

US Economic Scenario Getting Darker

April 12, 2009

Economic Scenario

In the last one month, global markets have been on an upsurge. All stock indices have moved higher despite of the expectation that - worst is behind us. Some analysts are indicating that US economy would revive by end of 2009 and in 2010 there could be return of strong growth. As always, we prefer to be rational and independent while analysing the information. Despite our best efforts we are unable to find too many positives in data released recently. Our analysis leads us to the conclusion that the economic slump in US would continue for foreseeable future. The present recession could easily extend for 4-5 years.

Durable goods data for February is cited as one indicator which points to rebound in industrial activity. The durable goods order in February is up by 1.1% compared to January. There are two things to be noted here. One, January data was revised to monthly contraction of 7.3% from initial figure of 5.2%. The rebound in February is minor compared to this. Two, February's new order was 28.9% down from February 2008, setting a record annual decline for durable goods series. The revised fall for January was 27.9%. A record year to year fall in durable goods is hardly a cause of optimism. ISM manufacturing and non manufacturing surveys continue to show month on month contractions, despite the low base effect. It is also evident from the surveys though, that there is slowdown in rate of contraction. This slowdown however does not imply that a recovery is around the corner. Economic activity does not collapse like a stone in water. Period of rapid fall is followed by some consolidation. During these periods it has to be seen whether fundamental problems have been solved.

The fundamental problem in the US economy is the bursting of credit bubble. Easy credit was available to consumers as well as industry. The level of debt as a percentage of GDP for all sectors combined reached levels higher than at the height of Great Depression. In 1981, US private debt was 123 per cent of gross domestic product; by the third quarter of 2008, it was 290 per cent. In 1981, household debt was 48 per cent of GDP; in 2007, it was 100 per cent. In case of consumers the easy debts lead to higher level of consumption than otherwise possible. In case of industry it leads to overpayment for assets and over investment (to cater for over consumption of consumers).

A key aspect of the credit bubble was the role played by financial sector. The gross debt of the financial sector rose from 22 per cent of GDP in 1981 to 117 per cent in the third quarter of 2008. With fall in value of residential and commercial properties as well as assets, the financial sector has seen its capital erode completely. Our estimate is that US financial sector has seen erosion of capital of more than \$ 2 trillion. The total capital of financial sector before start of credit crisis was \$ 1.4 trillion. By our estimates the US financial sector is now insolvent. As the prices of homes and other

assets continue to decrease the problem will become more acute. The lack of capital of US financial sector will lead to contraction in lending compounding the downturn.

Private-Public Investment Program (PPIP) which has been instituted for making a market for toxic assets seems to be transfer of assets from taxpayers to shareholders of banks. An explanation of the implications of plan as given by Prof. Jeffery Sachs is given below:

“Under the rule of the Geithner-Summers Plan, private equity investors and the TARP each put in 7.15 percent of the purchase price of \$636 billion, equal to \$45 billion each. The FDIC will loan \$546 billion. (All numbers are rounded). If the bad assets actually pay out the full \$1 trillion (which happens with 20 percent probability), there will be a profit of \$454 billion, equal to \$1 trillion payout minus the repayment of the FDIC loan of \$546 billion. The private investors and the TARP will each get half of the profit, or \$227 billion.

Since this outcome occurs only 20 percent of the time, the expected profits to the private investors are 20 percent of \$227 billion, or \$45 billion, exactly what they invested. Similarly, the TARP’s expected profits are also equal to the TARP investment of \$45 billion. Thus, both the TARP and the private investors break even. As competitive bidders, they have bid the maximum price that allows them to break even.

The bank shareholders, however, come out \$276 billion ahead of the game, while the FDIC bears \$276 billion in expected losses! This transfer occurs because the investment fund defaults on the FDIC loan when the bad assets in fact pay only \$200 billion, an outcome that occurs 80 percent of the time.”

This transfer of resources will prove to be insufficient given the scale of losses of banks. Additionally, the process keeps zombie banks in existence for a longer time. The process of recovery is delayed because instead of promoting lending the capital is being used to save institutions and management which played a large part in getting us here. To save banking it is not necessary to save the existing banks or their current management. The fresh capital could have been better used for supporting a new bank which would have capacity to lend. Instead the capital is being used to overprice toxic assets and support zombie banks. A wrong use of capital would have two consequences:

1. Normalisation of lending process will be delayed. Zombie banks would still be undercapitalized after the process is over.
2. The probability of higher inflation down the line increases. With wasteful capital usage the monetisation of debt increases. The Federal Reserve is monetising huge amount of debt by buying back bonds from market. A failed banking recapitalisation program like PPIP will only increase the amount of debt to be issued by US government. Given the magnitude of debt it is quite likely that it will be monetised.

Sustaining insolvent banks and monetising deficit is recipe for prolonging financial crisis. US policy makers are bent upon cooking this recipe. Do not expect a recovery in 2010 in US.