

2009: Deleveraging Process Continues (or Recession Explained)

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3rd week of March 2009 When you turn on the TV most of the analysts assure nowadays recession started with Sub-Prime or banks leveraged to 50 times its book value with toxic products. Defacto, shit began to happen a long time before. SEC established – for transparency reasons – that companies should report their results quarterly thus creating the pressure for short term results that would fulfil the expectations of shareholders and ultimately derive in huge bonuses for management. But we know that shareholder value should be optimized for the long run since break-even of a standard investment comes on average 3 to 5 years after the first dime was invested. During these years the rational manager would trade results for investment. But the Security Exchange Commission – SEC – brought irrationality to the game, turning management obsessed for the next report momentum. But all these people knew and were teaching in the best business schools that the fundamentals of the game in which they participate in a daily basis were totally wrong.

Manipulating statistical models to bring down the threshold of money lending to property acquirers it is ultimately fraud. Moreover everyone was aware it was a matter of time for the bubble to explode. But we can’t blame these managers once they were being rational by following the best pool of strategies that optimize the rules SEC defined for success: practice fraud. This is Recession ground zero.

The Deleveraging Process Briefly Explained – from Ground One and Counting

Households and Financial Institutions start deleveraging when Assets Price gets below their Book Value considering money was borrowed to acquire these assets, that is, to leverage. Families begin defaulting and financial institutions begin write-offs, thus creating a boom in assets supply in the economy, decreasing house and asset prices to historical minimums. This is when liquidity problems get into the picture: in the US aggregated losses amounted in a first moment to \$334 Bi and still Wall Street reacted with an aggregated new capital raise of about \$ 235 Bi, but then a \$99 Bi remained unsolved in Shareholder’s Equity. That created pressure to reduce loans to companies to force down Assets in the Balance Sheet. Moreover, households suffering without money run for their deposits bringing down Liabilities in Financial Institutions Balance Sheet, creating even more pressure to reduce credit to companies.

That’s when crisis gets to the Main Street: a truck company not getting leverage has less inventory and therefore needs less people, and so layoffs start, unemployment decrease aggregate demand, ultimately jeopardizing production, and so on and so forth.

The 29 Crisis – History as the best Lab for Economics Learning Curve

After the 29 recession, the US stock market would only regain its peak by 1954. 25 years for aggregate recovery. By the way, the Great Depression was not a stock market crash but a huge contraction of credit due to a stream of bank failures. It has in fact begun several months before the Black Thursday when banks suspended payments. More than 500 banks failed... among them the Bank of US, which accounted for about one third of the total deposits lost. Back to fundamentals, the true cause was that companies simply didn’t realize the imbalance between what they were producing and what the market could effectively bring home. Profits came down, debt stopped being serviced, share value plunged... and to harm definitely the downward spiral the FED denied liquidity to the financial system, bringing the economy to the chaos.

The FED knows today it would have been better off by making open market operations (cutting rates, making loans, or buying bonds) to create a positive impact in supply side dynamics. Instead, it strongly reduced credit to the banking system, driving banks to sell assets (loans) in a desperate search for liquidity to comply with depositors and avoid bankruptcy. The scenario got even worse when government signalled it might devalue the US dollar, in a last effort to boost exports... but it only made people even more desperate trying to swap dollars for gold, reducing even further the liquidity in the economy. In short, FED failed by raising the overall discount rates, leaving behind the chance for economy recovery both in Wall Street and in the Main Street. What about now? United States Strategy – the Good Way for Recovery

History tells us how not to replicate caveats from the past. But now I think they are making the right choices: the FED has cut federal funds rate from 5,25% to 0,25% and injected about \$1,1 trillion in the financial system. The economic policy now adheres to a crisis scenario, using Keynes adjusted model instead of the Great Depression neoclassical approach; and \$700 billion are currently being injected in the economy. \$300 Bi is already parked: the subsidised sale of Stearns to JP Morgan, the nationalization of Mac and Mae, the rescue of AIG, or the sale of WM to JP Morgan and Wachovia to Citigroup. Aggregated it’s almost a \$ 2 trillion liquidity cookie just made to invert the downward negative cycle.

Nevertheless, for common human beings, the next ten years will be tough. When a poor gets poorer the world gets smaller. Just do like the Bosnians in the 90's: in times of war take time to make love.