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Our Economic Dilemma

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Although it is too soon to tell whether the United States has entered a recession, there is mounting evidence that a recession has in fact begun. Key measures of economic activity stopped growing in December and January or actually began to decline. The collapse of house prices and the crisis in the credit markets continue to depress the real economy.

The sharp reduction in the federal funds interest rate and the new fiscal stimulus package may, of course, be enough to avert a downturn. Many forecasters still predict that the economy will just slow in the first part of this year and then rebound after the summer. But the hope that monetary and fiscal policies would prevent continued weakness by boosting consumer confidence was derailed by the recent report that consumer confidence in January collapsed to the lowest level since 1992.

If a recession does occur, it could last longer and be more painful than the past several downturns because of differences in its origin and character. The recessions that began in 1991 and 2001 lasted only eight months from the start of the downturn until the beginning of the recovery. Even the deeper recession of 1981 lasted only 16 months.

But these past recessions were caused by deliberate Federal Reserve policy aimed at reversing a rise in inflation. In those cases, the Fed increased real interest rates until it saw the economic slowdown that it thought would move us back toward price stability. It then reversed course, reducing interest rates and bringing the recession to an end.

In contrast, the real interest rate in 2006 and 2007 stayed at a relatively low level of less than 3%. A key cause of the present slowdown and potential recession was not a tightening of monetary policy but the bursting of the house-price bubble after six years of exceptionally rapid house-price increases. The Fed therefore will not be able to end the recession as it did previous ones by turning off a tight monetary policy.

The unprecedented national fall in house prices is reducing household wealth and therefore consumer spending. House prices are down 10% from the 2006 high and are likely to fall at least another 10%. Each 10% decline cuts household wealth by about $2 trillion, and this eventually reduces annual consumer spending by about $100 billion. No one can predict the extent to which the coming fall in house prices will lead to defaults and foreclosures, driving house prices and wealth down even further. Falling house prices also discourage home building, with housing starts down 38% over the past 12 months.

But the principle cause for concern today is the paralysis of the credit markets. Credit is always key to the expansion of the economy. The collapse of confidence in credit markets is now preventing that necessary extension of credit. The decline of credit creation includes not only the banks but also the bond markets, hedge funds, insurance companies and mutual funds. Securitization, leveraged buyouts and credit insurance have also atrophied.

The dysfunctional character of the credit markets means that a Fed policy of reducing interest rates cannot be as effective in stimulating the economy as it has been in the past. Monetary policy may simply lack traction in the current credit environment.

The collapse of the credit markets began last summer when the subprime mortgage crisis demonstrated that financial risk of all types had been greatly underpriced, that the market prices of complex financial assets overstated their true values, and that the credit scores provided by rating agencies are not to be trusted. Because market participants now lack confidence in asset prices, they are unwilling to buy existing assets, thus preventing current asset owners from providing credit to new borrowers.

The lack of confidence in asset prices also translates into a lack of confidence in the creditworthiness of other financial

institutions, impeding the extension of credit to those institutions. And because financial institutions do not even have confidence in the value of their own capital and in the potential availability of liquidity, they are reluctant to make new lending commitments.

It is not clear what can bring back the confidence in asset prices that is needed for credit to flow again. Some analysts suggest that confidence would return if the financial institutions declare the true market value of their assets by restating balance sheets at the depressed prices at which they could be liquidated today. But this is not a practical solution, since many complex securities are no longer trading in the market. Forcing an actual sale of these securities at fire-sale prices in order to establish market values could also create unnecessary bankruptcies that would further impede credit flows.

The current situation has the elements of a Catch-22: The credit flows needed for economic expansion require confidence in the values of existing financial assets, but market participants may not have such confidence while the risk of recession hangs over us.

There is plenty of blame to go around for the current situation. The Federal Reserve bears much of the responsibility, because of its failure to provide the appropriate supervisory oversight for the major money center banks. The Fed's banking examiners have complete access to all of the financial transactions of the banks that they supervise, and should have the technical expertise to evaluate the risks that those banks are taking. Because these banks provide credit to the nonbank financial institutions, the Fed can also indirectly examine what those other institutions are doing.

The Fed's bank examinations are supposed to assess the adequacy of each bank's capital and the quality of its assets. The Fed declared that the banks had adequate capital because it gave far too little weight to their massive off balance-sheet positions -- the structured investment vehicles (SIVs), conduits and credit line obligations -- that the banks have now been forced to bring onto their balance sheets. Examiners also overstated the quality of banks' assets, failing to allow for the potential bursting of the house price bubble.

The implication of this for Fed supervision policy is clear. The way out of the current crisis of confidence is not. We can only hope that those who predict nothing worse than a temporary slowdown are correct.

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