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Fair Game

Get Ready for Half a Recovery

By [GRETCHEN MORGENSON](#)

A ROBUST economic recovery in 2010 is certainly on most investors' wish lists as this year draws to a close. A return to prosperity would not only mean an end to our long financial nightmare, but it would also buttress a rebounding stock market, one of 2009's few bright spots.

The news out of Dubai late last week, however — that its investment company is struggling to meet repayments on some of its \$59 billion in debt — reminds us that we are far from finished with a ferocious deleveraging process that began last year. And the weight of debt that still must be worked out is one reason that Ian Shepherdson, chief United States economist at [High Frequency Economics](#), estimates that growth in the United States' output for 2010 will be no better than 2 percent.

Mr. Shepherdson — whose economic forecasts have been more right than wrong throughout the [credit crisis](#) — says that while cost-cutting has produced enviable productivity figures and rising earnings at large companies, continued growth in corporate output will be much harder to come by.

“Looking further ahead, you can't survive on cost-cutting forever,” he says. “We will have to see decent volume growth but we won't see that immediately.”

Mr. Shepherdson's 2 percent estimate for gross domestic product growth next year is roughly half what he would normally expect for a solid economic recovery. And a crucial reason is the fact that bad assets on personal and institutional balance sheets are the equivalent of a ball and chain strapped to the economy, he says.

“You can pick up that ball and walk with it,” he says, “but you have to walk slowly.”

All that debt overhanging consumers and organizations is the pivotal reason we are still seeing a free fall in bank lending. And small businesses, which account for half of all jobs in this country, are taking the brunt of this credit contraction. Smaller banks are especially worried about their own balance sheets and aren't making loans. This puts small businesses — important engines of growth — squarely on the brink.

INVESTORS may be celebrating data that points to improvements in economic activity — this month, for example, the [Institute for Supply Management](#) said manufacturing had expanded for three months in a row. But Mr. Shepherdson worries about what he sees in monthly figures put out by the [National Federation of Independent Business](#), a trade group representing small businesses.

The N.F.I.B. data was far more prescient than that of the I.S.M. in predicting the current [recession](#), which began in December 2007, Mr. Shepherdson says. The N.F.I.B. survey signaled a downturn in the spring of 2007, while I.S.M. studies didn't point to a recession until after [Lehman Brothers](#) failed in September 2008.

In its survey, the N.F.I.B. asks small businesses how easy it is for them to get loans. The most recent data shows that credit tightness peaked earlier this fall — the worst levels in 23 years, Mr. Shepherdson says. Although credit continues to remain troublingly hard for small business to come by, that phenomenon is a largely untold story.

“Wall Street focuses on big companies because they are in the Standard & Poor's 500, but small businesses are still in a very grim state,” he says. “Small-company activity according to the N.F.I.B. is still at deep recession levels.”

And while small businesses do not make up the big stock indexes, they do contribute significantly to the overall economy. The tens of millions of people who work at small concerns are, after all, customers of those big, high-profile corporations like [McDonald's](#), [Wal-Mart](#) and [Whirlpool](#).

What we all are enduring — and what small businesses, workers and consumers continue to be pummeled by, even as Wall Street wizards jump back into the bonus pool — is the dismantling of the great credit boom of the early 2000s. This necessary but grueling deleveraging began last year and is now in full swing. But it is nowhere near over.

Bank credit outstanding peaked in October 2008 at \$7.3 trillion and is now down to \$6.72 trillion. Still, Mr. Shepherdson says he thinks that banking-sector loan and lease assets have to fall by an additional \$2 trillion. That could take another two years.

“We are in unknown territory here,” he said. “Since the peak in October ’08, bank credit has dropped by 8 percent. That is enormous and it is accelerating. The peak-to-trough drop in the early ’90s was just 1.3 percent and that was enough to scare the pants off the Fed.”

This credit cave-in is the driving force behind the [Federal Reserve](#)’s mortgage purchase program, Mr. Shepherdson says. The last thing the central bank wants to see is a decline in the broad-based money supply, because when that happens it usually means a depression is afoot. Money supply didn’t fall in the early 1990s, but it fell by one-quarter during the 1930s.

The Fed’s asset purchase program is therefore not about driving down mortgage rates, Mr. Shepherdson says, but about trying to prevent a collapse in the money supply. When the Fed buys assets it creates deposits, which, in turn, helps offset the credit pullback. If the Fed wasn’t buying mortgages with both hands, Mr. Shepherdson estimates, the money supply would be falling 1 percent a month.

The message amid this gloom, he says, is that the Fed isn’t likely to raise interest rates anytime soon. In fact, he doesn’t anticipate an increase in rates until the spring of 2011.

“I WOULD be astonished if they raised rates in the heart of the credit contraction storm,” Mr. Shepherdson says. “The credit contraction will last for a couple of years and if the Fed is interested in offsetting it, they will have to buy assets through next year.”

Deflating an asset bubble is never fun, and this particular specimen is one for the record books. The binge may have been a blast, but the purge, alas, sure is painful.

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