“Dr. Doom”: U.S. Financial System is Insolvent; L-shaped Semi-Depression Possible

[This is a column by the bourgeois economist Nouriel Roubini, known as “Dr. Doom”, together with my introductory comments which I forwarded to friends on March 5, 2009. –S.H.]

Hi everybody,

Most bourgeois economists (and politicians of course!) are cheerleaders for the economy, and almost always try to put a positive spin on negative economic developments. But there are a very few establishment economists who, in order to make a name for themselves, are contrarians and actually openly blurt out some of the truth about just how bad and dangerous the current economic crisis is. One such, Nouriel Roubini, bills himself as “Doctor Doom”. And obviously lately what Dr. Doom has been saying is more on the mark than those predicting an early turn around for the economy.

In the article below Dr. Doom gives further evidence for thinking (what a number of us Marxists have been saying for a while) that the U.S. financial system *as a whole* is effectively insolvent. Only the huge, and *continuing*, government bailouts are keeping it above water.

In addition, Dr. Doom suggests that there is a growing possibility that this recession/depression will be L-shaped. For those not in the know, an “L-shaped” recession is one in which the economy drops steeply (like the first part of the letter “L”) but then levels off and stays low (like the horizontal part of the letter “L”). Sometimes you hear bourgeois writers wondering whether the “recovery” will be “U-shaped” or “L-shaped”, but of course the whole idea of the “L-shaped” scenario is that there is little or no *recovery* at all!

I think the reasons outlined here by Dr. Doom for thinking that the current Obama “stimulus plan” will not be nearly as effective as the government imagines are correct. I do expect some semi-stabilization for a while in the second half of this year, and then a resumption of the economic collapse (unless there is a much more massive Keynesian deficit package pushed through). In other words I am not near as tentative as Dr. Doom is about this “L-shaped” scenario, and I also add another vertical drop after the short horizontal part of the “L”. (I guess that turns the symbol into a lightning bolt shape!)

If there *is* any actual economic pick up towards the end of the year it will surely be short-lived. We are pretty definitely on our WAY into an outright depression, though there may well be a few very short, weak and partial stabilizations and/or recoveries along that road.

Dr. Doom has some useful statistics about China and the international situation here as well.

Again, this shows that this crisis is worldwide, and that no one country or region is going to appear to save the bacon for the all the other failing economies.

Dr. Doom, by the way, like all other bourgeois economists, does not even *begin* to understand the real causes for this current crisis, and how they arise from the very nature of capitalism itself (and specifically the extraction of surplus value from the workers). Thus his projections are not based on any truly deep understanding of the situation, and are not reliable over the long term. But for the short term (say the next year or so), he does seem to recognize the likely course of development.

Scott

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Doctor Doom
The U.S. Financial System Is Effectively Insolvent

Nouriel Roubini 03.05.09, 12:01 AM ET

For those who argue that the rate of growth of economic activity is turning positive--that economies are contracting but at a slower rate than in the fourth quarter of 2008--the latest data don't confirm this relative optimism. In 2008's fourth quarter, gross domestic product fell by about 6% in the U.S., 6% in the euro zone, 8% in Germany, 12% in Japan, 16% in Singapore and 20% in South Korea. So things are even more awful in Europe and Asia than in the U.S.

There is, in fact, a rising risk of a global L-shaped depression that would be even worse than the current, painful U-shaped global recession. Here's why:

First, note that most indicators suggest that the second derivative of economic activity is still sharply negative in Europe and Japan and close to negative in the U.S. and China. Some signals that the second derivative was turning positive for the U.S. and China turned out to be fake starts. For the U.S., the Empire State and Philly Fed indexes of manufacturing are still in free fall; initial claims for unemployment benefits are up to scary levels, suggesting accelerating job losses; and January's sales increase is a fluke--more of a rebound from a very depressed December, after aggressive post-holiday sales, than a sustainable recovery.

For China, the growth of credit is only driven by firms borrowing cheap to invest in higher-returning deposits, not to invest, and steel prices in China have resumed their sharp fall. The more scary data are those for trade flows in Asia, with exports falling by about 40% to 50% in Japan, Taiwan and Korea.

Even correcting for the effect of the Chinese New Year, exports and imports are sharply down in China, with imports falling (-40%) more than exports. This is a scary signal, as Chinese imports are mostly raw materials and intermediate inputs. So while Chinese exports have fallen so far less than in the rest of Asia, they may fall much more sharply in the months ahead, as signaled by the free fall in imports.

With economic activity contracting in 2009's first quarter at the same rate as in 2008's fourth quarter, a nasty U-shaped recession could turn into a more severe L-shaped near-depression (or stag-deflation). The scale and speed of synchronized global economic contraction is really unprecedented (at least since the Great Depression), with a free fall of GDP, income, consumption, industrial production, employment, exports, imports, residential investment and, more ominously, capital expenditures around the world. And now many emerging-market economies are on the verge of a fully fledged financial crisis, starting with emerging Europe.

Fiscal and monetary stimulus is becoming more aggressive in the U.S. and China, and less so in the euro zone and Japan, where policymakers are frozen and behind the curve. But such stimulus is unlikely to lead to a sustained economic recovery. Monetary easing--even unorthodox--is like pushing on a string when (1) the problems of the economy are of insolvency/credit rather than just illiquidity; (2) there is a global glut of capacity (housing, autos and consumer durables and massive excess capacity, because of years of overinvestment by China, Asia and other emerging markets), while strapped firms and households don't react to lower interest rates, as it takes years to work out this glut; (3) deflation keeps real policy rates high and rising while nominal policy rates are close to zero; and (4) high yield spreads are still 2,000 basis points relative to safe Treasuries in spite of zero policy rates.

Fiscal policy in the U.S. and China also has its limits. Of the $800 billion of the U.S. fiscal stimulus, only $200 billion will be spent in 2009, with most of it being backloaded to 2010 and later. And of this $200 billion, half is tax cuts that will be mostly saved rather than spent, as households are worried about jobs and paying their credit card and mortgage bills. (Of last year's $100 billion tax cut, only 30% was spent and the rest saved.)

Thus, given the collapse of five out of six components of aggregate demand (consumption, residential investment, capital expenditure in the corporate sector, business inventories and exports), the stimulus from government spending will be puny this year.

Chinese fiscal stimulus will also provide much less bang for the headline buck ($480 billion). For one thing, you have an economy radically dependent on trade: a trade surplus of 12% of GDP, exports above 40% of GDP, and most investment (that is almost 50% of GDP) going to the production of more capacity/machinery to produce more exportable goods. The rest of investment is in residential construction (now falling sharply following the bursting of the Chinese housing bubble) and infrastructure investment (the only component of investment that is rising).

With massive excess capacity in the industrial/manufacturing sector and thousands of firms shutting down, why would private and state-owned firms invest more, even if interest rates are lower and credit is cheaper? Forcing state-owned banks and firms to, respectively, lend and spend/invest more will only increase the size of nonperforming loans and the amount of excess capacity. And with most economic activity and fiscal stimulus being capital- rather than labor-intensive, the drag on job creation will continue.

So without a recovery in the U.S. and global economy, there cannot be a sustainable recovery of Chinese growth. And with the U.S, recovery requiring lower consumption, higher private savings and lower trade deficits, a U.S. recovery requires China's and other surplus countries' (Japan, Germany, etc.) growth to depend more on domestic demand and less on net exports. But domestic-demand growth is anemic in surplus countries for cyclical and structural reasons. So a recovery of the global economy cannot occur without a rapid and orderly adjustment of global current account imbalances.

Meanwhile, the adjustment of U.S. consumption and savings is continuing. The January personal spending numbers were up for one month (a temporary fluke driven by transient factors), and personal savings were up to 5%. But that increase in savings is only illusory. There is a difference between the national income account (NIA) definition of household savings (disposable income minus consumption spending) and the economic definitions of savings as the change in wealth/net worth: savings as the change in wealth is equal to the NIA definition of savings plus capital gains/losses on the value of existing wealth (financial assets and real assets such as housing wealth).

In the years when stock markets and home values were going up, the apologists for the sharp rise in consumption and measured fall in savings were arguing that the measured savings were distorted downward by failing to account for the change in net worth due to the rise in home prices and the stock markets.

But now with stock prices down over 50% from peak and home prices down 25% from peak (and still to fall another 20%), the destruction of household net worth has become dramatic. Thus, correcting for the fall in net worth, personal savings is not 5%, as the official NIA definition suggests, but rather sharply negative.

In other terms, given the massive destruction of household wealth/net worth since 2006-07, the NIA measure of savings will have to increase much more sharply than has currently occurred to restore households' severely damaged balance sheets. Thus, the contraction of real consumption will have to continue for years to come before the adjustment is completed.

In the meanwhile the Dow Jones industrial average is down today below 7,000, and U.S. equity indexes are 20% down from the beginning of the year. I argued in early January that the 25% stock market rally from late November to the year's end was another bear market suckers' rally that would fizzle out completely once an onslaught of worse than expected macro and earnings news, and worse than expected financial shocks, occurs. And the same factors will put further downward pressures on U.S. and global equities for the rest of the year, as the recession will continue into 2010, if not longer (a rising risk of an L-shaped near-depression).

Of course, you cannot rule out another bear market suckers' rally in 2009, most likely in the second or third quarters. The drivers of this rally will be the improvement in second derivatives of economic growth and activity in the U.S. and China that the policy stimulus will provide on a temporary basis. But after the effects of a tax cut fizzle out in late summer, and after the shovel-ready infrastructure projects are done, the policy stimulus will slacken by the fourth quarter, as most infrastructure projects take years to be started, let alone finished.

Similarly in China, the fiscal stimulus will provide a fake boost to non-tradable productive activities while the traded sector and manufacturing continue to contract. But given the severity of macro, household, financial-firm and corporate imbalances in the U.S. and around the world, this second- or third-quarter suckers' market rally will fizzle out later in the year, like the previous five ones in the last 12 months.

In the meantime, the massacre in financial markets and among financial firms is continuing. The debate on “bank nationalization” is borderline surreal, with the U.S. government having already committed--between guarantees, investment, recapitalization and liquidity provision--about $9 trillion of government financial resources to the financial system (and having already spent $2 trillion of this staggering $9 trillion figure).

Thus, the U.S. financial system is de facto nationalized, as the Federal Reserve has become the lender of first and only resort rather than the lender of last resort, and the U.S. Treasury is the spender and guarantor of first and only resort. The only issue is whether banks and financial institutions should also be nationalized de jure.

But even in this case, the distinction is only between partial nationalization and full nationalization: With 36% (and soon to be larger) ownership of Citi, the U.S. government is already the largest shareholder there. So what is the non-sense about not nationalizing banks? Citi is already effectively partially nationalized; the only issue is whether it should be fully nationalized.

Ditto for AIG, which lost $62 billion in the fourth quarter and $99 billion in all of 2008 and is already 80% government-owned. With such staggering losses, it should be formally 100% government-owned. And now the Fed and Treasury commitments of public resources to the bailout of the shareholders and creditors of AIG have gone from $80 billion to $162 billion.

Given that common shareholders of AIG are already effectively wiped out (the stock has become a penny stock), the bailout of AIG is a bailout of the creditors of AIG that would now be insolvent without such a bailout. AIG sold over $500 billion of toxic credit default swap protection, and the counter-parties of this toxic insurance are major U.S. broker-dealers and banks.

News and banks analysts' reports suggested that Goldman Sachs got about $25 billion of the government bailout of AIG and that Merrill Lynch was the second largest benefactor of the government largesse. These are educated guesses, as the government is hiding the counter-party benefactors of the AIG bailout. (Maybe Bloomberg should sue the Fed and Treasury again to have them disclose this information.)

But some things are known: Goldman's Lloyd Blankfein was the only CEO of a Wall Street firm who was present at the New York Fed meeting when the AIG bailout was discussed. So let us not kid each other: The $162 billion bailout of AIG is a nontransparent, opaque and shady bailout of the AIG counter-parties: Goldman Sachs, Merrill Lynch and other domestic and foreign financial institutions.

So for the Treasury to hide behind the "systemic risk" excuse to fork out another $30 billion to AIG is a polite way to say that without such a bailout (and another half-dozen government bailout programs such as TAF, TSLF, PDCF, TARP, TALF and a program that allowed $170 billion of additional debt borrowing by banks and other broker-dealers, with a full government guarantee), Goldman Sachs and every other broker-dealer and major U.S. bank would already be fully insolvent today.

And even with the $2 trillion of government support, most of these financial institutions are insolvent, as delinquency and charge-off rates are now rising at a rate--given the macro outlook--that means expected credit losses for U.S. financial firms will peak at $3.6 trillion. So, in simple words, the U.S. financial system is effectively insolvent.

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