

Dr Doom in Tartan

The bright economic news is fading



Being an economist and Scottish is sometimes hard to bear. The dismal science and the dismal weather make for a dismal soul. At least my natural gloom should have lifted during the last 18 months. The economies of the world have picked up and we have taken up residence in sunny Singapore.

Yet I still see only dark clouds. I pick up the newspaper and read about the American economy and its return to healthy growth and I find my eyes narrowing, sceptically. I look at the continuing boom in China and I find myself shaking my head. From my new office, where I look out across Singapore's lush Botanical Gardens, I see only monsoon rain.

It is worse than Scotland.

What makes me reach for the whisky is not just the thought that the economic crisis is far from over. It is that so many people think it is. There may be a few lingering issues and the recovery may be a bit lumpy, the optimists say, but we have already seen the worst.

I want to shake them. I want to say – of course it looks better! The world has been running on economic steroids for the last year and a half! Massive economic stimulus packages. Bank bailouts. Interest rates so low that money is almost free. Stock markets soaring as a result. It would have been astonishing if the troubled economies hadn't pulled themselves out of recession. We should thank our governments for averting a financial meltdown.

But we haven't paid the bill yet.

We'll take the low road

We still have a long way to go. Many banks are sliding again. In the US, more than 700 were rated as 'troubled' at the end of last year, a 50% rise in three months. Their problem loans now exceed \$400bn and are rising by \$15bn a month. Consumer debts are too high too, with families across Europe and the US still badly overstretched. They can't pay back 15 years of excess borrowing in 18 months. Unemployment is still rising. With the bailouts, government debt has soared. As a percentage of GDP, total borrowing in the US is 50% more than before the Great Crash of 1929 and still rising.

Businesses still need to adjust to the new normal. Capacity is too high. In many sectors, managers are assuming that demand will soon return to pre-crisis levels. But with consumers needing to save, governments needing to cut back and banks reluctant to lend, 2007 volumes are not coming back any time soon. In the car business, there are factories able to make 94 million vehicles a year. Sales will barely reach 60 million this year.

The idea that consumption in China is going to save us from all these troubles is appealing, but fanciful. China's consumption amounts to less than \$2trn a year. Consumption in the US and Europe is more than \$20trn. China cannot make up for the

decline in the developed markets. Besides, the Chinese like to save.

By 2015 the US will need to use 12% of its tax revenues just to pay the interest on its loans. That is equal to the current spending on defence and pensions combined. If the US wants to pay the loans back, it will need to divert even more tax dollars.

The piper needs paying

So what comes next? Some big changes, although they may happen slowly. Governments are going to have to stop supporting their economies. Otherwise they will go bust. Consumers are going to have to start saving. Or many of them will go bust too. That will take a change in mindset. And banks are going to have to call in their loans. This will lead to a widespread asset sell-off and deflation.

The alternative is default – where governments, individuals and businesses stop paying their debts, currencies collapse, inflation surges and we all start over. Those with savings and assets, the frugal and the governments of Asia, would see their wealth evaporate. How they would respond to such a loss is hard to say. But they will do more than shrug their shoulders.

So we are between a proverbial rock and hard place. We can opt to endure years of weak economic activity, austerity and high unemployment while the major Western economies put their balance sheets back in order. Or we can choose turmoil. And there is no guarantee that the first will not lead to the second, so great are the debts.

Not very cheery stuff, I know.

If you can see another option that is sustainable, do let me know. I'll stand you a whisky, and even let you put water in it, if it lifts my gloom.

