Green shoots of US recovery need liquidity to grow

Barry Eichengreen

The phrase of the moment is "green shoots." My most recent Google search on the phrase came back with some 30 million hits (although 30 million is a big number, 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). Yet I am still not a believer in green shoots. Much as green shoots need water to grow into healthy plants, an economy needs liquidity to expand and recover robustly. Even with the stress tests behind it, history suggests that the United States is not going to see normal levels of bank lending and liquidity for some years. The implication is that, even if the US economy bottoms out later this year or (more likely in my view) early next year, the recovery is not going to be vigorous.

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

Credit shortage

First, and most important, there will be only weak support from bank lending. We know the outcome of the stress tests was negotiated — and that in particular it understated the risk of losses to bank securities portfolios. 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 for banks) and by selling new shares (as Wells Fargo and Morgan Stanley did on the 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 as 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 than usual in this recovery.

History supports this conclusion. We know that it typically takes two years from when the authorities intervene in a 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 later in that decade. This is also the lesson of the Great Depression, when bank assets in the United States did not rise for fully five years after the Bank Holiday. Other countries that experienced banking crises in the 1930s learned a similar lesson. 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. One reason is the response — or nonresponse — of the banks.

Insufficient fiscal stimulus

Second, while fiscal stimulus helps, it is not enough. Globally, fiscal stimulus is on the order of 2% of GDP, but the output gap is nearly 6%. The IMF's latest *World Economic Outlook* projects global output to fall by 1.3% in 2009, down from a normal rate of 4½%. The difference between 4½ and -1.3 is nearly 6%. Economists normally assume that the fiscal multiplier is about 1½ — that increasing the fiscal deficit by 2% of GDP increases final spending by 3%. Thus, we are replacing only about half of the global private spending that the crisis has vaporized. This is a second reason why, though we will avoid another Great Depression, we will not see a vigorous recovery.

Unfavorable US policy mix

Third, we in the United States in particular are moving toward a policy mix that is unfavorable for investment and growth. To make myself clear: I am a strong supporter of the use of fiscal stimulus in the current circumstances — but I am also skeptical of the Obama Administration's plans for narrowing the deficit. Its scenario rests on revenues from cap-and-trade greenhouse gases[1] and savings from health care reform, the contributions of which 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 — the worst possible policy mix from the point of view of investment and growth.

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China big ease

Fourth, even if China is doing better, it is still only 7% of the world economy measured at market exchange rates, which is the

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conversion factor relevant for talking about its possible role as a locomotive for the global economy. Although it is clear that the Chinese economy is now recovering, I don't buy the authorities' headline number of 6.1% growth in the first quarter. We know that they can announce any number for GDP growth they wish. 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.

Sluggish American consumption

US consumption is likely to remain relatively weak as US households rebuild their retirement savings. Household savings are currently running at about 4% of household incomes, up from essentially zero before the crisis, and are likely to rise further. China and even the BRICs (the emerging group formed by Brazil, Russia, China, and India) together are too small to make up for American consumption,shortfall, even if they try.

Central bankers like Ben Bernanke display more optimism than I do. But they have a bigger stake: They understand that the state of the economy depends on confidence, and confidence depends on the state of the economy — 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 they talk up confidence excessively and consumers are ultimately disappointed by the outcome, the exercise can backfire. We shall see.

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[1]In short, the "cap" is a legal limit on the quantity of greenhouse gases that a region can emit each year and "trade" means that companies may swap among themselves the permission – or permits – to emit greenhouse gases.