Martin Feldstein's Looming Recession

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In a WSJ op ed (9/28/2018), Martin Feldstein warned that “another recession is looming”. There are reasons for readers not to be alarmed. Newspaper editors are notoriously eager to publish anything that foretells the serious pain of deep macro contractions. Such stories excite readers. Moreover, in Feldstein’s case, the “looming” recession at the beginning of his piece morphs into “a downturn brought on in the next few years” at the end. No economist actually employed to make some sense out of the the macro future could get away with such a wandering time frame after dramatically promising a “looming” recession.

But I am not interested in Marty’s forecasting accuracy. I read the piece to see what kind of macro model he is using to support his pessimism. It appears he remains mired, along with his mainstream colleagues in the academy, in the attempt to make market-centric general-equilibrium analysis stabilization-relevant. His argument rehashes of the housing bubble that occurred in the run-up to the great Recession. That’s OK but far from sufficient. He must show how a events in a relatively small sector of the economy will cause a substantial contraction of employment and output in the rest of the economy.

The academy’s consensus 2008-09 story motivates that collapse with the nontransparent packaging of subprime residential mortgages along with standard low-risk home loans into CDOs that were sold broadly to financial institutions. The ostensible problem was the widespread fraud with respect to the documentation of subprime household income that induced outsized loan default that contaminated the whole class of residential mortgage CDOs. With the bankruptcy of Lehman Brothers, which had concentrated holdings of the suspect instruments, investors became sufficiently scared to spurn the all residential mortgage assets; and the episode of extreme instability was underway. Feldstein offers an interesting variant on that well-known story. He makes no mention of subprime mortgages, the star of the *Big Short* and by popular consensus the cause of the Great Recession.

It could be that Marty dug into some of the little-appreciated facts. In particular, maybe he knows that there was no mass default of subprime mortgages. As readers of the GEM Blog know, only 4% of the subprime securities (a low rate) had been ‘materially impaired’ – meaning that losses were imminent or had already been suffered – by the end of 2009. If he knows that the ostensible cause of the 2008-09 investor panic is not factual, then he needs to come up with different mechanics for his looming recession.

Feldstein, after rehashing the housing-price bubble of more than a decade ago, sets the residential mortgage market aside in his looming recession story. “The principal risk now is that a stock-market slowdown [caused by rising longer-term interest rates] could shrink consumer spending enough to push the economy into recession.” That is a slender-reed conclusion that raises a host of questions. Feldstein has personally experienced a lot of slowdowns in equity markets and, to my recollection, none has caused a recession. Indeed, the 1987 stock-market crash, which was bigger than the famous 1929 Black Monday and therefore much more than a slowdown, struggled to induce a blip in real GDP growth. Along the same lines, experienced forecasters know that betting on a recession that is caused by consumer spending is a loser’s wager.

Most problematic in Feldstein’s story is the absence of a central role of aggregate nominal demand in his instability analysis. Adequate analysis of recessions – actual and prospective – must begin with identifying the how and why of an adverse disturbance in total spending. A useful op ed about a looming recession should say something about stabilization authorities’ appropriate response. In the extreme instability of the Great Recession, the successful policy was focused on out-of-the-box massive demand-management tools, involving the Fed becoming the buyer of last resort in a wide range of collapsing asset markets. That Feldstein has a shaky grasp of lessons of 2008-09 is indicated by his fussing that, over the next few years, the Fed’s capacity to manage macro cycles will be badly limited by a low fed funds rate (he sees 3% by 2020), providing little room to cut interest rates. Readers of the GEM Blog know that the central bank’s successful policy in the Great Recession to halt and reverse collapsing total demand was not much restricted by the zero-limit on the fed funds rate.

Feldstein’s misunderstanding of the macrodynamics of macro instability is the root problem with his analysis. If we are to prevent future recessions from morphing into depression, we must be clear-eyed about what worked in 2008-09. If we want to raise the bar on adequate stabilization policy-making, i.e., prevent future Great Recessions, we need to be guided by macro theory that that returns aggregate nominal demand to center stage. The Academy must become serious about micro-coherent, general-equilibrium modeling that rationally motivates causation from adverse total nominal spending to involuntary job loss and evidence-consistent movement in employment and output. Readers familiar with the GEM Project know that such modeling requires the generalization of rational exchange from the marketplace to information-challenged workplaces. It is time to get serious about actually understanding recessions, looming or otherwise.

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