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Economies Shoulder a Terrible Burden

Desmond Lachman
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The powerful global equity market rally of the past six months confirms that hope continues to spring eternal in the human breast. For one has to wonder whether there is any real basis for believing that the global economy is on the cusp of the V-shape type of economic recovery that the equity market seems to be expecting.

After all, there are all too many reasons to fear that the U.S. economy could stall again early next year once the fiscal stimulus has peaked and business inventories have been rebuilt. And there are also all too many reasons to be deeply concerned about the renewed deflation in Japan and the growing tensions within the eurozone, and what these factors might mean for a meaningful global economic recovery.

The optimists on the U.S. economy, who by and large spectacularly failed to anticipate the Great Recession, are now grossly underestimating the negative impact that falling household incomes and household deleveraging will have on U.S. consumer demand. They seem to be oblivious to the fact that the gaps now characterising the U.S. labour market are at their widest levels in the post-war period. They also seem to be ignoring the fact that, absent a strong economic recovery, these large gaps will more than likely persist in 2010 and continue to exert substantial downward pressure on wages.

A good indication of the unusually large size of today's U.S. labour market gaps is provided by the U.S. Labor Department's U-6 measure of unemployment. That measure includes in the unemployment estimate those part-time workers wishing to work fulltime but who are unable to find such employment. By that metric, U.S. unemployment has now risen a full seven percentage points over the past 18 months to a staggering 16½ per cent of the U.S. labour force. It is little wonder that over the past year the growth in U.S. household incomes has decelerated at the fastest rate in the post-war period.

Stagnating or falling incomes would constitute a serious problem for the U.S. economic recovery at the best of times. However, these are hardly the best of times for the U.S. consumer. With household debt levels at around 135 per cent of their incomes, U.S. consumers have never been as indebted as they are today. Making matters all the more serious is the fact that they are still reeling from the recent destruction of around 100 per cent of GDP in their wealth that has occurred as a result of sharply lower home and equity prices.

The U.S. households' very constrained balance-sheet position, along with markedly tighter credit conditions for the U.S. consumer, make one think that U.S. households will continue to try to rebuild savings to the detriment of any growth in consumer demand--much as they have done over the past nine months. In the context of weak consumer demand, it is difficult to envisage how the U.S. economic

recovery can be anything but anaemic, particularly considering that consumer demand still accounts for around 70 per cent of overall U.S. aggregate demand.

Further clouding the economic outlook is the fact that a feeble U.S. economic recovery will almost certainly delay the healing of the financial system, which will inhibit banks from extending sufficient credit to underpin a meaningful economic recovery. Today's high unemployment level is already substantially compounding the loan-loss problems of the commercial banks. At the same time, the U.S. commercial property market appears to be in freefall, even before a large volume of commercial property market loans is set to become due in 2010, while an expected new wave of home foreclosures in the months ahead is likely to delay the eventual stabilization in U.S. home prices.

Sheila Bair, the head of the Federal Deposit Insurance Corporation, acknowledges that more than 400 U.S. banks are already on the FDIC's troubled list. One would think that if U.S. unemployment does indeed climb to double-digit levels in 2010, and if the commercial property market does continue its freefall, the number of failing U.S. banks will be a multiple of the figure that she is now bandying about. In those circumstances, banks must be expected to remain reluctant to lend, which will further dim the prospects for any real U.S. economic recovery in 2010.

By early next year, it is highly likely that Barack Obama's administration will have come around to the view that a second fiscal stimulus package is needed to kick-start a flagging economy. However, the administration will find it no easy matter to sell such a package to Congress, especially in a mid-term election year. Many in Congress will be highly skeptical about the merits of another fiscal stimulus package when the first one, which was marketed as needed to prevent the unemployment rate from rising above 8 per cent, failed so miserably to prevent a relentless rise in unemployment to its present 9½ per cent.

Many in Congress will also wonder if the U.S. can afford another round of fiscal largesse. They will do so especially at a time when the non-partisan Congressional Budget Office is projecting that over the next decade the U.S. is set to see the largest peacetime increase in its public debt. According to the CBO, on current policies the U.S. public debt to GDP ratio is set to double from around 40 per cent to over 80 per cent by the end of the decade. The CBO also estimates that the U.S. budget deficit will remain above 4 per cent of GDP even after the economy has fully recovered.

The dangerous trajectory on which U.S. public finances are now set has to raise the real risk of a dollar crisis in the not too distant future, with all its attendant consequences for global financial markets.

Foreigners own more than half of all outstanding U.S. Treasury paper and they are now being called upon to finance an even larger proportion of prospective U.S. budget deficits. Foreign central banks are already expressing their discomfort at the size of their U.S. Treasury holdings. They also seem to harbour suspicions that, with the Federal Reserve engaged in an aggressive expansion of its balance sheet, the U.S. might in the end resort to inflating its way out of its debt problem. The Obama administration's lack of any medium-term fiscal plan to bring the U.S. public finances back to a sustainable path would only seem to be fuelling those fears.

Doubts about the U.S. economic recovery, while certainly of the greatest importance for the global economy, are not the only factor clouding the global economic outlook. Debilitating deflation has again reared its ugly head in Japan, the world's second-largest economy. Japanese consumer prices are falling at their fastest pace on record at the same time as the Japanese unemployment rate keeps rising.

Persistent Japanese deflation has to throw into question Japan's ability to generate meaningful domestic demand. At the same time, its public finances appear to be even more compromised than those of the U.S.; this has to close the option to the new Japanese government of another fiscal stimulus package to kick-start the economy. The result would seem to leave the Japanese economy ever more dependent on a vigorous global economic recovery to supercharge its moribund export sector as its only real prospect for resumed economic growth.

An overly export-dependent German economy would also seem to be counting on a vigorous global economic recovery to sustain its incipient rebound. This would especially appear to be the case now that, as Peer Steinbrück, German finance minister, himself acknowledges, the German banking system appears to be on the brink of another credit crunch. The German economy's reliance on external demand in the future would also be underlined by the expiration of its highly successful cash-for-clunkers programme and by the peaking of its fiscal stimulus package.

Of greater concern for the global economic recovery than Germany's likely lacklustre performance next year are the acute strains manifesting themselves in the eurozone's weaker membercountries. Portugal, Spain, Greece and Ireland are all in the throes of deep economic recessions that are wreaking havoc with their public finances. At the same time, all of these countries are weighed down by the loss of cost competitiveness that they have experienced over the past decade but that as members of the eurozone they are unable to remedy through any change in their exchange rates. Restoring cost competitiveness within the straitjacket of the euro is likely to condemn these countries to sub-par economic growth for a prolonged period, which could well test their political resolve to remain within the eurozone.

Spain's economic outlook is particularly troubling given howmuch the Spanish economy contributed to overall European growth before the recession. In that context, one has to be concerned about the highly negative impact that the continued bursting of Spain's outsized housing market bubble will have on the Spanish economy over the next few years. Spain's unemployment has already risen to more than 18 per cent, while its public finances have shifted from a small surplus prior to the recession to a deficit of around 9 per cent of GDP at present. The latter deterioration would seem to dictate that the Spanish government will have to engage in fiscal austerity at a time of deep recession, which will only further weaken the Spanish economy.

From a global perspective, one also has to be concerned about the ongoing crisis on Europe's eastern periphery. This is particularly the case since west European banks, most notably in Austria and Sweden, have \$15,000bn dollars at risk to the region. Mounting private-sector defaults in the Baltic countries, Ukraine and Hungary could well compound the European banking system's unresolved loan-loss problem with untoward consequences for the overall European economic recovery.

The optimists are hoping that rapid economic growth in China might somehow provide the underpinnings for a strong global economic recovery. However, they seem to overlook the fact that China's bold stimulus measures over the past year have been focused on expanding industrial capacity, which has only exacerbated the global excess in industrial capacity. They also seem not to notice how reliant China's policy stimulus has been on an unsustainable expansion of bank credit, which has given rise to a series of asset price bubbles and is now having to be reined in.

With all too many risks hanging over the fragile global economy, one has to hope that policy-makers do not allow themselves to be carried away by euphoria in the equity market.

Rather, policy-makers should draw the right lessons from previous episodes of deep financial market crises and of synchronised global economic recessions. Those earlier experiences would strongly caution against too early a declaration of victory over the global economic recession. They would also counsel against any premature exit from monetary and fiscal policies aimed at supporting the global economy in the misplaced fear of a renewed bout of global inflation.

Desmond Lachman is a resident fellow at AEI.