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

Real GDP: -1.76%
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

Year

Percent


1.0 2.0 3.0 4.0 5.0 6.0 7.0 8.0 9.0 10.0 11.0 12.0

6.1
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
- 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?

-1.76
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
- Consumption: the Perfect Storm
- End of Export Boom?
Business Investment share of Nominal GDP

- Producer Durable Equipment Share
- Nonresidential Share
- Nonresidential Structures Share


Percent: 10.9 7.17 3.81
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

Government debt-GDP ratio

Revolutionary
Civil War
World War I
World War

Percent of GDP