

US rebalancing continues

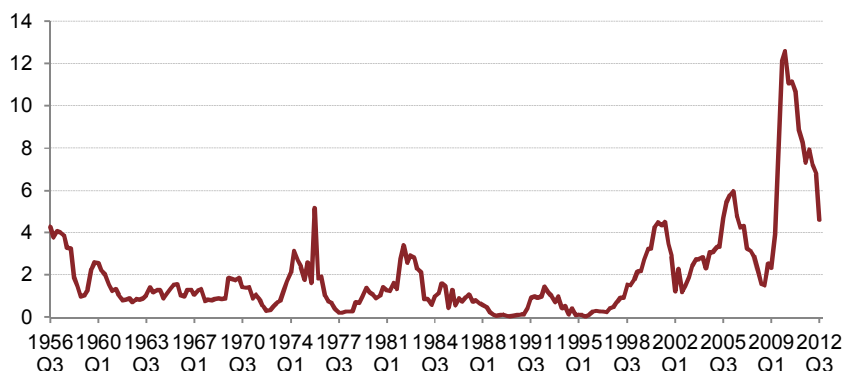
But the process is not over

According to the Federal Reserve's Flow of Funds for Q3, the US rebalancing and deleveraging process continues apace. This fits in with other recent data from the US, which shows that – subject to the 'fiscal cliff' – the outlook for 2013 should be reasonably positive.

This comment will look specifically at three developments. The first illustrates how much US economic imbalances have been worked out. In the third quarter, all sectoral financial balances narrowed. Crucially, the household sector retained a (small) surplus of savings over investment, in spite of a pick-up in the housing market. The household sector has now run a financial surplus for five years, something not seen since the early-to-mid 1980s. Moreover, the corporate sector financial surplus has come off its record highs; and, as the counterpart to those two, the public sector deficit narrowed to a four-year low – although at 8.5% of GDP, it needs to come down further. The disappointing development is that the foreign sector surplus (ie, the reverse of the US current account deficit) was broadly unchanged for a third quarter at around 4½% of GDP. That is a consequence of weakness in the rest of the world, combined with somewhat stronger growth in US domestic demand. But it highlights the problem that not only the US, but almost every major economy has with attempts to rebalance at the expense of 'foreigners'. If the rest of the world does not oblige, the only outcome is a slow and painful narrowing of domestic surpluses and deficits with foreign balances improving through weaker domestic demand. This is partly what is currently going on in the euro area (I intend to cover this early next week when looking at EA imbalances).

One way of illustrating the rebalancing of the US economy is to look at the sum of the squares of the deviation from long-term averages of each sector's financial balance.

Sum of the square of deviations from the average of sectoral financial balances for household, corporate, public and foreign sectors

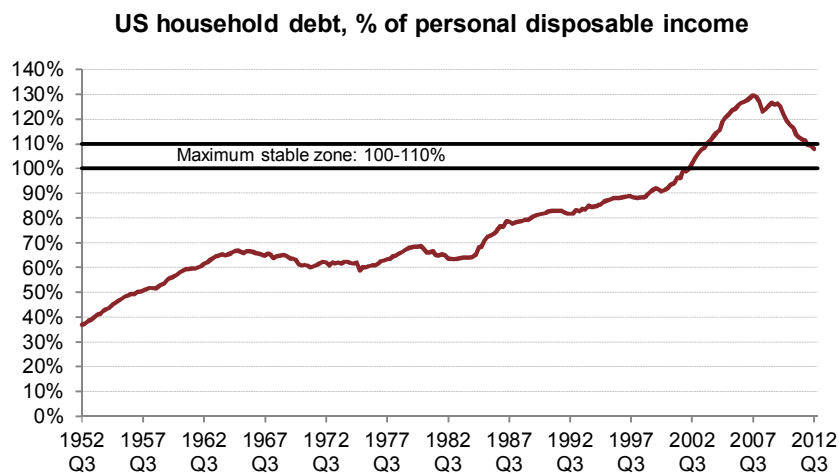


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As the chart shows, there is still some way to go before we get back to ‘sustainable imbalances’; however, much of the work has already been done and the rest does not necessarily imply a recession to achieve – just somewhat slower growth, and not always necessarily that.

The second aspect is the development of household debt. Based on historical data and the reactions of households, it seems that US households can cope with a debt in the range of 100-110% of personal disposable income (PDI) *at normal interest rates*. Obviously, right now interest rates are not normal (although whether ultra-low interest rates are in fact the ‘new normal’ is another point I hope to return to in coming weeks). Lower interest rates have allowed US households to deleverage faster. In Q3, household debt was within this maximum sustainable zone for the third quarter, amounting to 107.9% of PDI. This is still on the high side and is likely to fall further in coming quarters. However, the data confirms that the major fall in household debt refers to mortgage liabilities. In spite of the pick-up in the housing market, mortgage debt fell by 0.2% of PDI in Q3, the 17th quarterly fall in 18 quarters (there was a minimal rise in Q2 2012).



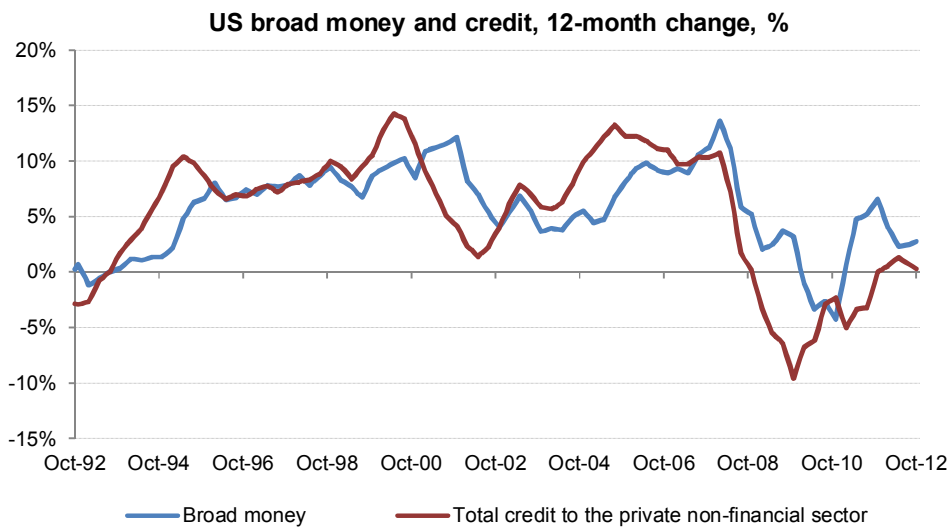
By contrast, households did take on more debt in other categories, such as student loans, car loans and other consumer credit. The implication is that households continue to feel fairly confident about the future, a point reinforced by the steady, if unspectacular rise in the University of Michigan consumer sentiment index, which reached a five-year high in November (subject to revision published after this has been sent to readers today).

This brings us to the third aspect of the Flow of Funds data, namely the updates for broad money. My recreation of the discontinued M3 measure is based on the Flow of Funds data, updated monthly by the deposit liabilities of commercial banks. Every three months the numbers can therefore be cross-checked. The latest data show that broad money growth has begun to pick up again; but both money and credit

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growth remain subdued certainly by the standards of past recoveries. Broad money growth should at least be in the 5-7% range to be consistent with trend output growth; in a recovery phase, you would prefer to see it at 10% for some time. It is currently languishing at around 2½%. One of the conclusions to draw from this is that the US household deleveraging will continue in coming quarters, if at a somewhat slower pace; another is that US companies, remaining flush with cash and cautious in their spending plans, are not in need of borrowing.



Even so, the willingness of households to borrow again, if mainly for consumption, implies that the impact of the much-dreaded and much-discussed 'fiscal cliff' is likely to be more muted, at least initially, than the worst-case scenarios allow. However, the on-going weakness of broad money and credit growth remains a concern for 2013, even though the US economy should still do better than much of the rest of the world.

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