Only Deft, Aggressive Policies Can Avert Deeper Recession

[Editor's note: These comments by Mark Zandi, chief economist of Moody's Economy.com, are edited excerpts of testimony he gave before the U.S. Senate Budget Committee on January 30, 2008.]

First, the economy is on the edge of recession, if not already in one. Real GDP growth slowed sharply during the last quarter of 2007, and the economy appears to be contracting in early 2008. The job market has stalled, retailers are struggling, and manufacturing is declining.

The substantial threat of recession is evident in the recent increase in unemployment. The unemployment rate rose 0.6% between its 4.4% cyclical low in March 2007 to 5% in December. Recessions are always preceded by such a rise, and such a rise has never occurred without an ensuing recession. The economic reasoning behind why higher unemployment sets off the vicious cycle that characterizes recession is that increased joblessness undermines consumer confidence and thus consumer spending. Businesses respond to flagging sales by cutting back their investment and payrolls, and unemployment rises further. A negative self-reinforcing cycle begins.

A number of large state economies are already in recession, including Arizona, California, Florida, Michigan and Nevada. These states account for one-fourth of national GDP. Alaska, Arkansas, Connecticut, Minnesota, Missouri, Ohio, Rhode Island, Vermont and Virginia are on the edge of recession. These states account for more than 15% of the national gross domestic product. The large metro economies of the Northeast, extending from Boston to Washington, D.C., are still expanding, but growth is sharply slowing, particularly around New York City, which is being hurt by Wall Street's travails. If these economies devolve into recession, then a national recession will occur.

Second, the most fundamental source of the economy's problems is the unprecedented housing downturn and resulting surge in mortgage loan defaults and foreclosures. Housing activity peaked 2½ years ago, and since then, home sales have fallen by approximately 35%, housing starts by nearly 50%, and house prices by 8%. Some two-thirds of the nation's housing markets are experiencing substantial price declines, with double-digit price declines occurring throughout Arizona, California, Florida, Nevada, the Northeast Corridor, and the industrial Midwest.

Housing construction and prices are likely to further decline substantially through the end of the decade as the record number of unsold homes mounts. This inventory reflects turmoil in global financial markets and its impact on the mortgage securities market and mortgage lenders and the recent weakening in the broader economy and job market. There is now a broad consensus that national house prices will fall by no less than 15% from their peak to their eventual trough. Even this disconcerting outlook assumes that the broader economy will avoid a full-blown recession and that the Federal Reserve will continue to ease monetary policy.

Residential mortgage loan defaults and foreclosures are surging. Falling housing values, resetting adjustable mortgages for recent subprime and Alt-A borrowers, tighter underwriting standards, and the weakening job market are conspiring to create unprecedented mortgage credit problems. According to very accurate data based on consumer credit files, 450,000 first mortgage loans were in default (the first step in the foreclosure process) as of the end of 2007. This equates to some 1.8 million defaults at an annualized pace. Even if mortgage loan modification efforts increase measurably in coming months, I expect almost 3 million mortgage loan defaults this year and next. Of these, 2 million homeowners will go through the entire foreclosure process and ultimately lose their homes. The impact on these households, their communities, and the broader economy will be substantial.

The unraveling of the housing and mortgage markets is undermining the fragile global financial system. Estimates of the mortgage losses that global investors will eventually have to bear range as high as $500 billion. The losses publicly recognized by financial institutions to date amount to no more than $150 billion. Losses on construction and land development loans that banks have made to homebuilders are sure to increase measurably in coming quarters, and the credit problems on other consumer loans are rising rapidly, particularly in those parts of the country already in recession because of the housing downturn. These stresses are also exposing other weak spots in the financial system, including the monoline insurance industry and the credit default swap market. Given the opacity of the global financial system, it is unclear who is most at risk, so players in credit and equity markets remain on edge, unwilling to extend credit to one another. The availability of credit has been impaired and the cost of capital has risen for nearly everyone, creditworthy or not, and the negative economic repercussions are mounting.

The housing downturn is also undermining consumer spending. Even a modest pull-back by consumers will push the economy into recession, since such spending accounts for 70% of the nation's GDP. The odds of such a retrenchment are high, given that the savings rate of the one-third of homeowning households that have borrowed against their homes in recent years is an estimated negative 10%. If this group, which also accounts for about one-third of all consumer spending, simply matches its spending to its income over the next several quarters, the negative impact on overall consumer spending will be substantial.

My third point is that although a recession might be unavoidable in coming months, it will take deft and aggressive monetary and fiscal policymaking to ensure that if the economy suffers a downturn, it will be short and modest.

The last two recessions, in 2001 and 1990-91, were short and mild by post World War II standards, only because of the aggressive monetary and fiscal stimulus that had been provided to shore up the economy. In the downturn of the early 1990s, the real federal funds rate fell from 5% to 0%, and the federal budget deficit increased from 3% to 5% of GDP. Early in this decade, the real funds rate fell from 4% to -1% and the deficit from 2% to -4%. So far in the current period, the real funds rate has fallen from 3% to 1.25% and there has been no fiscal policy response.

Policymakers should quickly provide more of a stimulus to the unraveling economy. The Federal Reserve has become much more aggressive, slashing the federal funds rate target quickly from last summer, when it stood at 5.25%. Even more rate cutting will likely be needed given that monetary policy has seemingly become less effective in stimulating growth in the current environment.[1] The most immediate conduit between monetary policy and the economy runs through the housing market. Housing is the most interest-rate sensitive sector of the economy, and historically it would receive a quick boost from monetary easing. This boost will be much more muted today, given the problems in the mortgage securities market. Issuance of bonds backed by subprime, alternative-A, and jumbo mortgage loans has collapsed. Save for conforming fixed-rate loans, which are only loosely tied to Fed actions, lenders are unable and unwilling to extend mortgage credit at any interest rate.

Various automatic fiscal stabilizers are beginning to kick in as the economy falters. Tax revenue growth is already measurably slowing, and spending on various transfer programs will soon ramp up. Even if policymakers do nothing in response to the eroding economy, the budget deficit will increase substantially.

Doing nothing would be a mistake, however. Fiscal policymakers have a window of opportunity to provide a substantial additional stimulus in a timely and targeted way. A well-designed tax rebate issued this summer, and additional spending for financially pressed households reliant on unemployment insurance and food stamps, would be very helpful in shoring up the flagging economy. This stimulus should be temporary. That way, it will result in a larger deficit this fiscal year and next, but will not weaken the nation's already daunting long-term fiscal prospects. Indeed, a well-timed, targeted and temporary stimulus could ultimately be less costly to the Treasury than doing nothing, since a debilitating recession would severely undermine tax revenues and induce more government spending.

My final point is that in addition to a greater monetary and fiscal stimulus, policymakers should consider responses to the difficulties in the housing and mortgage markets. Expanding the FHA's lending authority, temporarily lifting the mortgage loan caps on Fannie Mae and Freddie Mac, and the Hope Now initiative are all laudable efforts, but may very well prove inadequate to reviving the moribund mortgage securities market, mortgage lending and the housing market. Until these difficulties are addressed, the broader economy will struggle regardless of the monetary and fiscal stimulus provided.

What policymakers decide to do or not do in the next few weeks will determine whether millions of Americans lose their jobs this year and will have a significant bearing on the economic well-being of everyone else.

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[1] This point is well articulated in "Housing, Housing Finance, and Monetary Policy," Martin Feldstein, presented at the Jackson Hole conference of the Federal Reserve Bank of Kansas City, September 2007 http://www.kansascityfed.org/publicat/sympos/2007/PDF/2007.09.05.Feldstein.pdf