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Back From the Precipice

Recession Still Looms, but Bank Injections are Likely to Ease Pain

By DAVID WESSEL

So is it over? Have governments in the U.S. and Europe finally found the cure? Has recession been averted?

No. We're still in for a rough recession, with U.S. unemployment, now at 6.1%, likely to rise above 8%, with all the misery that brings.

'Something to Be Grateful For'
1:56
Economics editor David Wessel evaluates the government's response to the credit crisis. Though the U.S. economy isn't out of the woods just yet, we may have eluded a worst-case scenario, he says. (Oct. 15)

But it could be worse. For a few scary moments last week, governments began to take action to protect their own countries that made other countries worse off. It looked like the world economy was lurching uncomfortably close to conditions that precipitated the Great Depression. The newfound trans-Atlantic unity -- particularly the move by the U.K., then the rest of Europe and now the U.S., to give the banking system a taxpayer-funded transfusion -- has significantly reduced the odds of a really bad outcome. That alone is reason to be less panicky today than many were this time last week.

Paul Krugman, the newest Nobel laureate in economics, described in a CNBC interview Tuesday the latest government action as "emergency battlefield medicine to keep the guy from bleeding to death." That's no small accomplishment given how bad the wounds were. If the treatments work as intended, banks should resume lending at least to each other, a necessary step toward recovery.

The new U.S. plan "is going to boost confidence that the most extreme downside risks have been diminished, but the damage has been done, and this isn't going to prevent the economy from being in recession and remaining weak for a while," Laurence Meyer, an economic forecaster and former Federal Reserve governor, said Tuesday. Exactly.

The U.S. economy had slowed substantially before the chaos of the past couple of weeks. Unemployment was rising. Consumers were spending less readily. Businesses were growing more cautious about expansion and investment. Housing prices were falling. The credit crunch was spreading as lenders from banks to money-market funds hoarded cash in response to unfathomable uncertainty. A steady stream of banks were failing. The rest of the world was showing symptoms of the American ailment, which meant the U.S. couldn't count on export growth to offset domestic weakness. Any lingering hope that the U.S. would avoid recession evaporated. Forecasters began talking about two, three, maybe even four quarters of a contracting economy.

Then things got worse. The plunge in stock markets made everyone with a 401(k) or mutual fund poorer and wiped out whatever lingering confidence remained. Banking problems surfaced in Europe. The global economy's circulatory system -- the flow of credit from savers to investors, from lenders to borrowers, from one bank to another -- got clogged. All the

About David Wessel

David Wessel, The Wall Street Journal's economics editor, writes Capital, a weekly look at the economy and the forces shaping living standards around the world. He also appears frequently on CNBC.

David has been with The Wall Street Journal since 1984, first in the Boston bureau and then the Washington bureau, where he was chief economics correspondent and later deputy bureau chief. During 1999 and 2000, he was the newspaper's Berlin bureau chief. He also has worked for the Boston Globe and at the Hartford money that the Fed and other central banks were injecting into the banks was staying in the banks, and not being loaned. Financial markets were moving on panic, not reason. Even the coordinated interest-rate cuts by the Fed and European central banks didn't help.

Last week it became clear to the remaining advocates that buying bad assets from banks, as the original plan outlined by Treasury Secretary Henry Paulson involved, wouldn't suffice. It might help eventually, but it would take too long and was too indirect -- hence the radical remedy of investing taxpayer money directly into those banks that have a reasonable chance of survival. (Officials know, but haven't advertised, the corollary: Regulators must quickly close banks so weak that their only plausible strategy is to gamble for resurrection or use taxpayer money to take foolishly risky bets.)

The latest steps reduce the risk of the worst-case scenario and may mark a turning point in the 14-month-old crisis, though it's too soon to know. But they don't reverse the forces that were crushing the economy before Lehman Brothers Holdings Inc. went under on Sept. 14. Stock prices are well below Oct. 1 levels, so investors are poorer. House prices are still falling. Consumers, companies and bankers still have good reason to be extremely cautious, and they will be.

When in doubt, wait -- wait to buy a new car, wait to plan a Christmas vacation, wait to sign off on a loan, wait to approve a new hire. When everyone waits, the economy contracts. That realization restrained the stock market Tuesday after Monday's exuberance. And that realization is prompting Democrats and the economists they consult to contemplate another dose of fiscal stimulus, perhaps to be approved soon after the Nov. 4 election.

A lot still could go wrong. Banks could take the taxpayer capital, but not expand lending. Housing prices could fail to stabilize in the middle of next year, as has been widely predicted. Fear and pessimism could continue to depress the stock market. A big U.S. auto maker could stumble into bankruptcy court, or some other company believed today to be strong could disclose unanticipated vulnerability. Controversy or mini-scandal in the government rescue -- almost inevitable given its size and the speed with which it is moving -- could undermine government credibility. The transition from George W. Bush to the next president could create uncertainty about the direction of policy at a delicate moment.

The global economy is far from healthy. It almost surely will get worse before it gets better. The U.S. economy's legendary resilience will be tested. The market will have some bad days. But for the first time in weeks, governments -- with the grudging acquiescence of big banks -- are moving in ways that bolster, rather than undermine, confidence, and that's a very welcome development.

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(Conn.) Courant and Middletown (Conn.) Press. He has shared two Pulitzer prizes, one for a Boston Globe series on race in the workplace in Boston and the other for Wall Street Journal stories on the corporate scandals of 2002.

He is the co-author, with fellow Journal reporter Bob Davis, of "Prosperity: The Coming 20-Year Boom and What It Means to You" (Random House/Times Books, 1998), which argued that the next 20 years will be better for the American middle class than the previous 20 years.

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