

Reality Bites as Economic Resignation Sets In



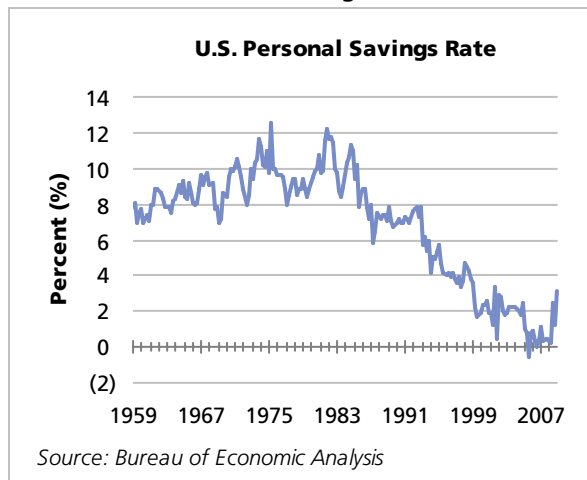
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Bleak deterioration, on what appears to be all fronts and on global scale, is the sad state of the economy today. In the United States, the primary questions are “what will get us moving?” and “how long will it take?” The questions relate to the consumer and the banking sector, and to economic health in general.

Buried under too much debt, consumers are particularly under pressure. They are also buffeted by other forces. They understand that unemployment will rise for the foreseeable future, which makes them fear for their own jobs. The value of their houses and retirement assets continue to decline. The consumers’ response has been to squarely face the imperative to save; quickly, the saving rate has risen to 5% of personal income, up from recent negative readings. Impressive as it is, the saving rate will need to go even higher, which will have the “paradox of thrift” effect of further reducing consumer spending and reinforcing the vicious cycle.

It is a time of transition, which generally makes for the worst of times, although policy support has come to the rescue. The Fed is “all-in” with monetary accommodation and the sharp decline in energy prices is another helpful counterweight. But consumer spending has to fall significantly further in order to increase savings or reduce debt more aggressively. Auto sales, which are 30% below 2008’s levels, might be a reasonable template for the necessary hit to retail spending. The fiscal policy initiatives from the new administration are a step to prime the Keynesian pump and should likely be viewed as the first of many. Whether the resurrection of a dead economist’s dormant ideas is actually going to have a positive impact remains yet to be seen. Regardless, government spending is likely to keep on coming as long as the Treasury can figure out how to raise the money. To do that, Treasury will access our lender of last resort, China, as well as tap the resurgent U.S. savings rate to fund its spending.

Retracement to 8%-10% Saving Rates Has Precedent



Raising more government debt is unfortunately a key part of the solution to get us out of a spiral caused by too much private debt. In some investor camps, the enormity of the public funding has also become the basis of fear for future inflation. My view is that the Bernanke Fed, knowing that Greenspan kept rates at 1% too long earlier in this decade, will remove policy accommodation preemptively and forcefully when the economy turns – initial claims for unemployment insurance might be a good monitoring point. But the proof of that won’t come for a long time. Right now, the world is flush with excess capacity – in manufacturing, construction, commercial real estate, and labor – all of which are disinflationary to the visible horizon.

Meanwhile, lagged impacts from the tottering consumer will affect the already shaky financial system. Unfortunately, escalating impairments in credit cards, student loans, and residential and commercial loans will continue to swamp the capital base of the banks. In this environment, the outlook for employment, wages and real assets remain a grim story. Improvement looks to be some ways away. ■

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