Stanford economist predicts 'large, short-run recession'

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(PhysOrg.com) -- Last Friday's Standard & Poor's downgrade of the U.S. credit rating topped a week that saw all three major stock market indexes delivering their worst performances since the 2008-2009 financial crisis.

Then the Dow tumbled 634 points Monday. And it climbed back 430 points Tuesday.

What does it mean? Stanford News Service asked Nicholas Bloom, an associate professor of economics at Stanford and an expert in market uncertainty and economic recovery, for answers.

What comes next? What practical effects will these violent ups and downs have on everyday Americans – long-term and short-term?

Right now, frankly, nobody knows what is going to happen next.

The U.S. and European debt crisis of the last week has generated massive economic uncertainty. One measure of the economic uncertainty – the VIX index of stock-market volatility – has jumped to levels not seen since the crash of 2008. In fact, stock market volatility is now so high that it's reached the level that occurred right after 9/11, a period of incredible political and economic uncertainty.

I have studied 19 previous uncertainty shocks – events like 9/11, the Cuban missile crisis, the assassination of President Kennedy – and the only certain thing about these is that they lead to large short-run recessions. When people are uncertain about the future they wait and do nothing. Firms do not want to hire new employees or invest in new equipment if they are uncertain about future demand. Consumers do not want to buy a new car, a new TV or refurnish their house if they are uncertain about their next paycheck. As a result, the economy grinds to a halt while everyone waits.

And what areas are likeliest to be hardest hit by the wild fluctuations?

These shocks hit hardest the sectors that make durable products – those like cars, TVs and furniture. These are goods that we can wait to replace. These industries typically see massive falls in demand, often of well over 50 percent as people put off purchasing expensive new goods for another six months.

Based on my research, I predict another short, sharp contraction in late 2011 of about 1 percent, with a rebound in spring 2012. This research looks at the average impact of the previous 19 uncertainty shocks to predict the impact of future shocks. Typically, these lead to reductions of growth of about 2 percent immediately after the shock, with a recovery about six months later once uncertainty subsides.

And I should point out this research is not all my own work. It builds on the research of a previous Stanford economics professor. This professor published his work in a now forgotten paper called "Irreversibility, Uncertainty and Cyclical Investment." But while that paper might be forgotten that professor is not – he is now the chairman of the Federal Reserve Board, Ben Bernanke.

The stock market rebounded today. How seriously should we take these swings?

This is exactly the problem, that the stock markets are bouncing up and down so much nobody can plan for the future. So what's the best thing to do? Wait it out. But if everyone waits it out, nobody invests and hires and we've got a recession. So, no, I don't think the rebound helps – it's still very clear we are in the middle of large uncertainty, and most businesses and people will quite sensibly wait it out.

The VIX index you mentioned – should we be looking at that more?

Yes. It turns out the VIX is a great predictor of short-run economic activity. The VIX uses the latest equity-option prices to predict stock-market volatility over the next year. So a high value means traders think there is going to be lots of volatility coming up, which is itself a good indicator for uncertainty.

So when the VIX is high the markets are predicting turbulent times ahead. It's their equivalent of the airline pilots' warning to "put your seat belts on." It does not always mean things are guaranteed to get bumpy, but it's definitely not the time to get out of your seat. Likewise, a high VIX predicts bumpy economic conditions, which many firms take as a signal to pause on hiring or investment.

The Federal Reserve said today that the risk of a downturn in the nation's economy had increased and that it was prepared to extend its period of exceptionally low interest rates until at least 2013.

The Fed's decision to guarantee low rates is a good idea – it reduces uncertainty over interest rates, at least.

Provided by Stanford University

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