RECESSION RECOVERY ALPHABET?

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Abstract: *What shape of alphabet will the economic recovery take is the subject of speculation? Is it a L, U, V, W or VL shaped recession? Speculation abounds as to what letter or symbol best characterizes the shape the crisis is taking. Each alphabet is characterized by how long and in what fashion the economy returns to a "normal" growth path. The commodity markets have reacted by elevating prices. Climbing out of this recession will take time and the task faces many pitfalls. The economy has felt the pain from the horrific slump in housing and the squeeze in credit worldwide. The likelihood that consumer spending growth will continue subdued for some time and the labor market will be slow to respond to so-called recovery. What kind of monetary policy and fiscal stimulus will help the economy to climb the hole? That summarizes the great questions that prevail as the world attempts to handicap the winding down of the Great Recession.*

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Following the breakdown of Lehman Brothers and the near failure of AIG in mid September, the international financial market crushed, global credit markets froze and commodity and equity prices collapsed worldwide. The global recession is already here. The US is enduring its most serious financial crisis since the Great Depression. The economy contracted at 5.5 percent annualized rate between September 2008 and March 2009 (Wesbury and Stein, 2009), a shocking slowdown that pitched the global economy into recession for the first time since World War II. The loss of 6.5 million jobs since December 2007 has prompted the sharpest rise in the unemployment rate since the 1930s in US. The question now is how bad and how long this recession going to be?

Most economists had expected for a US V-shaped recession, a sharp recession similar to the US recession in 1990 and 2001 and a general recession in the world economy that will be more severe than the recessions at the beginning of the decade. In the present global recession, some emerging-market economies may be able to achieve export growth as a consequence of the substantial currency depreciation that has already taken place. However, the contribution to recovery from exports seems likely to be modest because of the uniformly weak growth prospects of trading partners.

The V-shaped recession is deep, a swift plunge but short-lived (less than 8 months) followed by bounces back strongly. Since the US current recession has already lasted 18 months (from December 2007), it seems too late to consider it for a V-shaped recession, and it is neither 1) a U- shaped (a slower recovery with a longer time spent at the bottom), since there is already a sign of recovery nor 2) the L-shaped recession which is a prolonged version of the U-shaped recession where economic growth.

After the stock market crash last October 2008, people started talking about the dreaded L-shaped (in which economic activity falls off the side of a cliff and then stays horizontal) recession. The rally of Wall Street during the past couple months since early March 2009 reflects the belief that the L-shaped has been decisively averted, and suggests investors are betting on a V shaped rather than a U shaped for the economy. The explosive stock market rally has fueled hopes that the worst is really over and that the economy is no longer on the brink of a prolonged deep plunge. Is the recent mini-surge in the stock market a definitive proof of a recovery?

The economy has been in recession for more than a year, contracted rapidly toward the end of 2008, and is likely to continue to contract through the first half of 2009 and possibly beyond. Some economists, including Paul Krugman, Nouriel Roubini and Franklin Allen, express fairly pessimistic views about the recovery and predict the U.S. will see a “W” shaped recession - a double-dipped downturn - followed by a boom in the world’s economy. “This looks an awful lot like the beginning of a second Great Depression,” Nobel laureate Paul Krugman said in January. The rally in Wall Street, according to Paul Krugman, looks to him as if the investors consider the recession is a V-shaped, and the stock are now pricing in a rapid recovery in a V-shaped recession, which Krugman consider extremely unlikely. He and others argue that the rally is an illusion fed by interest rates near zero percent, a weaker dollar and rising commodity prices.

A W-shaped recession begins like a V-shaped but then ends up turning back down again after showing false signs of recovery. A W-shaped recession or sometimes called double dip recession, occurs when the economy has a recession, emerges from the recession with a short period of growth, but quickly falls back into recession. The economy drops twice before a full recovery is achieved. The most cited example of a W-shaped recession is the recession of 1980 in the United States. The National Bureau of Economic Research judge two recessions to have occurred in the early 1980s. The US economy fell into the first recession from January 1980 to July 1980, shrinking at an 8 percent annual rate from April to June of 1980. The economy then went into a quick period of growth, and in the first three months of 1981 grew at an 8.4 percent annual rate.

When the Federal Reserve under Paul Volcker increase interest rates to combat inflation, the economy dipped back into recession (hence, the “double dip”) from July 1981 to November 1982. The economy then entered a period of mostly strong growth for the rest of the decade. A W-shaped recession is painful because a lot of investors who jump back into the markets after they think the economy has found a bottom end up getting burned twice---once on the way down and then once again after the false recovery.

The current recession is not just a regular recession. This recession is different, as it is caused by turmoil in housing and finance and other factor rather than manufacturing or weak consumer spending. The current recession is likely to be serious and may be more severe than any economic downturn since the Great Depression of the 1930s. Some economists call today’s economic mess the “Great Recession.” The Great Recession of 2008-2009 has combined four recessions in one: first: a traditional V-shaped recession; second: a bubble melt-down in housing like the dot-com bubble collapse; third: a credit crunch similar to the S&L crisis – only global and much more bigger, and lastly, an oil price shock, not as sudden as the 1970's shocks, but more persistent.

The International Monetary Fund said on April 22, 2009 the global economy will contract 1.3 percent this year, downgrading its January projection of 0.5 percent growth. A recovery will take more time than normal because the slump was precipitated by a worldwide financial crisis, the IMF said. If the US and the world have not tackled the problems at the heart of the economic downturn - many of the underlying problems remain - the economic is likely to slip back into recession. Fiscal stimulus packages may provide merely a temporary boost to growth.

While the US economy is now gradually coming out of the traditional recession and economic growth starting up, a second downturn is likely to follow in the next couple of years because of the falling home price; continuing losses from the credit crisis and high crude oil price. The economy is being pulled between short-term boost of interest rate cuts and coming tax rebates and on the other hand the powerful downward force of falling home prices; constricting credit and high crude oil price. The later may continue to impart a drag on growth long after the former has been felt. Remaining issues with credit and housing will weaken the recovery when it does occur.

At this time, there is sign of some growth in the economy, but it's all government-generated. What will happen when the flow of public money subsides -- beginning next year when much of that stimulus package is spent and the government giveaway stops -- and the economy still won't be strong enough to stand on its own. If the consumer spending didn't pick up significantly, the economy will likely face a W-shaped recession/recovery -- not a V-shaped one. Consumers still have to continue spending after the government's money from various stimulus packages is over or the danger of a W-shaped recession is eminent. The signs of life in the global economy will be assessed once governments and central banks started to withdraw their unprecedented stimulus measures.

The economy growth is generally measured by Gross Domestic Product (GDP) which is the market value of all final goods and services produced within the borders of a country in a particular year, while an economic recession is defined simply as two quarters in a row of negative GDP growth. Normally, recessions are caused by a decline in GDP growth, which is itself caused by a slowdown in manufacturing orders, falling housing prices and sales, and a drop-off in business investment. This creates a downward slope in manufacturing and increased layoffs. In addition, an untrained work force from years of complacency in education and job flight abroad. The result of this slowdown is reduction in employment, and rising unemployment, which causes a slowdown in retail sales.

The near-term forecast for the US national economy continues to improve, but full recovery will be slow in coming. After shrinking this year, Gross Domestic Product (GDP) is expected to grow next year, but hundreds of thousands more jobs will be lost and unemployment will increase into 2010. U.S. industrial jobs will not grow for the year as a whole until 2011, and it may take another two years to finally get employment rolls back to the level recorded in 2007. That's really where the problem lies. By definition, recovery is the phase in an economic cycle where employment and output begin to rise to their previous level. Employment is the key. GDP growth alone can't feed a family, or pay a mortgage. In all, economic problems are expected to expand in varying degrees of severity for several more years.

Like day follows night, recovery will follow this recession, but there are growing suspicions that talk of a recovery is a Wall Street illusion and that the economy could dip into recession again if the job market doesn't improve soon. If unemployment steadies or worsens, consumer spending won't rebound strongly, bank-loan losses will keep rising and a recessionary relapse isn't out of the question. The end to the recession will basically depend on improvement in the labor markets. The optimism about the pace with which the economy will speed up was exaggerated. The economic crisis is anything but over. If there is a recovery at all – due to the fiscal stimulus - it isn't sustainable.

Even though the economy is already showing early indications of turning around after the Great Recessions, some consider the sign of recovery is unreal. The economy and financial markets are working through their problems and will, eventually, stabilize and strengthen on their own. The economy will recover even in the absent an effective federal fiscal policy response, but to speed the recovery up, one will be needed.

Moreover the recovery is a slow, compare with stimulus package that was enacted earlier. Central banks have poured thousands of billions of dollars of new money into the financial system over the past two years in an effort to prevent a depression. And the recovery is a jobless one. "The recovery is based on the destruction of the currency. As the dollar goes down, everything priced in dollars goes up," said Michael Pento, chief economist with Delta Global Advisors, Inc., a money management firm. The greenback has fallen about 10% against a basket of currencies since stocks bottomed in early March. At the same time, the price of oil is up almost 50%. Soybean prices are up nearly 25% while sugar futures have surged nearly 65%. And the price of copper has skyrocketed about 75%.

If these higher commodity prices trend continue, it's very likely that the price increases will eventually be passed on to consumers. This development could prompt the Federal Reserve to jack up interest rates in an attempt to cool off inflation. If the Fed has to raise interest rates, or the government has to raise taxes after a (real) recovery starts in 2010, the economy could be pushed back into recession. The danger of a W-shaped recession is eminent in this scenario.

Up to 2001, recoveries were proportionate to the recession: the bigger the drop, the bigger the rebound. In part, that's because the high interest rates crushed the demand for cars, houses and other big-ticket purchases which then creates the recession. While demand collapsed, business inventories accumulated, causing firms to reduce production. As soon as the interest rates went down, contained demand will accelerate. Firms will have to produce or to increase their production to meet the demand. This Great Recession is a bit different from earlier recession and can hardly be considered minor. The initial plunge was so deep and widespread, so it hard to imagine the rebound.

During the last decade, policymakers have relied on a series of simple tools for fighting recession and promoting growth: interest rates cut, government reduces tax rate, and a deregulated financial market provides easy money. The policy focused on demand side which may not work now for several reasons. Earlier this decade, interest rates never got that high and easy credit availability cause the bubble in housing that pushed home ownership beyond historic norms. Lowered interest rates don't seem to offer a lot of benefit here for the housing market, while the houses are still falling in value and the inventory of unsold homes is so large, and the bank's credit conditions so tight that there is likely to be little pent-up demand for a while. In the mean time, manufacturing inventories are already quite low and likely to stay that way, given more efficient supply-chain management. So the government has to change its strategy for assisting recovery.

There are many speculations and suggestions about the exit strategy on this recession. Macroeconomic policy will remain oriented toward restoring orderly conditions in credit markets and providing sufficient stimulus to assure that the recession is not unduly deep or prolonged and that the recovery is sufficiently robust. The biggest risk is that governments might be forced by global investors the possibility of a run on the currency, which would force them to increase interest rates. Banks seem to be enemy number one since their prudence my hinder the effort in the path of recovery, yet they have to play an integral part in the recovery. The bank has to do their home work until credit for both businesses and individuals starts running again, employment and housing is likely to remain stagnant.

There are normal evolutions that launch a recovery and drive an economy. These sequences involve individuals and businesses responding to opportunities and incentives. The government should focus on supply since there where the economic action really is. When the market respond, these individuals and businesses produce more goods and services valued in the marketplace, simultaneously increasing production, demand, and income. An effective stimulus policy identifies these economic processes and seeks to accelerate them.

This time the possibility of government reduces tax rate seems very slim to almost impossible, since government spending already exceeding their tax revenue; instead government should reduce the top tax rates on individuals, small businesses, and corporations to help the recovery. High taxes on workers drive up payroll costs, while high taxes on companies reduce the return to investors, whereas lower marginal tax rates usually able stimulate the economy because they improve the incentives facing individuals and businesses to work, invest, take risks, and seize opportunities. The sooner the government lessens the taxes, the better. Uncertainty about government action to push the recovery causes businesses to defer investment and job creation. Why build a factory if you don't know what the policies are going to be?

Government's deficit spending is not new. Economic need the spending to complement the demand from the private sector. The problem with government's spending is it cannot "create or save" jobs. It takes the job from the private sector to give to the public sector. In short, the unprecedented government spending goes up and private spending goes down, changing the composition of demand but not the total. In the mean time, the deficit in excess of tax revenues will be financed by borrowing from the private sector, depriving the nation of the credit necessary for a vigorous economy.

How about the financial market deregulation? With dollar falling in value against other currency in the world, it is doubted a deregulated financial market will provides easy money. Frank Allen believes that the housing and other property markets must show signs of stabilization before the economic recovery can truly be considered underway. Allen, like Krugman, believes that the recent surge on Wall Street should not be ignored but that the rally seems to be a bit “short-sighted”.

The current economic crisis – the global recession - is the result of many years of irresponsibility, both in government and in the private sector. The U.S. economy, still the world’s largest,with US $ 14 trillions market, should be the first exits the global recession, although it is unlikely to be strong enough to be the locomotive for global recovery due of their balance of payment deficit and government deficit. To reduce the balance of payment deficit, there was a lot of talk about economic stimulation resulting from increased exports (resulting from the weak dollar). For the second quarter of 2007, increasing net exports contributed 1.32% to the total of 3.8% GDP growth. The contribution for the third quarter was 1.38%. But for the fourth quarter the contribution to GDP growth from net exports fell to 0.41%. That doesn’t sound like an amount that will help stimulate the economy much. Emerging markets, especially China, do have some movement and may have the ability to pull the world economic out of the Great Recession. China’s growth is strong and their banks are flush with cash, but will China accept the obligation?

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