Washington's Dilemma: This Isn't a Recession, It's a Collapse

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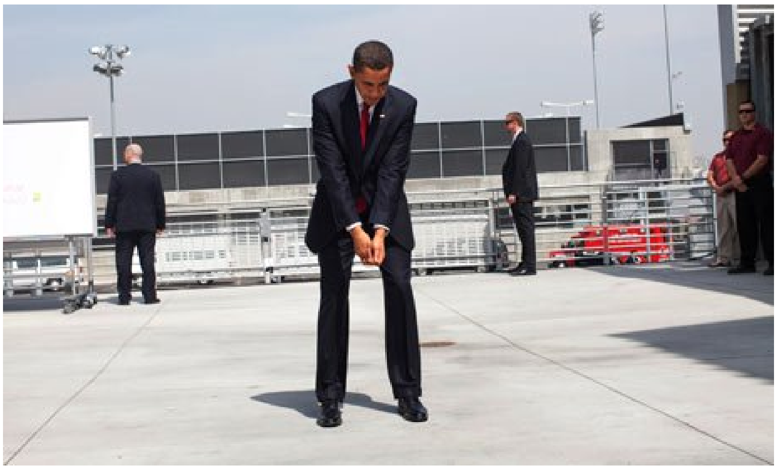
Washington is bluffing that it will not bail out California, and every other state suffering from collapsed revenues and massive job losses. If cuts in police and schools don't force DC off from its current position, then the math will. Because in many states the aggregate revenue losses and looming cuts to state payrolls will largely render the intended effects of federal stimulus as moot. Frankly, unless Washington prints money and bails out every state that needs capital, including California, federal power will decline amidst this severe economic recession, and the process of a soft American devolution will begin. If you think this idea is outrageous, then you've still not come to terms with a core reality of our current situation: the structure of this financial crisis is wholly different than any in our post-war era. This isn't a recession. This is collapse.

In Recession vs. Collapse published in March, this blog explained that in a normal recession existing savings are used to support government debt issuance and that those who remain employed increase their savings to also support government debt issuance. Neither phenomenon is at work today. Yes, the savings *rate* has soared in the US. But this has not resulted in any actual accrued savings. Because private sector debt came to define the internal structure of the US system, savings currently is little more than debt service. Also, bank purchases of US Treasuries are really just a result of the circularity of monetization. It's just money from the FED being recycled into Treasuries. There is no privately driven growth of bank deposits, in the aggregate. Americans as a class are broke. What the savings rate more accurately measures is a collapse of consumer spending.

The internal composition of the US economic and financial system when it hit 2007/8 was very different than in previous recessions, even the severe recession of 1980/82. It's this internal composition that's now determinative, to the outcome. The sawdust of debt, and the monetization of assets rather than the production of goods, continually came to define the internal composition of the system. The economy cannot, therefore, express the same kind of resilience it has done so often, since WW2.

This is the core problem of this collapse and why the prospect for recovery is dim. Americans can't actually rebuild the savings that the banking system needs to escape from the current mess. Individually, Americans are trapped by debt and cannot spend. In The Seigniorage Curse, I explain that one of the primary mechanisms for the hollowing out of the American economy over many years was the dollar advantage, which at first was earned. And then, came to be un-earned. By the time the US reached the 21st century, our primary manufactured product was debt, and dollars. Is it any wonder that once that system collapsed, that we quickly gave up 100% of the phantom job growth that had been sitting on top of the debt bubble? The current level of employment in the United States has now returned to the levels of June 2000. Enough said.



Washington apparently has a fresh dilemma on its hands, just inside of 6 months after the new administration came to power. Clearly the economic team, even though they were given almost 18 months to study the nature of the current crisis (starting in the Summer of 2007), incorrectly judged this recession to be of the post-war variety. Is that any surprise?

Nothing in the public record since the year 2000 indicates that Larry Summers, Ben Bernanke, or Tim Geithner understood that we had been building a skyscraper of private sector debt in textbook blow-off style, since the deflation scare of 2001. Now, two years after FED repair operations began on the broken credit system, and over 3 years since US real estate topped in price, major portions of the country are staring at further home price declines in most major markets. Indeed, it appears that the same macro cycle of the last two Autumns is about to repeat, with more waves of foreclosure, more withdrawals from savings and investment to pay for living expenses, and the attendant bailouts of financial institutions that comes around each time.

Washington can't really take a pass on this situation. If the federal government decides it can wait while "the states rebuild their balance sheets and clean up their payrolls" (as in past recessions) they'll be waiting forever. None of that is underway.

It's no surprise therefore that the country is already being prepped for a second stimulus. Sure, Washington would like to act tough and tell the States to clean up their act. This is the moral hectoring version of Ben Bernanke saying in 2006 he doubts US real estate will ever decline year over year, or Treasury Secty Paulson saying that the front-end of the crisis was just a problem contained to sub-prime. We've seen this script before. If California issuing IOUs in a state where banks refuse to accept them doesn't get the message across, nothing will. We are on the front end, not the back end, of a crisis within the States.

Unless Washington prints up dollars and bails out the States, of what use is Washington? Exactly what services can Washington provide, if California is let go? Left on its own, there would no doubt come an initial *hooray* from rubber-neckers and I-Told-You-So-ers. A newly broken relationship between Washington and the states might also quicken the pulse of anti-federalists, who feel we are long overdue for a tip in the balance of power. Perhaps it would all work out well. For the best, even?

In Washington today the annual budget deficit crossedthe one trillion mark. In Sacramento, there is a 26 billion dollar shotgun hole in*their* budget. (One hopes that CALPERS is marking to market, because if they're not, that would be a new liability for Sacramento to deal with). Meanwhile, Autumn approaches and whole range of rather nasty choices looms over the school system. Imagine living in a prime area of California and watching your house decline by 40%, your household income knocked for an initial 30%, and the after-school programs and town services get cut. Now throw some fees and tax hikes on top of that mess. For the coup de grace, imagine California voters sitting down each night to another wave of bailouts from Washington to financial corporations. Under those circumstances it seems quite unlikely Washington can say no, to the States.

Photos:
George Washington by Ike E. Morgan, Outsider Folk Art Gallery.
Barack Obama, *Golf Swing Without a Club*, Reuters.
FDR, via the Smithsonian.

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