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September 8, 2007

COMMENTARY

Recession 2008?

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September 8, 2007; Page A13

Over the past half century, every U.S. housing downturn as sharp as the current one has translated into a U.S. recession. U.S. house prices are falling at an annual rate of nearly 4% -- an event not seen since the Great Depression -- and the downward trend is accelerating.


The credit crunch that has emerged since late July is a clear signal of a move closer to recession. Tighter credit conditions mean that the drag on the U.S. economy will soon spread beyond the housing sector to affect consumption and investment decisions. Indeed, this week's disappointing employment numbers strengthen the case for recession sooner rather than later, thereby sharply increasing pressure on the Fed to ease and ease now.

Our credit problems are deeply entrenched because they spring from a securitization trend in the mortgage market -- the construction and sale of securities whose intrinsic value is tied to the assumption that U.S. house prices will never fall. Now that they are falling, and are expected to continue falling at a faster pace, the value of such derivative securities has collapsed. The holders of derivative securities are widely dispersed and their identity is not well known; nor is the actual value of the derivative securities they hold easy to establish as house prices accelerate downward and the economy slows.

The sharp rise in uncertainty tied to an extraordinary and unanticipated unwinding of the securitization of claims on mortgage issuers and other debts has caused segments of the credit sector, like asset backed commercial paper (ABCP), to virtually cease functioning. As credit markets are tightly linked by credit arbitrageurs, the impairment of the ABCP market and subprime mortgage market has reduced the flow of credit to all borrowers while increasing the cost of borrowing for credit-worthy borrowers. Less credit-worthy borrowers can't borrow at any cost.

The initial phase of the response to the unanticipated second wave of the housing slowdown, which began with the early June collapse of two Bear Stearns subprime hedge funds, ultimately resulted in a credit market panic in mid-August. Central banks managed to stem the panic with heavy injections of liquidity and stock markets recovered much of their mid-July to mid-August losses. Indeed, many have advanced the view that the worst is behind us. That is unlikely because the fact remains that house prices continue to fall and the unwinding of securitization isn't over. At this stage, the key thing to watch is domestic consumption, which accounts for 70% of the U.S. economy.

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It is easy to understand why many observers -- apparently including the Fed -- retain a sanguine view of the U.S. economic outlook that, if incorrect, will delay but intensify the U.S. economic slowdown that is emerging. American recessions are unusual because negative consumption growth is, in most cases, a necessary condition for a recession. The U.S. has not experienced a quarter of negative consumption growth since a modest 0.3% drop in the seasonally adjusted annual rate (SAAR) in the fourth quarter of 1991 and two consecutive negative consumption growth quarters of -2.7% and -1.7% during the fourth quarter of 1990 and the first quarter of 1991 -- the two quarters that marked the last serious American recession.

The modest 2001 recession was unusual because it never saw two consecutive quarters of negative growth and because it included no quarters of negative consumption growth. It was the highly unusual capital spending recession which saw business fixed investment fall for nine consecutive quarters (from first-quarter 2001 through first-quarter 2003). The persistent drop in capital spending resulted from the excess capacity that had accumulated during the stock market bubble. The bubble collapsed in early 2000 and the recovery in capital spending was delayed further by the sharp elevation of uncertainty tied to the 9/11 terrorist attacks on New York and Washington.

Working off the excess capital stock that emerged in 2000 caused a persistent drop in business investment during 2001 and 2002, just as working off the excess housing stock is causing a persistent drop in residential investment. That drop began in earnest in the second quarter of 2006 (-11.7% SAAR) and has persisted since, subtracting nearly a percentage point from GDP growth through mid-2007. This drag was prior to the onset of the acute credit contraction in the U.S. mortgage market that began in July and has, in turn, spread to credit markets in general.

While recessions are unusual and hard to predict, a call for a 2008 recession is looking easier and easier. The U.S. economy managed a 1.9% growth rate from mid-2006 through mid-2007, despite a one percentage point drag on growth from housing investment. This 1.9% growth was due to a strong boost from consumption along with modest support from net exports, investment and government spending.

The consensus outlook for third-quarter growth has been about 2.5%. This seemingly benign outcome, largely tied to the impact of good spending momentum prior to the financial turbulence that began late in July, may delay Fed easing as it looks for signs of a slowing economy to justify sharper rate cuts that are not tied to a financial bailout. That said, surprisingly weak August employment may reduce September consumption enough to push third-quarter growth below 2%.

Fourth-quarter growth, however, looks to be considerably lower due to a sharp consumption slowdown driven by a credit crunch, a persistent and possibly enlarged drag from residential investment, and slower business fixed investment. Flat consumption growth coupled with a 1% drag from business fixed investment leaves a negative one percentage point of growth to be made up for by "the rest" whose average contribution to growth has been 0.2 percentage points since 2001.

Taken altogether, that leaves a forecast of minus 0.8% growth in the fourth quarter, give or take a few tenths. The way to turn growth positive by next year would be for the Fed to explicitly -- not to mention inappropriately -- target stabilization of house prices. That is not going to happen. The Fed has said as much. Failing that, watch consumption and employment figures and pray that they turn down quickly. That outcome -- which we're beginning to see in the latest employment numbers -- will hopefully get the Fed on an easing path soon enough to escape with a mild recession.

More likely, as is typically the case -- witness the 1990-91 recession when the Fed didn't start cutting rates below neutral until December 1990 when the recession was already underway -- the Fed will wait for weak growth numbers and end up cutting rates from the 4.75% Fed funds level already expected for Oct. 31, 2007, to well below 3% during 2008 and possibly lower if the housing overhang-credit problems persist.

While it's true that many more recessions have been predicted than have occurred, the drag from continued falling residential investment and from credit-constrained consumers will, very probably, produce negative growth by the end of 2007 or early in 2008. The Fed will cushion the slowdown once weaker growth numbers appear, but there isn't much it can or should do to prevent the permanent unwinding of securities tied to undocumented-income, negative-amortization, and 100%-loan-to-value securitized mortgages rated triple-A by irresponsible rating agencies and sold to unsuspecting investors.

Perhaps the price we pay for that kind of collective stupidity is a recession. The Fed is behaving as if it is prepared to accept that outcome to make certain that a risk-be-damned housing/credit bubble won't recur.

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