

It's not only radical economists and cyberspace Cassandras uttering the "r"-word nowadays. Just what are we to make of it when Harvard economists, *The Economist* magazine, and Morgan Stanley followed by Goldman Sachs and

Merrill Lynch say the economy is headed toward, or already in, a recession?

You can bet the house, whatever its current value, that hard times are on the way -- more layoffs, fewer new jobs, lower wages, tighter family budgets, more debt, and higher poverty levels. This year will see rising economic hardship even if the U.S. economy scrapes by without sinking into an official recession, usually defined as two straight quarters of declining output.

How do I know this? Hard times have been the hallmark of the U.S. economy during this decade, even as the economy expanded. We will be in for more of the same, but worse, as the economy slows and the inevitable downturn in the business cycle exacerbates the economic injuries many people have already sustained thanks to long-term shifts in the U.S. economic system.

And Those Were the Good Times

For a while now, there have been plenty of signs that the overall U.S. economy is headed south. Economic growth stalled in the last three months of 2007, adding only 0.6 percent to output after correcting for inflation. In December, job growth ground to a near halt, and the economy lost 17,000 jobs in January, as construction suffered large job losses. The unemployment rate jumped to 5.0 percent for the first time in three years, and would be much higher if the labor force participation rate -- the fraction of the population either working or actively looking for work -- were at the same level as when George Bush took office. On top of that, retail sales tanked in December as worried consumers cut back on holiday spending. Finally, the terminally volatile stock market registered one of its worst Januaries on record, enough to induce a panicked Fed to make an emergency interest-rate cut.

But even leaving these and other recent numbers aside, U.S. economic performance this decade has been nothing to write home about. The economy has now expanded for 74 straight months, from November 2001 to December 2007, far longer than the usual 51-month postwar expansion. But economic growth has been the slowest of any postwar expansion, averaging just 2.8 percent a year, far below the 4.3 percent average posted by earlier postwar business cycles of similar length. Worse yet, the economic growth that has occurred has done so little for so many -- and so much for so few.

- Employment expanded by just 0.9 percent a year since the recovery began, compared with an average of 2.5 percent for all recoveries that have lasted at least this long.
- After correcting for inflation, weekly wages were just 1.9 percent higher in October 2007 than at the onset of the last recession in March 2001. The average postwar expansion drove wages up by twice that amount, 3.8 percent.
- Seven million more people were without health insurance in 2006 than when the expansion began in 2001.
- Median household income actually *fell* during this recovery. After correcting for inflation, median household income in 2006 (the latest year for which data are available) was down 2.0 percent from its 2000 level, and down 8.0 percent for black families.
- The poverty rate was 12.3 percent in 2006 (again the latest year available), down from 12.6 percent in 2005, but still a full percentage point above the 11.3 percent rate at the onset of the last recession.
- U.S. inequality reached levels not seen since the 1920s as the average real (inflation-adjusted) income of the richest 1 percent of households rose 34.8 percent from 2001 to 2005, while rising just 0.8 percent for the middle fifth of the population and *falling* by 3.0 percent for the poorest fifth.
- And corporate profits skyrocketed. Inflation-adjusted corporate profits rose 12.8 percent a year during the first five years of this recovery, compared to an 8.3 percent average growth rate in the other postwar recoveries lasting at least as long.

No wonder 7 out of 10 people think the U.S. economy is heading into a recession, according to a recent poll conducted by the Economic Cycle Research Institute, a New York-based independent think tank. For many, the recession that began in March 2001 and ended, officially, that October has in reality continued straight through the decade.

Pop Goes the Housing Bubble

Besides punishing people who work for a living and those who can't even find a job, the 2008 economy will face a financial crisis brought on by the bursting of the housing bubble. How bad will it get? Pretty bad. A decade long stagnation, as Harvard economist Larry Summers suggests, or "the worst housing bust ever," as NYU professor Nouriel Roubini suggests, are not out of the question. Here is why.

To begin with, subprime borrowers are not the only ones in trouble. The same types of loans that imposed inordinate risks on subprime borrowers have left many other homeowners vulnerable to foreclosure as well.

Defaults are now engulfing even better-off borrowers saddled with adjustable rate mortgages (ARMs), subprime or not, whose low introductory monthly payments are reset upward as interest rates rise in the economy. About one-quarter (24 percent) of *all* home loans are ARMs. Merrill Lynch economists have called ARM mortgages "ticking time bombs" that they suspect will add another \$100 billion in losses, on top of an estimated \$400 billion in losses on subprime and other mortgages. Lehman Brothers estimates that nearly \$156 billion worth of one particular type of ARM (so-called option ARMs) will face payment resets between 2008 and the second quarter of 2012. If home prices fall by 6 percent or more in both 2008 and 2009, the borrowers in over \$90 billion of these loans would owe as much as or more than the market value of their homes. With a growing number of borrowers already owing more than their houses are worth and, so, unable to refinance, foreclosure and delinquency rates have soared. By the third quarter of 2007, the percentage of home owners behind in their mortgage payments on all one- to four-unit residential loans already stood at a 19-year high, according to a Mortgage Bankers Association survey, and the percent of loans in the process of foreclosure was the highest ever.

As of October, home prices in the ten major metropolitan areas that make up the S&P/Case-Shiller home-price index were down a record 6.7 percent from a year earlier. In Las Vegas, Miami, San Diego, and Phoenix, cities whose housing markets were sizzling just a few years ago, housing prices have fallen even faster, dropping by 10 percent or more over the same period. Existing home sales were at their lowest rate on record, and down about one-third from their mid-2005 peak.

Not surprisingly, then, the supply of detached single-family homes listed for sale in October 2007 was at its highest (relative to the pace of sales) since 1985, according to the National Association of Realtors. A glut of unsold houses has in turn squashed housing starts, which hit a 16-year low in December.

How much more will housing prices drop and when will they hit bottom? While one real estate economist suggests that "parts of the housing market are scratching bottom right now," others think housing prices won't bottom out until 2009 or even 2010 and forecast prices at that point may be 12 percent lower than their peak levels. Summers points to one property derivatives market indicating that over the next several years, house prices could fall by as much as 25 percent from their previous peaks nationwide.

For anyone who doesn't believe that housing prices can fall for a long time, the recent history of the Japanese housing market suggests otherwise. So does the size of the U.S. housing bubble, which drove home prices up further and for longer than any period since 1890, according to Yale economist Robert Shiller's long-term U.S. house price index.

Economic journalist Doug Henwood, publisher of the *Left Business Observer*, calculates that housing prices at their peak were 40 percent above Schiller's long-term trend line, and notes that a 20 percent to 25 percent drop in housing prices would be "in line with past experience."

During the bubble, housing prices rose far more quickly than income; the resulting imbalance is another reason to expect home prices to keep falling. From 2000 to 2006 nationwide housing prices jumped 74 percent, while median household income rose just 15 percent (*before* correcting for inflation). To restore a historically normal ratio of housing prices to incomes, average home prices would have to fall by more than 30 percent from their peak levels, according to Princeton economist Paul Krugman.

Consumers to the Rescue?

The bursting of the housing bubble will likely put more of a dent in consumer spending than the stock market collapse of 2001. The two bubbles are of comparable size. But historically, a \$100 rise in housing wealth leads to about a \$6 increase in long-run consumption, one and a half times the \$4 gain from the same increase in stock wealth. Likewise, the current fall in housing wealth will likely translate into a sharper dropoff in consumer spending than would an equal-size fall in stock wealth.

And household consumption has been especially important in this decade's expansion. It now represents a record 72 percent of GDP, up from about 67 percent in the late 1990s. So you can expect a collapse of consumer spending to trigger a deeper recession than the 2001 downturn set off by the dot-com bust and a collapse in business capital spending, which at the time accounted for only 13 percent of GDP. In November, a report by the forecasting firm Global Insight for the U.S. Conference of Mayors predicted that "the deepening housing crisis will cut economic growth by more than 25 percent in 143 U.S. metropolitan areas by next year."

Meanwhile, as house prices fall and unemployment rises, defaults on consumer loans and credit cards, which put a sizeable dent in even American Express's earnings last year, will spike in 2008. And since consumer debt is chopped up, bundled, and resold much like mortgages are, bad consumer debt will add to the fragility of the financial system as far-flung creditors take further losses.

While more and more business economists now foresee recession in 2008, many remain convinced the U.S. economy will get through the year without lapsing into a recession. Most of the optimists are betting that foreign economies will provide enough stimulus to keep the U.S. economy out of recession. Recent Fed interest-rate cuts have reduced the value of the dollar, which in turn lowers the price of U.S. products to foreign consumers. This should spur U.S. export growth and buoy the economy. Indeed, in a recent note Morgan Stanley economists told their clients that their "meager" growth forecast for 2008 would be negative if not for export growth.

Perhaps the fast-growing emerging economies in the developing world offer some hope. In 2007 emerging economies contributed half of the globe's GDP growth measured at market exchange rates, over three times as much as the United States' did. In addition, emerging markets, which buy more than half of U.S. exports, continue to grow, some at an accelerating pace, even as industrialized economies cool. "This time," *The Economist* proposed in November, "they could be the rescuers."

"Don't count on it," says economist Stephen Roach, chairman of Morgan Stanley Asia. "American consumers spent close to \$9.5 trillion over the last year. Chinese consumers spent around \$1 trillion and Indians spent \$650 billion. It is almost mathematically impossible for China and India to offset a pullback in American consumption."

False Savior

All eyes are now on the Fed as it tries to prevent the housing slump from dragging down the broader economy by cutting interest rates and pumping liquidity into the system -- as it has following other financial crises. The Fed has cut interest rates repeatedly since the middle of last year and two times in January alone, including an extraordinary three-quarters of a percentage point cut to prop up the teetering stock market.

But because the current problem is not liquidity but solvency, the Fed's actions will likely be ineffective this time around. Injecting money into the economy won't solve today's credit problem because banks are reluctant to lend, even to other banks, when they don't know how much of the economy's bad mortgage debt any borrower may be holding. So when the Fed adds liquidity to the system, banks either hoard the money or, like everyone else, buy safe Treasury bills. With few willing buy to other bonds, long-term interest rates, or the yields on those bonds, have not dropped, despite repeated liquidity injections by the Fed. For instance, the interbank lending rate is still well above the rates on much safer government bond yields of similar maturity.

Economist and *American Prospect* editor Robert Kuttner likens the situation to "[t]he financial system holding a \$400,000 mortgage on a \$300,000 house. Lower interest rates can't fix that problem nor give people the confidence to lend."

The ability of the Fed to pull the U.S. economy's fat out of this fire is constrained in other ways as well. At the end of last year, higher energy costs and imports made more expensive by the declining value of the dollar pushed up consumer prices. The pick-up in inflation will make the Fed reluctant to cut interest rates further.

So too will the massive U.S. current account deficit. Each year the United States finances the huge gap between its imports and exports by enticing Asian and other foreign investors to buy dollar-denominated assets such as government bonds and corporate stocks and bonds. When the Fed cuts interest rates, that lowers the rate of return on U.S. assets and makes them less attractive to foreign investors -- especially as the U.S. economy falters. Should purchases of U.S. securities by foreign investors slow dramatically, then the dollar would crash, stock values would plummet, and a far more severe economic downturn would surely follow.

The "D" Word

With the sharp tightening of credit brought on by the bursting of the housing bubble, and with the Fed's ability to affect the picture highly limited, chilling comparisons between today's rocky economy and the 1920s economy prior to the onset of the Great Depression are now commonplace. No one has beaten that drum louder than Kuttner. "Future historians are likely to look back on the final year of the Bush administration as a moment not unlike 1930, when government dithered while a financial crisis deepened," he warns.

The comparison is an apt one. Reckless private borrowing and gaping inequality defined both periods. What's more, in both periods a borrowing binge pushed up asset prices, first stock prices and then housing prices in the current period, to historically unprecedented levels compared to economic growth and incomes, saddling the economy with unsustainable levels of debt.

At some point that mounting debt will cut the economy down to size, perhaps in a sudden debt deflation similar to the Great Depression, in which the value of most assets, not just housing, sinks below the value of the debt on those assets. More likely the post-stock market crash, post-housing bubble U.S. economy will sink into a lengthy period of economic malaise that looks as dismal as the economic prospects that most working people have already faced over

the last decade.

It doesn't have to be that way. But much will have to be done to rescue today's economy from its free-market excesses and to improve the life chances of those who have suffered as a few have enriched themselves. Spending and tax relief targeted at the most hard-pressed, who can be counted on to spend any extra money they get and immediately boost consumption, is not a bad place to start. Other good, quick stimulus measures include expanding unemployment insurance, cutting payroll taxes for families of modest incomes, getting funds to cash-strapped state governments so they can continue to deliver services, and providing mortgage relief for low-income homeowners. But the economic stimulus package the Bush administration and the Democratic leadership of the House recently agreed on does not cover even this modest agenda: it fails to extend unemployment insurance or funnel monies to state governments, and it wastes one-third of its \$150 billion price tag on accelerated-depreciation tax breaks for business that have no track record of inducing new investment, especially in a timely way. And whatever the specifics, a \$150 billion package is far too small to change to the direction of the \$14 trillion U.S. economy.

Massive social investment and fundamental financial reform are needed to put the bubble economy out of business and to create a housing market that serves the needs of most people, not speculators. Back in December, former democratic presidential candidate John Edwards proposed a progressive stimulus package that would also address some of the country's long-term environmental and energy needs. The Edwards plan would build a clean energy infrastructure, provide relief to states, expand unemployment insurance, and help families facing foreclosures. Nobel Prize-winning economist and mainstream rebel Joseph Stiglitz proposes some additional worthy projects: more federal support for state education budgets, tax breaks and spending to lower emissions. While it would take a while to get those programs in place, Stiglitz warns that this downturn is likely to last longer than other recent downturns.

Until those measures and many more are undertaken, the macroeconomy will lurch from bubble to bubble, while most people endure unrelenting economic hardship that intensifies when in an economic downturn but persists even when the economy grows.

This article is from the January/February 2008 issue of [Dollars & Sense: The Magazine of Economic Justice](#).

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The depths

Posted by: mbruton on Feb 8, 2008 1:22 AM

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This will continue, of course until citizens start to drag the richfilth into the streets and burn them alive along with all of their family members. Until then it will be organized crime as usual.

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Kucinich is the answer!

Posted by: Col. Jackleg on Feb 8, 2008 1:40 AM

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John Edwards is a johnny-come-lately and though a decent enough man his record in the Senate inspired nothing. Dennis Kucinich has labored long and hard in the House and has put forth a very aggressive economic recovery package that should be endorsed by every Democrat but he can't get it to the floor. Same is true of his Cheney impeachment resolution. He cannot be President but maybe, just maybe we can elect enough progressives in November to enable him to become Speaker. If that happens, it doesn't matter who is President and there will be hope for the changes Prof. Miller seeks and the nation requires to survive.

What has to scare everyone is the total absence of dialogue about the economy. Like daddy, like son...."its the economy, stupid!" When are the pretenders going to play that card or will they be economically "swift-boated" into oblivion ala Kerry.

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[» RE: Kucinich is the answer! give to his congressional re-election campaign](#) Posted by: undrgrndgirl

Good article - but what is missing?