

Credit and the economy

The scale of the credit crisis is huge and current wisdom, and it is pretty convincing, is that there will be no way out for at least a couple of years more. On the other hand, US economic growth remains robust even as unemployment rises in certain sectors and retail sales falter.

We already see that economic growth is not going to be driven by the consumer, by investment or by the government, primarily because all 3 groups have stressed cash flows and balance sheets. The one leg upon which any faster than expected recovery or softer than expected landing rests, is trade.

How does the current credit crisis fit into this scenario? Spreads are generally wide. That makes it hard for consumers to borrow for consumption and hard for firms to borrow for investment. Libor has been very volatile indicative of the damaged integrity of the banking system. Fannie Mae and Freddie Mac are likely insolvent, and in any case are levered to extreme levels. With a combined market cap of less than 6 billion USD, 36 billion in prefs and 19 billion in sub debt, while backing over 5 trillion USD of mortgage debt, the insolvency of the GSE's is not improbable. That said, the fact that the banking industry is a large holder of prefs and that the banks themselves are large issuers of prefs, mean that any bailout will likely have to be a wholesale bailout across the prefs as well as common equity. The costs to the taxpayer, already 25 billion and rising. On top of the primary action, the CDS market, side bets if you like, total over 6 trillion USD. Aside from the scale of the financial impact, roughly half of 6 trillion since there are two parties to each swap, so 3 trillion, X whatever default rates X the residual value, there is the issue of locating the risk since CDS are over the counter, non exchange traded instruments. This could potentially create a domino effect as CDS triggers result in counterparty defaults.

All this pretty much impacts the domestic economy, but what about trade? Trade decisions are based on relative demand and supply and comparative advantage. Trade finance while Libor based are relatively short term, fully secured against cargo and unlikely to see the extent of spread widening in corporate debt markets. While the BRICs are slowing as well, the nature

of their demand is likely to evolve so that infrastructure investment begins to take centerstage. Even Socialist and Communists can be Keynesian. The high tech and capital goods and industrial supplies economies of the US and Germany are likely to profit from this, as long as the terms of trade are favorable. The Japanese solution throughout the 1990s was in part to depress prices, debase the JPY and export its way out of trouble. In the meantime, the Fed may hope that while they keep interest rates low, long term US government bond yields will rise creating a steeper yield curve and the opportunity for banks to reflate via another (risky) carry trade.

Time is what the US economy needs. For the weaker USD to take hold, for the trade balance to adjust, for tax receipts to stabilize government coffers, for export and (later) tax cuts to sow the seeds of growth in another evolution of the US economy.

Will they be given that time?