When the 11th Edition went to press in the late spring of 2008, we did not even know the identity of the Democratic presidential nominee—as is evident, for example, in Chapter 28—much less the president. More important, the worst of the financial crisis was in front of us, not behind us—although no one knew that at the time. And while the U.S. economy was looking weak, it was not yet apparent that such a deep recession was in store for us. Since so much has changed since then, this Macroeconomic Update brings the story up-to-date through mid-February 2009—keyed to relevant portions of the text. Further Updates will be posted on this website as events merit.

The worst recession since the 1930s?

The macroeconomic portions of Economics: Principles and Policy deal with three main goals of policy: strong long-run economic growth, control of inflation, and avoidance of recessions and high unemployment (see, especially, Chapter 23). During 2008 and into 2009, the nation’s attention—and that of policymakers—shifted almost entirely away from inflation (which was negligible) and long-run growth, toward the worsening recession, which at this writing looks likely to be the longest and deepest since the 1930s.

Though its roots are quite complex (see below), the proximate cause of the recession was a series of sharp declines in aggregate demand (as described in Chapters 22, 25, 26)—first in housing, a component of $I$, starting in 2006, and then in consumer spending, $C$, starting with a vengeance in September 2008. By mid-February 2009, virtually every component of aggregate demand, $C + I + G + (X-IM)$, was in decline as we awaited revised data on the disastrous fourth quarter of 2008—which looks to have been one of the worst quarters in post World War II history (a history summarized in Chapter 22).

Why did this happen? While the lines of causation are complicated, it all began with the bursting of the “housing bubble” in 2006 or 2007 (depending on what data you use), mentioned first on page 483. House prices in the U.S. roughly doubled from 2000 until 2006-2007, and then began a sharp decline that is unprecedented since the Great Depression—and that is still going on.

The fall in houses prices decimated the home-building industry. Since spending on houses is part of $I$ (see Chapter 25), the multiplier process described in Chapter 26 began pulling real GDP down. At first, this downward pull was offset by rising net exports, $X-IM$, another component of aggregate demand, so total demand did not fall much. But everything fell apart after September 2008, when consumer spending dropped suddenly,
business investment followed suit, job losses mounted, and the recession spread worldwide, thus damaging U.S. exports (see page 574 and Chapter 36).

**Roots of the financial crisis**

At first, this set of problems was labeled the “financial crisis,” or even just the “subprime mortgage crisis,” because that is where it began. Irresponsible mortgage lending practices (see Chapter 29) led to many un-payable mortgages when house prices stopped rising (see, especially, the box on page 635). And that inflicted losses on banks.

Bank balance sheets are roughly described on pages 635-636. The text illustrates, but does not emphasize, that banks normally have relatively little net worth, relative to their assets—a factor called “high leverage”. In the example on page 636, the bank’s net worth is $1/11$ of its assets, making its “leverage” 11-to-1—which is a realistic example. Such high leverage helps banks make profits—for example, a 1% return on assets becomes an 11% return on equity. But it also puts them at great risk if borrowers are unable to repay their loans. Again using the textbook example, $\$500,000$ worth of loan losses, or 11.1% of loans outstanding, would wipe out the bank’s net worth. So banks were ill-prepared to absorb unexpectedly large losses on their mortgage portfolios when the housing bubble burst. They became imperiled and extremely cautious about lending. As explained in Chapter 29 (especially page 642), such attitudes lead to contractions of the money supply and credit.

On top of this “textbook” channel, “Wall Street” (a metaphor that includes London, Frankfurt, Tokyo, and other locales) had created a dizzying array of financial securities that, in effect, offered the buyers of those securities shares of the home mortgage loans that the banks had made—a process called “securitization of mortgages.” As more and more of the underlying mortgages started to look like they might default, the values of these mortgage-backed securities plummeted. Worse yet, in many cases the securities were so complex and opaque that nobody knew what they were really worth—a sure-fire cause for panic, which burst into the open in August 2007. The “subprime” financial crisis had begun.

Amazingly, while financial panics are normally short-lived though dramatic events, this one lived on, and on—and sometimes getting better and sometimes getting worse—until September 2008. That’s when Lehman Brothers, a venerable Wall Street firm dating back more than a century, went bankrupt—raising the panic to entirely new and frightening levels. Lehman’s failure set in motion a cascade of amazing events, as one large financial institution after another either failed or had to be rescued by the U.S. government. Pretty soon, credit became virtually frozen, as it seemed that no one wanted to lend any money to anyone except the U.S. Treasury. The seemingly insatiable demand for U.S. Treasury bills (described on page 649), the safest of all investments, drove their prices up and their yields down (as explained on pages 652-653)—to essentially zero for a while.
Monetary and fiscal policy responses

The Federal Reserve had reacted to the threat of economic weakness rather early, starting in the fall of 2007, with a series of interest rate cuts and emergency lending to banks through its “discount window” (described on pages 652-653). This was conventional monetary policy in action (see Chapter 30), though on a grand scale. But when that proved insufficient to the need, Fed Chairman Ben Bernanke, who had been a scholar of the Great Depression, did not hesitate to invent many new ways of lending to banks—and even to some non-banks. The Federal Open Market Committee (Chapter 30) even lowered the federal funds rate to virtually zero in December 2008.

Part of the unconventional monetary policy intersected with fiscal policy (Chapter 28). In October 2008, Chairman Bernanke and then-Treasury Secretary Henry Paulson persuaded Congress to allocate the whopping sum of $700 billion (roughly 5% of GDP) to stemming the burgeoning financial crisis by buying what they called “troubled assets”—mostly, the complicated assets based on mortgages that we mentioned earlier. The Troubled Asset Relief Program (TARP) was controversial from the start and remains so to this day. When the Bush Administration left office in January 2009, about half of the original $700 billion had been committed—and virtually none of that had been used to buy “troubled assets.” The rest of the TARP funds awaited decisions by the incoming Obama Administration, and its Treasury Secretary Timothy Geithner, who promised both to buy up some “troubled assets” and to use some of the money to mitigate mortgage foreclosures. By February 2009, many observers had concluded that $700 billion would not be enough; but the Obama administration had not asked for more.

Conventional fiscal policy (see Chapter 28) was also employed to fight the recession, starting in early 2008 when Congress enacted a one-time “tax rebate,” analogous to what it had done in 1975 and 2001. (These episodes are analyzed in Chapter 25, especially pages 538, and 547-548.) But as the economy worsened, it became clear that this modestly-sized fiscal stimulus (roughly 1% of GDP) was not close to enough. In addition, many economists argued (as in the text on pages 547-548) that temporary tax cuts have only minor effects on consumer spending. So the first major action of the new Obama Administration was to recommend a massive fiscal stimulus package, consisting of both tax cuts and increases in government spending, G. The overall magnitude was $787 billion, or about 5½% of GDP, although spread out over several years. The idea, of course, was to close the sizable recessionary gap between potential and actual GDP that forecasters were expecting--precisely as explained in Chapter 28.