A Very Different U.S. Recession

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In recent weeks, there has been a major shift in the U.S. economic debate. In the face of accumulating weak economic data and a disturbing widening of the credit market crisis, no longer is it being seriously questioned whether the U.S. economy might succumb to recession. Rather, the debate has now moved to addressing the question as to how deep and prolonged the recession might be.

As the present debate rages on, it is becoming increasingly clear that at the crux of the U.S. economy's present woes is that the economy is being subjected to multiple negative shocks. To compound matters, it is also becoming clear that those shocks include the bursting of housing market and credit market bubbles that are not amenable to the quick fix of monetary policy easing.

Among the more serious shocks presently afflicting the U.S. economy is the worst housing market bust since the Great Depression. At the national level, home prices are now falling at around an annual 10 percent rate. That decline has already had the effect of wiping out U.S. $2 trillion in household wealth and of increasing the number of U.S. households with negative equity in their homes. It is estimated that if home prices fall by another 10 percent in 2008, as many as 16 million or a third of all households will have negative equity in their homes.

Mainly as a result of falling home prices, the credit markets are presently gripped by what former Federal Reserve Chairman, Alan Greenspan, now describes as the most wrenching crisis in the post war period. This is having the effect of seriously impeding the extension of bank credit, which is the lifeblood of any well-functioning economy. As if this were not enough, international oil prices have surged to over U.S. $100 a barrel, the U.S. dollar is now in virtual free fall, and the equity market has succumbed to a bear market.

After vacillating for far too long, the Federal Reserve has of late shifted to aggressive monetary policy easing and to a policy of ample liquidity provision. In the short space of six weeks, the Federal Reserve has cut interest rates by an unprecedented 2 full percentage points, bringing them down to 2 ¼ percent. Simultaneously, the Federal Reserve has proved to be highly innovative in finding ways to pump liquidity into a troubled financial sector, which has repeatedly been on the verge of totally seizing up. On that front, the Fed's efforts have included the highly unusual steps of taking U.S. $200 billion in mortgage-backed securities onto its balance sheet, the engineering of JP Morgan's takeover of Bear Stearns, and the opening up of its discount window to the investment banks and the primary security dealers.

Yet, a highly disturbing aspect of the Fed's renewed activism is that it does not appear to be providing the economy with much of a desperately needed boost. While it is true that since August 2007 the Federal Reserve has cut its short term interest rate by 3 percentage points, it is also true that due to the credit crunch the spreads on long-term private sector borrowing have

increased by a similar amount. As a result, the interest rates at which households and corporations borrow today are not materially different from those prevailing last August when the Fed's easing cycle began.

Similarly, one finds that despite the Fed's frequent and innovative efforts to pump liquidity into the banking system, the Fed appears to be reactively moving from one financial system problem to another. No sooner has the Fed plugged one leak in the financial system than another leak springs up.

The apparent impotence of monetary policy over the past nine months has to raise a very basic question. Might the Fed be misdiagnosing the present situation as a liquidity problem amenable to orthodox monetary and fiscal policy measures? Might not the real problem that the country faces be one of solvency associated with past poor lending by the banks, especially to the housing sector?

By merely providing the banks with a breathing space, the Fed is not going to make the losses on their bad loans go away nor is it going to stop home prices from falling. Instead, what is really now needed are far-reaching policies to provide a real floor to housing market prices and a comprehensive plan to shore up a creaking financial system.

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