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The Liscio Report

On the Economy

For John Liscio 1949-2000

The debtless recovery

Our quarterly look at the Federal Reserve's flow of funds statistics—the second quarter numbers were released late last week—has been dominated by a single theme since the financial crisis hit: deleveraging. This quarter is no exception. And while the economic recovery remains weak and tentative, it's the only one in modern history that's been accompanied by a decline in debt outstanding—despite the explosion in federal debt. It's actually a bit of a miracle: the debtless recovery.

Maybe that can't last. If the recovery is ever to turn into a durable expansion, we'll probably need entities other that the federal government to do some borrowing. You do have to wonder if we'd have a recovery at all if Washington hadn't been spending money it didn't have. The weakening British economy is warning us that austerity is not expansionary. (More on this later in the week when we report on a new IMF study.)

QUARTERLY FLOW OF FUNDS REPORT

- ***deleveraging continues: mounting a recovery while debt declines***
- ***only Washington is borrowing in any size***
- ***household balance sheets ragged***
- ***corporate America: flush, tightfisted, eyes overseas***

credit summary: amazing contraction

Most major sectors saw declines in nominal debt in the second quarter. Domestically, only nonfinancial firms and, especially, the federal government increased their debt levels in nominal dollars. Nonfinancial firms' increase, though, was pretty much in line with GDP; as the graph on the top of p. 2 shows, its debt/GDP ratio has been flat for five quarters—and is only slightly above where it was two decades ago.

Households and especially financial corporations extended the contraction in their debt/GDP ratios that began in early 2009. The ratio is down about 10 points for households and 20 points for financial firms. Leading the financial decline in the quarter were ABS issuers, with some

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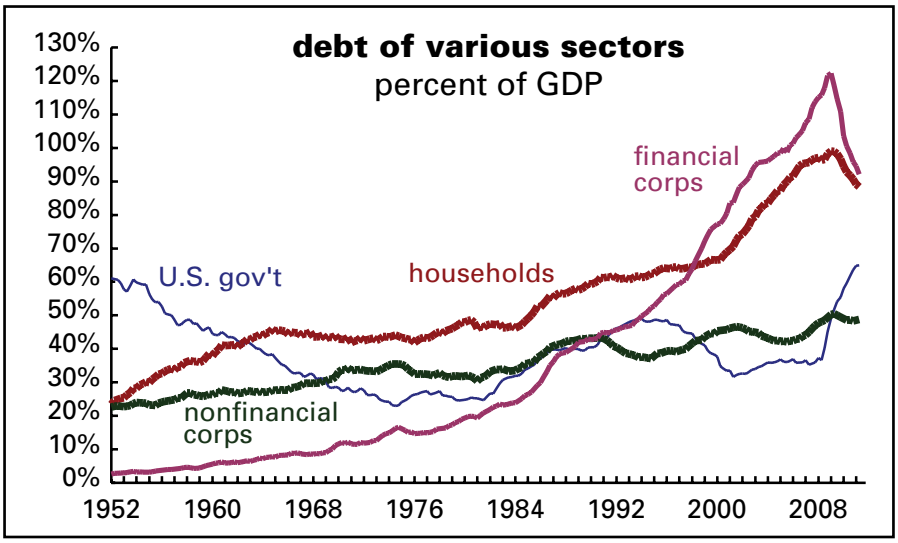
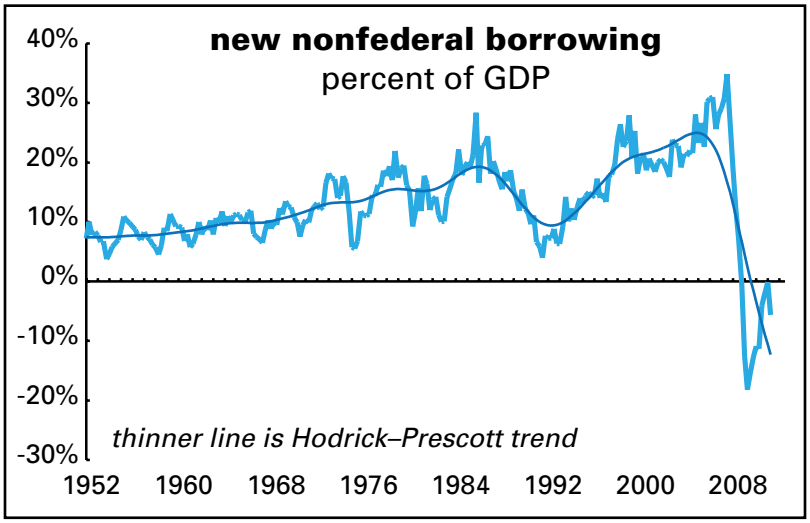
help from commercial banks. GSEs and federally related mortgage pools



expanded their debt slightly. But over the last couple of years, the outstanding debt of federally related mortgage pools is down more than 75%, and for ABS issuers, 45%.

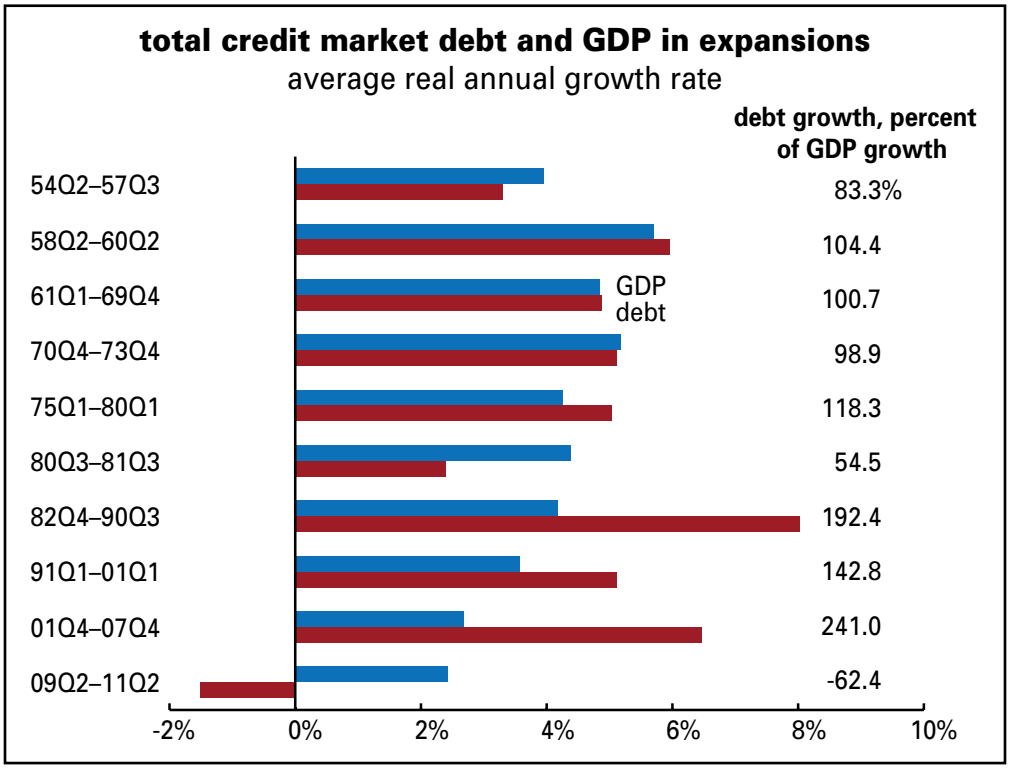


And as the graph directly above shows, after a brief recovery in nonfederal borrowing that ran from mid-2009 through last quarter, there was a significant pullback in the second quarter. State and local governments and especially households led the retreat.

On the holding side, households decreased their credit market debt by $58 billion (at a seasonally adjusted annual rate), as did commercial banks (down $113 billion) and savings institutions (–$16 billion). But the Federal Reserve increased its holdings by $220 billion. Unlike the depths of the financial crisis, the Fed is no longer the only major lender, but it's playing an outsized role in extending credit.

This contraction in overall debt is a remarkable event. As the graph on p. 3

shows, the current recovery is swimming against the tide of modern expansions. For the first four, from 1955 through 1973, debt rose in line with GDP. The 1975–80 expansion was the first in which debt growth outpaced GDP growth, but not by all that much. But things really changed starting in 1982, with debt growth greatly exceeding GDP growth, especially in the 2001–07 expansion. But two years into the current upcycle, total nominal debt outstanding has declined. That probably has a lot to do with why the recovery has been so feeble, but it's remarkable in a way that there's been a recovery at all.

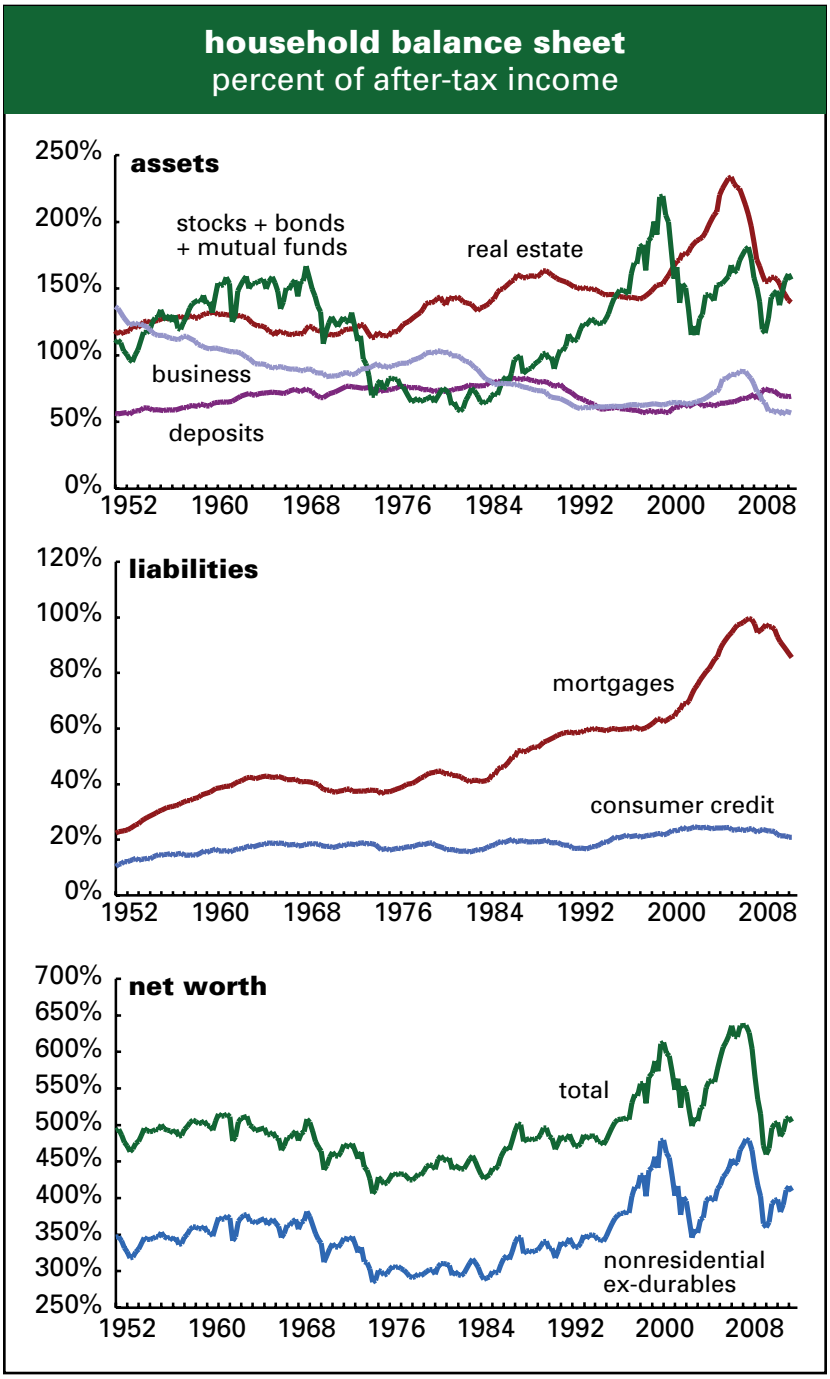


households: still deleveraging

Households are experiencing unprecedented changes to both sides of their balance sheets. As the graph on the top of p. 4 shows, the value of housing (relative to disposable personal income [DPI]) extended its long decline since the early-2006 peak. This measure has fallen in 18 of the last 21 quarters, and is now close to where it was in 1984 (perhaps not coincidentally, like the employment/population ratio)—and isn't much above where it was in 1962. It's tempting to think of this as a pretty decent neighborhood to start forming a bottom, but as the relative flatness of the line between 1952 and 1976 shows, that doesn't mean it's about to start rising again.

Financial assets turned in an underwhelming performance in the quarter. The value of tradable assets fell relative to DPI, as did bank deposits. Total assets fell to 623% of DPI, down from 631% in the first quarter—and from 771% at the beginning of 2007. Obviously, much of the decline—more than half, in fact—has come from the decline

in housing values. But the values of household financial assets and equity in noncorporate businesses are also down.



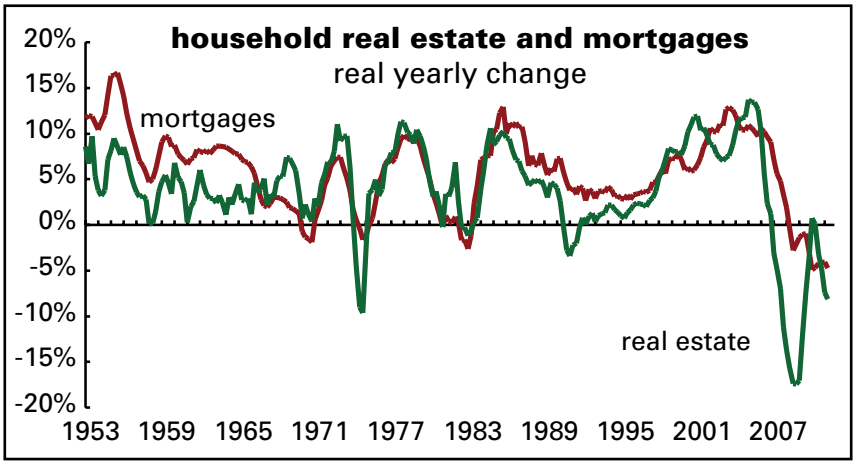
On the liability side, mortgage debt continued to fall at a rapid pace—down 3% of DPI in the quarter, and 12% since the 2006 peak. Consumer credit was also down for the quarter and for the five-year period, but by a much lesser amount than mortgages.

Net worth fell slightly for the quarter, and as the graph above shows, is down sharply from the peak. Relative to DPI, it fell from 511% to 504% in the quarter—

compared with 636% at the 2006 peak. The recovery from the 2009 low looks to have stalled.

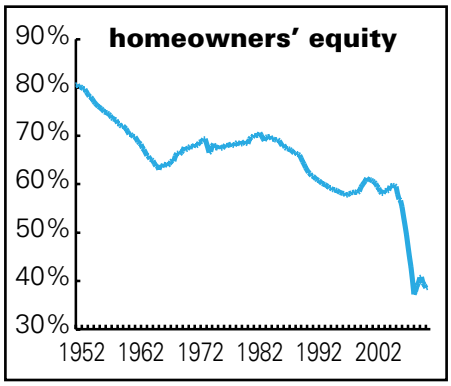
2000s. That experience was very much at odds with the previous 40 years.

As the graph directly below shows, the decline in the value of household real



The Fed oddly includes consumer durables in household assets—they produce no income and cannot easily be sold for cash, so they seem a lot different from a bond or a house—so the graph at the bottom of p. 4 also includes net worth excluding durables as well as mortgages and household real estate. Since middle-income households have most of their wealth in housing (and most of their liabilities in mortgages), that version of net worth is heavily skewed towards the affluent. But as the graph shows, while the 2006–2009 decline in that measure isn't as dramatic as the broader one, and the recent recovery is a little stronger, it's still well off its peak. An optimist could say that by exploring the lower end of their historical ranges, the net worth measures may be bottoming, but again, that's no guarantee that they're about to start spiking upwards as they did in the 1990s and

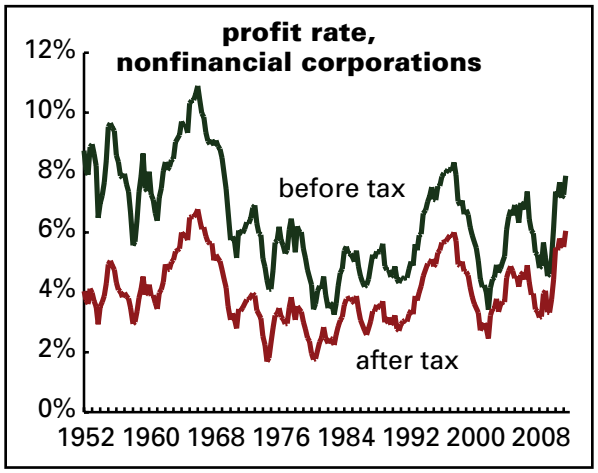
estate—both from the 2006 peak and from the brief 2009–10 recovery—has been sharper than the decline in the value of outstanding mortgages. As a result, home equity, which has been trending down for almost 20 years, really took a dive after 2006, and has only recently begun to stabilize. (See graph, left.) People who thought that houses, because they are tangible, are more reliable stores of value than financial assets, have had a rude awakening over the last five years.

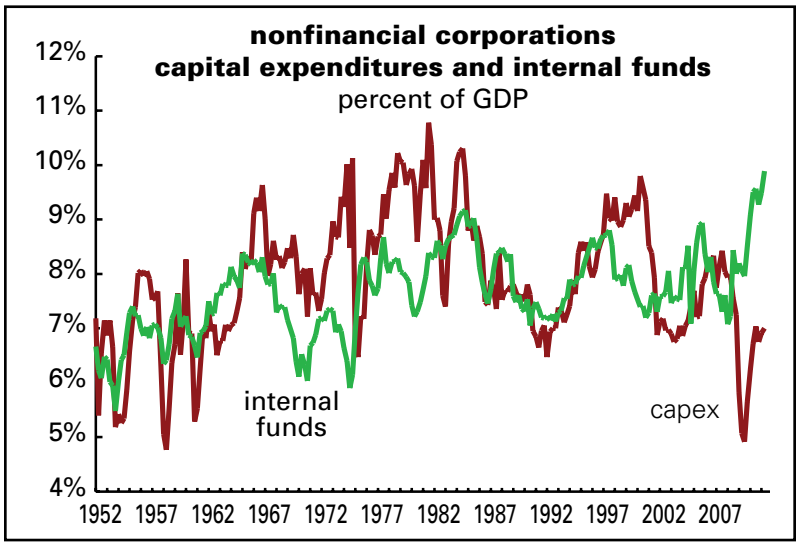


corporate America: flush & prudent

As we pointed out earlier, nonfinancial firms have kept a lid on their borrowing. As the graphs on p. 6 show, that's not surprising. Corporate profitability—defined as the value of corporate profits, both before and after taxes, from the national income accounts divided by

the value of tangible capital from the flow of funds accounts—which looked last quarter like it was beginning to roll over, recovered in the second quarter to its highest level since 1997. That's a remarkable achievement: 1997 was the heart of a major boom, and 2011 is anything but that. In the past, profitability has been a long leading indicator of overall economic health. You do have to wonder if it means quite as much as it did in the past. The 1997 heights were a result of a broadly strong economy and a productivity acceleration; not so 2011, where the black ink has been produced by cost cutting and other forms of tightfistedness.

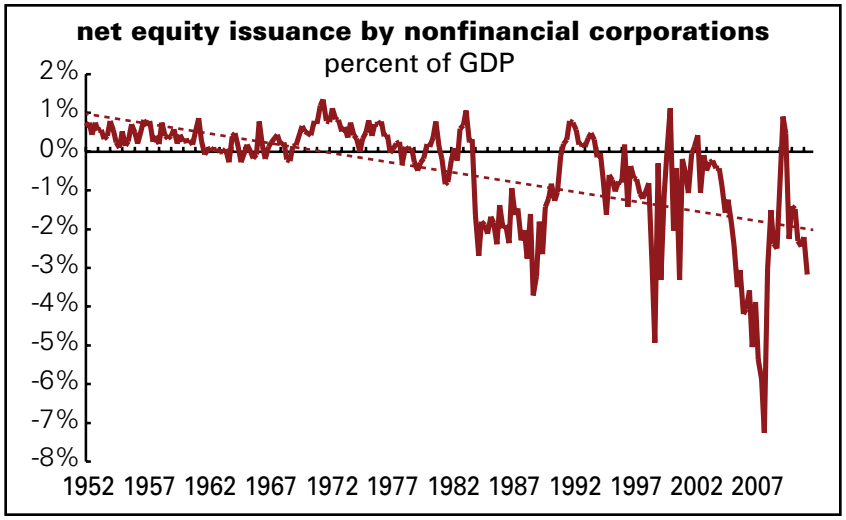




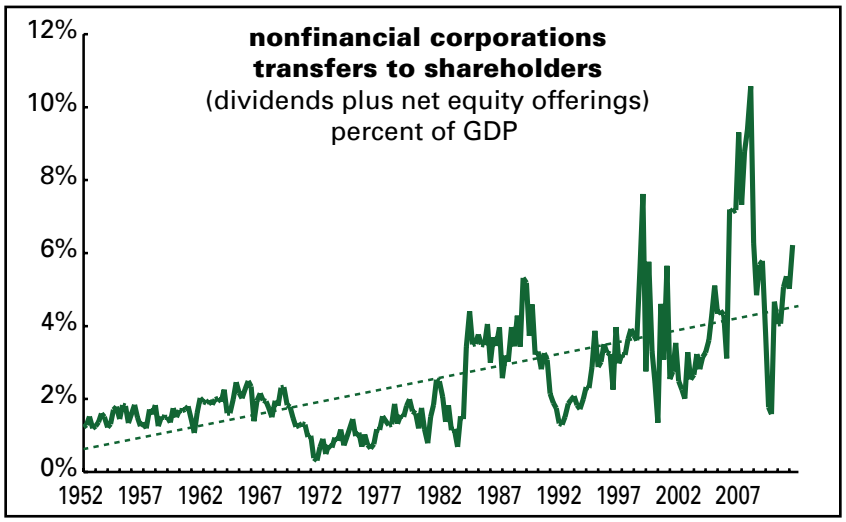
That tightfistedness amidst plenty is illustrated by the lower graph above: internal funds (profits plus depreciation as a percent of GDP) are at an all-time high, and more than two percentage points above their long-term average. But capital expenditures are a point below their six-decade average. Domestic expenditures, that is: foreign direct investment by nonfinancial firms was at a near-record high, relative to GDP, in the quarter. Firms have a lot of money—they're just not investing or hiring in the USA.

Firms are doing a good job of passing along money to their shareholders, though. Net equity offerings remain deeply negative, as far more stock is being retired through buybacks and takeovers than is being issued. The IPO pipeline has been recently clogged by market anxieties—but that explains only a small portion of the negative net equity figures. For example, Dealogic reports that there are $28 billion in equity offerings on file now, and another $44 billion in withdrawn offerings so far this year. (Poor Groupon.) That adds up to $72 billion. But the flow of funds accounts report negative net equity offerings of $475 billion

(annualized) in the second quarter, and $1.5 trillion over the last year. Clearly, more than a clogged pipeline is at work.



The net result has been an endless gusher of cash supporting the equity markets—above a rising trendline over the last year,



in fact, as the graph directly above shows. Where would the S&P be without this support?

Treasuries

A few words, and a graph at the top of p. 8, on who's buying U.S. government paper. Not households or foreigners, so much—but the Fed has been taking them up with both hands.

Will the Fed have to do a QE3, just to keep the Treasury market lively?

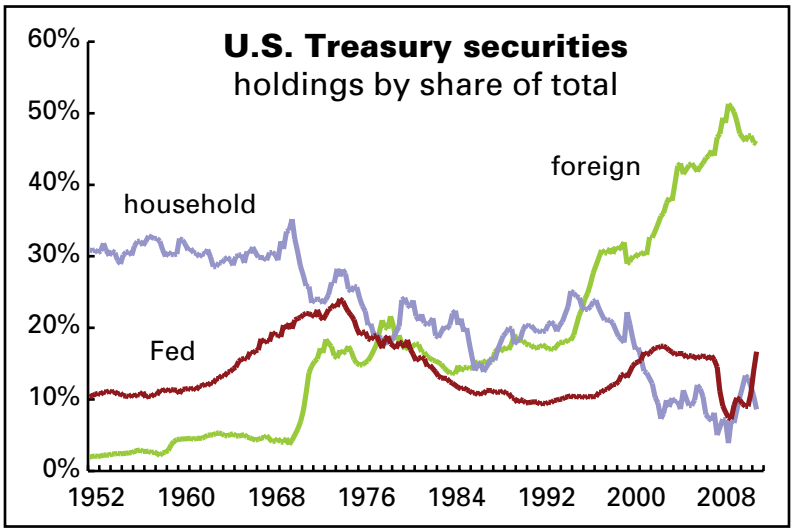
international view

Finally, a deep recession and weak recovery do seem to be helping to put the U.S. international accounts into order. As the graph at the bottom of p. 8 shows, despite the Treasury's massive borrowings over the last few years, our

foreign debt/GDP ratio has been flat over the last year or two—and adding in equity and FDI holding abroad pushes the lines on the graph up closer to the axis.

bandwagon?

We'd rather not think about those things, but that choice may not ours.



can this go on?

— Philippa Dunne & Doug Henwood

While slow growth and debt reduction are to some degree inevitable after a bubble of the proportions we experienced over the last decade (or two, actually), can the U.S. economy live with this? Can an economy that's come to depend on vigorous credit growth, and a social system that needs a growth rate of 3% or more to keep the population gainfully employed, reconcile itself to a world of contracting debt and 1% growth? And what happens if Washington joins the debt contraction