The subject of this session is the global financial crisis, and I think our panel can help us understand if there really is a global financial crisis. There's no doubt that in the United States there is a serious economic and financial situation. Some could certainly say that in the United States we are facing a potential crisis, if we're not already in one.

But, frankly, I don't see a similar condition in Japan, where real GDP is growing, where inflation has gone from negative to positive, but remains low. There are, of course, the traditional structural problems facing the Japanese economy and contributing to slow growth there, but I think Japan has succeeded in avoiding the problems that have affected the U.S. economy. Mr. Tanaka will tell us whether that perception is correct and, if so, how Japan has managed to avoid the financial problems affecting others.

In Europe, as I see it, the extreme conditions in the United States have been avoided, but there are serious financial problems and, I think, more to come, but Andrew Crockett will, among other things, help us to understand that.

I'm afraid that this discussion about the global financial situation and about the United States in particular is going to be a very negative one. I suspect that's why they saved this for the last session, so as to depress as few people as possible. But before I look at the current situation and at the near-term outlook, I want to express my personal optimism about the longer-term prospects for the U.S. economy.

Although we do continue to face long-term structural problems, particularly fiscal problems, I think the fundamentals in the U.S. economy are good, and it's important to bear that in mind. We have an adaptable and highly motivated labor force. We have strong entrepreneurial spirits. We have capital markets that supply capital to new ventures, and, although we complain about the burdens of regulation, my sense is that the regulatory burdens in the U.S. economy are less than in other countries around the world. We shouldn't lose sight of that long-term perspective when we focus on the very serious problems that the U.S. economy faces today.

My personal view is that we are now sliding into a recession, and I emphasize the word “personal,” because the National Bureau of Economic Research, of which I'm president, has the responsibilities for deciding when we do begin a recession in this country and when recessions end. We designate the peaks and troughs of the business cycle, and the NBER's official designation is something that is done only after there's
enough accumulation of evidence to say that the downturn has occurred, that it is broad, that it is deep, and
that it is protracted. At this point, we're really not in a position to do that in an official way. But my personal
view is that the evidence is pretty clear that we are sliding into a recession, that economic activity in the
United States peaked in December or January, and that it has been declining since then. Employment is down
three months in a row, personal incomes are down, industrial production is falling, and residential
construction is at a rate about one half of what it was at its peak in 2006. Consumer confidence has dropped
to a 26-year low.

Now, there are optimists, including, I would say, the official position of the current administration,
predicting that the U.S. economy is going to turn around and that that turnaround will occur in June or July.
There are three sources for that optimism. First, that the Federal Reserve has reduced short-term interest rates
dramatically from 5.25 percent to 2.25 percent. Second, that we have a significant tax rebate that will start to
put extra cash into people's hands as soon as next month. And third, that the dollar has come down, making
U.S. exports more competitive, and that has led to a substantial increase in U.S. exports.

All three of those are indeed positive. They all will help to dam the downward pressure on the economy,
but I don't think they will be enough to prevent the economy from sliding into a recession. For example,
although the short-term interest rates have been brought down by the Federal Reserve by 300 basis points, by
three full percentage points from 5.25 percent to 2.25 percent, the longer-term rates, the mortgage rates that
are so important, have not come down at all.

I think that there is a risk that this recession is going to be a deeper and longer recession than we have
seen in the last three decades. I think there is a risk that it will be the worst recession that we've seen since
World War II. I emphasize the word “risk” though. That's not a prediction that it's going to happen, but I
think it is a significant risk. Please don't go away and say, "I heard Marty Feldstein telling us that we're going
to have the worst recession since World War II," but you can accurately say that I think that there is a serious
risk, that that is, indeed, about to happen.

Why? Because this recession is different from the last three recessions. They were all caused by the
Federal Reserve tightening interest rates in order to counter an increase in inflation, and once the Fed said that
it had achieved that, it reversed directions, it allowed the real interest rates to fall, and that brought us out of
the recession.

That is not how we got into the current downturn. The Fed was not trying to undo increasing inflation,
and so, because we didn't get into this downturn in the way we did in previous recessions, it's not as easy for
the Fed to simply reverse policy and bring us out. This time, the downturn is caused by a combination of the
problems in the housing sector and the credit markets, and I say “combination,” because it's the interaction of
the two that has created this very serious problem. The problem is much more than just the sub-prime
problem. The sub-prime mortgages, the loans to people with poor credit records, was a significant part of it,
but it is, by no means, the entire part, and it has spread far beyond the sub-prime mortgages.

The key to the problem is that two things happened. House prices rose dramatically. There was a housing price bubble in the first half of this decade, and, secondly, mortgages changed character, and we moved to very high loan-to-value ratios. So, instead of people borrowing 70 or 80 percent, we saw people borrowing 90 or even 100 percent of the value of their homes. Because of this jump in house prices, estimated to have been some 60 percent more than the increase in the costs of building or increases in equivalent rents, because house prices got so out of line, it was inevitable that they would start coming down, and, indeed, they have started to come down, and we're seeing house prices falling at an accelerating rate. Since the middle of 2006, house prices nationally have come down 10 to 15 percent. The experts estimate that there's another roughly 20 percent further fall in house prices nationally.

Now, because of this fall in the price of houses, house values are falling below the level of the mortgages. What we see now is that there are many homes for which the outstanding mortgage is greater than the value of the house. It's estimated there are now about 10 million mortgages in the United States, about one-fifth of all mortgages, in which the size of the mortgage, the amount that the homeowner owes, exceeds the value of the property, and that number is increasing as prices fall.

There's an important and unusual feature of the U.S. mortgage market that you need to know, and that is that our mortgages are so-called non-recourse mortgages. What that means is that if a homeowner defaults, if a homeowner stops paying on his mortgage obligation, the bank can take the property, but that's all. They cannot take other assets that the individual has. They cannot look to bank accounts. They cannot look to future income. So, once an individual's mortgage exceeds the value of the home, that individual has a strong incentive to default on the mortgage. It has not been traditional for Americans to do that, but we have not been in a situation before, at least not in the post-war period, in which 20 percent of all mortgages were underwater, or 20 percent of all mortgages had negative equity and prices across the country were falling and expecting to fall further.

I think the major danger hanging over our financial sector and, therefore, our economy is the danger that this process of defaults, foreclosures, and sales by the creditors will cause further declines in house prices, and that they will not merely go back to a "normal level" but, in fact, will overshoot in a downward direction. And as house prices fall, that means homeowners have less wealth. When they have less wealth, they spend less, and that provides a drag on the economy. But in addition to that, as house prices fall and mortgages default, the financial institutions take losses. Their capital is eroded, and, therefore, their ability to lend is reduced.

The credit markets are dysfunctional now in the United States. They are certainly worse than I have ever seen. There are bits of improvement that have occurred, but I would say as a generalization, the credit markets are simply not working, and they're not working because of uncertainty of the value of assets. We
don't know what mortgage-backed securities are worth, because we don't know what the mortgages are worth, and we don't know what the mortgages are worth, because we don't know what's going to happen to the future of house prices.

It's not surprising that financial institutions, the executives of financial institutions faced with this uncertainty, do not have confidence in the counter-parties with whom they have to deal. They don't know what the other financial institutions are really worth. The Bear Stearns situation was an example of the kind of thing that participants in these markets feared.

So, lacking confidence in counterparties, there's an unwillingness to lend. Lacking confidence in the value of securities, there's an unwillingness to buy securities. Lacking confidence in the value of the financial institution's own balance sheet, they don't know what the assets that they hold are worth because they don't what's going to happen to future prices of homes and, therefore, of mortgages and mortgage-backed securities. Because they don't know what their own balance sheet is worth, they're reluctant to take on new lending obligations, and without credit it's hard to have economic growth. Until there is an end to the risk of this overshooting of house prices in a downward direction, I think this uncertainty will remain, and credit markets will remain dysfunctional.

One more word, and that's about inflation. Inflation is rising around the world. Inflation is certainly higher than the targets that central banks have set. In Europe, where there's a formal target, the inflation rate has increased to 3.6 percent. In the United States last year it was 4 percent. The real risk is that this will lead to increases in inflation expectations, which will feed into wages, into the cost of production, and, therefore, into a rising cycle of inflation.

I'm actually much more optimistic about inflation than I am about the negative things that I spoke about a moment ago, because most of the jump in inflation that we're seeing around the world is due to the increase in commodity prices. Commodity prices, whether it's oil or food or non-food agriculture, have jumped dramatically in the last year, and that has fed into the overall consumer price indexes around the world. Going forward, if those prices remain high but don't go up again, that component of inflation will go away. Inflation reflects not the level of prices, but the rate of increase in prices. If oil prices stay at $110 a barrel, if the prices of various food grains stay where they are today, there will not be commodity inflation next year. There may be some further increases. There may actually be decreases in those commodity prices, but it strikes me as very unlikely that they will contribute to inflation in the coming year to the same extent that they did in the past. The key challenge is to prevent the increases in inflation that have occurred until now from feeding into expectations and through expectations into higher wages and higher costs of production.

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