The Ongoing Recession: How Long and How Deep?

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No Debate About Recession

- (1) So Why Hasn't the Recession been "Officially Declared?"
  - Let's ask someone on the NBER BCDC
- (2) Background: Distinguish between Wall Street and Main Street
  - Wall Street Meltdown: Fingers of Blame
  - Main Street: Producing GDP and Earning Income

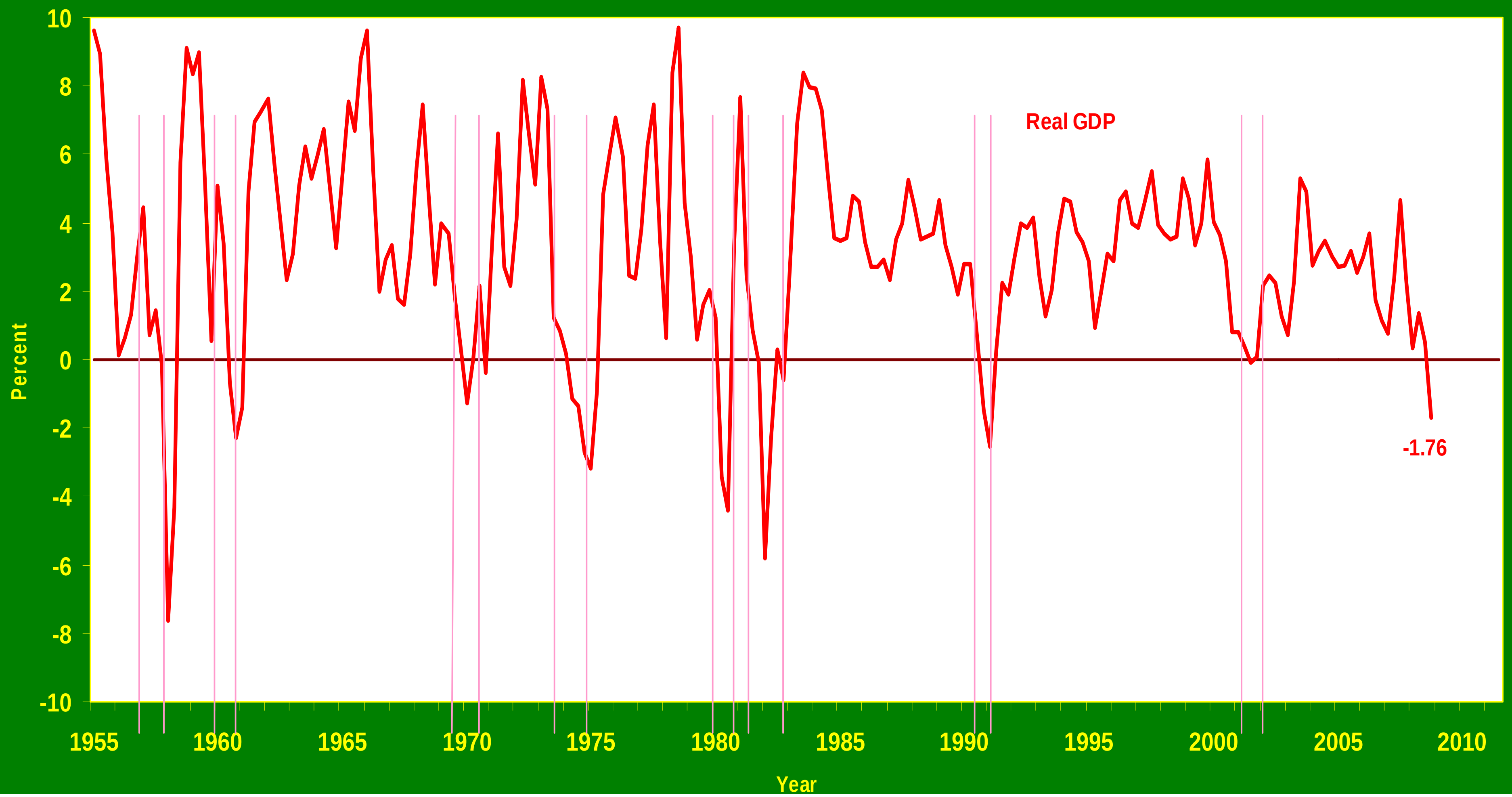
Common Features to All Graphs

- Vertical bars indicate previous recessions
- All changes are over six months for monthly data or two quarters for quarterly data
- All data are the latest releases
- Latest numerical observation is listed on each chart

First Chart: Real GDP, Two-Quarter Change Since 1955

- Includes 2008:Q3 and Q4
- Focus on
  - The “Great Moderation” Starting in 1984
    - Recessions Less Frequent
    - Recessions Less Severe
- Where will this recession rank?
- Already clear: worse than 1990-91, would be a stretch for it to be as bad as 1981-82 when unemployment peaked at 10.5 %

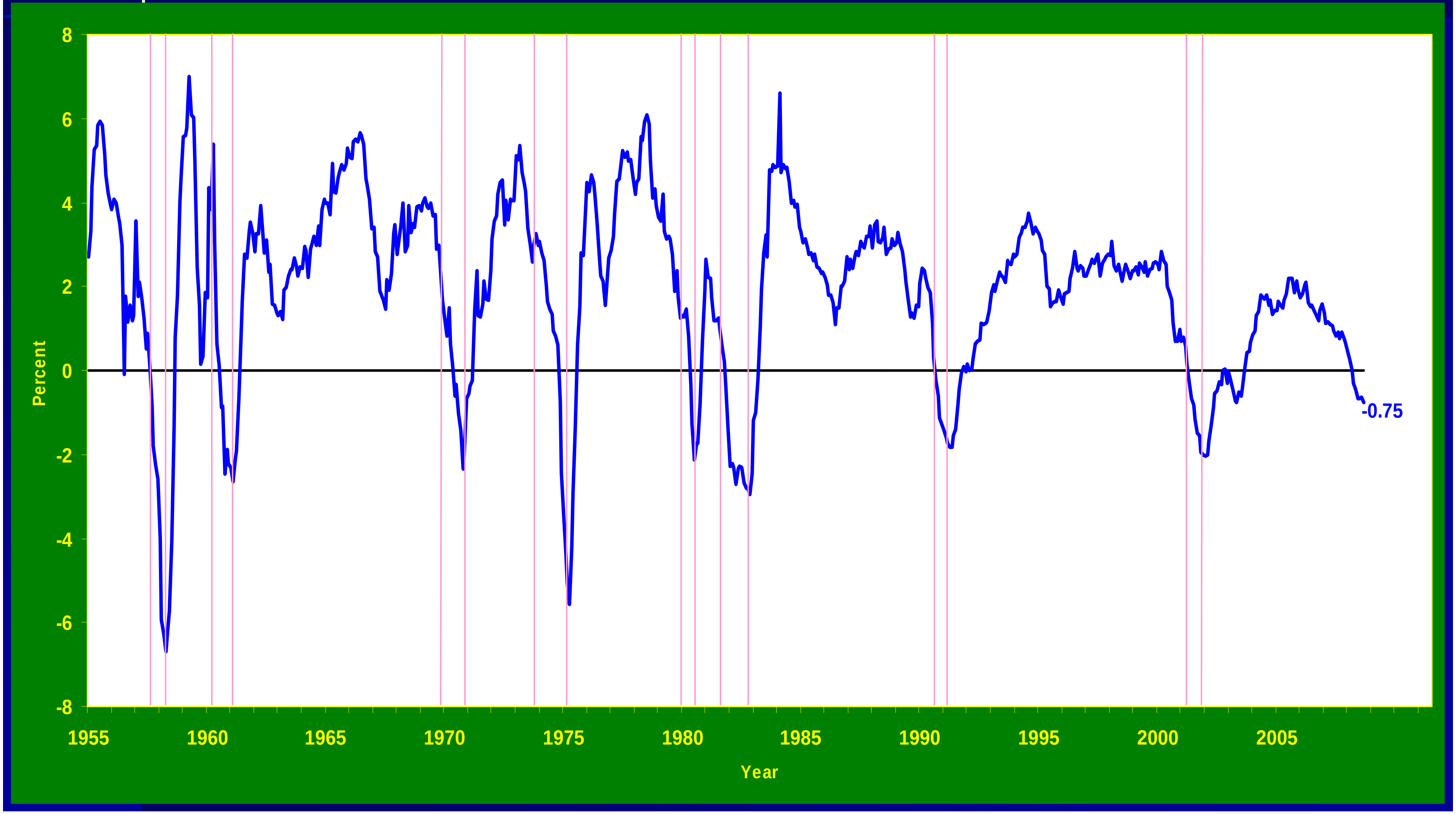
Current Quarter 2008:Q4 in Perspective since 1955



The Business-Cycle Dating Problem

- Real GDP Growth was Positive in 2008:Q2, +2.8 %
- Current Projections are -0.6 for Q3 and -2.8 for Q4
- NBER BCDC Doesn't Anticipate Data
- Casual Recession Definition vs. Actual BCDC Procedure
  - New Role of Monthly GDP
  - Peak? Where between December 07 and June 08?
- Payroll Employment Declined Starting Jan 08, Real GDP in 2008:Q3 ("Monthly GDP" declined starting in July 08)

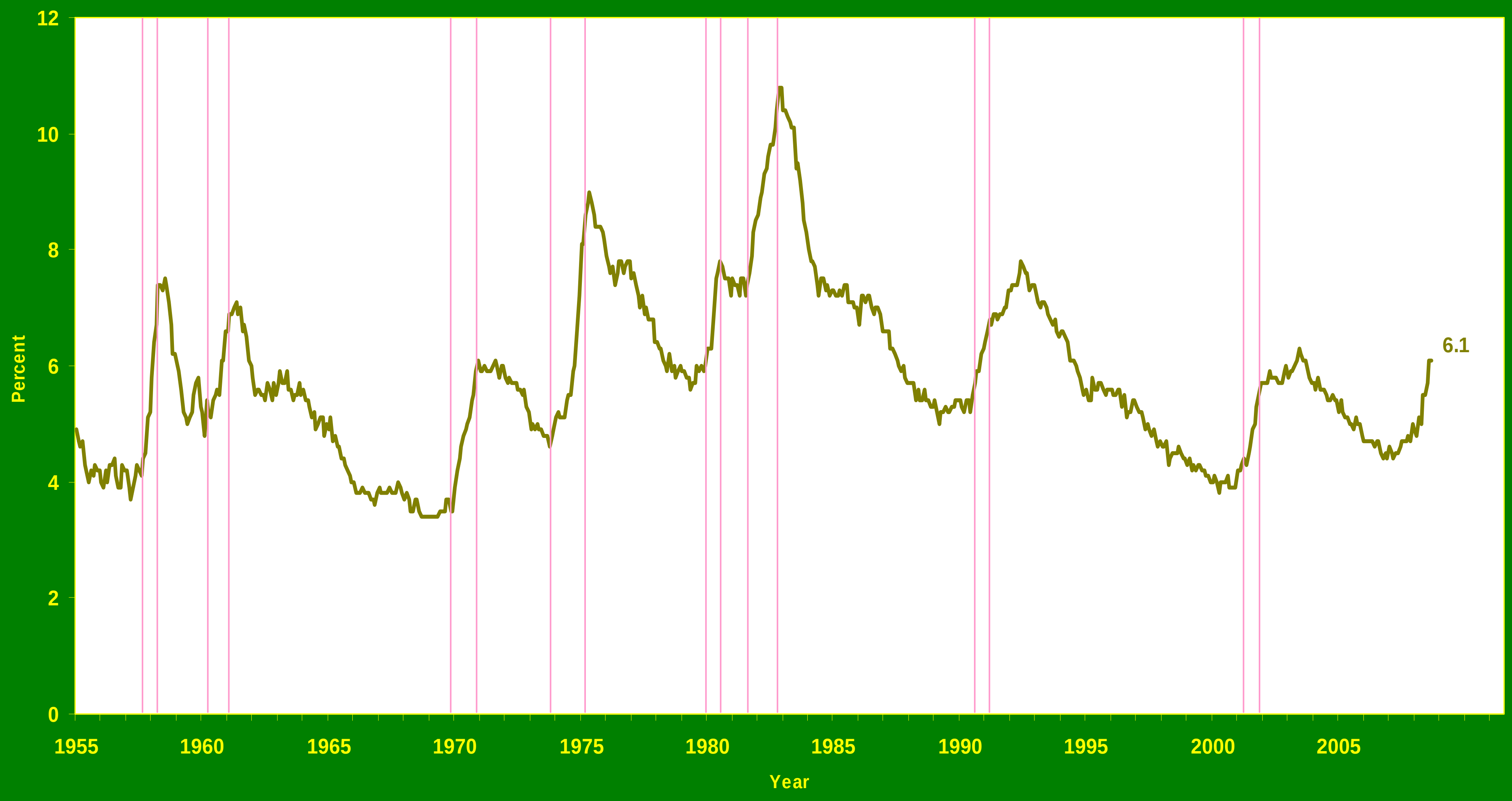
6-month AAGR Payroll Employment, 1/55 – 9/08



Precedents for Recession

- Never a negative 6-month change in payroll employment without a recession being declared
- Same for a one-percentage-point increase in the unemployment rate (see next slide)

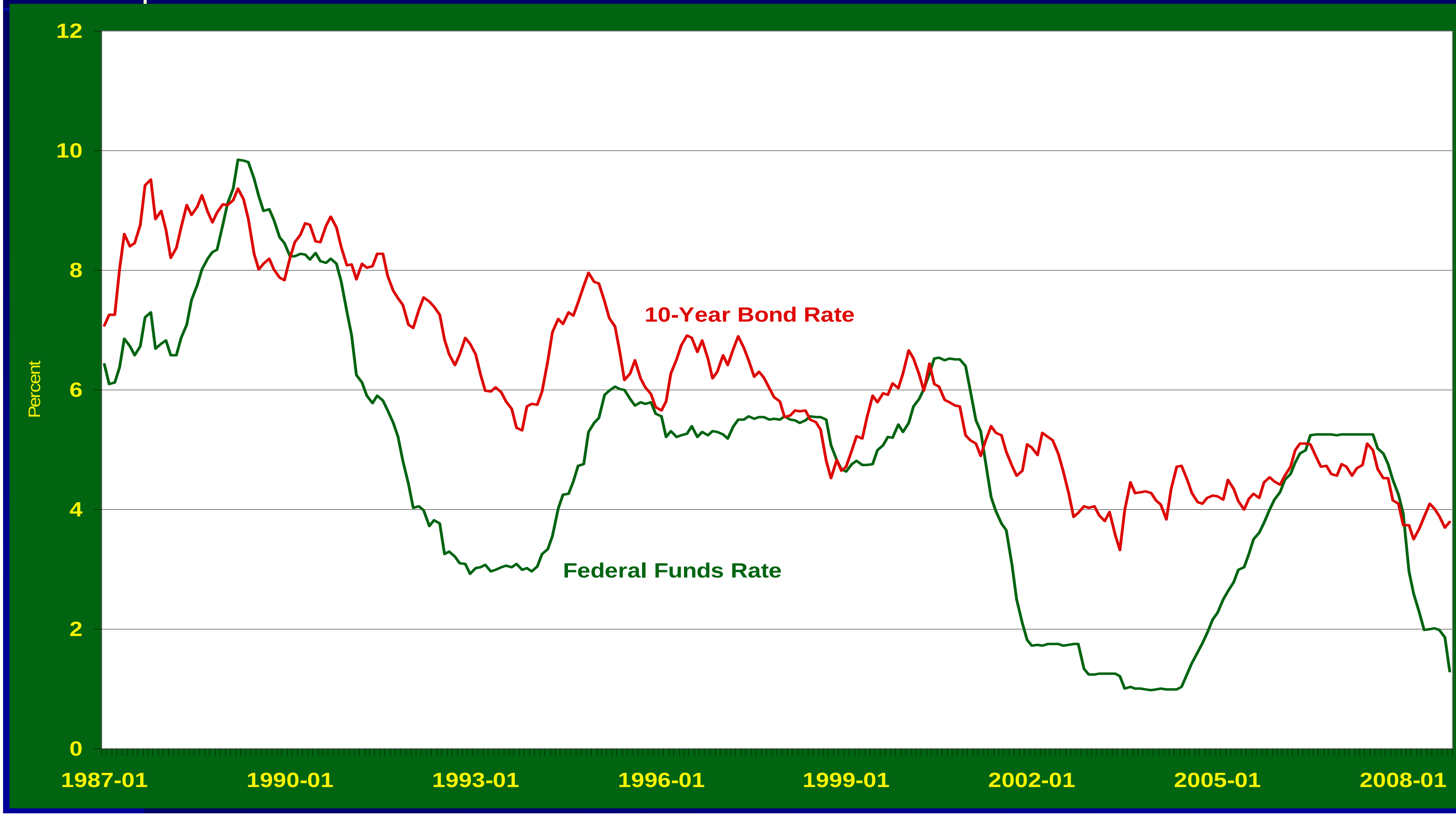
Unemployment Rate Since 1955, Monthly



Conclusion so Far:
Yes, We're in a Recession

- What Caused it?
- What Can be Done to Minimize its Impact
- Here's Where Main Street vs. Wall Street Comes in
- Trouble Started in 2001-2002

Federal Funds Rate: Too Low for Too Long



Seeds of Disaster Were Planted

- Adjusted for Inflation, Federal Funds Rate *was Negative throughout 2002-04*
- Auto Sales Exploded with Zero-Rate Loans in late 2001. Throughout 2001-2006 Auto Sales were Borrowed from the Future
- But the Real Problem was in Housing

The Case Against the Fed

- Asymmetric Approach to Asset Bubbles
  – Stock Market dot.com boom in late 1990s
  – Housing price bubble in 2001-06
- Fail to Raise Rates to Stop Bubble
- But then Slash Rates when Bubble Bursts
- This biased Monetary Policy Fuelled Risk-Taking and Credit Excess

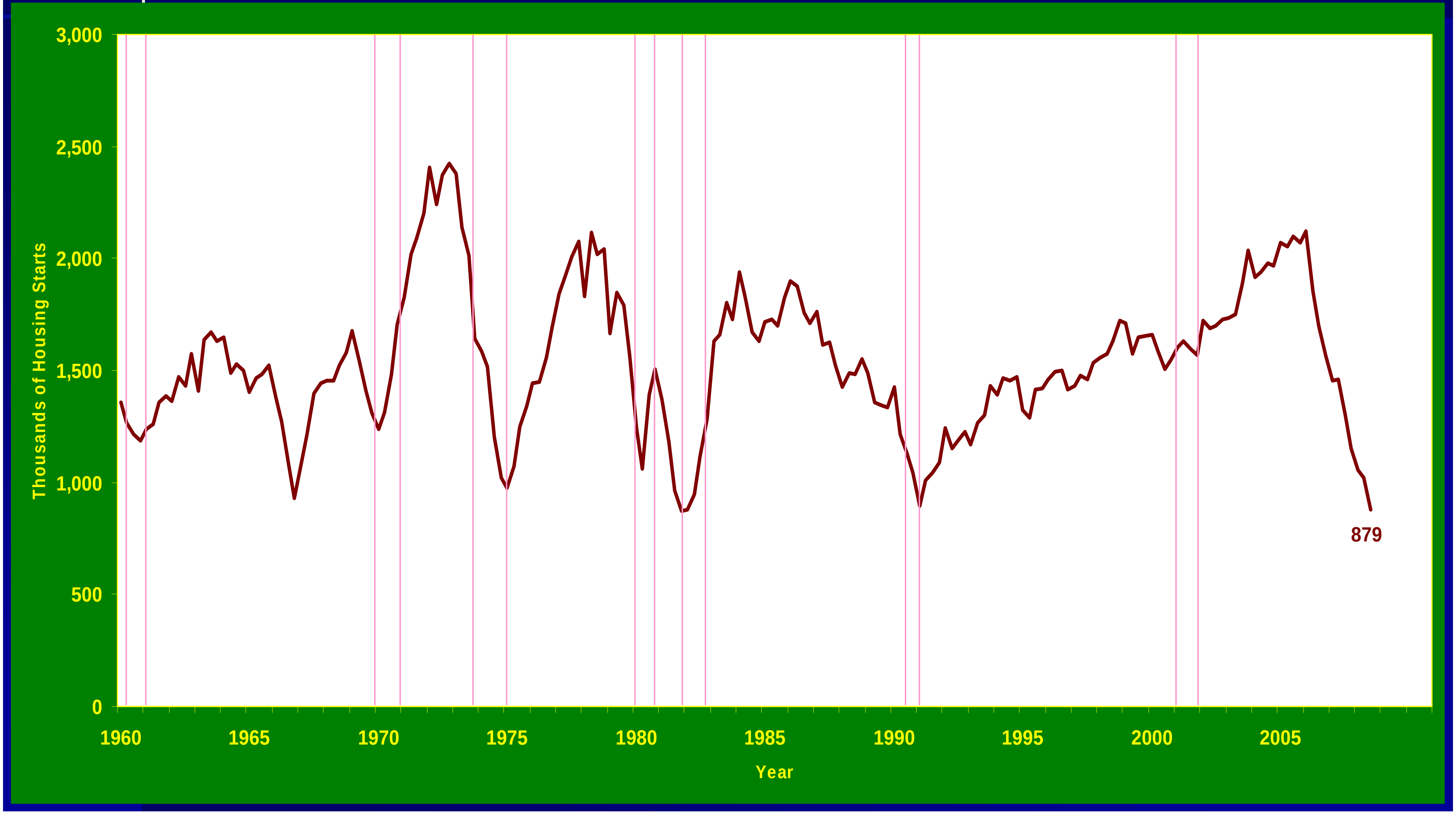
Results: Housing and Consumption were Artificially High

- Housing: Cheap credit pushed up
  - – Prices of Existing and New Homes
  - – Quantity of New Construction
- Consumer Spending Fueled by
  - – Low interest rates on mortgages, consumer credit
  - – Housing equity withdrawal

Housing and the "Great Moderation"

- 1985-2001 Housing construction was relatively stable after pre-1985 boom-bust cycles
- This helped to contribute to Great Moderation
- Conventional Wisdom: Financial Deregulation in 1978-80 made boom-bust cycles obsolete.
- But they didn't count on Alan Greenspan

Housing Starts, 1960:Q1 – 2008:Q3



Second Indictment Against the Fed

- Along with other Financial Regulators they were Asleep at the Wheel
- Failed to Appreciate the Scale of Risks Being Built up by "Shadow Banking System"
  - Credit swaps, derivatives
  - Originator of mortgages sells to Wall Street, repackaged in bundles of securities
- Fed made no attempt to create coordinated Federal regulation of new financial market instruments and especially predatory brokers

Result: Bubble Ended with Foreclosures and Collapse of House Prices

- Foreclosures Ruin Lives and Blight Neighborhoods
- Declining House Prices Lead to
  - Personal Bankruptcy
  - Tainted credit ratings preventing future borrowing and spending
  - Negative equity
  - Inability to move in response to family changes and new jobs

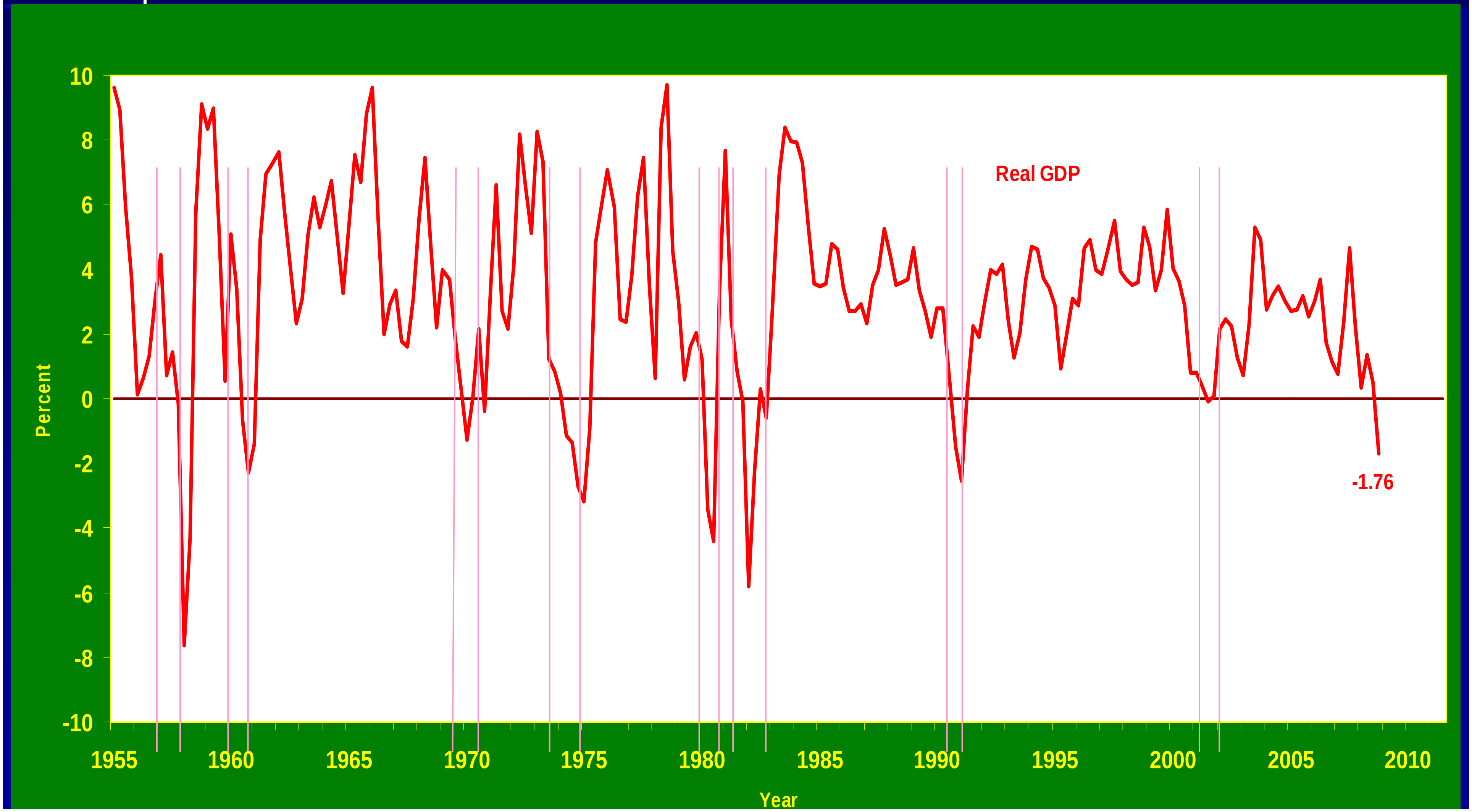
Already by Fall 2006 the Economy was in Trouble

- Household Saving Rate had been Pushed to Zero
  - Wealth Effect on stock prices and housing
  - Newly important mechanism of equity withdrawal further boosted consumption
- Late 2006, house prices peaked and in retrospect appear to have been at least 30 percent overvalued

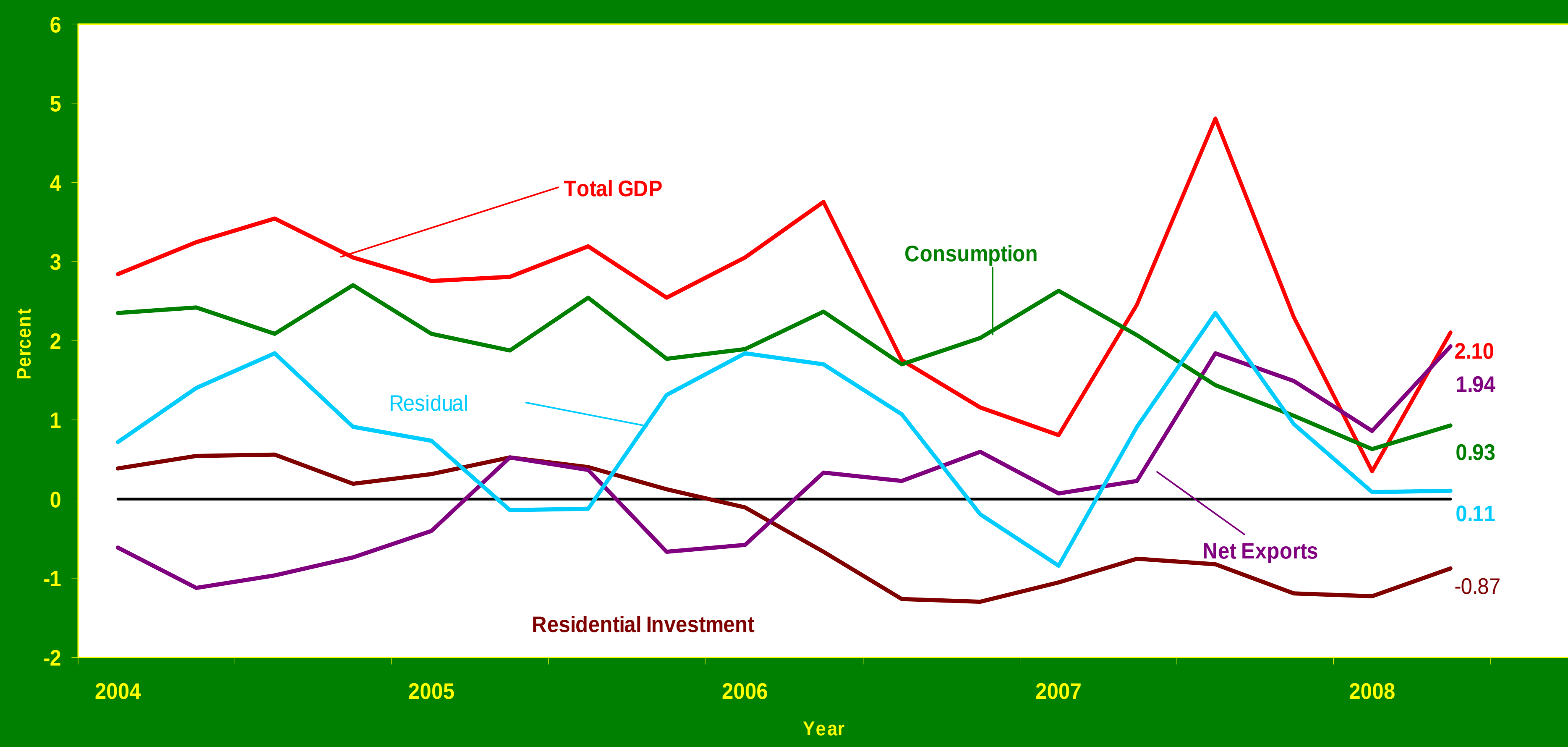
My Fall 2006 Macro Students Heard Dire Predictions

- House Prices would fall
- End of Equity Withdrawal
- End of Car buying boom
  - Special trouble for Detroit Big-3
- Higher Oil Prices cut Household Buying Power
- Real Wages Declining

The Big Surprise: Real GDP Kept Growing, How?



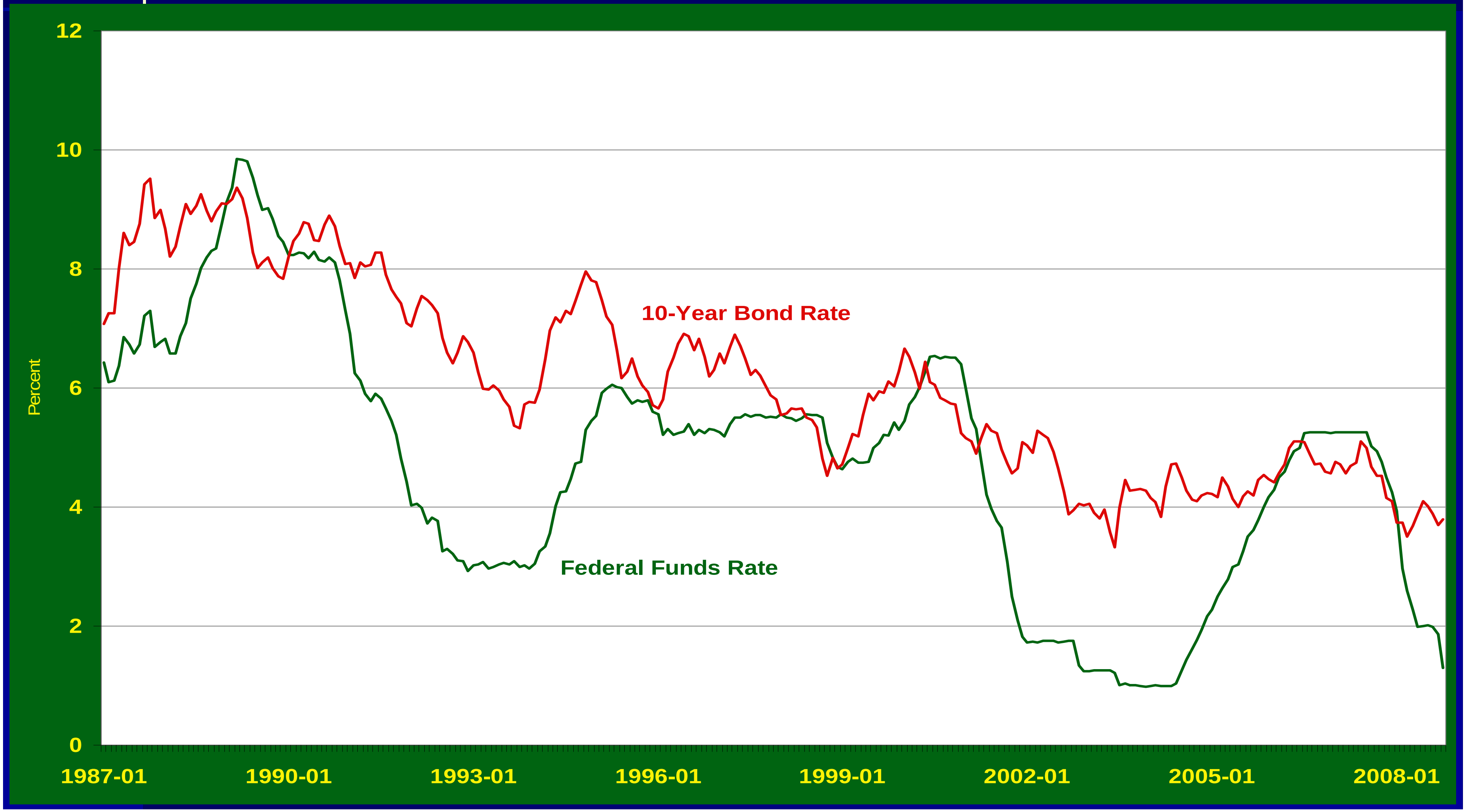
Contributions to Real GDP Growth by Component since 2004 to 2008:Q2



The Plot Thickens: Crisis Spreads from Main St to Wall St

- Flood of money from big emerging markets economies, esp. China
  - Emerging markets Central Banks now hold > $5 Trillion in Reserves
- Pushed Down US Long-term Interest Rates
- Fueled continuation of US boom despite Fed's tightening of Federal Funds Rate
- Ever spiraling "leveraging" as debt piled upon debt

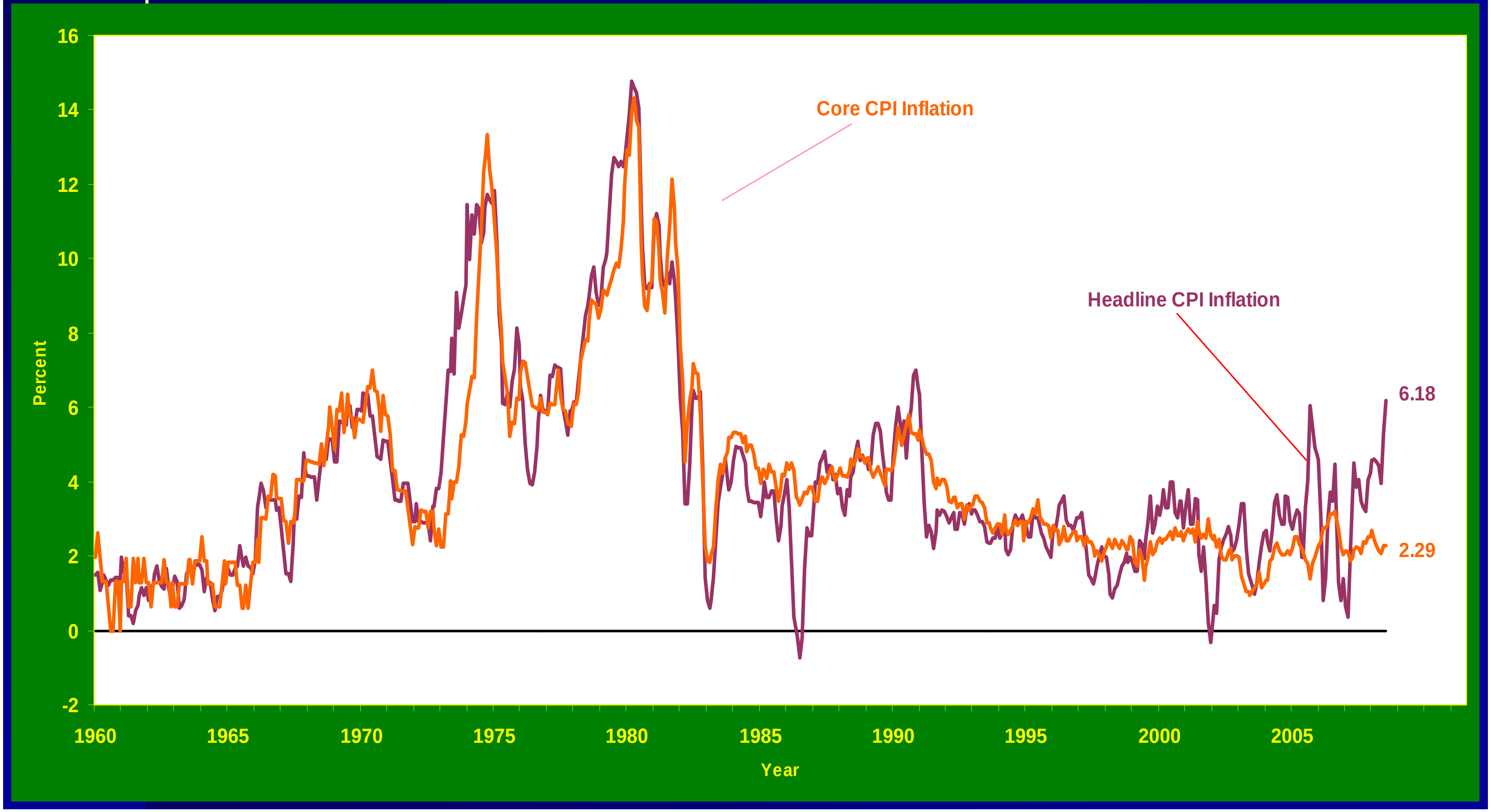
2004-2007: Ten-year Bond Rate Barely Responded



A Further Consequence: Commodity Price Inflation

- Consumer Buying Power further Diminished by Higher Oil and Food Prices
  - Demand from India and China
  - Misguided Ethanol Legislation Boosted Corn Prices
- Classic Dilemma for Central Banks: fight recession or inflation?

CPI Headline and Core Inflation, 1960:Q1-2008:Q2



Wall St Summary: “Six Fingers of Blame”

- #1: Households borrowed recklessly
- #2: Predatory lenders, half of mortgages outside regulated banking system
- #3: Regulators ignored debt explosion and toxic securitization
- #4: Stupid investors ignored risk
- #5: Investment bankers who dreamed up exotic securities
- #6: Rating Agencies (like hiring students to pay professors to grade their papers)

The Recession: How Deep and How Long?

- Housing Starts: How Low can they go?
- Business Investment, key driver of economic weakness in 2001-02
  - Nonresidential construction boom: A repeat of the 1920s. Look at downtown Chicago.
- Consumption: the Perfect Storm
- End of Export Boom?

Business Investment share of Nominal GDP

Predictions

- Suddenly Intermediate Macro Textbooks Become Relevant
  - Multiplier effect, the “slow-motion train wreck”
  - No limit to power of monetary and fiscal policy working together
- How Did Great Depression End? Money-fueled Fiscal Deficits

The Lucky U.S. Compared to Europe

- One Government, compared to 27 in EU
- No Maastricht Treaty Restrictions on Fiscal Deficits as in Euro Area
- Unified Administration and Congress after January 20
- Wise Economists Understand that a $2 Trillion Deficit can Cure a Lot of Problems
  - Recession, state-local finance, infrastructure, medical care
- Debt-GDP Ratio now 40%, 1945 110%
- “A Trillion Here, A Trillion There” . . . .

Keynesian Demand Policies Ruled in 1940-45, They can Do So Again