Restructuring the U.S. Economy -- Downward

by **Kurt Richebächer**

The deficit country is absorbing more, taking consumption and investment together, than its own production; in this sense, its economy is drawing on savings made for it abroad. In return, it has a permanent obligation to pay interest or profits to the lender. Whether this is a good bargain or not depends on the nature of the use to which the funds are put. If they merely permit an excess of consumption over production, the economy is on the road to ruin.

- Joan Robinson, Collected Economic Papers, Vol. IV, 1973

Finally, the greatest boom in American housing history is going bust. The impact on the economy has only just begun to be felt. Demand for homes is sharply down, while the number of vacant dwellings is ballooning – up more than 40% for existing homes and more than 20% for new homes year over year. At issue now is the severity of the impending bubble aftermath.

It does not seem, though, that there is a lot of worrying around. There appears to be a widespread belief that the U.S. economy is now out of trouble because the Fed decided not to raise interest rates. We presume the following interpretation:

1. This is not just a pause, but the end of all rate hikes.
2. In the absence of an overheating economy, inflation is yesterday's issue.
3. Steady or lower interest rates will boost the stock market.
4. As the Fed no longer tightens, the possibility of a hard landing can be dismissed.
5. Abundant liquidity continues to underpin the markets.

Treating bad economic news as good for the financial markets, Wall Street is running wild with more aggressive speculation. "The world economy is on track to grow at a 5.1% rate this year, but the risk of a severe global slowdown in 2007 is stronger than at any time since the September 2001 terror attacks on the United States," said the International Monetary Fund in a report to finance ministers, mentioning two possible triggers: a sharp slowdown in the U.S. housing market or surging inflationary expectations that would force central banks to raise interest rates.

Taking this forecast into account, the sudden plunge of commodity prices may not be totally surprising. On the other hand, prices of risky assets and mortgage-backed securities have, despite the obvious problems in U.S. housing and consumer finance, held steady. Stock prices of U.S. lenders up to their necks in subprime, interest-only and negative-amortizing mortgages have been rising 5-10% since late August. Since hitting bottom in June, emerging stock markets have rebounded 20%. Developed international markets have risen by 12%, and U.S. stock markets by around 8%. A vertical slide by the yen since May suggests that yen carry trade is back with a vengeance.

Given the growing talk of impending recession in the United States, all this may appear rather surprising. The underlying rationale seems to be the assumption that this recession will be just another soft patch forcing the Fed to what the speculative community likes most: a return to easier money.

The U.S. economy will again prove its outstanding resilience and flexibility.

There is talk of recession, but definitely no recession scare. Popular perception appears to trust that the U.S. economy will again prove its outstanding resilience and flexibility. And are the balance sheets of private households not in excellent shape, as rising asset valuations have vastly outpaced the rise in liabilities over the years? The possible scary parts of the new development, a deeper recession and a precipitous decline in economic growth, have not yet come to the fore.

Over the past five years of recovery from the 2001 recession, U.S. economic growth has been "asset driven," according to colloquial language. More to the point, protracted sharp rises in house prices served private households as the wand providing them with prodigal borrowing facilities to increase their spending. For years, it was the economy's single motor. The Fed estimates that mortgage equity withdrawals exceeded $700 billion, annualized, in the first half of 2006.

In 2005, the last full year for which data are available, new borrowing by private households amounted to $1,241.4 billion. Now compare this with the following spending and income figures. Disposable personal incomes grew $354.5 billion in current dollars and $93.8 billion in inflation-adjusted dollars. Spending increased $530.9 billion in current dollars and $264.1 billion in chained dollars.

We have presented these figures to highlight the paramount importance of the large equity extractions on the part of private households for U.S. economic growth during the U.S. economy's current recovery. Plainly, it prevented a much deeper recession. Absence of any wealth gains could have easily induced private households to do some saving out of current income.

For the consensus, the U.S. economy's shallow recession in 2001 is the most splendid justification of Mr. Greenspan's repeatedly expressed idea that it is better to fight the bubble's aftermath with easy money than to prick it in its prime. This is plainly a gross misjudgment, because America's shallowest recession was followed by five years of the shallowest economic recovery, with unprecedented large and lasting shortfalls in employment, income growth and business fixed investment.

Actually, there have been major changes in the U.S. economy's pattern of employment and resource allocation, but altogether changes for the worse, not for the better. These structural changes are bound to depress U.S. economic growth in the long run.

The striking feature of the housing bubble – distinguishing it diametrically from an equity bubble in this respect – is its extraordinary credit and debt addiction. The reason is that it requires borrowing for two different purposes: first, for driving up house prices; and second, for the cash out of the capital gains. Every single dollar for this purpose has to be borrowed.

Since end-2000, American households have offset their badly lacking income growth with an unprecedented stampede into indebtedness, up so far by $5.3 trillion, or 77%. But as soaring house and stock prices added a total of $15.6 trillion to the asset side of their balance sheets, households miraculously ended up with an unprecedented surge in their net worth from

$41.5 trillion to $53.8 trillion in the first quarter of 2006.

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Referring to this fact, Fed Chairman Bernanke noted in a speech on June 13 that "U.S. households overall have been managing their personal finances well."

Manifestly, the rapid creation of the housing bubble in 2001 did prevent a deeper recession. But this should raise the further question of how the housing bubble and its financial implications have affected the U.S. economy from a longer perspective. In other words, are they in better or worse shape today than in 2001 to weather the aftermath of the housing bubble? Our answer is categorical: Underlying cyclical and structural conditions have dramatically worsened.

In 2001, the Greenspan Fed could cushion the fallout from the bursting equity bubble with the creation of the housing bubble. This time, manifestly, there is no alternative bubble available to be inflated to cushion the fallout from the housing bubble. Rather, there is a high probability that the popping housing bubble will pull the stock market down with it. That is the first ominous difference between 2001 and today.

The second ominous difference is that the economy and the financial system have accumulated structural imbalances and debts as never before in history. Vastly excessive borrowing for consumption and speculation has turned the U.S. economy into a colossus of debts with a badly impaired capacity of income creation.

And finally, equity and real estate bubbles are very different animals, of which the latter is manifestly the far more dangerous. In its World Economic Outlook of April 2003, the International Monetary Fund published a historical study, titled When Bubbles Burst, and explained differences in the effects between bursting equity and housing bubbles. It stated, in brief, the following:

First, the price corrections during housing price busts averaged 30%, reflecting the lower volatility of housing prices and the lower liquidity in housing markets. Second, housing price crashes lasted about four years, about 1 1/2 years longer than equity price busts. Third, the association between booms and busts was stronger for housing than for equity prices… Fourth, all major bank crises in industrial countries during the postwar period coincided with housing price busts.

The severe cases of bursting housing bubbles badly affecting the banking systems in the late 1980s were in England, the Nordic countries and Switzerland, not to speak of Japan, where, however, commercial real estate played the key role.

Regards,

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Kurt Richebächer was an international banker and economist. He frequently contributed to the Daily Reckoning and was best known for his newsletter, "The Richebächer Letter," which we were lucky to publish for him.