

CRITICAL QUESTIONS

Economic Uncertainty

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Q1: What caused the uncertainty in the United States?

A1: Economists agree on the troubles besetting the U.S. economy: a sharp drop in new construction; the falling value of existing houses, the largest asset held by many Americans; sales of derivative instruments backed by inherently risky, subprime loans that became evident when the housing bubble burst; enormous losses by many commercial and investment banks when subprime borrowers were unable to service their mortgage obligations; the lack of certainty about the eventual extent of these losses; and the consequent inability of even banks to borrow from each other because of doubts that the borrowers would be able to repay the loans. The deepest problem growing out of these events is the lack of liquidity in global markets.

Q2: What can governments do to alleviate the foregoing concerns?

A2: The Federal Reserve and other central banks can add liquidity to the system using a number of techniques, such as buying bonds and other debt instruments, adding to bank reserves; lowering the federal funds rate that banks charge when lending to each other; and lowering the discount rate at which banks borrow from the Federal Reserve. In the end, the Fed used all these techniques, although it was reluctant to do so early in the process for fear of stimulating inflation. In the end, the Fed concluded that preventing a recession was more urgent than fighting inflation in the short term.

Q3: What happened in stock markets in the leading financial centers?

A3: The table below shows the daily changes in stock markets during the critical period from January 21 through January 24. The swings were considerable.

Daily Changes of Averages in Major Stock Markets				
	1/21/2008	1/22/2008	1/23/2008	1/24/2008
DJIA (U.S.)	closed	-1.06%	2.50%	0.88%
IPC (Mexico)	-5.35%	6.36%	2.71%	1.03%
Bovespa (Brazil)	-6.60%	4.45%	-3.32%	5.95%
FTSE 100 (UK)	-5.48%	2.90%	-2.28%	4.75%
DAX 30 (Germany)	-7.16%	-0.31%	-4.88%	4.90%
BSE 30 (India)	-7.41%	-4.97%	5.17%	-2.12%
SSE (China)	-5.14%	-7.22%	3.14%	0.31%
HIS (Hong Kong)	-5.49%	-8.65%	10.72%	-2.29%
Nikkei 225 (Japan)	-3.86%	-5.65%	2.04%	2.06%
KOSPI (Korea)	-2.95%	-4.43%	1.21%	2.12%

Following the sharp declines in Asia and Europe on January 21 (the New York Stock Exchange was closed that day for the Martin Luther King Jr. holiday), the Fed cut the federal funds rate by 75 basis points (three-quarters of a percent) to 3.5 percent and the discount rate to 4 percent. The New York state insurance regulator called together bond insurers on January 23 to commit what ultimately could be as much as \$15 billion for specialist insurers (known as monolines). Both U.S. political parties agreed to negotiate a short-term fiscal stimulus package to go into effect in February. The Dow Jones index rose sharply January 23 following these measures.

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Q4: Do these actions solve the underlying problems?

A4: Probably not. The talk of a fiscal stimulus actually scared rather than calmed Asian investors because it made the fear of a U.S. recession even more real. The fiscal stimulus being discussed is a short-term infusion of funds amounting to about 1 percent of U.S. gross domestic product (GDP). Even if this amount is spent quickly, which is far from certain, the amounts are modest. The underlying fear of a recession or sharp economic decline in the United States has not yet been dissipated. The events of the past week made clear that we live in a globalized economy and that it is hard for particular regions to decouple from this reality.

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