How bad will it get?

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The subprime-mortgage meltdown is strikingly similar to major financial crises in other countries. Will the aftermath be as costly?

Is the U.S. economy in a recession? By a well-known rule of thumb — two or more consecutive quarters of negative growth — no. Gross domestic product grew an estimated 0.6 percent in the first quarter of 2008, the same pace as in the fourth quarter of 2007. Many economists forecast more growth for the rest of the year, albeit small.

But it certainly feels like a recession. Prices at the grocery store and gas pump are soaring. The economy lost jobs in April, for the fourth straight month. Housing prices have been falling steadily, with no bottom in sight. The Commerce Department's final estimate of first-quarter growth, due out this month, could reverse the estimated minuscule gain.

To date, much of the debate about whether or not we are in a recession, or about to enter one, has framed that (looming) recession as a relatively short and shallow downturn. A recent poll of 52 economists, for example, found that two-thirds believe a recession is under way (hence our "Surviving a Recession" package), but 89 percent of that group expects it to be mild.

But what if we are on the verge of something worse? A recent study shows that the subprime meltdown of 2007 is ominously similar to previous financial upheavals. The study, by economists Carmen M. Reinhart of the University of Maryland and Kenneth S. Rogoff of Harvard University, finds "stunning qualitative and quantitative parallels to 18 earlier postwar banking crises in industrialized countries." In particular, the huge run-up in housing and equity prices and the acceleration of capital inflows prior to the subprime crisis — "standard financial crisis indicators" — tracked the averages of those indicators for the 18 previous crises.

What happened after the onset of the previous crises? In 13, the average drop in real per-capita growth exceeded 2 percent, and the average time to return to trend growth was two years. But in the "Big Five" crises — in Finland, Japan, Norway, Spain, and Sweden — the losses involved were far greater. Per-capita growth for all five countries fell at least 5 percent and trended well below normal growth for more than three years.

And the costs of cleaning up a Big Five mess were immense. They ranged from 6 percent of Sweden's GDP, following the collapse of its real-estate and financial bubble in 1991, to perhaps 20 percent or more of Japan's GDP, the high estimated price of its "lost decade" of the 1990s. To put this in perspective, the U.S. savings-and-loan crisis of the 1980s is estimated to have cost 3.2 percent of GDP.

Telltale Signs

Three of the telltale signs bode poorly. In terms of rising equity prices, "the United States looks like the archetypical crisis country, only more so," write Reinhart and Rogoff. The difference is that the S&P 500 has remained relatively high so far, thanks probably to the billions pumped into the financial system by the Federal Reserve. Meanwhile, U.S. housing prices are above the average for the Big Five crisis countries (see "Will History Repeat?" at the end of this article).

As for capital inflows, measured by the current-account deficit, the United States "is on a typical trajectory, with capital inflows accelerating up to the eve of the crisis." Indeed, at around 5.5 percent of GDP, the U.S. current-account deficit in 2007 was more than twice as large as the Big Five average.

On the other hand, real per-capita GDP growth is slowing less sharply here than in the Big Five countries, and U.S. public debt remains well below the average. Inflation is lower around the world today, note Reinhart and Rogoff. They also acknowledge that many observers contend the United States can run large and persistent current-account deficits "without great risk of trauma," although they themselves are not so sure.

Yet, they conclude, "given the severity of most crisis indicators in the run-up to its 2007 financial crisis, the United States should consider itself quite fortunate if its downturn ends up being a relatively short and mild one."

As Housing Goes…

Eight of the last 10 recessions were preceded by a housing downturn — not surprising, considering the effects on job growth and consumer spending. Right now, we may be in the mother of all downturns. In March, sales of new homes fell to the slowest pace since 1991. According to S&P/Case-Shiller Home Price Indices, housing prices in 20 U.S. metropolitan areas have dropped nearly 15 percent since their peak in July 2006. National prices were down 10 percent from peak through December 2007 and are widely expected to fall further.

In this regard, another study, published several years ago, may be relevant today. As part of the International Monetary Fund's (IMF) World Economic Outlook in April 2003, economists Thomas Helbling and **Marco Terrones** examined the macroeconomic effects associated with housing-price busts. A housing-price bust was defined as a drop in prices of more than 14 percent, compared with 37 percent for equity crashes. The IMF researchers identified 20 such busts in 14 industrial countries between 1970 (when housing-price indices generally start) and 2002.

The housing-price busts tended to coincide with recessions and were often synchronized across countries, the economists found. They were fewer and farther between than equity-price busts, but they lasted longer — four years on average, compared with two and a half years for equity-price busts. The average price correction was 30 percent. This suggests that U.S. housing prices have a lot more room to fall, with the bottom not reached until 2010. (Yale economist and eponymous index co-founder Robert Shiller has said that housing prices could drop as far as 50 percent in some places.)

Housing busts also took deeper bites out of economies, according to the IMF study. Typically, a slowdown began around the same time a bust began; recovery started nine quarters later. On average, economic output three years after a bust was 8 percent smaller than it would have been had growth continued at prebust rates.

In the United States, economic growth has been sputtering since the housing-price peak. Real GDP growth fell from 3.1 percent in 2005 to 2.9 percent in 2006 and 2.2 percent in 2007. Following the 0.6 percent first-quarter gain, this year's growth is anyone's guess. Still, if the IMF study results are predictive, we could see a recovery begin in the second half of 2008. (The IMF recently forecast a gradual recovery starting in 2009.)

Given all of the problems currently besetting the U.S. economy, that would be good news indeed.

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