[What a Year!: Economy Took Americans for a Rough Ride in 2008]

By: Andrew Brod

Brod, Andrew (2008). What a Year!: Economy Took Americans for a Rough Ride in 2008. *Greensboro News & Record*, December 28, 2008

Made available courtesy of Dr. Andrew Brod and the Greensboro News and Record: http://www.news-record.com/

***** Note: Figures may be missing from this format of the document**

Article:

When it comes to the economy, what can one say about a year like 2008? I say we wish it well but be glad it's over. Of course the biggest economic story of 2008 was the financial crisis and recession.

The R-word

2008 began with uncertainty over whether a recession was under way but ends with a clear consensus. The recession started in December 2007 and will almost certainly extend well into 2009.

For the first several months, the recession was fairly shallow in spite of employment declines. But then it deepened very quickly this fall in a flurry of bank failures and bankruptcies. Soon thereafter, other economic indicators started looking very bad.

In September, industrial production recorded its largest one-month decline since 1946. In October and November, retail sales registered the largest two-month drop since the 1980s. In October, an important index of manufacturing activity hit its lowest value since 1982, and the Conference Board's Consumer Confidence Index fell to its lowest level since the index was established in 1967. New claims for unemployment insurance rose to scary heights, home construction continued its downward march, and the stock market was down more than 40 percent from its 2007 peak.

Financial Meltdown

The financial crisis of 2008 was a long time in the making. We built too many homes during the housing boom of 2003-05, and the subprime mortgage crisis was essentially the hangover from that binge. Foreclosures rose and home prices fell, and the complex securities based on people making their mortgage payments became increasingly suspect. Throughout 2007 we wondered if the crisis would spread into the broader financial sector.

We got our answer in March, when the investment bank Bear Stearns collapsed due to its involvement with mortgage-backed securities and was rescued by the Federal Reserve, which arranged a sale (at a deep discount) to JPMorgan Chase.

In September, things got scary. The government-sponsored wholesale mortgage lenders Fannie Mae and Freddie Mac were taken over by the federal government. The insurance giant AIG collapsed and was partly taken over as well. The investment bank Lehman Brothers also collapsed but was allowed to go bankrupt. Merrill Lynch was near collapse when it was acquired by Charlotte-based Bank of America. In November, yet another federal rescue allowed financial-services giant Citigroup to avoid bankruptcy.

Depression?

There are some striking similarities between the current recession and the Great Depression. Both were generated by financial crises, excessive leverage, and inadequate government regulation. Both feature a rare condition called a "liquidity trap," in which interest rates are virtually useless as an anti-recession tool. And like the 1930s, a growing number of economists believe that the best medicine is a massive and sustained fiscal stimulus, including a WPA-style jobs program to rebuild our crumbling infrastructure.

But it's important to keep some perspective. During the Great Depression, the unemployment rate rose to 25 percent. We may well see double-digit unemployment, a dubious milestone we haven't achieved since 1983, but no credible economists believe that unemployment will get anywhere near 25 percent. Moreover, being unemployed is a less grave circumstance than it was in the 1930s, due to two-earner households and unemployment benefits.

This is likely to be the worst recession since the 1930s. But it won't be as bad as the 1930s.

Bailouts "R" Us

The Bush administration took steps to prime the pump for a recovery, and it deserves credit for ignoring economic ideology, even to the point of partially nationalizing segments of the financial sector and the automobile industry.

Some efforts have paid off, such as the government's commitment to be the buyer of last resort of commercial paper (unsecured short-term loans between businesses). And the sharp increase in the money supply this fall could provide much needed liquidity when the dam finally bursts and the recovery begins. But on the whole, the measures taken by the Bush team have been tentative and uncertain, as though officials are just biding time until the Obama administration takes over.

Commodity-price roller coaster

In the first half of this year, the big economic story was the dramatic across-the-board increases in prices of basic commodities, from energy to food to metals. Of course the poster child for this was crude oil, whose price rose above $140 per barrel in July, driving gasoline prices above $4 per gallon.

Many alleged villains were blamed, but the most important factor driving up commodity prices was unseen by American consumers: increasing demand in emerging economies, especially Brazil, Russia, India, and China.

This summer, high prices finally induced some conservation, and as a result prices began to fall. But then the financial crisis hit and the recession suddenly deepened, and a rapidly weakening global economy deflated prices further. By mid-December, the price of oil dipped below $40 per barrel and gasoline prices hovered near $1.50 per gallon. The price of copper fell to $1.30 per pound after rising above $4 in July. Corn prices fell about 40 percent since the middle of the year.

Thanks to falling commodity prices in general, consumer prices in the U.S. fell 2.8 percent from August to November, the largest four-month drop in at least 60 years.

Deflationary spiral?

And yet there's bad news even in this. A few months of falling prices is a welcome respite in a tough economy. But a sustained general deflation can create a spiral in which credit markets seize up. Deflation makes borrowing unattractive because borrowers have to repay loans with dollars that are worth more than those they were lent. At a time when the supply of credit is already tight, the last thing we need is tight demand as well.

Deflationary spirals cause other pathologies as well, including falling production and wages. If we were to have a second Great Depression, a deflationary spiral is probably the path we'd take to get there. So let's hope for a little inflation in 2009.