Economic Consequences of the Paulson Plan

In the US:

The consumer is quite broke. Unemployment is rising. Firms have no access to credit. And now the government is quite broke too. The cost of cleaning up the banking system will fall on the government first. A budget deficit would imply austerity and a severe limitation to government fiscal spend as well as possibly higher taxes down the road.

The Fed will have to cut rates or face deep recession. Normally this is highly inflationary but given that the BRICs are slowing down as well, inflation is likely not to be a problem.

The USD will come under pressure improving terms of trade and providing some relief to the economy in the form of export growth. This will be limited by the synchronized slow down in Europe and Asia.

The recovery will take multiple years depending on the approach taken. If the scale of the bailout is big enough and the time frame is short and decisive enough, this could take a further 2 years or so to work through.

Equity markets should begin to price this in earlier but no further than 1 year in advance. Credit markets may react more quickly.

This is the good case scenario.