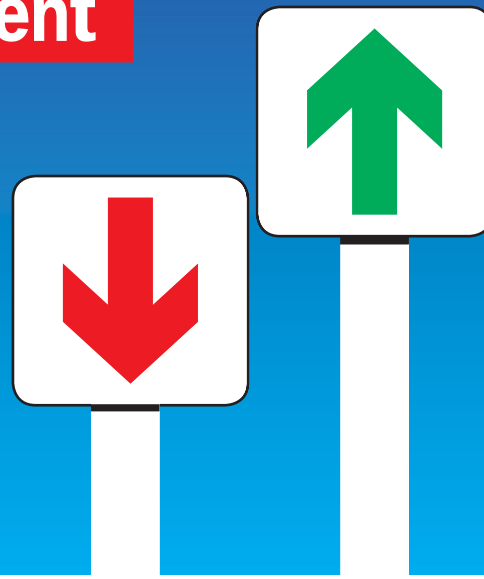
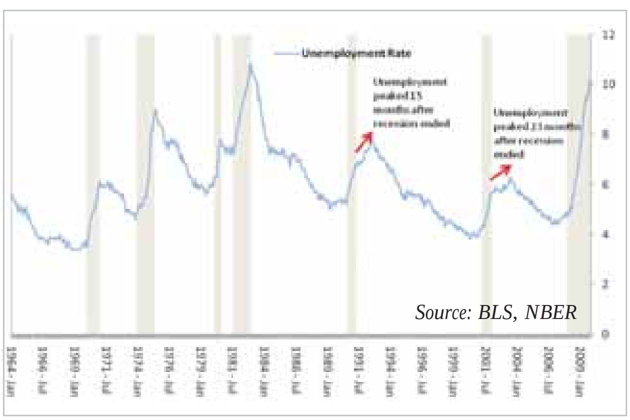
Recession, Unemployment and Recovery

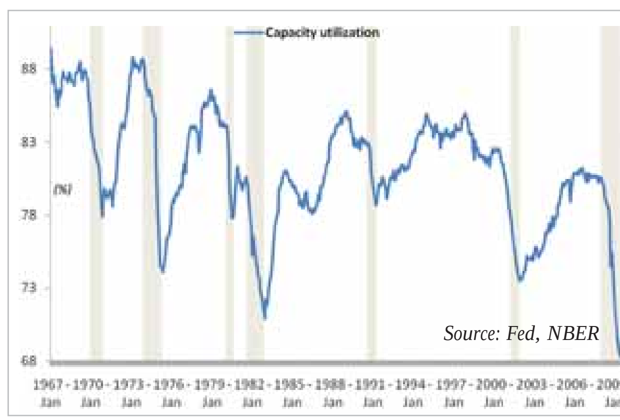


With ultra low interest rates, the US consumers need to deleverage and reduce their indebtedness to manageable levels, because if the interest rates begin to rise, the increase in debt servicing would shrink their income basket further and lead to disastrous results, says Kunal Kumar Kundu

A look at the US unemployment data trend indicates that the unemployment rate in US generally tends to peak a few months after the recession ends. In the last couple of recessions, however, unemployment remained high for an extended period even after the recessions ended.



Source: BLS, NBER



Source: Fed, NBER

Source: BEA, NBER

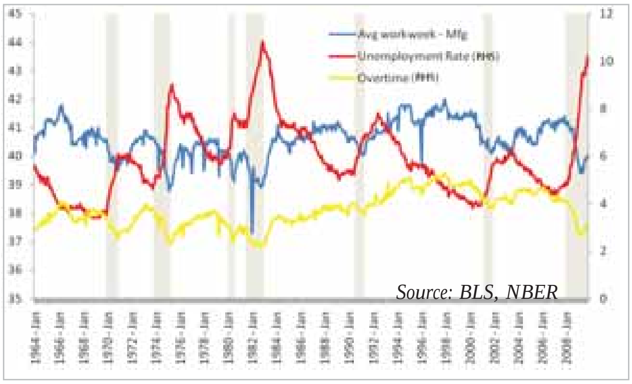
What explains this phenomenon?

When an economy enters into recession and demands slide, economic activity reduces. Manufacturers start to reduce production (resulting in falling capacity utilization), lay off workers (rising unemployment rate) and start drawing down on inventories.

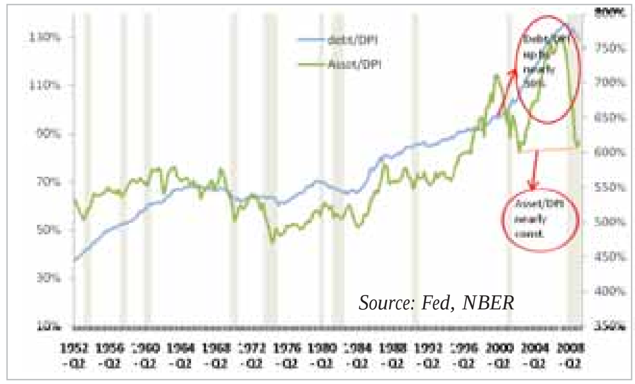
What this means is that, the end of recession is signalled by the reduction in the pace of inventory drawdown, leading to inventory built up. This, however, does not mean that the employers would restart hiring, even when demand shows signs of bottoming up and maybe even rising. Only when they are convinced that the rising demand will be sustained will they start hiring. Till that time they would bank on productivity increases, hire part-time workers and make the existing workers (the critical mass of people they want to hold onto) work more.

Now, with the pace of inventory drawdown diminishing and some signs of economic activity picking up, there is a feeling that the economy has moved out of recession and the unemployment rate will peak during the first quarter of 2010 and, thereafter, things would improve. Meaning that economic activity will be first buoyed by inventory restocking and then, as consumers flock back to the market, demand will pick up on a sustainable basis and employers will start hiring. It's as simple as that.

Or is it? All the pieces of the puzzle



Source: BLS, NBER



Source: Fed, NBER

actually do not seem to fall in place. Here I am referring to the US domestic demand. As compared to the previous recessions, it is different this time, and it is not only because this is the deepest recession since the great depression. It is also because of the fact that the US consumers are in the most precarious situation now than ever before. The consumers, whose demand account for a little over 70 per cent of US GDP, are excessively leveraged.

Despite some correction, the current US household debt to disposable income ratio is as high as 130 per cent. This excessive leverage situation is nearly a seven year old phenomenon. It started moving up from nearly 100 per cent to this level from 2002. This was aided by benign global interest and inflation scenario and huge flow of credit, leading to asset price inflation which manifested itself in the form of a bubble. The lending institutions lowered the bar for their lending practices, as they relentlessly started chasing income. The risk appetite increased so much that soon price of risk fell to zero and anybody and everybody jumped onto the bandwagon. Artificial demand for houses jacked up the prices. With every rising house prices, US consumers started withdrawing equities in huge numbers (MEW or Mortgage Equity Withdrawal), giving them more (yet artificial) purchasing power. Easy availability of credit and rising demand boosted corporate profits and hence the equity markets also went on an overdrive. All of these positive developments fed into each other and the bubble kept on building up. As long as these positive sentiments were there, the US household somehow managed the high debts. In fact, between the last recession and the current, when their Asset to Disposable Personal Income (DPI) ratio remained more or less the same (after having gone up to stratospheric level in between, aided by rising equity and house prices), their leverage (debt to DPI ratio) has gone up by nearly 30 per cent.

To be sure, demand has not fallen off the cliff totally. Aided by the steroidal effect of the stimulus plan, demand is still holding up, and in certain cases maybe even rising, albeit ever so slowly. But the pain is visible. The delinquency levels are still very high. Number of housing loan foreclosures remained above 300,000 for the seventh straight month.

Now, there is an optimism that the US consumers can sustain the impact of leverage, as their networth is showing signs of revival on the back of rising equity prices, and start to consume. That to me is like building a castle is the air. Most of the equity markets globally have run ahead of fundamentals, based on expectation of quick recovery. The US is insisting on continuation of the stimulus and ultra low interest rates as it is quite clear that the economy, at this point in time, cannot sustain on its own. The continuation of the stimulus is absolutely important for the growth to continue. Currently, the ultra low interest rates and the concomitant deluge of dollar carry trade is leading to asset price inflation that can be construed as leading to another bubble. But many analysts are banking on their recovery theory based on the ability of the US consumers to loosen their purse strings as they see their networth increasing. But this, as I mentioned earlier, is illusionary and once the bubble is pricked, the consumers will retrace.

Also, it is important to note that the low interest rate scenario is not going to last a lifetime. It is easy to be leveraged when the interest rates are low. But given the extent of indebtedness, if the consumers do not start to deleverage now and reduce the extent of debt to manageable levels, the impact will be disastrous when the rate rises. The demand on the consumers' consumption basket from various quarters is already very high. Medical expenses, for example. The Personal Consumption Expenditure (PCE) as percentage of GDP currently accounts for about 71 per cent of the US GDP. And medical expenses currently account for about 13 per cent GDP, as compared to about 3 per cent nearly 60 years ago. As a result, PCE ex medical expenses (as percentage of GDP) is falling. High oil prices extract its pound of flesh. On top of it, the moment the interest rates rise, the increase in debt servicing requirement (of the highly indebted consumers) will shrink the income basket available for consumption even lower.

In essence, there are two basic scenarios that can play out. Either the consumers start deleveraging now (which will mean the expected growth of the US economy will peter off in the near future) or they continue to consume and stay leveraged (which will lead to another recessionary scenario as and when the interest rate rises). To me, the first scenario is logical and preferable. Only time will tell how things pan out.

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