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Interview: Srinivas Thiruvadanthai on why this recession is different

By Hao Li

The U.S. recession that started in 2007 is the most severe economic downturn since the Great Depression.

It is different from other recessions – and more difficult to recover from – because the private sector is saddled with an enormous amount of debt and is forced to spend money paying it down. Meanwhile, consumption, investments, and the overall economy stalls.

This is called a "balance sheet recession."

In an Interview with *IBTimes*, Srinivas Thiruvadanthai, the director of research at The Jerome Levy Forecasting Center, a macroeconomic research and consulting firm, explores this concept and other factors that make this recession different from other ones.

IBT: What is the definition of a "balance sheet recession"?

Thiruvadanthai: A "balance sheet recession" is not our term. Our term [for the recent recession] is "contained depression."

We like to think of depressions as long-term adjustments in physical capacity and adjustments in leverage and asset values [on the financial side].

We call it a "contained depression" because it was contained by government mechanisms that [prevented] a full-fledged collapse of the banking system.

IBT: Why was it nearly a depression? Why made it so severe?

Thiruvadanthai: Over a long period of time, what you had in the U.S. economy – and you had it in Japan, too – was private sector debt growing faster than incomes, whether it was the corporate or household sector. The overall banking sector also grew faster than GDP.

If debt is growing faster than GDP, the ability to [repay] that debt continues to [deteriorate]. [However], during this period of time, you [also] had big declines in interest rates, which allowed the private sector to [repay existing debt with new debt. Meanwhile, debt began to pile up.]

In 2008, interest rates came [down] to zero, [but that] was not enough relief and the private sector [was unable to continue borrowing].

That's why you have a depression, [because] the private sector balance sheet cannot grow anymore.

There are other factors.

Collateral values have dropped so fast, so sharply that you cannot borrow against collateral, especially in housing, but also in non-residential real estate and other things.

So that's the debt side.

There is also the balance sheet/asset side. Just as debt rose in relation to income, assets also rose in relation to income.

A lot of people thought, "Oh, assets are growing faster than debt, net worth is going up, and debt can always be paid with assets. " But that doesn't always work. Asset values can drop very rapidly, as we have seen in the housing sector, and the debt remains in nominal terms. Then we have a real problem.

IBT: How long do you think it will take the economy to adjust and heal? Is Japan still adjusting from their bust from a long time ago?

Thiruvadanthai: Adjustment will take a long time, it is a multi-business cycle process. In Japan, it's taking a long time; we don't think it will take that [long] in the U.S., it will be done faster than that. Maybe 10 years.

This doesn't mean it's going to be a constant decline. [In other words], you can have a cyclical expansion within a secular depression. Japan had multiple expansions in the last 20 years, but they failed to reach prosperity; [the expansions] were just not robust enough.

It's the same thing happening here [in the U.S.] You can see the current recovery, people are getting excited. [But] the fact is that growth rates are very, very anemic.

IBT: So, mechanically speaking, how does an economy adjust and heal? What is the process?

Thiruvadanthai: One thing is households paying down their [mortgage debt], or defaulting. [Most of this process is coming through defaults now]. Actually, they will also start saving and paying down debt [in the future]. Even if their income doesn't increase much, their debt will go down, so the debt-to-income ratio will decline.

IBT: So it's just paying down or restructuring debt?

Thiruvadanthai: That's one side to it. Asset values will also come down. In the stock market, you have seen valuations come down. Even though prices have risen, the profits have also gone up.

The stock market, you can say, has been on a secular downtrend since 2000 because the P/E ratios have been kind of declining. But we think we have more to go. They're still high.

And then [you have] commercial real estate [which is also overvalued.] So you'll see valuation there go down [as well].

Corporate debt will have to come down. Eventually the banking sector will be much smaller, a much smaller part of the economy.

IBT: So currently, you think stocks and commercial real estate are still overvalued?

Thiruvadanthai: Yes. You know they're not over-valued if you compared [them] to the valuations of the 1990s. But they're over-valued in the long-term sense.

IBT: What do you think of the Federal Reserve's second round of quantitative easing (QE2) and policies in general to make inflation higher? [If inflation is higher, it is easier to pay down debt, which is fixed in nominal terms.]

Thiruvadanthai: Deflation is just a symptom of the contained depression. You're trying to kill the symptom by raising inflation.

First of all, none of these [policies like QE2] will work.

The process of inflation is ultimately caused by an economy that is strong enough so that you can pass on higher price increases…. and also [there needs to be] wage increases, which will only come when the unemployment rate is low.

None of these two things will come [to pass] for a long time. It is very difficult to [artificially] get inflation up and sustained.

The problem is not inflation expectations.

There is actual overcapacity, so there is very little need to invest, to expand capacity. I don't know anyone who wants to build a few more hotels or airlines trying to increase their fleet.

The balance sheet side is the financial side of it. [This is] the physical side of it, when you have physically more capacity.