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Recession in 2008?

January 2, 2008. The third quarter of 2007 was an excellent one for the U.S. economy. The Commerce Department reported gross domestic product (GDP) annualized growth at 4.9%, the best quarter since the sizzling 7.5% in 2003's third quarter. Year-to-year quarterly corporate profits rose a respectable 2.7%, to $1.153 trillion. Unemployment continued at the historically low rate of 4.7% into December. Christmas season sales were up 3.6% according to MasterCard Advisors, with a 22.4% spurt for online spending.

Housing was the weak spot, shaving an estimated 1.08 percentage points from the GDP. This was offset by several favorable developments: Consumer spending was up 2.8%; consumer purchases of durable goods were up 4.5%; business spending increased by 9.3%; and U.S. exports rose by a muscular 19.1% as imports climbed just 4.4%.

With all this great economic news, why is everyone so gloomy?

Mortgage defaults, falling house prices

Economic problems in 2007 originated in the "subprime" sector of the mortgage market, where a substantial number of adjustable rate mortgages had their rates ratchet upwards. Some borrowers were unprepared for that development, leading to an increase in defaults and foreclosures. Then the story becomes more complicated.

Home values were down in many areas. In October home prices were 6.1% lower than the year-earlier figure in 20 large metropolitan areas. Some homeowners have found that their mortgage indebtedness now exceeds the value of their property. Without equity in the home, these people have no ability to refinance, and little flexibility when interest rates move against them.

These developments led to major losses at many major financial firms around the country, and then to liquidity problems in the credit markets, triggering concerns about the onset of a recession in 2008.

To reduce that possibility, the Federal Reserve Board cut interest rates by one-quarter point three times. However, the third cut was met by a wave of selling in the stock market and a sharp drop in the stock indices, as many investors had evidently been hoping for a larger adjustment.

Inflation pressures are real

But, does the Fed have room for a larger cut? Energy prices are sharply higher, rising 34% in the last three months, driving inflation to unacceptable levels. The Producer Price Index rose 3.2% in November, the second-highest monthly increase since data collection began in 1947. The Consumer Price Index had its biggest monthly jump in two years in November, with a 0.8% increase. Balancing the application of economic stimulation while reining in inflation will be a major challenge for the Fed throughout 2008.

The AMT is patched

Just days before Christmas Congress finally acted to apply an inflation-adjustment patch to the Alternative Minimum Tax (AMT) for the 2007 tax year. Without that action, some 20 million taxpayers would have been drawn into the AMT snare for the first time, owing an additional $2,000 each in federal income tax.

Unfortunately, the action came long after the IRS had sent the 2007 tax forms out for printing. What's more, the IRS computers will need to be reprogrammed to reflect the change in the law, a process that will take an estimated seven weeks to implement and test. The upshot is that tax refunds are expected to be delayed, and because the filing deadline won't be extended beyond April 15, the IRS will have a much shorter window than normal for processing returns.

However, the AMT question was settled only for 2007; for the 2008 tax year we are back to the old, unindexed AMT exemption levels. More tax debates this year are a certainty.

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