

America's \$6 trillion rescue plan

- Triumph of moderates in Obama's team has reassured markets
- Will it work where Japan's efforts failed?
- Longer-term the risk is inflation, not deflation

Peter Anderson, CIO US Equities at RCM, the specialist global equity company within Allianz Global Investors, comments on the US economic rescue plan ahead of Obama's inauguration as President on Tuesday 20th January.

The team

"When it comes to economic policy, the moderates have emerged triumphant and the left wing of the Democratic Party has little to show for their efforts. Old Clinton hands like Larry Summers at The National Economic Council, Tim Geithner at Treasury and Peter Orszag at The Office of Management and Budget are going to be the dominant voices in the new administration's economic deliberations. These selections have reassured investors and have helped to stabilise financial markets after the precipitous decline of October/November 2008.

The plan

"The total size of the economic stabilisation effort is likely to exceed \$6 trillion spread over several years. This represents approximately 40% of yearly GDP. This staggering sum consists of three key components:

1. Direct capital infusion – This includes aid to financial institutions, auto manufacturers and others. This stands at more than \$1 trillion and is likely to grow rapidly as banks will need repeated capital injections, the cost of the auto bailout escalates to \$125-150 billion and other business entities request assistance as cash flows implode.
2. The Obama stimulus package – The cost is currently estimated at \$800 billion but will almost assuredly exceed \$1 trillion as the fiscal condition of various states continue to deteriorate. Beyond help to state governments, tax cuts and infrastructure spending will account for the bulk of the stimulus. Finally, a major attempt to help beleaguered homeowners in foreclosure is likely to be unveiled shortly and will almost certainly involve major government expenditure.
3. Government debt guarantees and other steps to reliquify markets – This is the biggest single component of the \$6 trillion rescue effort. This includes implicit and explicit guarantees of Fannie Mae and Freddie Mac debt, commercial paper stabilisation and the purchase of other private sector debt.

“The cost to the tax payer of these efforts is unknown. Will capital infusions into ailing banks and manufacturers stabilise these institutions thus allowing repayment or is it merely postponing their collapse? Will the government have to make good on its guarantees?”

“Despite all these uncertainties, one thing is clear – for many borrowers, the government is becoming the lender of first not last resort.

Will it work?

“In the near term, is this rescue package enough? After all, Japan in the 1980s engaged in massive infrastructure spending, drove interest rates to 0.5% and flooded the financial system with liquidity all to no avail. Japanese consumers saved more and spent less, banks were unable or unwilling to lend because of weak balance sheets and capital spending declined as fearful companies retrenched. But the magnitude of the stimulus is so much greater in the US than in Japan in the 1980s that it seems far more likely that we will see a revival in economic activity by late 2009. That revival is likely to accelerate in 2010-2011 and it seems probable that the rest of the world will follow in America’s wake. Equity markets should respond positively to this recovery in growth.

“Longer term, the risk is not deflation but inflation. \$1 trillion federal deficits are likely to be the norm in the next few years. Withdrawing fiscal stimulus will prove politically difficult. Monetary and fiscal policy will be in conflict. Present policies are sowing the seeds of the next bubble in 3 to 5 years. Therefore there will be a crucial window of time when policies to address the risk of deflation need to be balanced against the risk of a much more negative scenario, and that bubble spells inflation, dollar depreciation and a fresh recession of considerable magnitude. In this environment, the equity market would suffer from not only an earnings collapse but a severe contraction in valuations resulting in a market decline even more severe than the 2008 experience.”

- Ends -

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