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Johnson: Brace for a Long Recovery From Credit Glut

Illustration by Jason Polan

By Simon Johnson ***Sep 12, 2011***

Until recently, the standard narrative most analysts applied to macroeconomic news went like this: We had a major financial crisis in the fall of 2008, which immediately brought on a severe recession that would be followed by relatively fast recovery.

All countries suffered to some extent; all should recover, albeit presumably at varying rates, and reasonable people could disagree about which nation would grow faster and in a more durable manner.

The prevailing thought was that a rising tide lifts all boats. It turns out that may have been the wrong maritime metaphor. A more apt image may be the advice to investors attributed to Warren Buffett: “You don’t know who’s swimming naked until the tide goes out.” The questions that preoccupy us now are: Is the tide coming in or still going out? Or did the big storm permanently ruin the beach?

To get a fix on where the global economy is heading, start by thinking about just three countries: the U.S., Germany and China. For all three, the central issue is the same: Credit.

Each nation is contending with a different kind of credit crisis, but the crux of the problem is the same for all: How to move away from a model of growth based on very high leverage, while still managing to grow.

Consumer Spending

In the U.S., households are at the epicenter of the crisis as consumption accounts for slightly more than 70 percent of final spending. Many Americans ran down their savings and borrowed heavily in the years before 2008; they were encouraged, of course, by some parts of the financial sector. Does anyone think house prices will rise consistently again in the near future, let alone provide enough wealth to finance retirements?

In any case, some lasting increase in the household savings rate is to be expected. Similar thinking probably applies to the small-business sector. The death of credit in October 2008 has made everyone want to be more careful. There is a legitimate reluctance to spend and to hire, and it's hard to imagine a politically feasible fiscal stimulus that would make a difference.

If consumers and entrepreneurs paid closer attention to the macro numbers, they would probably be more pessimistic. A 1 percent per year expansion of gross domestic product -- the latest official read on second-quarter growth in 2011 -- is about what the U.S. needs to keep pace with population growth, which the Census Bureau estimates between 0.85 percent and 1 percent most years over the past decade.

Lost Half-Decade

If you compare nominal GDP per capita for the second quarter of 2006 with the number for the second quarter of 2011, the U.S. has had about 8 percent growth. Yet inflation during the same period -- using the standard indices -- has been a bit higher. In other words, the world's largest economy, accounting for about 25 percent of global output, has already lost a half decade.

The U.S. could begin to pull out of its malaise. It still is home to a great deal of innovation and big companies are making plenty of money. The equity-financed part of the private sector has strong prospects and new technology-based ventures continue to attract top talent from around the world.

Still, it isn't helpful that our politicians insist on pounding down consumer confidence through rhetoric and confrontation, and by doing nothing to prevent job cuts by state and local governments.

Those cuts make little sense. The U.S. is the world's best credit risk and there is wide agreement that strengthening education is the path to long-term productivity growth, yet teachers are being laid off around the country.

Banking Crisis

To make matters worse, there is no good news from the U.S. banking system. The Obama administration made the decision to allow big banks to recapitalize as the economy recovered, while also permitting dividends to increase and high bonus payouts to resume. As the recovery stalls, this strategy looks increasingly dubious because the banks' equity capital levels are now probably too low to buffer the shock of another down leg.

Compounding this, directly and indirectly, is the economic disaster in Europe. The over-borrowing there can primarily be attributed to governments -- encouraged by most of the financial sector -- that enacted crazy rules allowing banks to view sovereign loans as "risk free." That version of a highly leveraged growth model needs to be unwound and it will be hard to do so smoothly.

Greek Debt

The Germans are the leading creditor to the euro zone and their thinking sets the tone. The main idea at present is to ring-fence a restructuring of Greek debt to ensure the impact doesn't spread to the rest of the currency union. This, too, is proving difficult; witness the repeated upward pressure on Italian interest rates.

In the end, the European Central Bank may well hold a great deal of Italian, Spanish and other debt. But their on-off bond buying process is likely to bring with it tighter

credit across the “periphery,” an elastic geographic concept that keeps threatening to expand.

Perhaps the euro will weaken enough to help rescue Italy and others. But the effect could be short-lived as U.S. politics will discourage big capital inflows and many official holders of reserves would rather diversify away from the dollar. The British pound looks unlikely to gain value, the Japanese yen remains volatile, and the Swiss franc is now tied to the euro.

Stark’s Resignation

The European currency may remain relatively strong, so we shouldn’t expect a depreciation-induced export miracle for the euro zone. Even so, the resignation on Sept. 9 of Juergen Stark -- a German member of the ECB Executive Board -- pushed the euro lower. Any further backing away from the ECB by Germany could be a game changer.

The continent has entered a period of fiscal austerity and monetary confusion. In this situation, it is hard to see how the European Union will show anything other than low growth for the next several years, placing another quarter of the world’s economy in the doldrums.

And then there is China, which has long featured a great deal of borrowing by state-run enterprises and their spin-offs, but has recently moved rapidly into consumer credit, particularly as high-income households buy real estate on the expectation of future asset-price increases.

China’s share of global output remains relatively small -- about 12 percent, even with the most generous adjustment for purchasing power -- but it contributes more than a quarter of world growth, and has a definitive effect on many commodity prices, with significant consequences for prosperity across most of the developing world.

China’s Hybrids

Can China do a better job managing the flow of credit to its hybrid state-private sector combinations than the U.S. did with its private sector and the euro zone did with its governments?

Probably not. Careless lending, backed by implicit government guarantees, has increased around the globe over the past 40 years (see “Will the Politics of Global Moral Hazard Sink Us Again?” which I wrote with Peter Boone).

The Chinese learned these practices from the best in the business, that is the people and organizations that were revered for their wisdom in the 1990s and early 2000s, but ultimately systematically mispriced risk.

Economic development is often described as “catching up.” But the prospects for global growth in the short term greatly depend on whether China can avoid following in the footsteps of the U.S. and Europe.

Growth based on a great deal of leverage has proved fragile, but we haven’t yet moved to a different model. For now, the transition away from high levels of private and public sector debt will most likely be prolonged. It will certainly be painful.

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