

# RECESSION LESSON:

*Navigating the fear  
of the unknown*



## DEFINITION:

*Economic Uncertainty is if outcomes will occur with a probability that cannot even be estimated, the decision-maker faces uncertainty. (Knightian Uncertainty - Frank Knight)*



### Explanation of economic uncertainty

It turns out it's hard to play the game when you don't know the rules. That's one way to think about uncertainty. Economic uncertainty is the fear of the unknown. It develops when someone can't predict or estimate what might happen to the economy in the future. Uncertainty can emerge from many sources, including changes in government policies, job and income losses, price changes, investment losses or inflation worries. When economic uncertainty appears, it affects confidence on the sidelines, and until they stop feeling queasy about the uncertain economy, few businesses or consumers are willing to jump back in the game.

### Role of economic uncertainty during the recent recession

There were many catalysts to economic uncertainty. Volatility (intense fluctuations) in the market, job losses, changing government policies - these can all individually lead to hesitation. The current financial crisis and recession, however, had all of these situations and more:

- Government proposals to increase tax rates created uncertainty and risk for businesses and investors.
- Congressional reform on health care delivery systems created uncertainty for businesses, as they didn't know what future health insurance requirements would include.

- Financial markets faced uncertainty as the U.S. Treasury Department, the Federal Reserve and other regulators arranged bailouts and mergers for some large struggling institutions, such as Fannie Mae and Freddie Mac, Bear Stearns, and AIG; but allowed other firms, such as Lehman Brothers, to fail.

- The Federal Reserve Bank increased the money supply by over 1 trillion dollars in excess reserves to banks through bail-out programs and open market operations, which increased liquidity but also raised questions about uncertainty over possible inflation in the future.

- Households were uncertain about stable jobs and income, and responded by postponing major purchases.

## Lessons learned about uncertainty

One remedy to uncertainty is time. The public needs time to become comfortable with changes or “new rules” to live by. When the financial markets calm down, investors and businesses begin to have faith in recovery, which can spur investments and business activity. Entrepreneurs, who are often the first to re-enter unsure markets, may use periods of uncertainty as an opportunity to start new businesses. The self-employed may bounce back before larger businesses, as they are more flexible to change. Strong recovery begins when households and businesses begin exchanging goods, services and resources again.



### Historical example of economic uncertainty: September 11, 2001

While threats of a recession loomed prior to September 11, 2001, most economists thought we were on track to avoid it. The United States was recovering from the collapse of the dot-com bubble, but things were looking better. After the attacks on the World Trade Center in New York, however, uncertainty about the strength of our economy in the face of the disaster surfaced.

Once again, a variety of forces were causing economic uneasiness, but the Federal Reserve Bank worked quickly to alleviate some pressures. Banks, businesses, investors and consumers needed to be assured that the financial system would remain stable in spite of the crisis. If electronic banking, checks and cash weren't available, businesses might have shut down and employees wouldn't get paid. This could have led to gridlock in our financial system. The Federal Reserve Bank provided liquidity to the economy by making additional money available to banks. The Fed also used the monetary policy tools of the discount window and open market operations to calm financial markets, both in the U.S. and internationally. These actions helped relieve the

uncertainty of the public, kept the recession short, and began to return the country to normalcy.

(For a related lesson plan, titled *Open and Operating: The Federal Reserve Responds to September 11*, view the San Francisco Fed's website at [www.frbsf.org/education/teachers/open/index.html](http://www.frbsf.org/education/teachers/open/index.html)).



# PICTURING ECONOMIC UNCERTAINTY

The following charts help show what economic uncertainty looks like.

## S&P 500



Source: Dow Jones

Uncertainty always exists in the market, and consumers are accustomed to dealing with manageable levels. This is especially true in the stock market. However, larger amounts of uncertainty can make the task of navigating the stock market more difficult and uncomfortable. This chart provides two examples of the stock market dealing with economic uncertainty. During the beginning of 2001, the stock market was still feeling the aftermath of problems in the dot-com industry. As the uncertainty began to slightly ease, the market faced another sharp decline following September 11.

There was a lot of talk about financial markets seizing up during the recession. The TED Spread, shown to the right, is one way to see what that looked like.

The TED Spread shows the difference between three-month Treasury Bills (a low-risk investment) and the three-month London Interbank Offered Rate, or LIBOR (the rate which banks borrow unsecured funds from other banks). The important thing to remember is that the TED Spread provides clues about the willingness of banks to lend to each other. When the TED Spread is low, the perceived risk of lending to another bank is also low, so interbank loans are made. As the spread rises, so does the perceived risk. A high TED Spread means banks suspect other banks might default on loans, and instead of taking chances, they opt for the low-risk, T-Bill option.

The spikes in the chart to the right show times of uncertainty in the financial sector. Consider just a few of the events that took place during the spike in September 2008:

- September 7, 2008 - The Federal Housing Finance Agency places Fannie Mae and Freddie Mac in government conservatorship.
- September 15, 2008 - Bank of America announces its intent to purchase Merrill Lynch & Co. for \$50 billion.

## TED Spread



Source: Federal Reserve Board of Governors

- September 15, 2008 - Lehman Brothers Holding Incorporated files for Chapter 11 bankruptcy protection.
- September 16, 2008 - The Federal Reserve Board authorizes the Federal Reserve Bank of New York to lend up to \$85 billion to the American International Group (AIG).
- September 25, 2008 - The Office of Thrift Supervision closes Washington Mutual Bank. JPMorgan Chase acquires the banking operations at WaMu.



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# RECESSION LESSON LEARNED: ECONOMIC UNCERTAINTY

## Activity 1

Introduce the topic of insurance and define the word “insure” as “to make sure or certain; to make safe.” Ask students to name the types of insurance (see the examples below) they are familiar with and tell why it is important for families to have this coverage. Divide students into groups to research the following types of insurance by going to: <http://dallasfed.org/ca/wealth/pdfs/wealth.pdf>, p. 27 - 30:

- Auto
- Home
- Health
- Disability
- Life; Long-term care

Ask each group to find information to complete these questions:

- What is the purpose of this insurance?
- Is this insurance required by law?
- Are there different options for this type of insurance?
- How would owning this kind of insurance reduce economic uncertainty?

Have students share their findings with the class. As an extension, you may want to discuss how the Federal Deposit Insurance Corporation (FDIC) insures banks against financial losses.

## Activity 2

Play a game of “Econ Twenty Questions” with students to give them an experience with uncertainty. Discuss the following rules for the game:

- only ask questions with yes/no answers
- ask questions that narrow word list choices from general to specific
- do not use part of the word as a clue
- do not guess the word itself until at least three clues are given.

Using the economic word list below, the teacher chooses a word and asks students to guess it following these four rules. On the next round of play, the teacher permits changes to the rules by encouraging students to use all types of questions and clues. For example, the teacher tells students they can ask questions such as “Does this word have ‘Bank’ within it?” or allows them to guess the word itself randomly without narrowing it down through clues.

Continue changing the rules intermittently until students protest that the game isn’t fair or they are frustrated with the rule fluctuations. (Some may actually stop playing altogether). Point out that this is

how uncertainty feels: you become uneasy about an ever-changing situation and your confidence in making the right decision is affected.

Expand the discussion to uncertainty during the recession, reviewing the key points on how businesses, banks and consumers couldn’t predict what would happen in the economy and therefore became “frozen on the sidelines.”

- *Economic Word List* - consumer, economy, entrepreneur, Federal Reserve Bank, inflation, investor, recession, reserves, stock market, workforce

