept relatively high by such special factors as heavy long-term borrowing for the savings and loan bailout and the retreat of some Japanese investors from the American bond market.

He finds the lack of a recession signal coming from the private-Treasury spread baffling, and suggests that the data used in the Stock-Watson index do not reflect the downgraded credit ratings of well-known companies or the yield spread between "junk bonds" and Treasuries, which he says is soaring.

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But Professor Harvey denies that such data are now signaling a recession. Using the spread of interest rates between Baa and AAA bonds, as rated by Moody's, he notes that the spread between low-quality and high-quality bonds rose to 262 basis points in 1982 before the recession, and above 300 basis points before earlier recessions, but has been rather stable since, oscillating gently between 121 in October 1983 and 126 in October 1990, with only a small uptrend in recent months.

Recession could still happen if the current extremely pessimistic psychology should translate into a self-fulfilling prophecy by causing consumer spending and business investment to plummet, or if war in the Persian Gulf should send oil prices soaring. But the Fosler, Harvey and Stock-Watson analyses offer hope that recession can still be avoided.