

The Economic Outlook and Budget Challenges
Testimony to the House Committee on the Budget

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Chairman Spratt, Ranking Member Ryan and other members of the Committee, it is an honor to be afforded the opportunity to appear before you today at this critical moment in our nation's history.

The purpose of my presentation is to review the state of the economy, and to draw historical lessons from the academic literature to help sketch out the range of possibilities going forward.

It is always a perilous thing to opine on the state of the economy. The data that we use to assess the economy are published with significant lags. While we can now feel fairly certain about the character of the fourth quarter of 2008, the current quarter is still underway, and economies can and do change direction rapidly.

Accordingly, discussion of the current state of the economy should be cautious. However, there is one thing that is well established at this point. There is no debate among economists that we are currently in a recession. The National Bureau of Economic Research is the official arbiter of such matters, and they have dated the beginning of this recession to December 2007.

This determination is important, because economists have established that the economy tends to proceed in a "nonlinear" fashion; that is, we can think of history as having consisted of discretely different "good" times and "bad" times. When we are in good times, good quarters tend to follow good quarters. When we are in bad times, bad quarters follow one another.

The fourth quarter of last year was one of the worst quarters in memory. It is likely that GDP declined at an annual rate of around 6 percentage points. While there is little data in hand for the current quarter, a decline of a similar scale seems to be in order.

Bad times are here. But it is worth noting that declines of approximately this scale have been posted before. The economic data available do not suggest that we are in something fundamentally different from past recessions. It would not be unprecedented for GDP to decline six percentage points a quarter or two from the beginning of a recovery. For example, in the first quarter of 1958, GDP declined well over 10 percent at an annualized rate. In the second quarter of 1980, GDP declined by an annual rate of 7.8 percent.

How long will the recession continue this time? Is the outlook so negative that policy action is urgent and necessary?

At first glance, the history of recessions might provide some cause for optimism. The typical recession in post-war U.S. history lasted about 10 months. The worst two recessions, that of 1973 and that of 1981, both lasted about 16 months. If the recession truly began in December 2007, then one might expect that the recovery would be near.

There is cause, however, to be reluctant to accept such a rosy view.

The first cause is an important qualification to the NBER announcement. There is a good deal of uncertainty surrounding the precise start date of this recession. An alternative econometric approach pioneered by University of California economist Marcelle Chauvet, uses economic data to estimate the real-time probability that we are in a recession.¹ Her estimates clearly indicate that we are now in recession, but the start date may have been much later.

This latter possibility was acknowledged by the NBER when it announced that a recession had begun, writing that, “The committee found that economic activity measured by production was close to flat from roughly September 2007 to roughly June 2008.”²

But if the recession truly began as late as June, then even if we receive a favorable draw and have an average recession by historical standards, then we can expect it to last into the summer. If this recession matches in duration the two worst post-war recessions, then it will last until October 2009.

There is a strong reason to believe that we should count ourselves fortunate if this recession resembles anything like a typical recession. A new study by economists at the IMF gathered data on 122 recession episodes in OECD countries between 1960 and 2007.³

The authors found that there have, sadly, been many historical precedents for the current crisis. Recessions have been preceded by credit crunches before. Recessions have also been preceded by home price collapses, and by equity price collapses as well. As can be seen in figure 2, it has usually been the case that these negative forces have occurred in isolation.

Of the 18 recessions that followed credit crunches, three saw coincident housing price collapses, one saw a coincident equity price collapse, and four saw all three negative factors. The key finding of the paper is the significance of these factors in determining the outlook. Figure 3 shows how credit crunch recessions have differed over time from normal recessions.

The news is not good. The typical decline in output during severe crunches, and this episode certainly qualifies as severe, lasts 4.33 quarters, and posts a GDP decline of 12.38 percent. These numbers may be large because of outliers. If one uses the median, rather than the mean, as a guide, then the average severe crunch recession lasted 3 quarters, and posted a 6.15 percent decline in GDP. In comparison, the four recessions containing a house price bust, equity price

¹ See Figure 1.

² <http://www.nber.org/cycles/dec2008.html>

³ Claessens, Stijn, M. Ayhan Kose and Marco E. Terrones. “What Happens During Recessions, Crunches and Busts.” IMF Working Paper, WP/08/274, December, 2008, http://www.aei.org/docLib/20081212_IMF.pdf.

bust and a credit crunch had an average duration of four quarters and a decline in GDP of 9.15 percent.

While this outlook is sobering, it is, if anything, a rosy scenario compared to other analyses. For example, a recent paper by economists Carmen Reinhart and Kenneth Rogoff focused exclusively on what could be called “severe financial crises.” Their key results are depicted in the next two charts.

Figure 4 looks at the typical unemployment experience for countries that have seen severe financial crises. On average, the unemployment rate increased 7 percentage points, and the downturn lasted a whopping 4.8 years.

If this chart characterizes the experience we are likely to have, then the unemployment rate in the United States will increase to about 12 percent.

Employment is often slow to respond to improving economic conditions. Jobless recoveries are far too common. Thus, the unemployment data may tell too negative a story. However, figure 5 indicates that the record of GDP growth after financial collapses is also startlingly negative, with the typical decline in GDP being 9.3 percent, and the typical downturn associated with financial crisis lasting 1.9 years.

Figure 6 shows that this bad economic news has been very bad news for budget authorities. On average, a financial crisis has led to almost a doubling of outstanding government debt.

In its most recent budget outlook, the CBO forecasts that GDP will decline 2.2 percentage points. Given the history of financial crises, it seems that this estimate is probably more like a best case scenario. Accordingly, I encourage the members of the committee to be cognizant of the fact that the budget outlook is likely to deteriorate significantly as the year progresses.

That realization should not discourage this body from supporting fiscal policy action. But it is important to note that the average experience discussed above is taken from a sample of countries that were governed by highly motivated policymakers dedicated to doing everything they could to soften the economic downturn. Even with the shrewdest policy action that governments were able to devise, the typical experience was a lengthy and deep downturn.

There is a genuine concern that the economy will continue to be soft past the time when this year’s stimulus efforts have had their effect, and that deficits could be much larger than those currently forecasted.

We have not yet reached the point where skyrocketing debt levels have caused heightened concerns among investors in U.S. Treasuries. If this Committee wishes to avoid testing those waters, it should consider tying stimulus efforts with genuine steps toward long run deficit reduction.

Figure 1.

Marcelle Chauvet – CREFC and University of California Riverside

Probabilities of Recession up to September 2008
using data available as of November 26, 2008

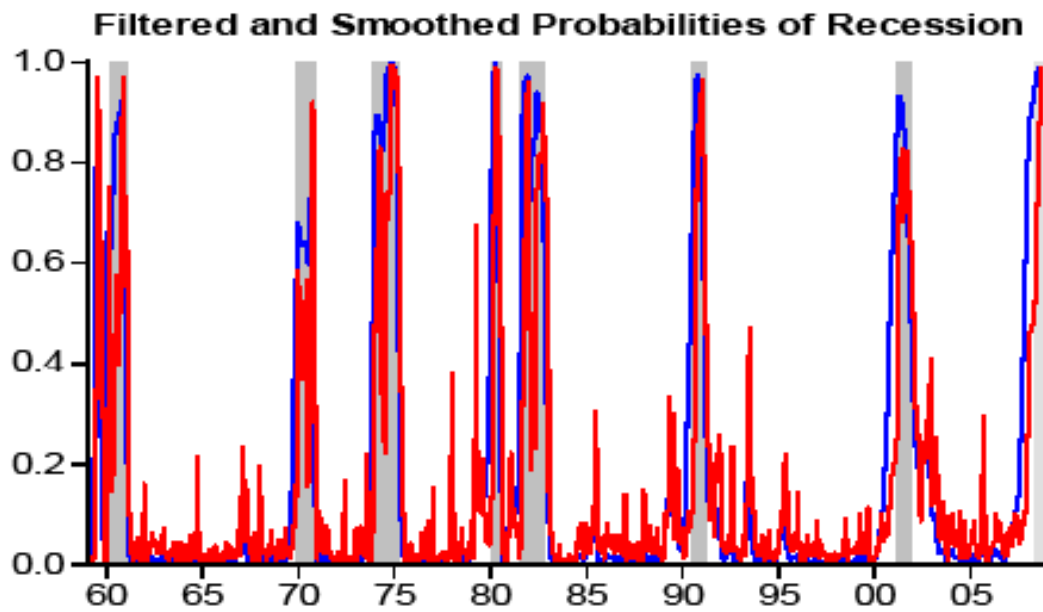
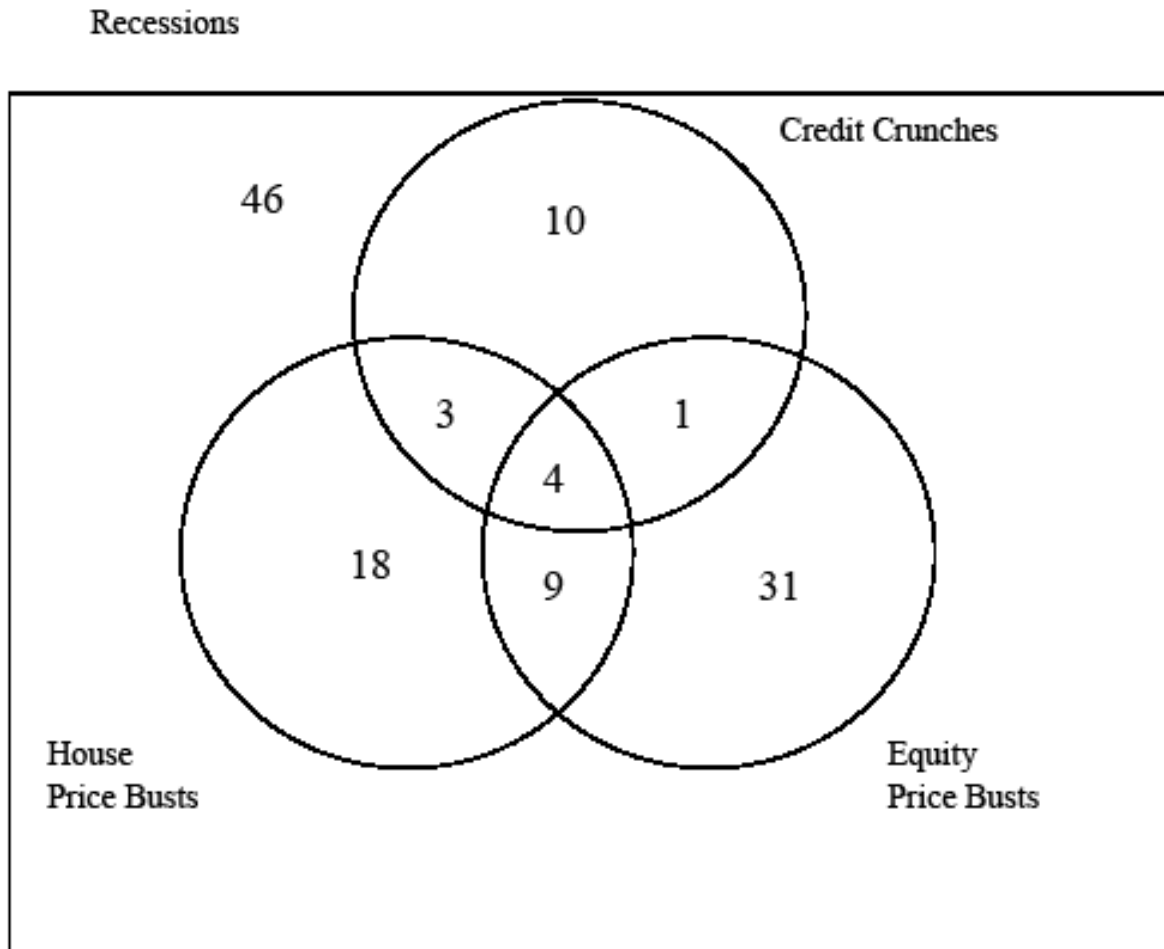


Figure 2.

Associations between Recessions, Crunches and Busts
(number of events in each event category)



Notes: The rectangle shows the distribution of 122 recession episodes in the sample into those associated with crunches and busts (76) and those associated with none (46). Out of 122 recessions, 18 are associated with credit crunches, 34 are with house price busts, and 45 are with equity price busts. 46 recessions are not associated with either a crunch or bust episode.

Claessens, Stinj, M. Ayhan Kose and Marco E. Terrones. "What Happens During Recessions, Crunches and Busts." IMF Working Paper WP/08/274, December, 2008, http://www.aei.org/docLib/20081212_IMF.pdf.

Figure 3.

Recessions Associated with Credit Crunches
(percent change unless otherwise indicated)

	Median Values			Mean Values		
	Without Crunches	With Crunches	With Severe Crunches	Without Crunches	With Crunches	With Severe Crunches
A. Output						
Duration ^{1/}	3.00	3.00	3.00	3.64	3.78	4.33
Amplitude	-1.82	-2.19	-2.7*	-2.47	-3.71	-4.05
Cumulative Loss	-2.87	-4.44*	-6.15**	-6.05	-8.85	-12.38
B. Components of Output						
Consumption	-0.04	-0.41	-0.58	-0.19	-0.16	0.79
Total Investment	-3.98	-4.97	-3.83	-5.90	-5.61	-4.70
Residential Investment	-3.72	-7.42	-8.16	-6.38	-8.92	-10.04
Non-residential Investment	-3.58	-4.25	-1.66	-5.12	-4.00	-1.40
Exports	-0.53	-1.82	-1.13	-0.65	-2.22	-2.01
Imports	-3.64	-4.53	-5.23	-3.81	-6.08	-7.07
Net Export (% of GDP) ^{2/}	0.48	1.06	1.17	0.67	1.10	1.48
Current Account (% of GDP) ^{2/}	0.45	0.88	1.39	0.57	0.42	1.65
C. Other Macroeconomic Variables						
Industrial Production	-4.02	-5.68	-6.48**	-3.84	-5.30	-6.58**
Unemployment Rate ^{2/}	0.55	0.90	1.00	1.14	0.89	0.83
Inflation Rate ^{2/}	-0.31	-0.33	0.53	-0.38	0.20	0.79
D. Financial Variables						
House Prices	-1.82	-4.04**	-4.88	-3.08	-6.38	-8.11
Equity Prices	-6.28	-2.47	7.88**	-4.50	-1.19	6.78**
Credit	1.54	-4.25***	-4.85***	2.82	-4.9***	-5.73**

Notes: Severe credit crunches are those that are in the top half of all crunch episodes. In each cell, the mean (median) change in the respective variable from peak to trough of recessions associated with credit crunches is reported, unless otherwise indicated. The symbols *, **, and *** indicate that the difference between means (medians) of recessions with credit crunches and recessions without credit crunches is significant at the 10 percent, 5 percent, and 1 percent levels, respectively.

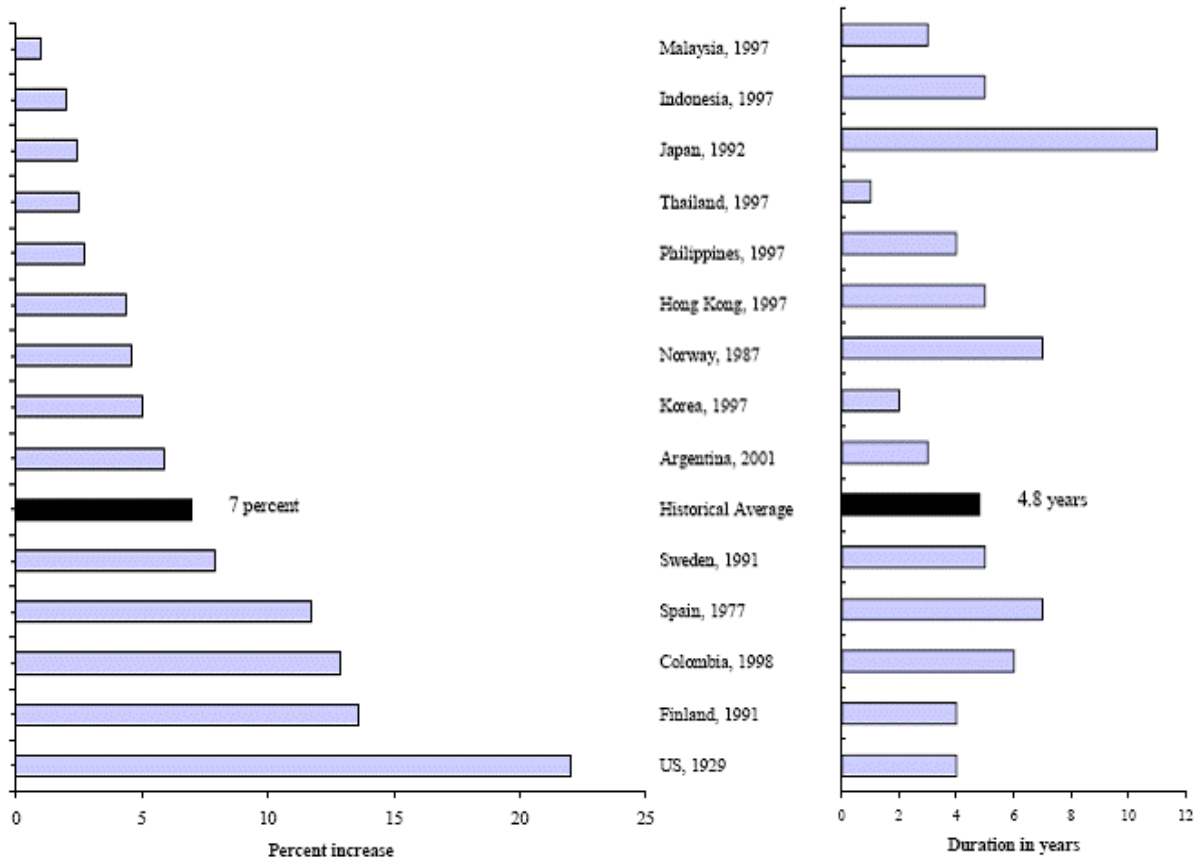
^{1/} Number of quarters.

^{2/} Change in levels.

Claessens, Stijn, M. Ayhan Kose and Marco E. Terrones. "What Happens During Recessions, Crunches and Busts." IMF Working Paper, December, 2008, http://www.aei.org/docLib/20081212_IMF.pdf.

Figure 4.

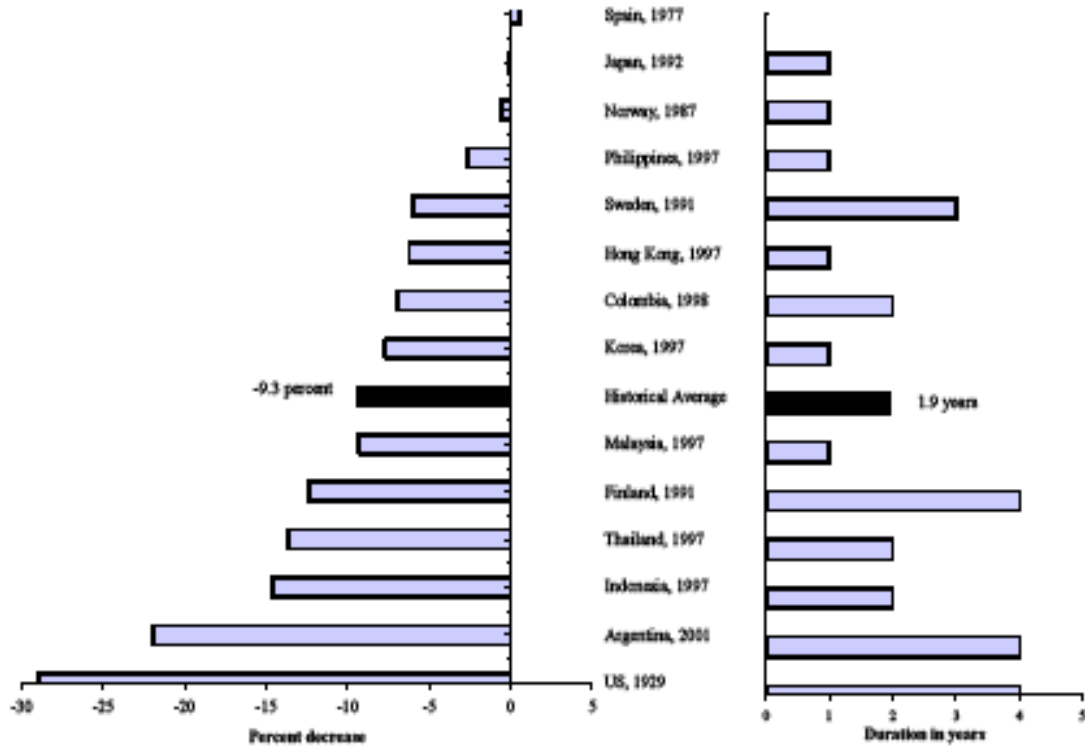
**Past Unemployment Cycles and Banking Crises: Trough-to-peak
Percent Increase in the Unemployment Rate (left panel) and Years Duration of Downturn (right panel)**



Reinhart, Carmen M. and Kenneth S. Rogoff. "The Aftermath of Financial Crisis." National Bureau of Economic Research Working Paper 14656. January, 2009, www.nber.org/papers/w14656.

Figure 5.

**Past Real Per Capita GDP Cycles and Banking Crises: Peak-to-trough
Percent Decline in Real GDP (left panel) and Years Duration of Downturn (right panel)**



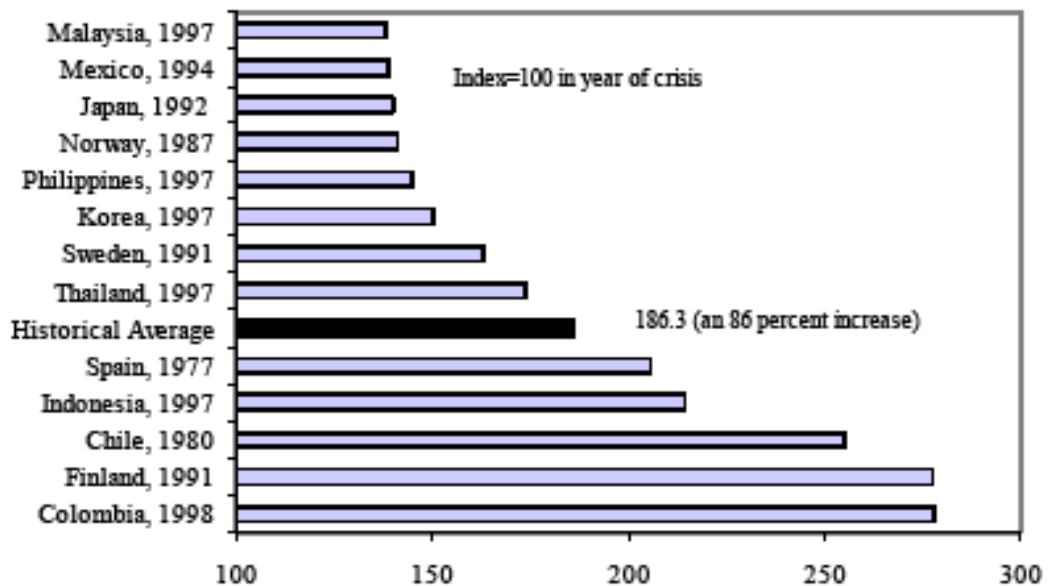
Sources: Total Economy Database (TED), Historical Statistics of the United States (HSOUS), and authors' calculations.

Notes: Each banking crisis episode is identified by country and the beginning year of the crisis. Only major (systemic) banking crises episodes are included, subject to data limitations. The historical average reported does not include ongoing crises episodes. Total GDP, in millions of 1990 US\$ (converted at Geary Khamis PPPs) divided by midyear population.

Reinhart, Carmen M. and Kenneth S. Rogoff. "The Aftermath of Financial Crisis." National Bureau of Economic Research Working Paper 14656. January, 2009, www.nber.org/papers/w14656.

Figure 6.

Cumulative increase in real public debt in the three years following the banking crisis



Sources: Reinhart and Rogoff (2008b) and sources cited therein.

Notes: Each banking crisis episode is identified by country and the beginning year of the crisis. Only major (systemic) banking crises episodes are included, subject to data limitations. The historical average reported does not include ongoing crises episodes, which are omitted altogether, as these crises begin in 2007 or later, and debt stock comparison here is with three years after the beginning of the banking crisis.

Reinhart, Carmen M. and Kenneth S. Rogoff. "The Aftermath of Financial Crisis." National Bureau of Economic Research Working Paper 14656. January, 2009, www.nber.org/papers/w14656.