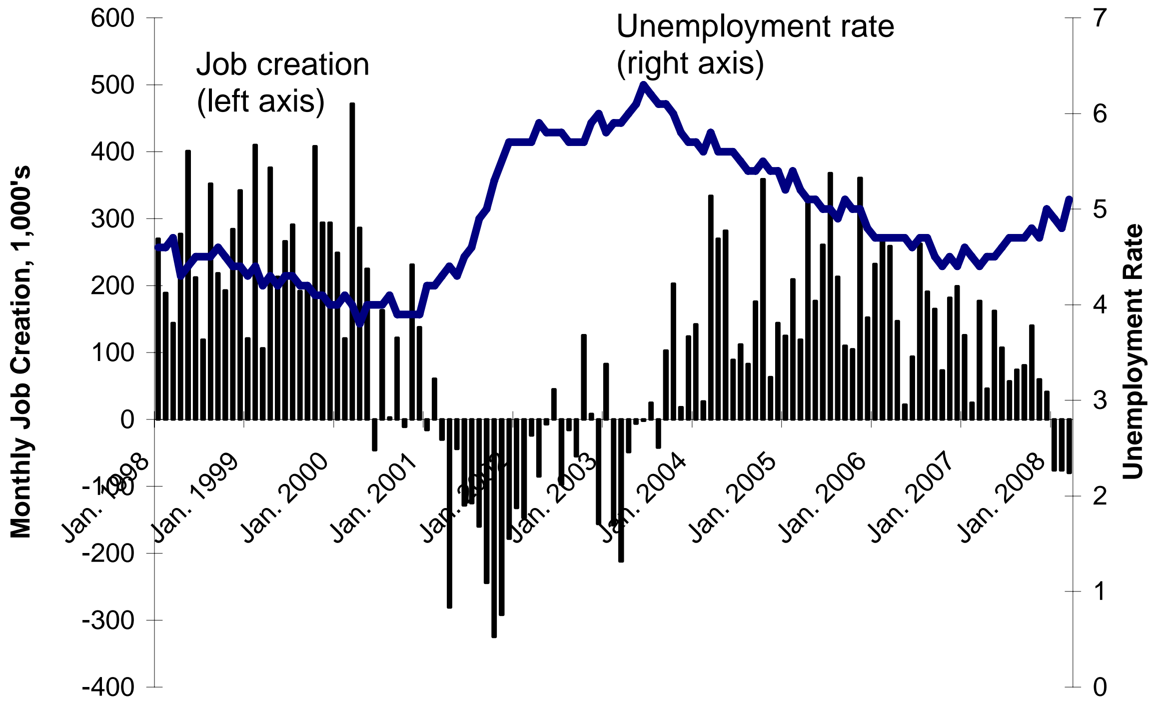
The Department of Economics welcomes students, faculty, and staff to:

Current Issues in Economics: Looming Recession?

Tuesday, April 15
4:30- 6:00
Farrell Room, St. Edmund's Hall

With a meltdown in the market for subprime mortgages, rising interest rates, and stock market declines, many economists are predicting a recession in the U.S. this year. Recent declines in job creation support this view, while rising prices suggest the return of 1970's–style stagflation. Is a recession in the U.S. likely, and how would a recession impact jobs, wages, and inflation? Or can the Federal Reserve act now to forestall a downturn?

Economics professors John Carvellas and Reza Ramazani will discuss these issues, and take questions from students, faculty, and staff.


Monthly Net Job Creation and Unemployment Rate, 1998-2008
Job creation
(left axis)
Unemployment rate
(right axis)
Monthly Job Creation, 1,000's
Unemployment Rate
600
500
400
300
200
100
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-100
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7
6
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Jan. 1998
Jan. 1999
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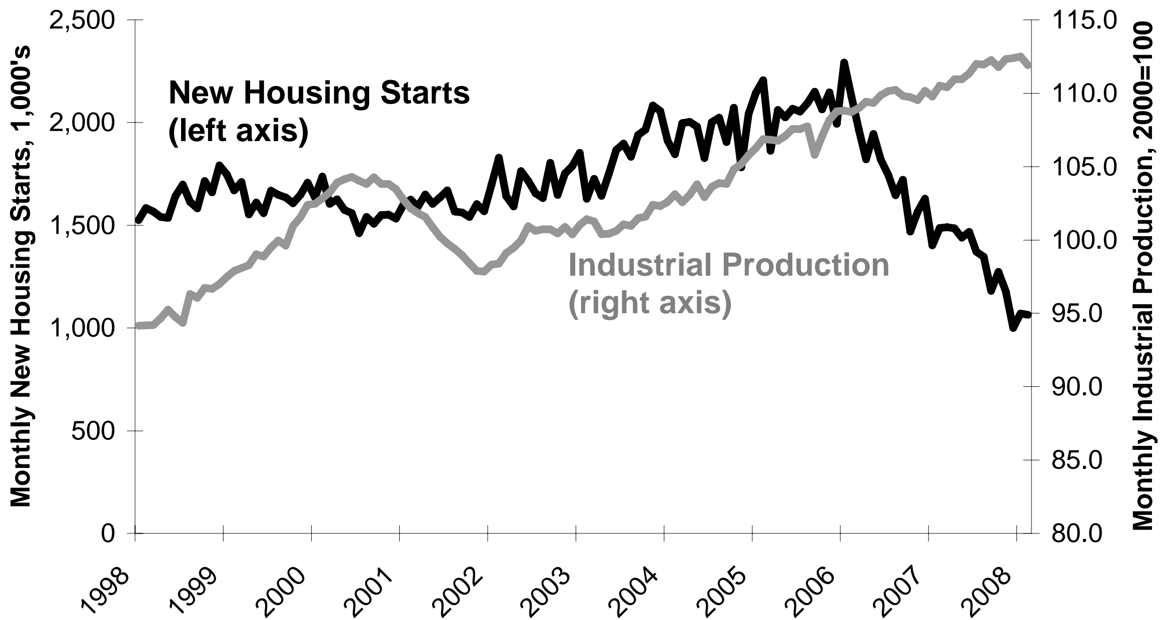
Monhtly Industrial Production and New Housing Starts, 1998-2008
New Housing Starts
(left axis)
Industrial Production
(right axis)
Monthly New Housing Starts, 1,000's
Monthly Industrial Production, 2000=100
2,500
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1,500
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500
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110.0
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95.0
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2006
2007
2008

Wake up to the dangers of a deepening crisis

By Lawrence Summers

Financial Times, November 25 2007

Three months ago it was reasonable to expect that the subprime credit crisis would be a financially significant event but not one that would threaten the overall pattern of economic growth. This is still a possible outcome but no longer the preponderant probability.

Even if necessary changes in policy are implemented, the odds now favour a US recession that slows growth significantly on a global basis. Without stronger policy responses than have been observed to date, moreover, there is the risk that the adverse impacts will be felt for the rest of this decade and beyond.

Several streams of data indicate how much more serious the situation is than was clear a few months ago. First, forward-looking indicators suggest that the housing sector may be in free-fall from what felt like the basement levels of a few months ago. Single family home construction may be down over the next year by as much as half from previous peak levels. There are forecasts implied by at least one property derivatives market indicating that nationwide house prices could fall from their previous peaks by as much as 25 per cent over the next several years.

We do not have comparable experiences on which to base predictions about what this will mean for the overall economy, but it is hard to believe declines of anything like this magnitude will not lead to a dramatic slowing in the consumer spending that has driven the economy in recent years.

Second, it is now clear that only a small part of the financial distress that must be worked through has yet been faced. On even the most optimistic estimates, the rate of foreclosure will more than double over the next year as rates reset on subprime mortgages and home values fall. Estimates vary, but there is nearly universal agreement that – if all assets were marked to market valuations – total losses in the American financial sector would be several times the $50bn or so in write-downs that have already been announced by big financial institutions. These figures take no account of the likelihood that losses will spread to the credit card, auto and commercial property sectors. Nor do they recognise the large volume of financial instruments that depend for their high ratings on guarantees provided by credit insurers whose own health is now very much in doubt.

Third, the capacity of the financial system to provide credit in support of new investment on the scale necessary to maintain economic expansion is in increasing doubt. The extent of the flight to quality and its expected persistence was powerfully demonstrated last week when the yield on the two-year Treasury bond dropped below 3 per cent for the first time in years. Banks and other financial intermediaries will inevitably curtail new lending as they are hit by a perfect storm of declining capital due to mark-to-market losses, involuntary balance sheet expansion as various backstop facilities are called, and greatly reduced confidence in the creditworthiness of traditional borrowers as the economy turns downwards and asset prices fall.

Then there are the potentially adverse effects on confidence of a sharply falling dollar, rising energy costs, geopolitical uncertainties especially in the Middle East, or lower global growth as economic slowdown and a falling dollar cause the US no longer to fulfil its traditional role of importer of last resort.

In such an environment, economic policy needs to be governed by the clear and public recognition that restoring the normal functioning of the financial system and containing any damage its breakdown may do the real economy is the central macro-economic and financial challenge facing the US. In the US today, as in many other countries in the past, confidence will return the first day an official statement about the economy proves to have been too pessimistic.

What concrete steps are necessary? First, maintaining demand must be the over-arching macro-economic priority. That means the Fed has to get ahead of the curve and recognise – as the market already has – that levels of the Fed Funds rate that were neutral when the financial system was working normally are quite contractionary today. As important as long-run deficit reduction is, fiscal policy needs to be on stand-by to provide immediate temporary stimulus through spending or tax benefits for low- and middle-income families if the situation worsens.

Second, policymakers need to articulate a clear strategy addressing the various pressures leading to contractions in credit. Very likely this will involve measures that are non-traditional, given how much of the problem lies outside bank balance sheets. The time for worrying about imprudent lending is past. The priority now has to be maintaining the flow of credit. The current main policy thrust – the so-called "super conduit", in which banks co-operate to take on the assets of troubled investment vehicles – has never been publicly explained in any detail by the US Treasury. On the information available, the "super conduit" has worrying similarities with Japanese banking practices of the 1990s that aroused criticism from American authorities for their lack of transparency, suppression of genuine market pricing of bad credits, and inhibiting effect on new lending. Perhaps there is a strong case for it, but that case has yet to be made.

Third, there needs to be a comprehensive approach taken to maintaining demand in the housing market to the maximum extent possible. The government operating through the Federal Housing Administration, through Fannie Mae and Freddie Mac, or through some kind of direct lending, needs to assure that there is a continuing flow of reasonably priced loans to credit worthy home purchasers. At the same time there need to be templates established for the restructuring of mortgages to homeowners who cannot afford their resets, so every case does not have to be managed individually.

All of this may not be enough to avert a recession. But it is much more than is under way right now.

The writer is the Charles W. Eliot professor at Harvard University

Hold the Hysteria

By Robert Samuelson

Washington Post, March 26, 2008

WASHINGTON -- Regarding the economy, it's hard not to notice this stark contrast: The "real economy" of spending, production and jobs -- though weakening -- is hardly in a state of collapse; but much of today's semi-hysterical commentary suggests that it is. Financial markets for stocks and bonds are described as being "in turmoil." People talk about a recession as if it were the second coming of Genghis Khan. Some whisper the dreaded word "depression." Meanwhile, Americans are expected to buy about 15 million vehicles in 2008; though down from 16.5 million in 2006, that's still a lot.

There's a disconnect between what people see around them and what they're told is happening. The first is upsetting (rising gas prices, falling home prices, fewer jobs) but reflects the normal reverses of a $14 trillion economy. The second ("panic," "financial meltdown") suggests the onset of something catastrophic and totally outside the experience of ordinary people. The economy, said The New York Times last week, may be on "the brink of the worst recession in a generation" -- an ominous warning.

Perhaps, but so far the concrete evidence is scant. A recession is a noticeable period of declining output. Since World War II, there have been 10. On average, they've lasted 10 months, involved a peak monthly unemployment rate of 7.6 percent and resulted in a decline of economic output (gross domestic product) of 1.8 percent, reports Mark Zandi of Moody's Economy.com. If the two worst recessions (those of 1981-82 and 1973-75, with peak unemployment of 10.8 percent and 9 percent) are excluded, the average peak jobless rate is about 7 percent.

No one doubts that the economy has slowed. Many economists think a recession has already started. Zandi is one. He forecasts peak unemployment of 6.1 percent (present unemployment: 4.8 percent) and a GDP drop of 0.4 percent. If that comes true, the recession of 2008 would actually be milder than the average postwar recession and milder than the last two, those of 1990-91 and 2001.

Broadly speaking, the story is similar for stocks. So far, their weakness is unexceptional. A standard definition of a "bear market" is a drop of 20 percent or more. Last week, the market was at times close to that. Declines would have to get much worse to qualify as momentous. Since 1936, there have been 11 bear markets as measured by the Standard & Poor's index of 500 stocks, says Howard Silverblatt of S&P. On average, they've lasted 20 months and involved a decline of 34 percent. One was 60 percent (1937-42) and two were nearly 50 percent (1973-74 and 2000-02, the last being the "tech bubble").

Some causes of the present hysteria are familiar: media hype; political finger-pointing -- always given to exaggeration; and whining from Wall Street types. But there's also another large cause:

disagreement over whether the economy is highly unstable or whether business cycles are mostly self-correcting.

"This argument is as old as economics," says economic historian Barry Eichengreen of the University of California, Berkeley. "There is no more consensus (now) ... than there was 70 years ago." Those who think the economy is highly unstable talk now of an alarming "negative feedback loop" -- a "vicious circle" to most people. Housing prices fall, creating more foreclosures; losses on mortgages increase, eroding the capital of banks and causing them to curtail lending -- which weakens the economy, depresses housing prices and causes more foreclosures and losses. Just as in the Depression, a crippled financial system spreads the slump. Only forceful government intervention can break the downward spiral.

Not necessarily, if most markets self-correct. As housing prices fall, more buyers come into the market; sales and construction revive. If inventories get too high, production slows and surpluses are sold; then production accelerates. If consumers or businesses are overindebted, they reduce spending to repay loans; spending speeds up when debt burdens drop. Government can help smooth business cycles and prevent financial panics. But if it's too aggressive, it may make matters worse. That occurred in the 1970s when easy credit created double-digit inflation -- and then required harsh recessions to suppress it.

Hardly anyone adheres rigidly to either view but many favor one or the other. That explains why today's situation seems so threatening to some and less so to others.

The Great Depression doesn't settle the issue. True, massive bank failures converted an ordinary recession into a calamity; but it's also true that government policy -- excessive rigidity by the Federal Reserve -- actually aggravated the banking collapse. Still, economic conditions in the 1930s (average unemployment: 18 percent) were so different from today's that casual references to "depression" amount to fear-mongering. If catastrophe strikes, it will probably result from something we don't now know or we haven't yet imagined.