

Recovery from the World Financial Crisis Has Started but Will Be Slow

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We are now beginning to see some signs of economic recovery, but growth in the United States and other advanced countries will be slow well into 2010. There has been a flurry of policies, proposed reforms, and fiscal and monetary actions in an attempt to put the economy back on stable ground and quell the financial crisis and deepest recession since the Great Depression. But the questions surrounding whether we have seen the bottom, as well as what type of recovery we actually are in, continue to be debated. In this paper, I will examine the efficacy of the fiscal, monetary and other policies adopted to overcome the crisis, and evaluate the reforms now being proposed to prevent future crises and put the economy back on a sound growth path

The Stimulus Package, Health Care, and U.S. Indebtedness

The \$787 billion stimulus package introduced in the first quarter of this year when the U.S. Gross Domestic Product (GDP) was falling at a rate of 5.5 percent and the rate of unemployment was 7.2 percent seems to have gained some traction. Together with the hugely expansionary monetary and other policies, it prevented the U.S. economy from falling into a depression reminiscent of 1929, but it did so at a huge cost to the American people, sharply increasing U.S. debt, in particular. I believe that the U.S. economy is likely to start growing again in the third quarter— but slowly. Growth appeared to resume at some levels in the second quarter in France, Germany, and Japan, but I think it is still likely to remain weak. China and India are growing only slightly less rapidly than in 2008, while most other emerging markets have either resumed growth or are expected to demonstrate growth soon.

But unemployment is still a big concern. In the U.S., the economy lost nearly 7 million jobs since the beginning of the crisis and would likely need 9 million jobs to reach full employment (an additional 2 million workers have entered the labor force during the past two years). As a lagging indicator, the rate of unemployment in the U.S., is now touching 9.7 percent and I believe it is likely to rise by year-end and reach 10 percent in 2010. Simulations indicate that without the stimulus package, the number of unemployed would be approximately 1 million higher than current levels.

The unemployment problem is much worse than the Obama administration had projected. The stimulus package simply did not deliver the type of “immediate help” expected and promised by the Administration. One important reason is that most of the billions of dollars “made available” for increased expenditures seemed, instead, to have gone into savings. This was to be expected in view of the \$13 billion destruction in household wealth that occurred during the past two years. To be fair, the stimulus was passed only six months ago, and more time will be needed to evaluate its full effect.

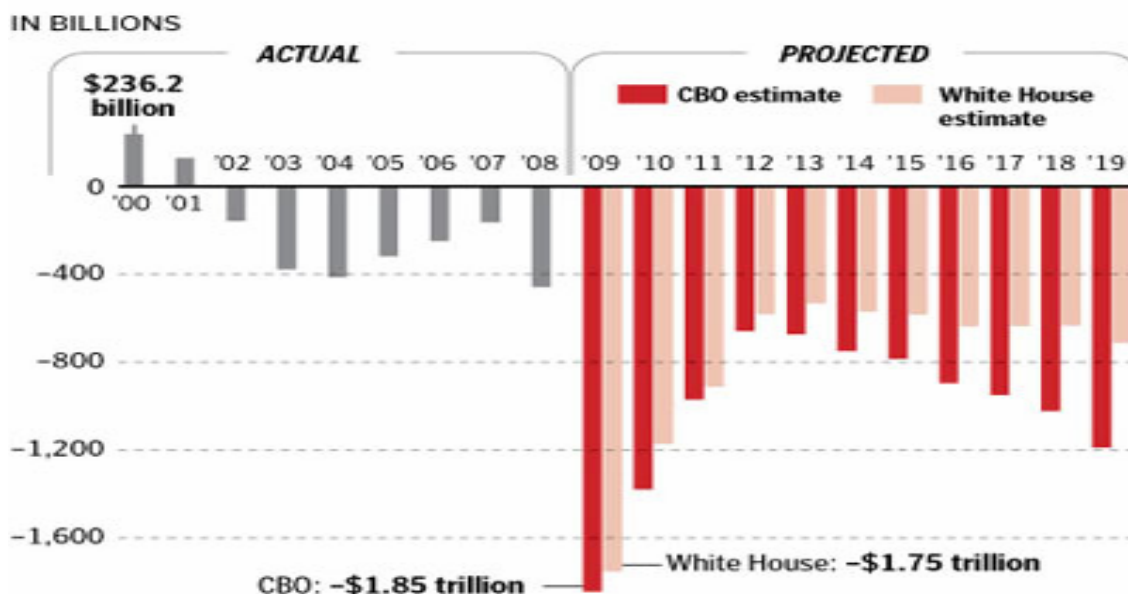
The Administration is now pushing for a very ambitious health care reform plan to provide universal coverage and contain future health care costs by eliminating waste and

introducing more competition (potentially including a government health plan to keep private health insurance costs down). The cost is expected to be paid mostly by tax increases on high-income earners (defined as those earning more than \$250,000, \$350,000, or \$1 million, depending on who's talking). But as pointed out by Douglas Elmendorf, the head of the Congressional Budget Office (CBO) on July 16th, the current House health care bill could cost from \$200 to \$300 billion more than the \$1 trillion Congressional estimate, and is likely to lead to higher taxes on all but the lowest income people to pay for it; so the plan may have to be drastically scaled down to ensure passage. Indeed, there also seems to be a strong grassroots backlash regarding the government option and its cost.

But even without factoring in the inevitable higher costs and taxes from potential health care reform, Figure 1 shows that the stimulus package and all other expenditures to bail out the banking sector will lead to much higher U.S. government debt and taxes in the years to come. Balancing the CBO-projected out-year budget would require a 44 percent increase in everyone's taxes. Without an increase in taxes, the U.S. government debt as a percentage of GDP is expected to increase from 40 in 2008, to 65 in 2010, 70 in 2012, and 103 in 2017. Faced with a drastic decline in their wealth as a result of the deep recession, and anticipating much higher taxes in the future to pay for the stimulus package and the other huge government programs to overcome the crisis, business will invest less and individuals and families will tend to save more and spend less, leading to a very low multiplier (barely above one) for every stimulus dollar spent.

Europe and Japan generally have smaller stimulus packages in the relation to their GDP than the United States because of a stronger social welfare net and in order to avoid very large increases in their already-high government debt.

Figure 1: The Bush and Obama Budget Deficits, 2000-2019



Monetary Policy, Exit Strategy, and Inflation

U.S. Monetary policy became very aggressive at the end of 2007 when the Fed realized that the economy was heading for a deep recession. The Fed lowered the interest rate from 4.25 percent at the beginning of 2008 to practically zero (0-0.25 percent) by the end of the year. Needing more stimulus, the Fed flooded the market with liquidity, as evidenced by the increase in its balance sheet (and reserves of commercial banks held at the Fed) from \$900 billion in the summer of 2008 to over \$2 trillion today. This could potentially generate an explosive rise in future bank lending and in the money supply, and thus lead to a huge inflationary spiral; however, I believe that present conditions, including massive excess capacity and rising unemployment (deflationary conditions) in the United States and in the rest of the world, make this unlikely.

With the resumption of growth, the potential for inflationary explosion becomes a serious danger. Indeed, the fear in the market that the Fed would not be able to reverse course in unwinding its huge unconventional monetary stimulus, prompted Ben Bernanke to outline the Fed's exit strategy at his semiannual testimony to Congress on July 22. This immediately calmed markets and led to a sharp decline in U.S. Treasuries. Bernanke testified that he expected the U.S. economy to start growing again at the end of the year but, with unemployment likely to reach nearly 10 percent, growth would very likely be slow through 2011, so that the economy would face little inflationary pressure.

When necessary, Bernanke indicated that an exit strategy could be established very quickly to mop up the excess liquidity by letting emergency lending programs wind down or expire, raising the short-term interest rates paid on reserve balances (to help set a floor under interest rates), letting short-term credits expire, and selling longer-term assets to the public. He acknowledged that, as always, the difficulty will be deciding the precise timing to begin to tighten and set the appropriate pace of the tightening effort. At the same time, Bernanke warned Congress and the White House to get budget deficits under control or risk damaging the recovery. The U.S. budget deficit is expected to reach 12 percent of GDP this year and to remain above 5 percent through 2019 -- as compared with the 3 percent ratio that Bernanke and most other economists regard as sustainable and non-inflationary in the long run.

Some economists, including Alan Metzler of Carnegie Mellon, have deeper concerns. They believe that it takes about two years for an anti-inflationary policy to work, which would mean that the Fed needs to implement a policy now and stick with it. I think that this concern is overdone. I believe that the U.S. economy is likely to grow well below its potential at least though next year so that demand-pull inflation does not seem as serious a threat. I think that only with another flare up in the price of petroleum and other primary commodities is inflation likely to become a serious problem. Be that as it may, it is most unlikely that the Fed and the other major Central Banks will start tightening before mid-2010 – they stated as much at the recent meeting at Jackson Hole, Wyoming.

Despite huge stimulus packages and highly expansionary monetary policies (and the resumption of growth in the second quarter of 2009 in France, Germany, and Japan – see Figure 2), all the largest industrialized (G-7) countries are expected to face negative

growth for 2009, as a whole, and very slow growth in 2010 (ranging from about 1.0 percent in the United States down to 0.2 to 0.7 percent in the other G-7 countries). Of the largest emerging markets, only China and India will have positive (albeit slower than in 2008) growth in 2009, while most other emerging economies are still facing recession. The recession is expected to end in Brazil, Russia, Korea, Mexico and Argentina in 2010, but growth will be slower than in 2008.

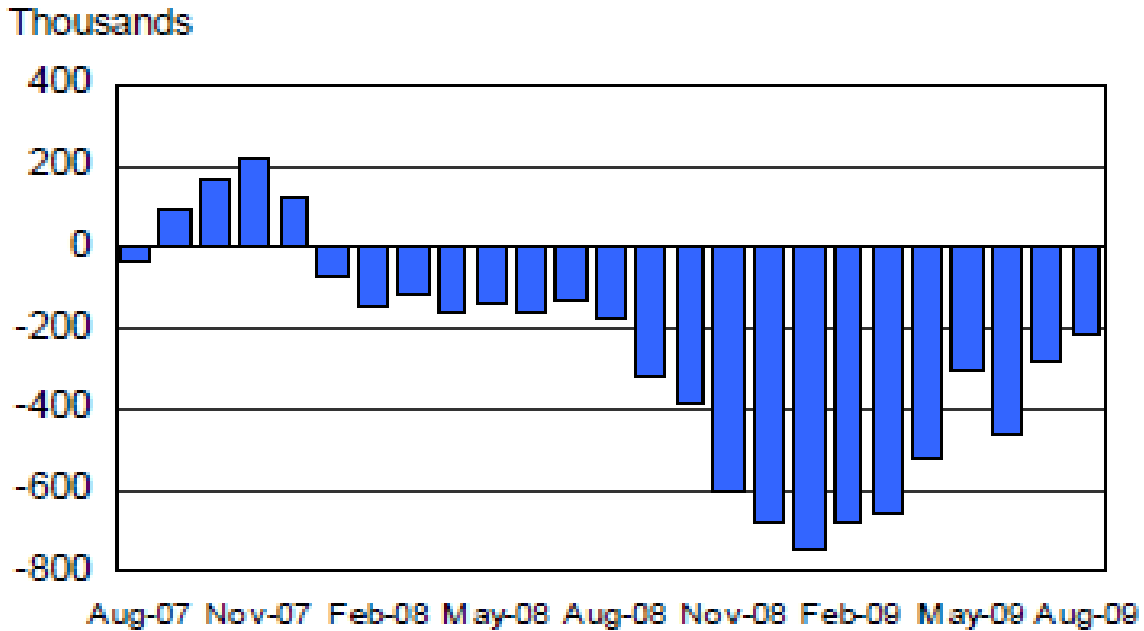
**Figure 2: Growth Resumed in France, Germany and Japan
In the Second Quarter of 2009 after Four Quarters of Negative Growth**



The problem on the road to recovery and growth is that most countries still expect to rely on rising exports, at a time when the huge stimulus provided by the excessive and unsustainable U.S. trade deficits will no longer be available. The U.S. current account deficit, which exceeded 6 percent of U.S. GDP in 2006, fell to 4.7 percent in 2008 and is expected to be only 2.8 percent this year and the next. It is true that China is shifting some of its production capacity to produce goods and services to satisfy increasing domestic demand, but a great deal of its production is still targeted to exports, and so is the case in India, Brazil, as well as the European Union and Japan. But not all economies can have an export surplus and there has not been sufficient rebalancing in most advanced and emerging market economies to power rapid growth domestically.

Although the huge stimulus package and powerful expansionary monetary policy did not prevent a deep recession, they did prevent the United States from falling into an economic depression and they are now providing the basis for a recovery, as evidenced by the reduction in the pace of job losses (see Figure 3), increase in manufacturing activity, stabilization of the housing market, and improvements in financial markets. U.S. growth in the second quarter of this year was -1.0 percent at an annual basis (after -6.1 percent in the last quarter of 2008 and -5.5 percent in the first quarter of this year) and likely positive but slow in the third quarter, fueling the White House argument that the stimulus is working -- with a lag. It appears that growth is also likely to remain slow for the next couple of years. How rapidly growth will occur in subsequent years may depend to a large extent on the reforms that will be adopted in the next few months or year.

Figure 3: U.S. Monthly Job Losses since January 2008

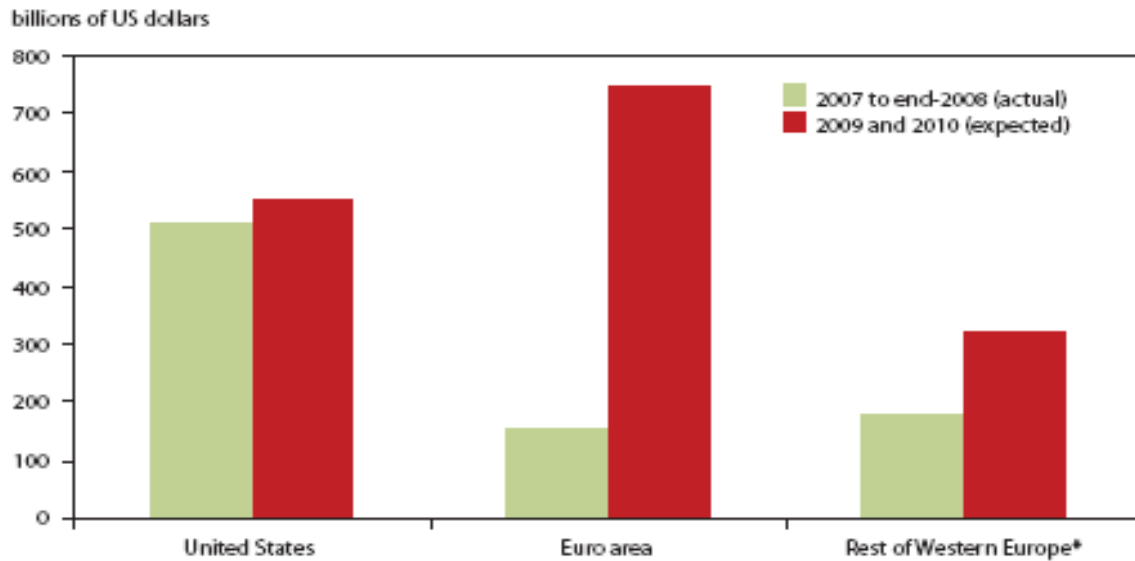


The Bottom but not the End of the Financial Crisis

While we may have touched bottom, the financial crisis is by no means over. Most U.S. banks, including some of the largest ones, face potentially huge losses during the second half of the year on loans (mortgages and credit cards) to consumers hard pressed by the recession. Banks will be pressured by losses on commercial real estate, which account for 13 percent of the U.S. GDP. It is true that Goldman Sachs and JP Morgan declared strong earnings for the second quarter (based on reduced competition and by deploying funds in risky businesses where spreads are high), but most other large banks (such as Wells Fargo and Morgan Stanley), as well as smaller regional banks, reported or face huge losses on bad loans. Citigroup and Bank of America were in the black for the quarter only as a result of selling off some of their business units.

The Public-Private Investment Program (PIPP), designed to enable banks to dump troubled assets that was introduced with great fanfare by Treasury Secretary Timothy Geithner last March, has been scaled down considerably and now focuses solely on toxic securities, not on bad loans, which is the main problem for many smaller banks. As these loans deteriorate and securities lose value, banks may be unwilling or unable to make new loans to consumers and business, thus hindering the recovery. As bad as the banking problem is in the United States, it is expected to be worse in Europe (see Figure 4) where the adjustment has only just started.

Figure 4: Bank Write-downs in the United States and Europe: Past and Future



Source: IMF, *Global Financial Stability Report*, April 2009.

*Denmark, Sweden, United Kingdom, Iceland, Norway, and Switzerland.

Reforms of the Financial and Economic Systems and Future Growth

Following are the proposed reforms to prevent future crises and strengthen the U.S. financial system:

1. Systemic Risk (Macro-Prudential Regulation):

Fed to monitor all large financial companies for systemic risk
& FDIC authority to take over and shut down failing institutions.

2. Market Regulation (Micro – Firm – Supervision):

Derivatives, especially credit default swaps (CDS), to be mostly standardized and traded on regulated exchanges;
Hedge Funds to register with the Securities and Exchange Commission (SEC);
More stringent capital requirements for all financial institutions;
Issuers of securitized loans to retain at least 5% stake or credit risk;
Investors to have more say in executive compensation;
Credit Rating Agencies to face more stringent oversight.

3. Consumer Protection (Consumer Financial Protection Agency):

Mortgages, credit cards, all other consumer financial products to be regulated by a new Consumer Financial Protection Agency (CFPA).

There is a great deal of disagreement on some of these proposals and it is difficult to predict which will be adopted in the present or revised form and which will be completely eliminated. It is less likely that some of these proposals will be adopted as we move closer to recovery. At this point, Congress seems unwilling to grant a greater supervisory role to the Fed, which it holds partly responsible for the housing bubble and in view of its apparent inability to foresee and prevent the current financial crisis. The proposed reforms would deal with the problem of “too big to fail” by more regulation rather than breaking up of huge banks and other firms, as some see as necessary. There is also a great deal of opposition and disagreement on the creation of the new Consumer Financial Protection Agency. Credit default swaps will be subjected to greater regulation to make them more transparent without forcing them to be traded on organized exchanges. Similarly, consumer credit agencies will be subject to greater regulation without, however, eliminating the conflict of interest arising from them being paid by the very financial firms that they rate.

In deciding which reforms to adopt, the United States will also try to achieve some degree of harmonization with the reforms that Europe is likely to adopt, so as to establish some sort of level-playing field and avoid putting American financial firms at a competitive disadvantage vis-à-vis European firms. However, this is likely to be extremely difficult to achieve. The financial system reforms that the United States are expected to adopt will be very important for the future growth of the U.S. economy. Over-regulation or the wrong type of regulation could sharply reduce future growth. This is not an idle concern. Many reforms now being proposed seem aimed at making the American economy more like the European economy, with its stronger social welfare net but traditionally slower rate of growth, higher rate of unemployment, and generally fewer economic opportunities.

A New Bull Market?

Figure 5, shows that on July 23, 2009 the stock market, as measured by the Dow Jones Industrial Average (DJIA), closed at about the same level as at the beginning of the year, having regained all that it had lost from January to March. The DJIA closing at 9,497 on September 8 was 45 percent higher than the low of 6,547 of March 9, 2009. Some people are calling this a new bull market, while others refer to it as a cyclical bull market in a secular bear market that dates back to the beginning of the decade when the DJIA was 11,000 (the DJIA remains 33 percent below its record close of 14,165 of October 9, 2007 – see Figure 6). Markets are also doing very well in Europe and generally even better in emerging markets.

The recent sharp rise in the U.S. market is based on reports of stronger-than-expected profits and bullish outlooks by many corporations for the second quarter and other signs that an economic recovery is at hand. Indeed, as a leading indicator, the market rise seemed to be correctly anticipating the recovery. The market has also been helped by President Obama’s decision to reappoint Ben Bernanke as head of the Fed as a reward for a job well done, thus eliminating the uncertainty regarding the succession, and ensuring continuity. I believe that after a pause, the market will resume its upward trend only if the

recovery gains speed in the months ahead. If March 9th represents the ultimate bottom (which, of course, no one could have perfectly timed), being in the market brought huge gains, but I think the market is now likely to pause and moderate, especially if the recovery turns out to be “U-shaped” rather than “V” shaped”.

Yields on both junk-rated and higher-quality companies are now dramatically lower as investors have become less concerned with corporate debt – and, of course, as yields fall, bond prices rise. With yields on emerging market sovereign bonds now almost 2 percentage points above those of A-rated U.S. corporate bonds, emerging-market bond volumes are now even higher than before the financial crisis started in July 2007.

Figure 5: DJIA in 2009

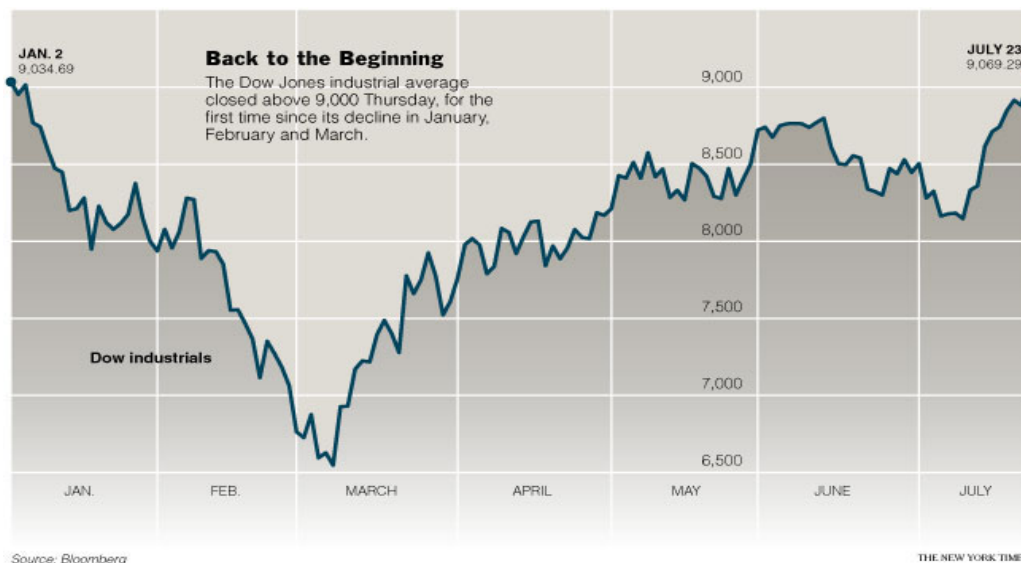


Figure 6: The Ten-Year DJIA

