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Recession is here - economists

A weak report about the services sector has caused some experts to declare that the economy has already entered downturn.

By Chris Isidore, CNNMoney.com senior writer
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NEW YORK (CNNMoney.com) -- A growing number of top economists believe that the U.S. economy has now toppled into recession.

Alarm bells were set off Tuesday by a grim report on service businesses, which make up the majority of the U.S. economy.

The Institute of Supply Management said that activity in the service sector declined for the first time in nearly five years. This report also indicated that employers are cutting staff.

The survey covers the retail, transportation and health care industries as well as hard hit areas such as finance, real estate and construction.

Some economists argued that the normally low-profile ISM services reading, coupled with the government's report Friday showing the first monthly net loss in jobs in more than four years, is proof that recession is now a reality.

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"My forecast had been that the recession would begin this quarter, but the hard data wasn't there yet," said Keith Hembre, chief economist of First American Funds. "But now we're seeing that. The service sector is a much larger component of the economy [than manufacturing] and this is very much a recession reading."

The National Bureau of Economic Research is the official arbiter of whether the economy has entered recession. But the NBER typically does not declare a recession until well after one has begun.

Weakness spreading

Economists took the latest report as a sign that problems are no longer restricted to just housing and manufacturing.

"We're definitely seeing conditions spread to more parts of the economy. The big drop in business activity, that's a huge red flag," said Gus Faucher, director of macroeconomics for Moody's Economy.com.

Faucher said his firm now believes the economy is in a recession but he believes it's possible that growth will resume in the second half of this year.

However, Faucher noted this will depend upon additional rate cuts from the Federal Reserve, coupled with Congress quickly passing a proposed $150 billion stimulus package. That package includes $600 tax rebates for most U.S. taxpayers and some temporary tax cuts for businesses.

Economist Bob Brusca of FAO Economics said he doubted that the U.S. was in recession a week ago, but now he believes there's about a 75% chance that a recession began in January.

"That's what recessions do. They come upon you all of a sudden," he said. "When you look back at history, you're struck by how even-keel it is until the bottom just falls out."

What's next for the Fed

Besides the ISM and jobs report, Brusca said he was concerned about the results of the Federal Reserve's survey of senior lending officers released Monday. The survey showed a tightening of lending standards for business and residential loans in the past three months.

According to a statement from the Fed, lenders are reporting a "reduced tolerance for risk" as the reason why they are being more cautious.

And even for the relatively safe "prime" residential loans made to borrowers with good credit, 55% of lenders surveyed by the Fed reported tighter lending standards.

Brusca said this is a major concern for the central bank. "The Fed has been leaning on banks to not tighten so much," he said.

Worries about banks tightening their lending standards is one reason why the Fed announced two large rate cuts in just the course of eight days in late January, reducing the key federal funds rate from 4.25% to 3%.

Most economists aren't looking for additional cuts of that magnitude, but they do expect more cuts.

Even Federal Reserve Bank of Richmond President Jeffrey Lacker, who is known primarily for being more concerned about inflation than economic growth, said in a speech Tuesday that "the prominence of downside risks means that further easing ultimately may be warranted." Lacker does not get to vote on monetary policy decisions this year, however.

Lacker added that "sluggish growth in the near term" -- not an actual recession -- is the most likely economic scenario. But he did not completely rule out the possibility of a "mild recession, similar to the last two we have experienced."

Moody's Economy.com is forecasting cuts totaling three-quarters of a percentage point over the next three scheduled Fed meetings in March, April and May.

But the markets want more drastic action by the Fed. The Chicago Board of Trade's fed fund futures are pricing in a 30% chance of a quarter-point cut this month, when the Fed isn't even scheduled to meet.

Those futures are also pricing in a 100% chance of a quarter-point cut in March, and a 28% chance of a half-point cut during the month, up from virtually no chance of a half-point cut ahead of Tuesday's ISM report. ■

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