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The Dismal Science:

It was the historian Thomas Carlyle who first used the term "dismal science" to describe economics. There is some disagreement over whether he was referring to the Reverend Malthus' views on population or John Stuart Mill's ideas on the emancipation of slaves.

Anyway, by late last year, the consensus forecast among economists was still for slow growth in 2008, but the odds were climbing for the more dismal outcome of a recession this year. The economic data were quite clear that a downturn had not started by Christmas, but there were some straws in the wind. There's reason to believe that a recession would be relatively short and mild. However, the widespread financial fragility that emerged last year could make the adjustment harder.

Recent data indicate that the economy continued to expand, despite the strong "headwinds" posed by high energy costs and falling housing markets. Real Gross Domestic Product (GDP) grew rapidly in the third quarter and rose at a slower but still positive pace in the October-December period. Consumer spending held up reasonably well during the Christmas season.

Other indicators have been less positive. Job growth slowed significantly during the year and there's the possibility that the annual revisions due out in a few months could make the number look even weaker. Consumer confidence has been dropping. Home building and sales have been falling and so have home prices. The Federal Reserve estimated that homeowners' equity shrunk by $125 billion during the third quarter thanks to falling house prices. Mortgage foreclosures are rising rapidly and a number of financial institutions are taking very large losses as a result of the sub-prime meltdown.

Both the Wall Street Journal and Business Week surveys show that practically all economists are predicting slow growth but not recession in 2008. The forecasters have, however, been increasing the odds they attach to a recession during the coming year to roughly 40%. Former Fed Chairman Greenspan has said that the probability is closer to 50%. He ought to know because his unwillingness to deal with the sub-prime problem and mortgage excesses in general is a major reason for the bind we find ourselves in.

Whether there's slow growth or recession depends on how various factors play out. A further rise in oil prices would feed inflation and shrink consumer purchasing power. Most forecasts of continued U.S. expansion assume a decent overseas economic growth in order to keep our exports rising. However, Europe may be starting to show signs of weakening, partly because falling U.S. dollar is curtailing European exports. Our gain from the lower dollar is their pain from the higher Euro! There's also the potential downdraft from the 1.8 million adjustable rate mortgages scheduled to reset during the next two years. This is certain to lead to additional foreclosures, but how many is anybody's guess.

Technically, a recession is a decline in the overall economy as measured by major indicators such as jobs and real GDP. A convenient rule of thumb is to describe a recession as two consecutive quarters of real GDP decline. The actual process of identifying a downturn is more complex, but this simple view works.

There've only been two recessions during the past quarter century, starting in 1990 and 2001. During the previous 25 years, we experienced four downturns. The two most recent were shorter and milder than their predecessors. They lasted only about eight months compared to the 12 months of the previous four. Real GDP shrunk only 1½% in 1990-91 and even less in 2001 vs. an average contraction of 2½% in the preceding cycles. The most likely explanations for these differences are that inflation has been much lower since the early 1980s and the Federal Reserve has become more adept at combatting downturns.

While we probably have the recent history on our side, current financial conditions could lead to a more severe downturn than the latest two. It is possible that problems in some parts of the financial sector will spread. For example, several of the major insurance companies that provide credit guarantees for certain types of mortgages and some types of bonds are experiencing financial strains. What if they can't honor all their guarantee obligations? This could send shivers through financial markets and cause some bond yields to jump. There's also the possibility that house prices could fall more than the 4-7% expected for this year by economists. This would further erode household wealth, undermine consumer confidence and exacerbate problems in the mortgage markets.

Musings & Amusings

Harry S. Truman
"A *recession* is when your neighbor has lost his job. A *depression* is when you lose yours."

Paul A. Samuelson
"The stock market has predicted 9 of the past 5 recessions."

Chairman Greenspan in October 1990
"The economy has not yet slipped into recession."
The recession had started in July 1990.

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Some Implications:
The Fed would certainly cut interest rates aggressively to combat recession and to try to keep the falling house prices from being the prelude to overall deflation. Under the slow-growth scenario envisioned by most economists, the Fed is predicted to cut Fed Funds rate another 50-75 basis points from the year-end 2007 level of 4¾%. In a recession, however, it is not at all unlikely that Dr. Bernanke and friends would slash Fed Funds all the way down to 1 or 2%. What about inflation? Well, recession would probably keep a lid on for a while. Furthermore, the Fed has a dual mandate from Congress to promote price stability *and* reasonably full employment. It would deal with the recession threat first and then later on turn to fighting inflation – if that was a problem.

What would happen to the stock market in a recession? Professor Samuelson's comment about the stock market's forecast track record (see Musings & Amusings) pertains to its performance in predicting peaks in the economy, i.e., the start of recessions. In contrast, stocks are a pretty good leading indicator of when the economy will start to recover. They usually begin rising before the economy does.

However, putting numbers on these relationships is difficult because of the problem of picking the appropriate starting and ending points when so much else is usually happening at the same time. For example, the most recent recession began in March of 2001 and ended by November. The S&P 500 stock price index peaked in 2000 but didn't bottom until 2003 during the early stages of the invasion of Iraq. The total decline in the S&P 500 from 2000-2003 was almost 50%. However, only a portion of that drop was due to the recession itself. Major portions reflected the uncertainties after the 9/11 tragedies and from the risks associated with the invasion of Iraq in early 2003.

Whether the economy grows slowly or slips into recession has huge political consequences in a presidential election year. Research by economists into past elections says that people do indeed vote their pocketbooks when it comes to the White House and the Congress. According to my Yale colleague, Ray Fair, voters have short memories when it comes to economic growth, mainly considering what has happened during the year before the election. They have a longer perspective with respect to inflation, going back almost four years. He bases this on his studies of U.S. elections since 1916.

Using the consensus forecast of slow growth in 2008, Fair's model predicts that the Republicans would lose the White House in 2008, despite the advantage of being the incumbent party. A recession would widen the loss margin. As a rule, each percentage point slower GDP growth in the three quarters preceding the election shaves a percentage point from their share of the two-party vote.

If you're interested in pursuing this further, go to *fairmodel.econ.yale.edu*. Professor Fair not only explains the model further but also allows you to plug in your own economic forecasts and see how they affect the popular vote.

Finally, the regional economy would obviously be affected by a national recession. However, as noted previously, there's no reason for southern New England and metro New York City to fare much worse than the nation as a whole. This is in contrast to the early 1990s, when the nation experienced a brief and mild downturn while we endured a very deep and lengthy recession. The Northeast was hit hard because of a large amount of overbuilding of homes and office space during the real estate boom of the late 1980s. There were also cutbacks in defense spending, a shift away from large computers to smaller ones and PCs as well as serous problems within the banking system back then.

Happy New Year!

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