



Pain Not Over Yet

July 24, 2009

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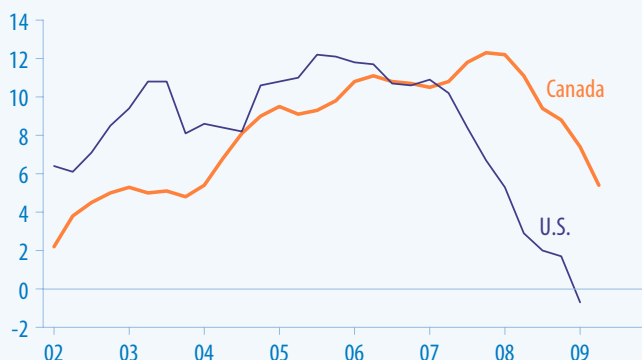
Since 2007, with the beginning of the U.S. housing meltdown and the ensuing financial crisis, there has been a global decline in private sector spending, a dramatic shrinkage in global trade and an unprecedented spike in government spending. Only the degree to which this has occurred varies from country to country, but the pattern is ubiquitous. Moreover, despite enormous federal government stimulus, it has been nowhere near as large as the meltdown in private spending. The change in trade flows has reduced the U.S. trade deficit, thereby enhancing the U.S. trade position and reducing its drain on GDP, as imports have fallen relative to exports. But for America's trading partners, the reverse has been true. For example, Canada's trade surplus has turned to a record deficit, dampening overall GDP growth. The same is true for China as its trade surplus diminished with reduced global demand.

Previous overspenders—households and businesses that were heavily indebted—have significantly reduced spending, decreased their debt and thereby increased savings. For the U.S. household sector, savings rates have risen from less than 1% of income to a whopping 7%. Households are attempting to rebuild assets decimated by the decline in the value of their stock and bond portfolios and the plunge in the value of equity in their homes. The same is true, more or less, for households in the U.K., Ireland and Spain—the countries with bursting housing bubbles. Canadian housing dipped only mildly in comparison as household leverage is far lower than in these bubble countries. Virtually all Canadians must either put down at least 20% of the house price to get a mortgage or

qualify for mortgage insurance, which requires a good credit score, reasonable steady income and lots of documentation.

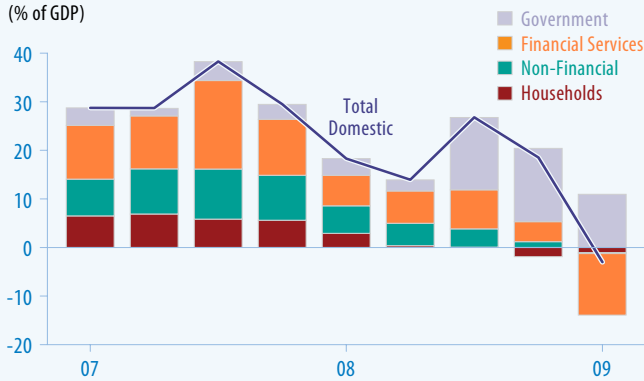
In response to reduced private sector spending, excess capacity in the U.S. has risen to its highest level in the postwar period, hence commercial real estate values are falling sharply and the unemployment rate will continue to rise through early next year. Although headline unemployment is posted at 9.5%, up five percentage points since 2007, the broader measure is a whopping 16.5%. The average duration of unemployment is at a record high. With the sharp reduction in aggregate income,

CHART 1
CREDIT DEMAND DOWN
(y/y % chng)



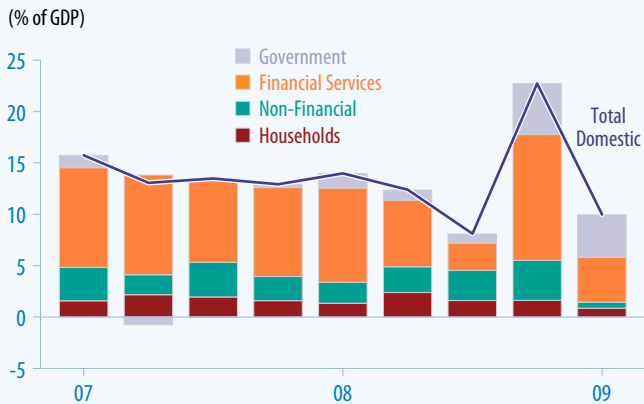
Sources: Bank of Canada, U.S. Federal Reserve

CHART 2
U.S. DOMESTIC BORROWING
(% of GDP)



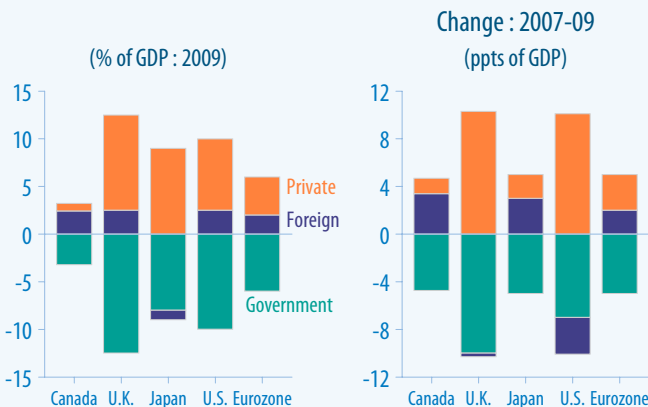
Sources: U.S. Federal Reserve, Financial Times

CHART 3
CANADIAN DOMESTIC BORROWING
(% of GDP)



Source: Statistics Canada

CHART 4
SAVINGS LESS INVESTMENT



Sources: Financial Times, Statistics Canada

spending and property values, tax revenues have plunged at every level of government. Given that many states have balanced budget laws, prohibiting deficit spending, programs have been slashed, jobs cut and municipal services reduced, contributing to the downturn. So the real spender of last resort remains Uncle Sam.

It is too soon for federal government spending to have meaningfully boosted private demand. At this point, the fiscal stimulus is merely partially offsetting the reduction in the private sector. Though deficits and Treasury borrowing are at postwar highs, household and business credit growth have fallen sharply, mitigating the possibility of government borrowing crowding out household and business credit needs (*Chart 1*). Declines in private borrowing as a percent of GDP are noteworthy, especially for the U.S. (*Chart 2*) and, to a much lesser degree, in Canada (*Chart 3*).

According to Martin Wolf in a recent *Financial Times* column (July 15, 2009), the huge shift in spending and borrowing from the private sector to government is seen in the OECD forecasts for current account and fiscal balances (*Chart 4*). In 2007, the U.S. private sector spent 2.4% of GDP *more* than income. Through borrowing, households especially spent more than they earned. This had been going on for years as U.S. household wealth increased thanks to capital gains and employer retirement contributions eliminating the need for saving out of income. Credit was readily available and at low cost. Consumers cashed out the equity in their homes and ran up credit card bills. The illusion of wealth accumulation without saving disappeared with the housing crash and the economic contraction. By this year, the OECD estimates that the private sector will spend about 8% of GDP *less* than income.

Deleveraging is a very painful process and will continue for some time. It is most evident in Britain and the U.S., while for Canada, the shift has been relatively minor, especially in the private sector. Indeed, the rise in government deficit spending has been larger than the reduction in private sector spending, helping to explain why the Canadian economy appears to be recovering with relative buoyancy. The bigger risk in Canada is the declining trade balance, exacerbated by the sharp rise in the Canadian dollar, although to date, the Bank of Canada does not appear to be too concerned.

Even as the U.S. recession appears to be ending, private sector prudence is likely to endure as regulations are tightened and mountains of consumer and business debt remain. It will take years for the gross household borrowing-to-GDP ratio to return to historical norms. This is especially troubling with the aging of the population and with a quarter-to-a third of the population in the boomer age range of 43-to-63. Median boomer age in Canada and the U.S. is roughly 53—not a good time to be eroding a nest egg or losing a job. These folks are spooked, and for good reason.

So long as this period of retrenchment lasts, the risk will not be inflation, but rather deflation. One of Chairman Bernanke's and Treasury Secretary Geithner's greatest concerns is that the economy slides into an extended period of subpar growth and deflation, as in Japan.

The Bottom Line: It is likely that the output gap in each country will remain for years, requiring governments to maintain stimulative policies. A quick reduction in fiscal deficits would entail devaluing the currency through inflation as well as massive bankruptcies. The G20 has proven that they won't let that happen. So while the recession is ending, the pain is far from over.

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