

Green Shoots of US Recovery Need Liquidity to Grow

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The phrase of the moment is “green shoots.” My most recent Google search on the phrase came back with some 30 million hits. (30 million is a big number, although it’s kind of quaint to have a reference to a million rather than a billion or a trillion in a piece about the financial crisis.) That said, I am still not a believer in green shoots. Much as green shoots need water to grow into healthy plants, an economy needs liquidity in order to expand and recover robustly. Despite putting the stress tests behind it, history suggests that the United States is not going to get the resumption of normal levels of bank lending and liquidity for some years. The implication is that that, even if the U.S. economy bottoms out later this year or, more likely in my view, early next year, it is not going to experience a vigorous recovery.

Why am I betting on a relatively tepid recovery? Four reasons.

First, and most importantly, there will be only weak support from bank lending. We know the outcome of the stress tests was negotiated and that it understated the risk of losses on the banks’ security portfolios in particular. Banks will be raising their ratio of capital to assets by earning fees (less competition for the Big Four in the wake of financial-sector consolidation guarantees more fees) and by selling new shares (like Wells Fargo and Morgan Stanley did on second Friday of May), but also by limiting the growth of their assets. Limiting the growth of their assets is of course just code for not lending to the same extent that they normally do in recoveries. Job creation in recoveries typically comes from small firms, and small firms need bank credit to create jobs. They will get less bank credit than usual in this recovery.

History supports this conclusion. We know that it typically takes two years from when the authorities intervene in concerted fashion to when the banks start lending again. This is the lesson of the Nordic banking crises of the early 1990s and the Japanese banking crisis of the late ‘nineties. This is the lesson of the Great Depression, when bank assets in the United States didn’t rise for fully five years after the Bank Holiday. It was also the case in other countries that experienced banking crises in the 1930s. More generally, the IMF reminded us in its spring 2009 *World Economic Outlook* that recoveries from downturns marked by financial crises are slower than recoveries from other downturns. The response – or non-response – of the banks is why.

Second, while fiscal stimulus helps, it is not enough. Whereas fiscal stimulus is on the order of 2 per cent globally, the output gap is nearly 6 per cent of GDP. The IMF’s latest *World Economic Outlook* projects global output to fall by 1.3 per cent in 2009, down from a normal rate of 4 ½ per cent. The difference between 4 ½ and -1.3 is nearly 6 per cent. Economists normally assume that the fiscal multiplier is about 1 ½ -- that increasing the fiscal deficit by 2 per cent of GDP increases final spending by 3 per cent of GDP. Thus, we are replacing only about half of the global private spending that has been vaporized in the crisis. This is a second reason why, though we will avoid another Great Depression, we will not see a vigorous recovery.

Third, we in the United States, in particular, are moving toward a policy mix that is unfavorable for investment and growth. To be clear, I am a strong supporter of the use of fiscal

stimulus under current circumstances. But I am also skeptical of the Obama Administration's plans for narrowing the deficit going forward. Its scenario rests on revenues from cap-and-trade and savings from health care reform, whose contributions range from the politically problematic to the imaginary.

At the same time, I am convinced that the Fed will do whatever it takes to prevent inflation from revving up once the economy begins to grow. It has the instruments it needs to do so, ranging from encouraging banks to hold more reserves by paying interest on them to issuing Federal Reserve Bonds (plans for which were announced in March). After all of its unprecedented recent actions, the Fed will be concerned to reassert its independence by showing that it is serious about price stability. Unfortunately, this combination of big deficits and tight money will mean high interest rates, which is the worst possible policy mix from the point of view of investment and growth.

Fourth, even if China is doing better, it is still only 7 per cent of the world economy, when measured at market exchange rates, which is the conversion factor relevant for talking about its possible role as a locomotive for the global economy. It is clear that the Chinese economy is now recovering, although I don't buy the authorities' headline number of 6.1 per cent growth in the first quarter. We know that they can announce any number for GDP growth they like. Historically, a good proxy for manufacturing production in China is electricity consumption, and electricity consumption was down in the first quarter. In part that reflects the changing composition of production (less aluminum production, for example). But it also suggests that the authorities' headline estimate of GDP growth is exaggerated.

U.S. consumption is likely to remain relatively weak as US households rebuild their retirement savings. Savings out of current incomes by households is currently running at about 4 per cent, up from essentially zero before the crisis, and it is likely to rise still further. China and even the BRICs as a group are too small to make up for this, even if they try.

Central bankers like Ben Bernanke display more optimism than I do. But they have a stake in doing so. They understand that the state of the economy depends on confidence, and confidence depends on the state of the economy – so that if they can talk up confidence they can talk up the economy. Not being a central banker, I can offer the unvarnished truth. I also worry that if one talks up confidence excessively, and consumers are ultimately disappointed by the outcome, the exercise can backfire. We shall see.

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