Economics
04 August 2011

Financial Markets Outlook

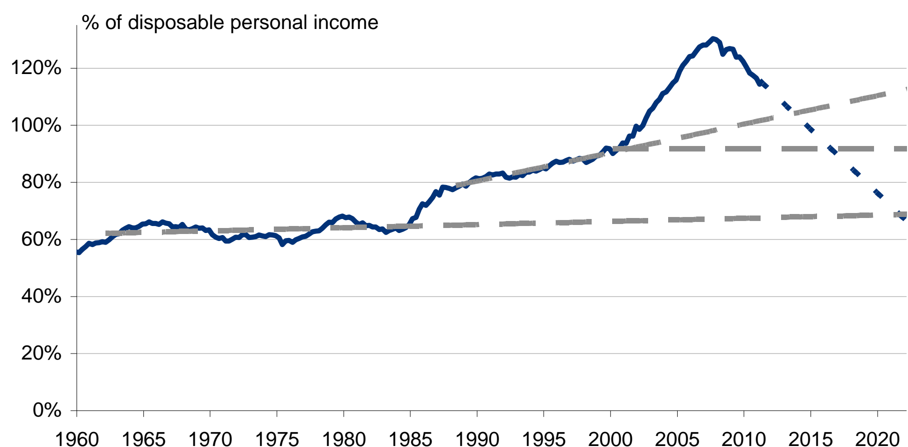
Sayonara America

Three years into the recovery US growth remains feeble. The US is starting to look more and more like Japan in the 1990s – but it is not too late to draw lessons.

With the debt ceiling out of the way, we no longer have to worry about sudden deep government spending cuts that could push the US economy back into recession. But the outlook is by no means bright. Last week the revised GDP numbers showed that the US recession has been even deeper than previously thought: -5.1% peak to trough. Even today, three-and-a-half years into the recovery, the US economy operates below its pre-crisis peak. Moreover, the recovery lost speed in the first half of 2011. Consumption slowed to a paltry 0.1% QoQ in 2Q11, as high oil prices and low-wage growth ate into household purchasing power.

While oil prices have stabilised recently, we do not expect consumption growth to stage a vigorous recovery in the second half of this year – or thereafter, for that matter. Consumption in the US is still being depressed by household deleveraging. In the 2000s, households ran up debt rapidly, using their homes as collateral and cashing in on rising home prices. Part of the debt was used to buy existing homes, thus contributing to the inflation of the housing bubble. But households also borrowed to invest in home improvement and decoration, and to increase consumption. These drivers of consumption and investment suddenly went in reverse after 2007. As households started to deleverage, a bigger part of income was diverted away from consumption and used to pay off debts. After three years of tepid consumption growth, household debt has indeed come down. Debt as a percentage of disposable personal income (DPI) has fallen from 130% in late 2007 to 114% DPI in 1Q11. But when will households stop deleveraging and return to consuming?

Fig 1 US household debt



Residential mortgages and consumer credit, as percentage of disposable personal income. Grey dotted lines show 1988-2000 trend, 2000 level, and 1962-1985 trend, respectively. Blue dotted line continues deleveraging as seen in 2008-2011. Source: EcoWin, ING calculations.

This important question has no straightforward answer. What we do know, is that the heydays of debt-financed consumption will not return soon. But stabilisation of the

Rate forecasts & market views

	3Q11	4Q11	1Q12	2Q12
ING forecasts				
US	0.00	0.00	0.00	0.50
EU13	1.50	1.75	1.75	2.00
JPN	0.05	0.05	0.05	0.05
Implied market rates (3mth strip)				
US	0.370	0.480	0.530	0.555
EU13	1.590	1.570	1.560	1.560
JPN	0.330	0.330	0.335	0.335

As at 1430 BST at 04 Aug 2011

Source: Bloomberg, ING estimates

ING FX forecasts

	3Q11	4Q11	1Q12	2Q12
EUR/USD	1.48	1.50	1.46	1.43
USD/JPY	82	85	88	92
GBP/USD	1.62	1.67	1.66	1.68

Source: ING

Upcoming key events

5 Aug	US Jul Avg Hourly Earning All Employees US Jul Change in Manufact. Payrolls 000s US Jul Change in Private Payrolls 000s US Jul Unemployment Rate Germany Jun Industrial Production Canada Jul Net Change in Employment 000s Switzerland Jul CPI
8 Aug	UK Jul RICS House Price Balance
9 Aug	US Jul NFIB Small Business Optimism US FOMC Rate Decision Japan Jun Tertiary Industry Index UK Jun Industrial Production UK Jun Manufacturing Production
10 Aug	Germany Jul F CPI Norway Jul CPI Norway Norwegian Deposit Rate China Jul Exports China Jul Imports China Jul Trade Balance $bn
11 Aug	Sweden Jul CPI
12 Aug	US Jul Advance Retail Sales US Aug P University of Michigan Confidence France 2Q11 GDP

Source: Bloomberg, Reuters

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US households have been paying off their debts for 3½ years now, resulting in slow growth

household debt-to-income ratio would already boost consumption, as households need fewer funds to pay off debt. When will the debt-to-income ratio stabilise? Economic theory provides no clear-cut household debt ratio that is considered ‘healthy’ or ‘sustainable’. Moreover, debt ratios vary wildly between countries. US history does provide some guidance. The development of US household debt as a % of DPI until 2007 can be divided into three periods. From the 1960s until halfway in the 1980s, the ratio was roughly stable just above 60% of DPI. Then, after 1985, the ratio started to increase. The third phase, starting in 2000, saw an even stronger acceleration. The peak was reached in 2007, after which deleveraging set in.

Deleveraging could continue to depress growth for two to over ten years

By extrapolating the trend debt ratio from the three phases and from deleveraging since 2007, we get three scenarios for deleveraging. In the most benign scenario, the debt ratio returns to the 1988-2000 trend. This would mean that deleveraging – and the slow consumption growth that goes with it – would be over in 2013, when the debt ratio is around 105% DPI (see Figure 1). In our second scenario, the debt ratio returns to just above 90% of DPI, as it was in 2000. This would be reached in 2016. In the last and most pessimistic scenario, debt would return to the trend that prevailed in the 1960s until the early 1980s. It would take until 2022 to reach this level when deleveraging continues at its current speed!

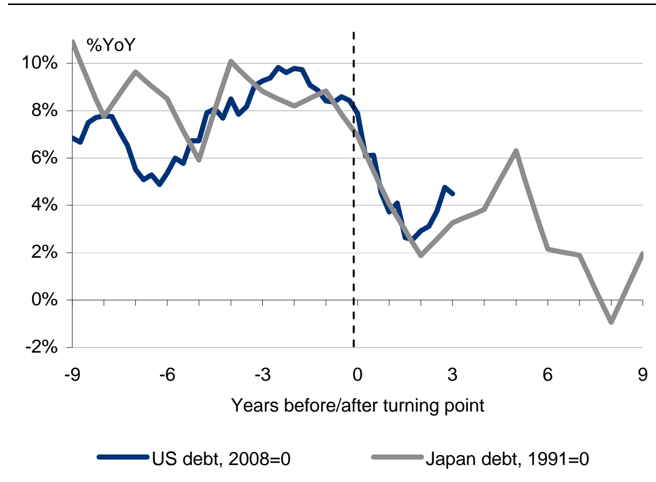
The US after 2008 is different than Japan after 1990…

But there are other ways to assess how the ‘balance sheet recession’ will affect the US economy in the coming years. We can, for example, draw parallels with the bursting of the Japanese stock and land price bubble in 1990. There are important differences between the two. One important distinction is that while in the US it was the household sector that took on too much debt, in Japan it was mainly businesses that loaded up and subsequently had to deleverage. From a country balance sheet perspective however, the result is very similar: the domestic non-financial private sector needs to deleverage, and it is up to the government to fill in the void.

…but there are disturbing parallels as well

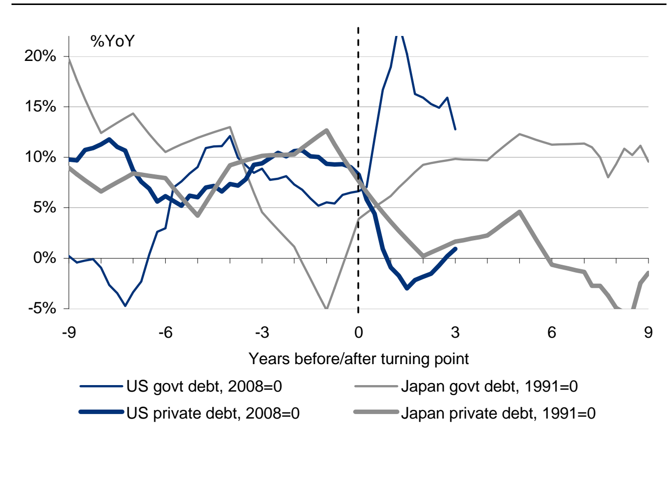
Figure 2 shows net borrowing by the domestic non-financial sector, taking as year ‘zero’ 1991 for Japan and 2008 for the US. Both countries experienced credit booms in their bubble-inflating years. After the bubble popped, credit growth slowed dramatically. The Japanese experience shows that low-credit growth could persist for years. Both in the US after 2008 and Japan after 1990, the government stepped in to partly offset decreased private sector borrowing and spending (Figure 3).

Fig 2 Net domestic non-financial borrowing



Yearly growth of outstanding debt from households, non-financial business and government. Source: Ecowin, Bank of Japan, ING calculations

Fig 3 Net borrowing by sector



Yearly growth of outstanding debt from government and private non-financial sector (households and non-financial businesses). Source: Ecowin, Bank of Japan, ING calculations.

The government reaction in the US was more pronounced, although this also includes borrowing to support the financial sector (this occurred only several years later in Japan). A stronger government reaction was justified in the US, as the collapse in US household

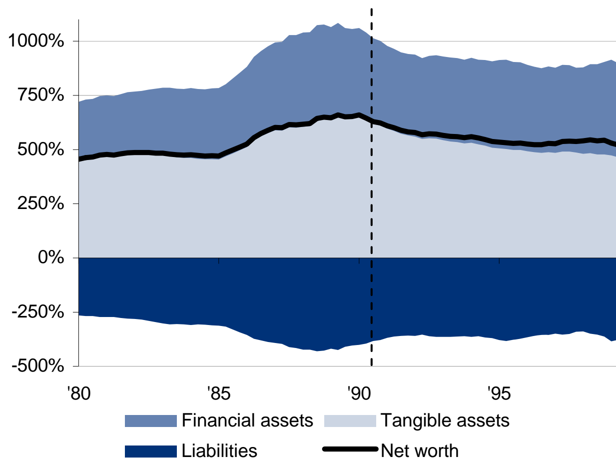
Japan spent 15 years deleveraging, but was a slow starter

and non-financial business borrowing was bigger than in Japan. Japanese non-financial private sector borrowing remained subdued for years: the non-financial private sector debt-to-GDP ratio stabilised only in 2006, 15 years later. If such a scenario were to unfold in the US, deleveraging would continue until after 2020 – consistent with the most pessimistic deleveraging scenario sketched in Figure 1. The Japanese experience may not be the right guide though: deleveraging only really started in 1997, when banks started restructuring their loan books. While the US seems to be burying its head in the sand at times as well – take the still large inventory of delinquent mortgages and foreclosures that mortgage lenders are grappling with – arguably balance sheet restructuring is progressing faster than in Japan in the early 1990s.

The US initial adjustment has been faster

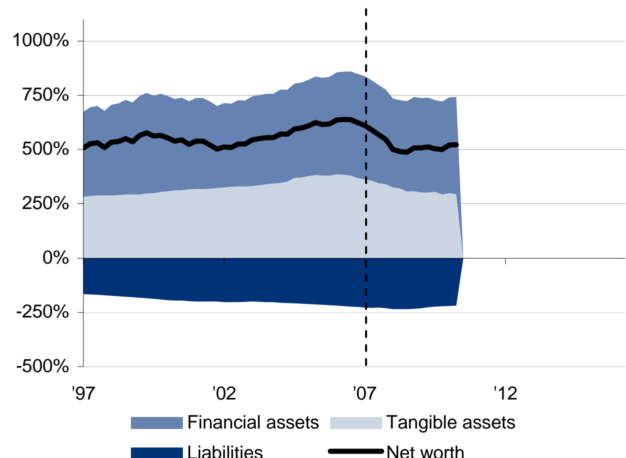
This argument is supported by the development of net worth in both economies. In Japan, net worth of households and non-financial business increased from 475% of GDP in the early 1980s to a peak of 660% by 1990 (Figure 4). When the bubble burst, net worth started to decline, settling around 530% of GDP after 1995 (afterwards, the government started running up its debt). Household and non-financial business net worth in the US fluctuated around 530% of GDP in the late 1990s and early 2000s, before rising to a peak of 638% of GDP in 2007. But the decline afterwards was much faster: with both house and stock prices and dropping fast, net worth fell below 500% of GDP as early as 2009, and has been roughly stable since then (Figure 5).

Fig 4 Net worth, Japan households and business



Assets, liabilities and net worth of households and non-financial business.
Source: EcoWin, Bank of Japan, Japan Ministry of Internal Affairs and Communications, ING calculations.

Fig 5 Net worth, US households and business



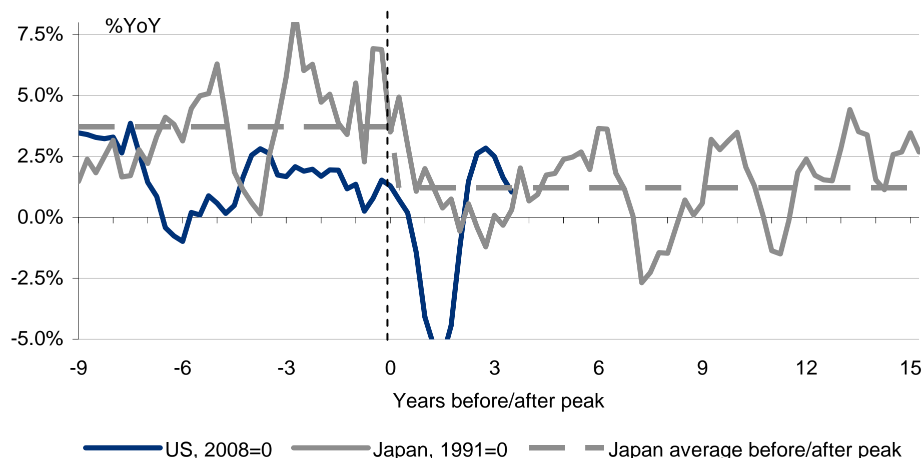
Assets, liabilities and net worth of households and non-financial business.
Source: EcoWin, ING calculations.

While private sector net worth has stabilised in the US, Figure 1 shows that the deleveraging process has by no means finished yet. The US may take fewer than Japan's 15 years, but other crisis episodes show that deleveraging sill typically takes 5 to 7 years (C.M. Reinhart and V.R. Reinhart, *After the fall*, 2010). During these years, debt was reduced, while simultaneously the amount of tangible and financial assets kept falling, both due to depreciation and net sales.

Demographics are more favourable in the US than in Japan too

But what does all this mean for GDP growth? We should be careful in simply comparing Japan in the 1990s with the US now. The Japan crisis was concentrated in the business sector, while in the US it is the household sector that is deleveraging. Moreover, the Japanese economy was bogged down by ageing: population growth averaged only 0.4% per year in the 1990s. While ageing does impact the US, the effect is much less severe. The population is projected to grow by a yearly 0.8% in the coming decade, twice the pace of Japan. To correct for ageing, we look at GDP growth per person of working age. In Japan, growth per capita fell back from 3.7% in the 1980s to a mere 1.2% afterwards (Figure 6).

Fig 6 GDP growth per person of working age



Growth of GDP per person aged 15 to 64. Grey dotted line shows average growth in Japan before and after 1991.
Source: United Nations, EcoWin, ING calculations.

Nonetheless, the US should be heading for several more years of subpar growth

The US had slower GDP growth per person of working age to begin with: 1.6% in the years leading up to the crisis. Growth per capita in the three years since the crisis averaged -0.7%. While we do expect positive GDP growth per capita in the coming years, a stellar growth performance does not seem to be on the cards any time soon.

Japan shows that policy responses can make or break the recovery

Growth of US domestic demand will be limited in the coming years, as resources are allocated to reducing leverage. Household deleveraging will probably take at least two more years, but could last for as long as a decade. The duration depends to no small degree on policy responses: the US government could take more action to speed up the deleveraging process, such as significant mortgage modifications (unlike existing programmes that do not really change the burden for households). Moreover, Japan shows that tightening fiscal and monetary policy too soon can easily push back the economy into recession. This is what happened in Japan in 1997 (t+6 in the charts). Fed Chairman Bernanke is certainly heeding this lesson. In political circles, the focus has shifted to deficit reduction. While this is important, fiscal policy should not be tightened too soon. The US$917bn of spending cuts contained in the US debt ceiling deal are back-end loaded, sparing the economy in the first years: Federal spending will be reduced by only US$21bn in 2012. It is up to the newly established Committee on Deficit Reduction, which is due to report in November, to come up with measures that strike the right balance between getting federal finances back to a sustainable path and sparing the economy in the short term.

Fig 7 Financial markets movements

	04/08/11	%WoW	%MoM
US 3-mth LIBOR	0.268	1.5	2.3
US 2-year	0.336	-10.8	-13.9
US 10-year	2.621	-36.0	-56.2
US 30-year	3.902	-38.4	-49.0
EU13 3-mth LIBOR	1.554	-0.5	4.8
2-year bund	1.046	-21.8	-62.0
10-year bund	2.403	-24.8	-61.7
Japan 3-mth LIBOR	0.195	0.0	0.0
2-year JGB	0.150	-1.3	-1.7
10-year JGB	1.018	-7.0	-14.4

As at 1430 GMT at 04 Aug 2011

Source: Bloomberg, ING

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