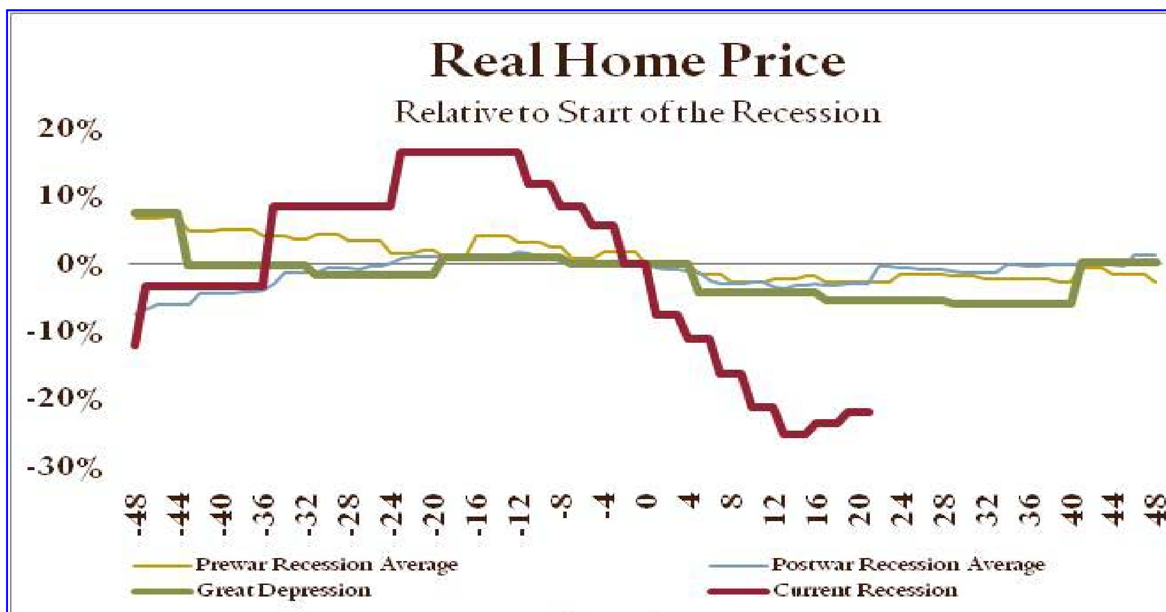
## Special Report - May 2010: There is Nothing "Normal" about this Downturn

*Economists continue to offer relatively pessimistic views on the strength and immediacy of the recovery. A few comparisons of the current recession and recovery with prior economic cycles illustrate why there is such guarded optimism. The charts that follow provide a timeline comparison of the recent recession and recovery with past downturns and recoveries. The data are centered on the beginning of the downturn (marked by "0"), separating pre and post-downturn periods. Indicators and measures for the current recession are plotted in red against the average of all post–World War II recessions plotted in blue. The dotted lines represent the mildest and the most severe experiences in past cycles. The charts in this report are from "The Economic Recovery in Historical Context," by Paul Swartz pswartz@cfr.org.*

The current recession started with a break in the housing bubble that interacted with the value of assets linked to mortgages. Moral hazards in the lending market, associated with efforts to expand loans to low income borrowers through Fannie Mae and Freddie Mac, fueled unsustainable pricing of housing. Chart 1 illustrates the unique and dramatic role housing played in the initial stages of the current recession. Unlike other downturns, consumers were hit with lost wealth in their biggest asset (housing) in addition to lost jobs and income.

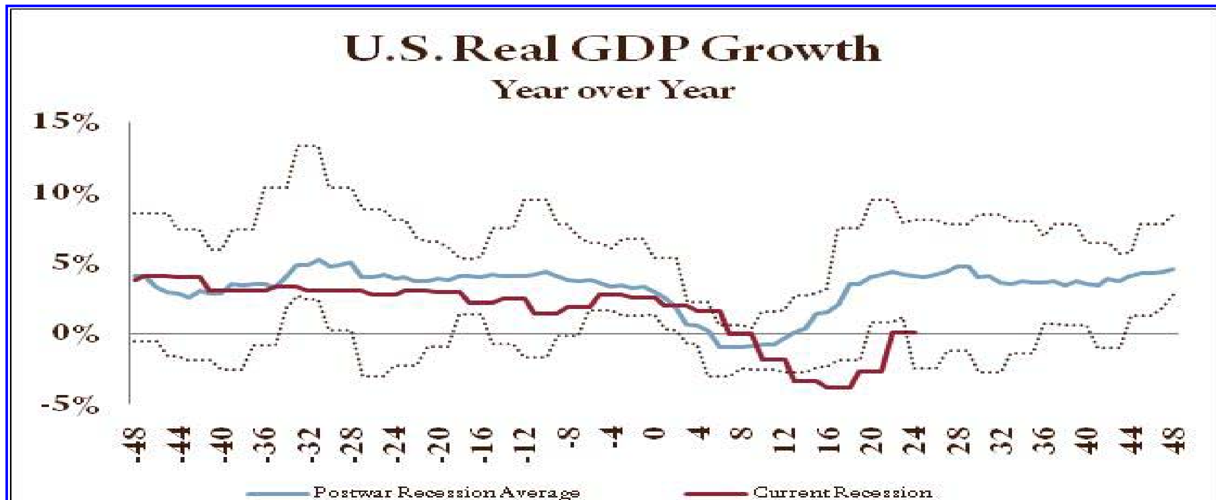
**Chart 1: Real Home Prices in U. S. Recessions and Recoveries**




*Source: irrationalexuberance.com*

In the second chart, real GDP growth, which has been weaker than in any other postwar recession, has entered positive territory after about two years from the start of the recession. The duration from the start of the recession to the start of a recovery (positive GDP growth on a year over year basis) has been longer than in any prior downturn ,even though the response by fiscal and monetary policies were larger and were implemented sooner than in other any other downturn.

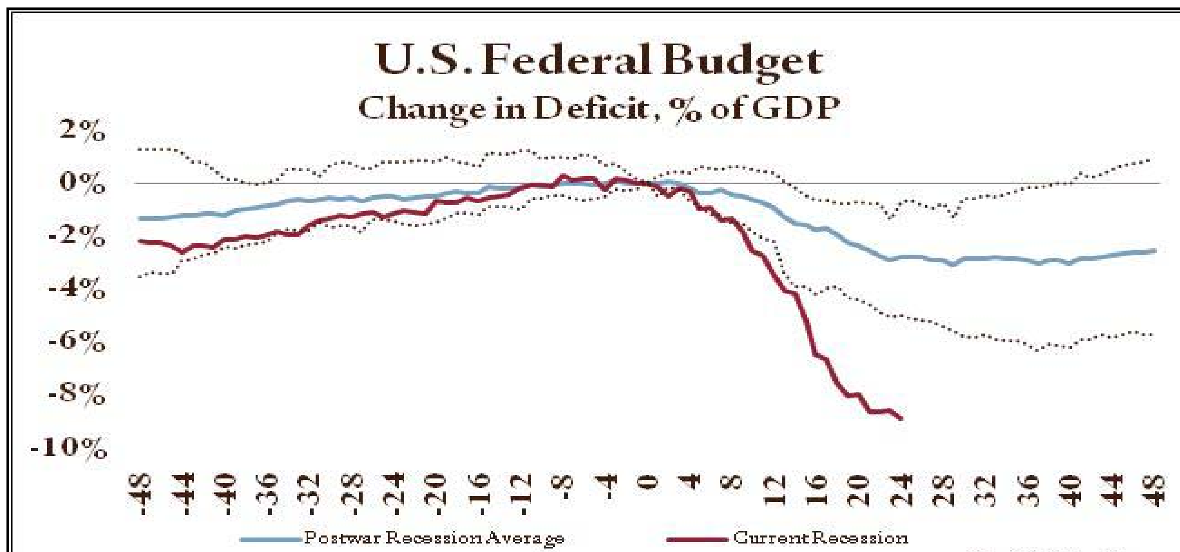
**Chart 2: Year over Year GDP Growth in U. S. Recessions and Recoveries**




*Source: Bureau of Economic Analysis*

The third chart shows that the federal budget deficit has grown deeper and faster than in any past recession as fiscal policies responded to the weak economy with massive spending and bailout packages. There is no sign of returning to lower deficits in the near future and new bailout money is needed for Freddie Mac and Fannie Mae.

**Chart 3: Federal Budget Deficits in U.S. Recessions and Recoveries**




*Source: U.S. Treasury*

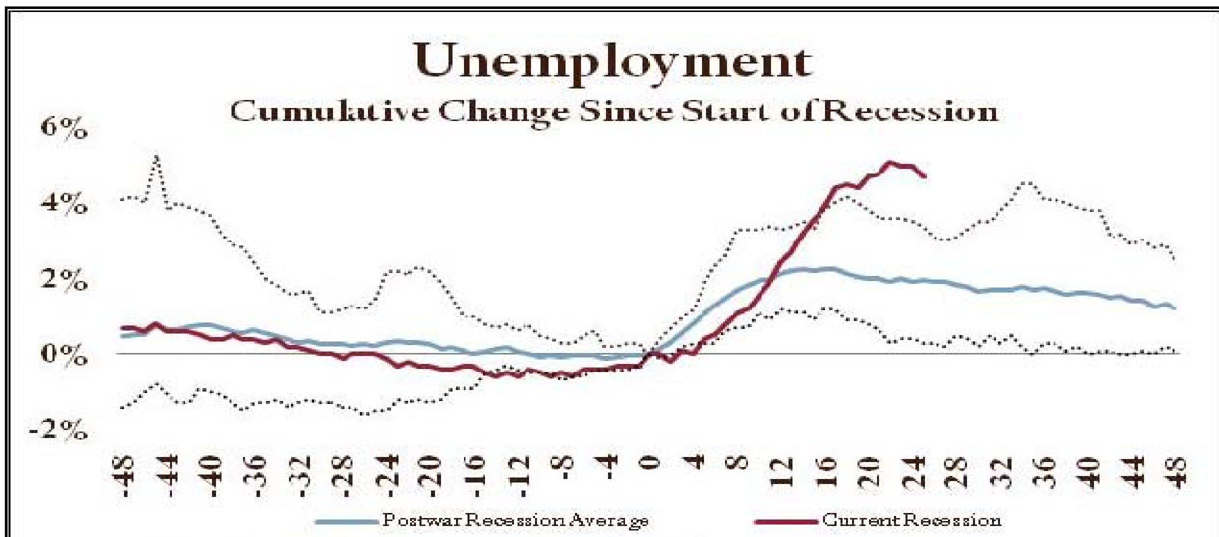
Chart 4 shows that the recent contraction in the U.S. economy corresponds with the largest disruption to world trade in history. Worse yet, there are obstacles for any return to more normal conditions. Free trade may be threatened going forward as countries try to protect domestic markets. Such policies actually lead to further reductions in trade and limit wealth creation.

**Chart 4: World Trade in U.S. Recessions and Recoveries**

*Source: World Trade Organization*

There is a time lag between an improvement in GDP and an improvement in unemployment. Normally, unemployment peaks and begins a decline about 16 months from the start of the downturn and takes a few years to return to pre-recession levels. Chart 5 illustrates the more dramatic climb in cumulative unemployment during the current recession. As a recovery in GDP begins unemployment remains well above the pre-recession levels.

**Chart 5: Unemployment in U.S. Recessions and Recoveries**

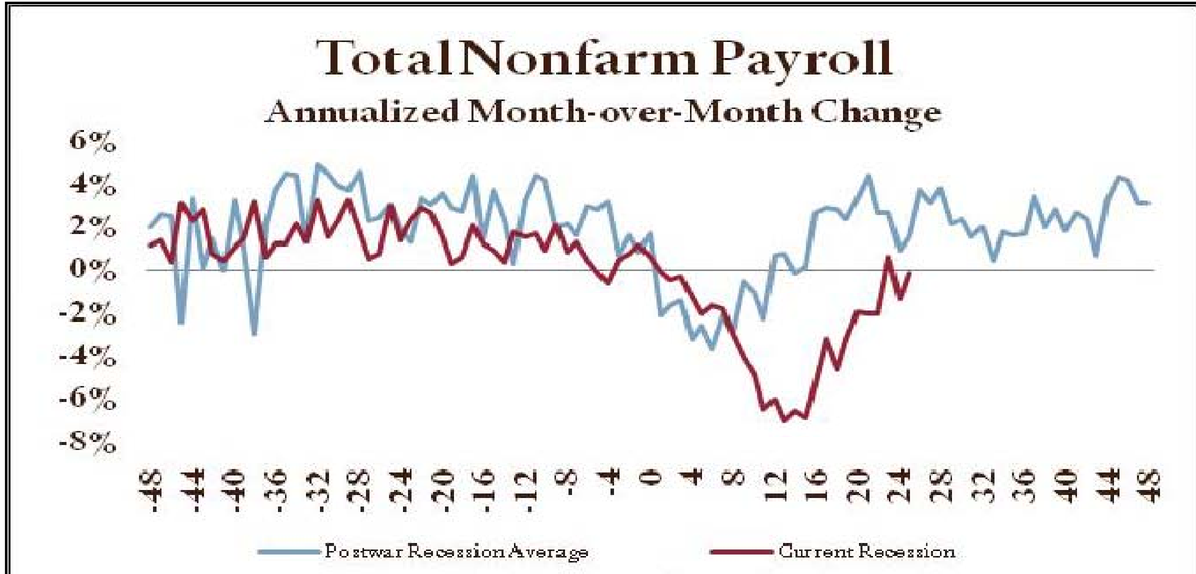



*Source: U.S. Bureau of Labor Statistics*

Job loss in the current recession exceeded 8 million. Normally, job losses end about one year after the start of the recession and positive additions to jobs begins. As Chart 6 illustrates, the economy is just starting to add jobs after about two years from the start of the recession. Given the magnitude of job loss, it will take a long time to replace the millions of lost jobs and make up

for growth in the labor force. (Note: See the Vantage, IV Quarter 2009 Outlook for an overview of "Okun's Law" and the duration of high unemployment in this recession.)

**Chart 6: Total Nonfarm Payrolls in U.S. Recessions and Recoveries**




*Source: Bureau of Labor Statistics*

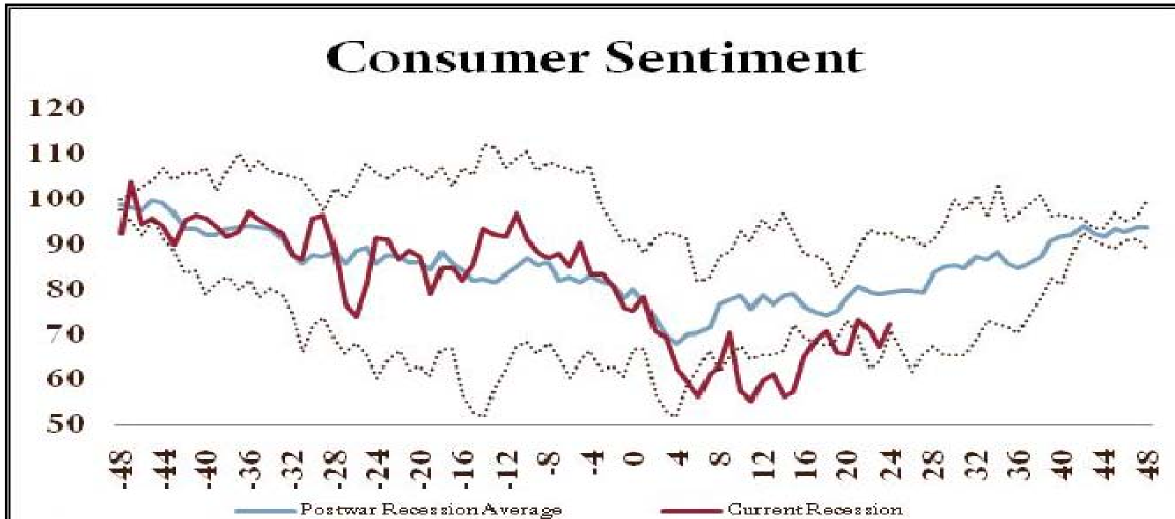
Industrial production held up well in the early stages of this recession but continued to deteriorate well beyond the point where improvement takes place in a normal recovery. Chart 7 illustrates that the fall off in production in this recession rivals the worst downturn in history.

**Chart 7: Total Nonfarm Payrolls in U.S. Recessions and Recoveries**

Source: Federal Reserve Bank

Chart 8 shows that consumer sentiment remains below the level in normal recessions. Sentiment is improving but there is a long way to go before reaching pre-recession levels.

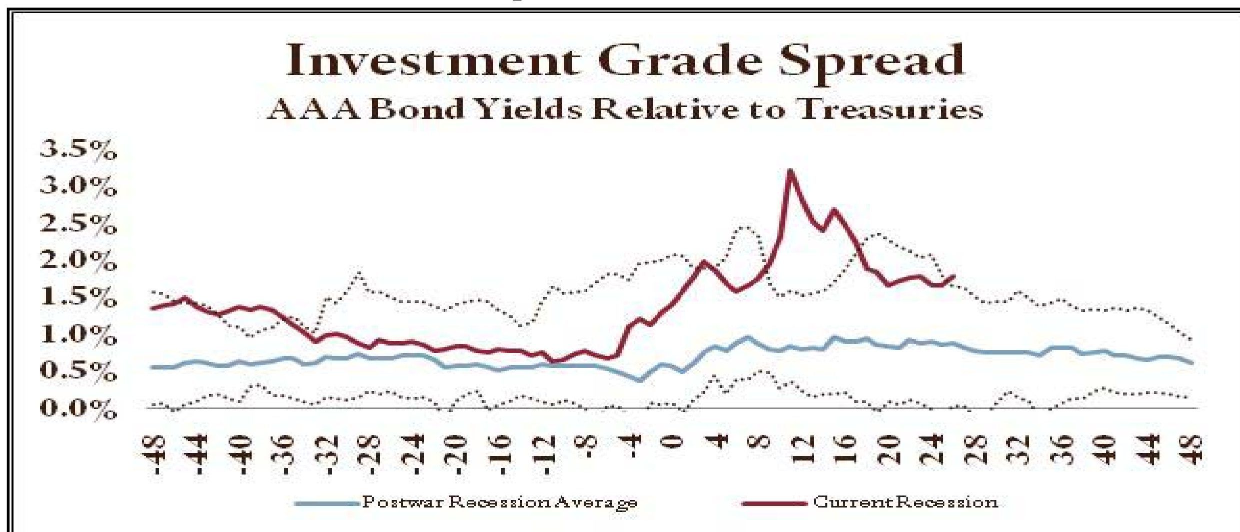
**Chart 8: Consumer Sentiment in U.S. Recessions and Recoveries**




*Source: University of Michigan*

A credit risk spread represents the added return an investor requires on a risky asset relative to another less risky asset. A common measure of a risk spread is the difference between high grade Corporate bonds (AAA) and Government Treasury securities of like maturity. Since the AAA bond is riskier, there is a positive yield spread. The spread widens when investors become more risk averse and concerned about uncertainty in the markets. Chart 9 illustrates the time series movement of the credit risk spread before and after U.S. recessions.

**Chart 9: Credit Risk Spread in U.S. Recessions and Recoveries**




Source: U.S. Treasury

The current recession is unique in that the spread "jumped" more than in other downturns and has remained well above pre-recession levels. Risk aversion and concerns over future economic prospects are higher than normal and have not yet moderated as expected in a post-recession period. Higher spreads hurt corporate financing and long term investing.

There are several key points that are clearly illustrated in the charts presented above. These points are outlined below.

- Unlike other economic downturns, this downturn was fueled by falling values of real estate. The real estate bubble and its collapse had a magnified impact on the economy due to a complex interaction of government policies toward secondary markets for mortgages, moral hazard in the lending process, and asset holdings of securitized mortgages by financial institutions. Unlike other downturns, there was a large wealth effect in addition to more normal income effects from the recession. The lost wealth in the form of lower housing values is not bouncing back anytime soon.

- While we appear to be in the second year of a recovery, the depth of the downturn and the duration of the downturn are worse than in other postwar cycles.

- Both monetary and fiscal policies reacted quicker in this downturn than in prior downturns and the size of fiscal stimulus was larger. The expansion of the government deficit was unprecedented, yet the downturn still exceeded normal recessions in severity and duration. It is also likely that the deficit is stabilizing at a high level without a pattern of deficit reduction for some time to come.

- Unemployment is more dramatic than in normal recessions and recovery of lost jobs will take much longer.