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We don't know whether the worst is over for our economy

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Newton's Law of Economists says that for every economist there is an equal and opposing economist. A corollary says that both are wrong. With this disclaimer out of the way, here is my account of the U.S. economy.

We have experienced a banking panic over the quality of bank loans and the adequacy of bank capital. The U.S. and other major governments have now gone to extraordinary lengths to rescue the financial system and restore confidence, but we do not know yet whether the worst is over.

While the crisis was developing, U.S. unemployment rose to 6.1 percent, home prices in 20 U.S. metropolitan areas fell 16 percent year-over-year, and financial institutions reported losses of almost $600 billion. We do not yet know what the the total credit losses of financial institutions will turn out to be. A few days ago the International Monetary Fund estimated the total at $1.4 trillion. Pessimists say that it will go higher, up to $3 trillion.

Because of those losses, the financial system is not providing adequate credit to the rest of the economy. The economy cannot function without credit. The financial crisis and disappearing confidence have already inflicted enough damage for the economy to experience a recession, possibly as long as 16 months.

It is not entirely clear yet when the recession started, and, therefore, when it will end. The Business Cycle Dating Committee, a group of economists who date recessions, is always late in determining when a recession started or ended. There is a good chance, however, that the recession started in December 2007 and will end in March 2009.

Unemployment increases in recessions. When a recession is accompanied by a significant decline in home prices, unemployment may go to 9 percent before it starts declining.

The stock market has been falling on concerns about declining home prices, mortgage defaults, bank losses, inadequate credit, the likelihood that the economy is in a deepening recession and dissatisfaction with the initial government policy response. The investor and philanthropist George Soros once summarized the interaction between government actions and stock market response in the line, "The government puts on a show and the markets write a review."

As households and businesses reduce spending, it is probably a good idea to increase government purchases of goods and services. Such new government spending could include roads, bridges, sewer systems and clean energy, such as wind generation of electricity. Additional government stimulus could include tax rebates and extended unemployment benefits.

Some economists also advocate a government plan to write down the value of distressed residential mortgages — as was done during the Great Depression — to avoid a flood of foreclosures, additional bank losses and further declines in home prices.

We will get additional indication of the severity of the recession as the Christmas shopping season approaches. After adjusting for inflation, retail sales have declined a little more than 4 percent year-over-year. This is more than the decline during the recession of 2001, and about the same as the decline in 2002, following a long and painful decline in the stock market.

We will have regulation and central trading of credit default swaps, financial instruments that represent side bets on loan defaults. Regulation and supervision of banks and other financial institutions will change.

The economy, the financial system and the stock market will recover. Some analysts think that the decline of the stock market from its October 2007 high — 42 percent as of October 15, 2008 — already reflects a severe recession, and that the market will go up soon. For them, it is time to buy some cheap stocks of good companies.

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