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The Economics of Recession and Recovery

This week I was a guest speaker at a graduate journalism class at U.C. Berkeley. Their semester project is to cover the recession and stimulus package in local communities around the Bay Area. Based on their reactions and questions I decided to write down some basic concepts about recessions and stimulus economics with particular emphasis on current events and why today's recession is different from the bad recessions of the past 35 years. I hope these ideas are helpful in understanding what is happening today on the street and in Congress.

Measures of Recession

We usually identify and measure recessions by 1) the amount of job losses, 2) the reduction in the national production of goods and services (a decline in real GDP) and 3) the result of these first two events—a sharp rise in unemployment rates. A recession is a prolonged period of economic downturn.

Friday's employment report shows that the current recession is deepening and there is broad agreement that the economy will decline for at least another six months and probably longer. The national unemployment rate at 7.6% is up from the March 2007 low of 4.4%. Job losses totaling 3.6 million jobs were experienced since December 2007. National GDP declined by 3.8% in the 4th quarter of 2008 with a larger drop expected in this quarter.

Why Recessions Happen

Recessions occur when there is a prolonged drop in spending. When total spending in the economy declines, there is not enough demand to keep everyone employed and as sales and production drop, companies begin to lay off workers. There are not enough customers to keep everyone employed.

There are many reasons why total spending can start to decline suddenly. After the Vietnam War and again in the early 1990s there was a drop in government defense spending. In the early 1970s our economy was hit by a sudden and very sharp rise in energy prices from the spike in international oil prices. As a result we had less income to spend at home.

In the early 1980s in response to high inflation the Federal Reserve policy raised interest rates to double-digit levels. This was a policy-induced recession to try and stop runaway inflation. The economy slowed and national unemployment rates were over 10% for a year as spending fell sharply. In 2000 Silicon Valley had a big recession while the nation had a mild recession after many dot-com companies went bankrupt and technology stocks had a substantial loss of value.

In all cases there was an initial event or events that sent spending downward and the following loss of jobs and wealth brought a drop in consumer spending, which is more than 2/3 of total spending.

The Anatomy of the Current Recession

The current recession was started when there was a broad recognition that home prices were far above normal levels and that many borrowers had bought homes they could not now afford. The combination of these events started a sharp drop in home prices and foreclosures that is still continuing.

These two events also created a tightening of home lending criteria and caused a huge decline in home construction and related jobs and spending.

The next event was the realization that banks and other financial institutions were severely affected by the losses in home values and were holding loans that would never be repaid. The housing downturn became a financial sector crisis as financial institutions faced large loan losses. The nation saw mergers, bankruptcies and federal takeovers to try and stabilize the banking sector.

These events resulted in a loss of confidence and decline in the stock market. The large loss of wealth in home and portfolio values caused a slowdown in consumer spending.

At the same time that our domestic economy was turning down, economies all around the world were slowing (Nissan announced 20,000 layoffs today), which will contribute to a decline in U.S. exports--another spending sector to turn down.

Currently these declines in spending are feeding on each other creating large continuing job losses and great uncertainty and fear and further layoffs as businesses are preparing for lower sales in 2009.

What is Different About This Recession?

This recession includes a substantial loss of wealth, continuing uncertainty in where the bottom of housing prices and foreclosures lies, and uncertainty about the solvency and future of our banking system.

This is why President Obama and others have characterized our efforts to reverse the economy's downturn as a three-legged stool—1) stimulus spending to boost demand and create jobs, 2) a new effort to stem home foreclosures and 3) programs to bring stability to the banking system.

As a result economists believe that a successful stimulus package is not enough by itself to restore confidence and spending in the economy—the foreclosure and banking sector challenges must also be successfully addressed.

Who (or what) Creates Jobs?

This question is at the heart of the political divisions evidenced in the stimulus bill debate. There is no issue with **where** most jobs are created. It is in the private sector. In January 2009 the nation had 22 million government sector jobs and nearly 125 million private sector jobs.

However, these jobs are created by the demand for goods and services, i.e. by the choices of consumers, businesses and government to spend and invest.

Some jobs are created by entrepreneurs who take great risks to invest and develop new goods and services. Our history is full of innovations like personal computers, mobile phones, the explosion of Internet-based services and many other inventions or new services that enrich our lives. So a tax system that encourages people to take risks in pursuit of reward is good for the economy.

This is the popular image behind the call for business tax cuts to increase incentives for business to “create jobs”.

However, most business decisions are not about developing some brand new product or service but about how best to respond to consumer demand for homes, cars, and the many other goods and services we buy every day. And when consumers have lost jobs and wealth and are scared, they stop buying. The result is lower sales followed by a cut in production and, eventually, the loss of jobs—3.6 million so far in this recession.

There is very little that the private sector can do by itself in deep recessions to create jobs. In fact, good business practice tells companies to cut their workforce in response to a persistent decline in customer spending.

The Economics of Stimulus Efforts to Fight Recessions

Since recessions are caused and continue as a result of a drop in spending, the antidotes are policies designed to boost spending.

As President Obama said (my paraphrase) with some exasperation recently “Some people complain that the stimulus bill is a spending bill. What do they think stimulus is if not programs to increase spending”?

Actually there is no disagreement about the goal of increasing spending. The political dispute is about the way to increase spending. The federal government has the big anti-recession arsenal. There are three main anti-recession weapons—1) interest rate cuts, 2) tax cuts and 3) direct government spending.

Interest rate and tax cuts are designed to provide incentives to increase private sector spending by households and businesses. Direct government spending makes government the “customer” who will increase spending to restore production and jobs.

The theory behind interest rate cuts is to lower the cost of interest to consumers and businesses. If interest rates are lower the cost of buying a home or car or investing in a new plant will be lower. In addition payments on credit card and other consumer debt will be lower.

The theory behind tax rate cuts is that 1) they increase income for consumers and businesses and 2) they increase the incentive to work and invest.

The theory behind direct government spending as stimulus is 1) we can be sure that all the money will be spent and 2) we can target the money to “deserving” areas such as increases in unemployment benefits, infrastructure investments and minimizing the reduction in state and local education and health spending.

Why is Direct Government Spending Large in Current Stimulus Proposals

The guidelines for successful stimulus efforts are the three T’s—temporary, timely (quick acting) and targeted (to be most effective).

Direct government spending plays a large role in current stimulus proposals for four major reasons.

One reason is concern about the ability of interest rate and tax cuts to increase spending quickly. Interest rates have already been reduced significantly. The federal funds rate is close to 0% already. And many other interest rates are at or near historic lows.

There are tax cuts in the current stimulus bills and it is a subject of intense political differences of opinion as the current Senate debate has shown. While there is broad agreement that tax cuts for low-income households will be fully and quickly spent, there is concern about the effectiveness of other tax cuts. The 2008 experience with tax rebates found that they were not fully spent.

There is skepticism about the effectiveness of large tax rate cuts for businesses. We are experiencing a large shortage of customers combined with fear and anticipation that prices may fall further for homes, cars and other big-ticket items.

It is not clear why businesses would be motivated by tax cuts to expand capacity **now** since they are furiously cutting capacity in response to the lack of customers. The question of the proper incentives for long-term private investment is a serious conversation we need to have as a nation.

Just as I think some of the spending proposals should really be kept separate and debated as long-term, not stimulus, proposals, the questions about corporate taxation are long-term issues and the idea that corporations would boost spending now is really a stretch since there is a shortage of customers.

There are some targeted and temporary tax cuts being debated to provide incentives to accelerate car, home and business investment spending.

But, for the most part, the tax cuts in the current stimulus bill are part of long-term agendas—such as the permanent tax cut for working families and elimination of the Alternative Minimum Tax (AMT) for most households.

Two, the President argues that targeted direct government spending can do “double duty” for the country. It would have a short-term impact of job creation **plus** a longer-term impact of creating a benefit for the future. For example, infrastructure investment creates jobs (the evidence is that this kind of spending has the highest “multiplier” on economic activity) while creating an asset for the future—a bridge, water system, more energy efficient building, a more technologically capable school facility or a national broadband network.

The challenge is to pick projects that can be started quickly and to avoid bad projects—what we call “pork”.

Three, direct government spending is the only way to prevent cuts in state and local programs for education and health care as state and local governments cannot maintain spending without raising taxes because they cannot run deficits even though the country is in a deep recession. This federal spending is a question of priorities—preventing cuts in services to children and health care for poor families and the resulting impacts in terms of education and health and the associated loss of jobs from teachers to school janitors and health care workers.

It is a flaw in our social contract about safety net spending that the federal government is supposed to pass emergency aid for programs like food stamps and unemployment insurance while state and local governments must cut back on safety net spending when it is most needed.

Four, the size of required stimulus spending to turn the economy around is very large and the downturn is accelerating. The addition of direct government spending adds size, priorities and immediacy to the ability of the federal government to support the economy and restore confidence.

Beyond the Stimulus Bill

The stimulus bill is likely to pass the Senate this week and go to conference committee where there will be a discussion of at least two of the major cuts by the Senate—1) aid to states and schools and 2) some construction monies.

Beyond the stimulus bill itself the other two “legs of the recovery stool” will be unveiled in the next few days—1) additional financial sector aid and reforms and 2) a larger program to reduce foreclosures through loan modifications.

All three components are needed given the size of the downturn and the major challenges remaining in the housing and banking sectors.

Overcoming Blame to Find the Common Interest

There is plenty of blame to go around. Families borrowed money to buy homes they could not afford. Lenders made loans without regard to the ability of borrowers to pay back the loans. There was no effective oversight of this collective imprudence.

Most families and businesses “played by the rules” and behaved responsibly.

Those who played by the rules are now helping people who took wild risks because their fates are connected. We have learned the language of connectedness and common interest. Main Street, we say, is connected to Wall Street and it is true. Some potentially undeserving people and businesses will get financial assistance as the country struggles to recover from the recession and related housing and banking challenges.

We are still wrestling with who should bear the losses. This is the main barrier to reducing foreclosures in that we have not found agreement yet on how to apportion the losses. It is also a barrier to building support for an imperfect plan in an imperfect world facing the reality of a greater challenge--avoiding an even deeper and longer economic slide.

But in getting to a better future, whether that is next year or the next 20 years, our connections need have greater voice than our differences and we must find ways to deal with blame that do not inflict harm on the economy and the millions of innocent victims of this economic crisis.