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The Recession: How Deep Will It Go?

*Michael Mussa*, saying there will be an end to this recession, assesses the latest economic indicators and the Obama administration’s plans for a financial system bailout.


Steve Weisman: This is Steve Weisman at the Peterson Institute for International Economics. Our guest today on Peterson Perspectives is Michael Mussa, senior fellow at the Institute. Mike, what is your assessment on where we are in climbing out of this downturn?

Michael Mussa: The short story is that we don’t seem to be climbing out quite yet. The economic data for the fourth quarter in the United States and around the world have been quite negative, with US real GDP probably shrinking about 5 percent at an annual rate when the revised figures come out at the end of the month; the Japanese economy suffering a very large decline, over 12 percent at an annual rate in the fourth quarter; and Western Europe doing poorly.

Most of the world economy was certainly shrinking the end of last year at rates we’ve not seen since the recessions of the early 1980s and the mid-1970s. And it doesn’t appear that preliminary data for the first quarter points to a substantial strengthening yet, really anywhere in the world economy. The United States may shrink a little bit less this quarter than last quarter, but there’s certainly no signs that we’re beginning an upturn.

Steve Weisman: What about the financial sector in the United States and Europe? How troubling is it that they remain so weak?

Michael Mussa: This remains actually as probably the most serious immediate concern. We have made some progress in reducing stresses in credit markets worldwide, and some interest rate spreads have been reduced significantly. The commercial paper market for prime issuers has been resurrected in the United States. Mortgage rates have come down, but financial markets remain under very considerable stress. This is registered in the continuing declines in stock values and equity values in the United States and around the world.

Steve Weisman: Although rates and spreads may be coming down, people aren’t borrowing, and that’s bad, right?

Michael Mussa: Yes, of course. Part of that is, due to the demand side, that people are cutting back their consumption, so they need to borrow less. Part of it is due to the supply side. If you want to get a loan to buy an automobile, it’s significantly more difficult to do so than it was six or eight months ago. The declining credit volumes reflect both of those factors.
Steve Weisman: Recessions have typically lasted at least a couple of years, and this recession supposedly started more than a year ago. What’s your latest thinking about how long this one is going to last?

Michael Mussa: In the United States, the previous 10 recessions have been as short as seven months and as long as 20 months. This time, I think we’re in for a recession of beyond the average length. My own forecast continues to be that we’ll certainly continue to be in recession this quarter and next quarter, and I’m anticipating the turnaround is likely to come in the summer. Other forecasts for the US economy are more pessimistic generally than I am, expecting the recession to continue into the summer and some into the fall or even into 2010.

Steve Weisman: Why is it that your forecast is a little bit less pessimistic than some of the others?

Michael Mussa: I’ve been forecasting the US economy seriously for the past 27 years, and I’ve reviewed the record going back longer. There’s a tendency when the economy is sinking to ask the question that Alice asked as she falls down the well, “Down, down, down. When will it ever end?” And to believe there’s never going to be an end.

That has not proven to be the case in the past. My view is that once the negative forces pounding down on the economy abate, there’s a natural tendency for the economy to recover, particularly as inventory investment recovers, and those sectors that have been beaten down, like housing and autos, begin to come back from really quite depressed levels.

I think we’re also laying the foundation for some recovery through policy measures. The monetary authorities have been very active in seeking to revivify the credit markets. Short-term interest rates are at exceptionally low levels. And we now have a very substantial stimulus package, which is being signed into law today by President Obama.

Steve Weisman: Let’s talk about the package. It was nearly $800 billion, and of course there’s a new package I believe being announced this week to revitalize the mortgage market and also prevent foreclosures. Do you think these measures are having a significant impact, and do you have any problems with how they’ve gone about it?

Michael Mussa: With the stimulus package, it’s too soon to expect any impact today as the President has barely signed it. The nature of the package is such that it doesn’t provide a large amount of very short-term stimulus. The stimulus package of 2008 provided immediate tax cuts in a sort of lump sum and produced a sudden, jolt reaction virtually immediately after the measure was passed but petered out very quickly. This package tends to build its effect somewhat more slowly but should last considerably longer. I would have preferred it if it had a little bit more of an upfront jolt to it, and perhaps didn’t quite have such a long spending tail into 2012 and 2013. Whatever the merits, I don’t think that’s really stimulus.

Steve Weisman: We’re also beginning to see the outlines of the bank and financial institution rescue from Treasury Secretary Geithner, but the market last week seemed unimpressed
because of a lack of detail. Where do you think they're going with this, and do you think it's understandable that they haven't filled in a lot of the blanks yet?

Michael Mussa:

Well, I think they made a mistake in marketing it. The President himself said, “My Treasury Secretary tomorrow is going to present the details of our plan.” And if he had said instead, “My Secretary of Treasury tomorrow will outline the main elements of the plan, and we will follow up with the details later,” then there wouldn't have been this problem of building up expectations that weren't quite fulfilled.

I think that the plan, as I understand it, is quite sensible. They’ve learned some important lessons about what does and does not work, so Secretary Geithner was very clear they’re not going to have any more Lehman Brother type failures where they force a systemically important financial institution into the bankruptcy court naked without support and tend to produce a crisis. They’re going to avoid that; they certainly learned that lesson. They also have learned that it’s very important to rebuild confidence in financial markets, and the Federal Reserve can be very useful in that endeavor.

The efforts have succeeded in restoring some functioning to the market for prime commercial paper, not asset-backed commercial paper, but prime commercial paper; people know who the borrowers are. That market was completely frozen last October and November. The Fed has provided a backstop to it. Now, the private market is beginning to take it over again.

And I think that’s the strategy that they’re going to attempt to implement going forward. The Fed is going to become more active in a variety of credit markets and attempt to get them started. Then as the private market is prepared to take over the business, the Fed will price its activities in such a way that they become the higher-priced supplier but still the backstop in the event that something goes wrong. I think we’ll see more of that approach, and that’s one of the more important messages I got from Secretary Geithner’s speech and question-and-answer session.

What’s not clear are really two things. One, there is the problem of the toxic assets, as they call them; largely these complicated packages of mortgages and other securities, which no one knows quite how to value. Secretary Paulson tried to address that issue initially when he proposed the TARP, but then he wasn’t able to follow through on it. Similarly, the Obama administration hasn’t quite figured out how to do it.

Except I think it’s clear that they’re going to use a combination of approaches. They’re going to continue with the type of activity they had with Citigroup and Bank of America where they provided insurance coverage when these assets continued to be held by an important financial institution. They will also try to construct some type of bad bank or asset acquisition instrument where, with some support from the government, private equity capital can take over some of these assets from the banks, setting up prices for them. How that’s going to be done is not yet clear, but Paulson couldn’t answer it either. It’s not surprising; it’s a very difficult question.
Steve Weisman: Actually the TARP was Paulson's second attempt. He first had that idea of the SuperSIV, the structured investment vehicle.

Michael Mussa: Yeah, I thought that was laughable.

Steve Weisman: But that was supposed to be some entirely private sector instrument or entity that would take over the toxic assets; then he swung over to having a government do it. Is the Geithner plan combining at least aspects of those two approaches?

Michael Mussa: Well, they clearly had not worked out the details as of 10 days ago. We do know that a number of private equity firms are interested in acquiring some of these assets. Of course, they hope to buy them at really cheap prices. And the government can make it attractive to do that by providing financing. The private equity would take most of the risk; the government would provide additional liquidity to finance the holding of these assets until they mature. There clearly is some room to do that. The other approach of guaranteeing assets or writing insurance for assets that are on the balance sheets of individual banks, you can do that with big banks where you've got large pools of these potential assets.

Steve Weisman: How many big banks are there by that definition?

Michael Mussa: Oh, I would say that's an approach that can probably be applied to a dozen or so leading banks. But you've got a lot of much smaller institutions…

Steve Weisman: Hundreds, thousands, right?

Michael Mussa: Those that have particular problems with this are probably in the hundreds rather than in the thousands. But it's going to be very hard to try to have a bank-by-bank approach for a number of smaller institutions including nonbanks. So you want to have some mechanism that can help solve this problem for those smaller institutions as well, and I think what the administration has indicated is the necessity to have a kind of battery of approaches rather than relying exclusively on one approach.

Steve Weisman: A final question; if you think they seem to be headed in the right direction, why was the market so negative last week?

Michael Mussa: I think the market was anticipating hearing more, and also was hoping to hear that somehow the Treasury is going to step in and bail them out. And I think it's clear the attitude in the Congress and amongst the American people is not at this time particularly sympathetic to putting a lot more public money into bailing out banks that have made mistakes, and that Geithner wanted to be very careful about not reinforcing the expectations that somehow the public was going to step in and bail out these financial institutions. It's a very difficult line to walk.

Steve Weisman: Michael Mussa, thank you as always for shedding light on this.

Michael Mussa: Good to talk to you again, Steve.