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Outside the Box

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Global economy’s cure is worse than the disease

Commentary: Take two aspirin and call Bernanke in the morning

By Satyajit Das

Editor’s note: Satyajit Das will hold a live chat at 4 p.m. Eastern on Thursday, Aug. 2 to discuss readers’ comments and questions. Join the chat or post a comment for him now.

SYDNEY (MarketWatch) — Dear Doctor: Thank you for referring Mr. Global Economy to me.

The patient’s history includes a seizure in 2007/2008 — financial losses, banking problems, a major recession. Liberal injections of taxpayer cash avoided catastrophic multiple organ failure, assisting a modest recovery.

Fed sees action if growth’s sluggish

Central bankers, impatient with the economy's performance, are moving closer to taking new actions to spur growth and employment if they don't see evidence soon that activity is picking up. Jon Hilsenrath has details.

Governments ran large budget deficits in the period after the crisis. Interest rates around the world were reduced to historic lows, zero or negative in many developed countries. Balance sheets of major central banks have increased to $18 trillion from around $6 trillion, reflecting an unprecedented 30% of global gross domestic product.

Mr. Economy is now addicted to monetary heroin. Increasing doses are necessary for the patient to function at all.

Mr. Economy has not made the changes necessary for a return to full health. He seems to have taken rock star Steven Tyler’s advice: “Fake it until you make it.”

Borrowing levels remain unsustainable. Debt levels for 11 major nations have increased to 417% of GDP in 2012 from 381% of GDP in 2007. Debt has increased in Canada, Germany, Greece, France, Ireland, Italy, Japan, Spain, Portugal, the U.K. and the U.S.

Global imbalances — major current account surpluses and deficits — remain. Little progress has been made in bringing the banking system under control.

Critical diagnosis

Physical examination of Mr. Economy reveals serious problems. The U.S. is in marginally better condition than other organs — the “cleanest dirty shirt” is the commonly given expression. Despite a $1 trillion annual budget deficit (6% of GDP) and expansionary monetary policy, U.S. growth is a tepid 2%.

The U.S. housing market’s rate of descent has slowed but prices remain 30%-60% below highs. New housing starts have stabilized, at around 50% below peak levels. Benefiting from a weaker dollar, manufacturing has improved. Lower oil and natural gas prices have benefitted the economy.

Employment remains weak. If discouraged workers who have left the workforce and part-time workers seeking fulltime employment are included, then unemployment is above 15%, far higher than the headline 8% rate. The total number of Americans now employed is around 140 million — well-below the peak level above 146 million.

Consumer spending remains patchy. Job insecurity, lack of earnings and wealth losses are causing households to reducing spending and repay debt.

Record corporate profits have been achieved mainly through cost reductions and minimal revenue growth. Investment is weak due to the lack of demand.

Bank lending is sluggish due to lower demand for credit and problems of financial institutions.

Federal public finances remain unsustainable. Cuts in spending, mandated under the 2011 increase in the national debt ceiling, would improve deficits but adversely affect growth. State and municipal finances are under severe stress, with an increasing number of borrowers filing for bankruptcy.

Low interest rates have created massive unfunded pension liabilities for governments and companies. S&P 1500 companies have aggregate pension deficits of $543 billion, an increase of $59 billion in the first half of 2012.

Europe's respiratory failure

Europe's condition, meanwhile, is characterized by high debt levels, budget and trade deficits, social spending inconsistent with tax revenues, poor industrial competitiveness (with some exceptions), a rigid monetary system and inflexible currency arrangements. This is compounded by weaknesses of the European banking system with large exposure to sovereign bonds issued by peripheral nations. Read archived Das commentary: Europe deposits hope in a central bank.

Intellectually and institutionally, Europe is unable to deal with its debt crisis. Europeans believe stabilization and recovery can be achieved through greater integration. Even if issues of national sovereignty can be overcome, integration will not work. Unsustainable levels of debt do not magically become sustainable by changing the lender or guarantor.

The monetary arithmetic of European debt problems is that the EU and Germany, its main banker, do not have enough funds to rescue the beleaguered euro zone members. Read archived Das commentary: Germany and France can't afford euro zone bailout.

Austerity dooms Europe to a prolonged and severe recession as the debt burden is worked off. The alternative, a debt write-off, would result in significant loss of wealth for the mainly Northern European lenders, triggering an economic contraction and prolonged period of economic stagnation.

Crumbling BRICs

Japan is in a state of advanced atrophy. Its primary investment merit is that almost all possible man-made and natural disasters have happened and the worst is factored in.

Mr. Economy's physicians originally hoped that the BRIC (Brazil, Russia, India, China) nations would be able to offset weakness in more developed economies. Unfortunately, China's growth is slowing rapidly. India and Brazil have also lost momentum, with growth weakening. Russia is dependent on high energy prices.

BRIC weakness is a function of lower demand from developed countries reducing exports and weaker commodity prices. The withdrawal of European banks, that are historically major lenders to emerging markets, has decreased the flow of money to countries needing foreign investment.

The number of medical advisers involved and variety of drugs — stimulus, austerity, quantitative easing, witchcraft —

Emerging markets show signs of the developed world credit virus. A rapid expansion of domestic credit in China, Brazil, Eastern Europe, Turkey and India will result in banking system problems. The combination of external and internal weaknesses threatens emerging economies, naturally prone to serial crises.

Attempts by nations to increase their competitive position by weakening their currency also threaten tit-for-tat currency wars, trade restrictions and barriers to investment flows. Read more: Euro crisis brings world to brink of depression.

is unhelpful.

Mr. Economy now has a serious chronic condition with limited prospects of a full cure. He might continue to live for a prolonged period but in an impaired no- or low-growth state. The threat of a sudden life threatening seizure cannot be discounted. Constant management will be needed.

The number of medical advisers involved and variety of drugs — stimulus, austerity, quantitative easing, witchcraft — is unhelpful. While doing nothing is politically and socially impossible, the treatments may not be helping. As French playwright Moliere noted: "More men die of their remedies than of their illnesses."

Satyajit Das is a former banker and author of "Extreme Money" and "Traders, Guns & Money."