



Economic Review



Issue XXXI
March 2008

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Musings & Amusings

More George Carlin

“Why is it when we bounce a check, the bank charges us more of what they already know we don't have any of?”

“When someone asks you, ‘A penny for your thoughts’ and you ‘Put your two cents in,’ what happens to the other penny?”

“Why is the man who invests all your money called a broker?”

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The “Consensus”:

One of my favorite cartoons (which I have managed to misplace) shows several economists standing in a circle. The caption goes something like, “We all agree that either the recession has come and gone, hasn't arrived yet or won't be here at all.” Well, it is looking increasingly like the recession has arrived.

Recent actions by the Federal Reserve and the prompt passage of the stimulus package should help, but there are some doubts about how effective these will be. Most “recession economists” are betting that the overall decline will end around mid-year and that the economy should start reviving during the second half.

The economic data available so far in 2008 have been weak, prompting a number of economists to conclude that real Gross Domestic Product (GDP) peaked during the final quarter of last year and then started to decline in 2008. The official scorekeepers at the independent National Bureau of Economic Research (NBER) won't render a judgment about when the recession started until summer – at the earliest. Hopefully, by that time the recession will be over. It is still possible, but unlikely, that this will turn out to be a brief slowdown rather than a recession.

Housing data have been much worse than expected. Building activity as measured by housing starts has plunged more than 50% since the peaks of 2006. Nationally, prices are falling at

rates last seen during the Depression of the 1930s.

The labor market is increasingly giving off signs typical of early recession. Jobs have started to decline and unemployment is rising. No wonder then that consumer confidence has plunged and consumer spending has started to slip. Together, consumer spending and residential construction (including home renovations) account for more than three-fourths of the GDP. Hence, real GDP probably fell during the first quarter of 2008, but we won't know for sure until the data come out in late April. After that, it's quite likely there will be another quarter or two of decline.

But don't despair, help is on the way! The Federal Reserve started a major interest rate reduction program last August. It has also taken some novel steps to deal with the growing problems in the nation's credit markets. Early this year, the Fed started auctioning off funds to member banks. This is to supplement the borrowing that takes place at the Fed's Discount Window, where member banks can get loans. The new Term Auction Facility (TAF) is an attempt by the Fed to inject liquidity where it is needed most.

The stimulus package, which was passed with amazing speed by the Congress, consists of tax rebates to households, investment tax incentives for businesses and a temporary lifting of the maximum size of home mortgages that can be guaranteed by Fannie Mae and Freddie Mac from \$417,000 to as much as \$730,000 – depending on the part of the country.

Will these measures do the trick? Obviously they didn't come in time to prevent a recession. While

financial markets tend to react immediately to Fed interest rate cuts, it takes anywhere from 9-12 months for monetary policy to affect the overall economy in terms of jobs and GDP. And it will take several months to implement the stimulus package, with rebate checks going out in May. Hence, these measures should help end the recession and fuel the recovery.

Or will they? A number of concerns have been raised about both the fiscal and monetary policy actions. Those who are skeptical about the effectiveness of the rebates usually point to surveys taken in 2001 before the checks arrived, the last time rebates were used to combat recession. The majority of respondents said they intended to “save” rather than spend their checks. However, what people said and what they did are two different things. There's pretty good statistical evidence that they actually spent most of their windfall rather quickly.

More troublesome, however, are concerns that arise from the special nature of the current business cycle, the “credit crunch.” One of the most important channels of monetary policy is to lift homebuilding via lower mortgage rates. However, this avenue seems to be clogged by falling housing prices and the widespread tightening of mortgage lending terms in the face of growing foreclosures. Falling prices make builders and buyers reluctant to enter the market. And interest charges on fixed-rate mortgages have actually risen since the Fed started cutting the short-term Fed funds rate. One reason for this is an increase in the risk that lenders now attach to mortgages in light of rising defaults and foreclosures. And there's evidence of credit tightening elsewhere. Turmoil in

the bond insurance business has raised interest rates for many municipalities and not-for-profits. The commercial paper market, which is an important source of funds for corporations, is shrinking as buyers of these promissory notes pull back. There are reports that it will be more difficult to get student loans for college tuition next fall.

If these credit problems threaten to lengthen the recession or restrain the recovery, additional policy responses would be likely. As of early March, the Fed had lowered the Fed funds rate to 3% from 5 ¼% last year. There's still more room to cut since the Fed funds rate was reduced to 1% during the last round of monetary easing aimed at combating the 2001 recession. The Fed seems willing to do whatever is needed to keep the economic situation from deteriorating further.

Temporarily raising the limit on "conforming mortgages" may not be enough to stabilize the housing market. There are growing calls for a federally financed program that engages in the large-scale purchase of troubled mortgages, something last seen during the 1930s Depression.

Sure, there would be cries that this would amount to bailing out investors. In fact, Treasury Secretary Paulson, who was President Bush's point man on getting the stimulus package passed, has expressed the Administration's opposition on just these grounds. However, there may eventually be little alternative for halting the bleeding in the housing

Industry Employment (% of total, 2006)

	CT	MA	RI	NY	US
Construction	4.0	4.3	4.7	3.6	5.6
Financial	8.6	6.9	7.1	11.1	6.1
Ed. & Health	16.7	18.7	19.6	18.1	13.1

Metro NYC which includes Westchester

Source: Economy.com

market. The time for toughness was several years back when the regulators should have stopped the nonsense. The problem with "tough love" is that it could make life rough for all of us by causing home prices to fall further even for those dwellings with solid mortgage financing.

The question marks are large at the regional level. As noted in the last issue, there's no reason for the Northeast to replay the early 1990s when we endured a much deeper and longer recession than the nation as a whole. Southern New England lost more than 10% of its jobs during the 3-year downturn of 1990-92. The nation lost less than 2% of its employment during a recession that lasted only eight months.

We fared much better during the 2001 national recession, but still underperformed the rest of the country. If, it seems increasingly likely, a national recession is unfolding, then jobs will probably fall nationally and in southern New England.

It is quite possible that we might get off

a little more lightly than the nation. Raising the cap on conforming mortgages is especially helpful to southern New England and lower New York because home prices are so much higher here than in much of the rest of the United States. The outlook for defense spending is pretty good and so are the prospects for civilian aircraft engines and equipment. Compared to the other states, we have a much higher proportion of our jobs in education and health care, which are generally viewed as being more recession resistant than other industries. We also have a smaller share in construction, which is under considerable downward pressure.

However, the driving factor in determining how our region performs relative to the nation is likely to be what happens in the financial services industry in light of the large losses being experienced at a number of major institutions. Employment in financial services is much more concentrated in southern New England and New York than in the nation as a whole.

Keep your fingers and your toes crossed!



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