



Max Bublitz

Cold turkey for credit

The huge expansion of credit did little for the US economy, so what can we expect next?

Recent events have made it painfully clear that the US economy was given a significant boost this decade through massive injections of the economic growth hormone known as credit. I've even taken to characterising the seemingly insatiable need for this brand of growth stimulant as our economy's jones, or addiction, to credit. And as the stimulation has been withdrawn, many are shocked to find that weaning oneself off the addiction is no walk in the park.

So as we look back on this period of unprecedented credit expansion, it's natural to try to figure out what the heck we got for the effort. By some analyses, the acronym-laden unregulated shadow banking system that fired most of the growth in credit had actually swollen so much that it became larger than its more traditional, regulated cousin. Fine, the shadow banking system grew too fast and got too big. That much we know, and it's being dealt with... it's called a credit crunch, folks.

But what does it say about the inner workings of the unjuiced economy? Even when mixing the decade's massive expansion of credit with multiple and sizable injections of additional monetary and fiscal stimulants after 9/11, the best domestic economic growth we could muster over the last four or five years was to artificially pump GDP up to the 3.0% to 3.5% range – hardly the stuff of awe. That these meagre levels of economic output were all that could be produced from a veritable binge of stimulation speaks volumes about what to expect as the credit crunch unfolds.

Firstly, expect the market to continue to be surprised by how little was understood about the true source of the recent economic growth, and by how fragile its foundations were. With each new piece of knowledge about how much leverage and mispriced risk had seeped into the financial system, expect serial headline-bombs to continue to pound market and consumer sentiment.

Despite bleatings from the Fed to the contrary, and after the initial downdraft, expect the domestic economy to grow at a below-potential pace well into 2009. With employment weakening, home

prices and stock portfolios falling, and energy costs skyrocketing, things don't look that great for American consumers as they struggle with the decreased availability and increased cost of credit.

Spring cleaning

Expect fiscal and monetary authorities to respond to the loss of economic stimulation coming from credit by greatly increasing the dosage of their own brand of juice, which they'll inject liberally into the system. The real issue, which will no doubt be debated for years to come, is how both monetary and fiscal policymakers could be so slow to realise to the impact a massive deleveraging might have on an economy so hooked on artificial stimulants. Excuses abound, but excessive hand-wringing about inflation and moral hazard missed the point entirely, not to mention a chance to be proactive and actually get in front of a problem. The bottom line is that the financial system is shrinking – going through its cyclical spring cleaning – and will continue doing so until house prices stop falling and/or until financial institutions recapitalise.

Expect the current obsessions about lagging inflation data to be replaced by media-stoked fears of a Japanese-style deflation. The recent blip in reported inflation is more a result of the export-led economic bounce seen in the second and third quarters of 2007 than an indication of things to come. There is no way that a housing deflation, a debt deflation and an economic recession are inflationary, so expect that fear to wane as we move toward the summer months.

And most of all, expect this to take time. The price of risk may be nearing the extremes that mark opportunity, but the housing deflation and leverage unwind need more time to cleanse the excesses created by another of capitalism's inevitable mood swings. Expect some false starts, but when the wash phase of the credit cycle is over, look for the credit markets to emerge healthier for the cleansing.

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