US credit shrinks at Great Depression rate prompting fears of double-dip recession

Both bank credit and the M3 money supply in the United States have been contracting at rates comparable to the onset of the Great Depression since early summer, raising fears of a double-dip recession in 2010 and a slide into debt-deflation.

By Ambrose Evans-Pritchard, International Business Editor
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FedRes: Ben Bernanke has been appointed to a second-term at the helm of the US central bank, the Federal Reserve Photo: AFP

Professor Tim Congdon from International Monetary Research said US bank loans have fallen at an annual pace of almost 14pc in the three months to August (from $7,147bn to $6,886bn).

"There has been nothing like this in the USA since the 1930s," he said. "The rapid destruction of money balances is madness."

The M3 "broad" money supply, watched as an early warning signal for the economy a year or so later, has been falling at a 5pc annual rate.

Similar concerns have been raised by David Rosenberg, chief strategist at Gluskin Sheff, who said that over the four weeks up to August 24, bank credit shrank at an "epic" 9pc annual pace, the M2 money supply shrank at 12.2pc and M1 shrank at 6.5pc.

"For the first time in the post-WW2 [Second World War] era, we have deflation in credit, wages and rents and, from our lens, this is a toxic brew," he said.

It is unclear why the US Federal Reserve has allowed this to occur.

Chairman Ben Bernanke is an expert on the "credit channel" causes of depressions and has given eloquent speeches about the risks of deflation in the past.

He is not a monetary economist, however, and there are indications that the Fed has had to pare back its policy of quantitative easing (buying bonds) in order to reassure China and other foreign creditors that the US is not trying to devalue its debts by stealth monetisation.

Mr Congdon said a key reason for credit contraction is pressure on banks to raise their capital ratios. While this is well-advised in boom times, it makes matters worse in a downturn.

"The current drive to make banks less leveraged and safer is having the perverse consequence of destroying money balances," he said. "It strengthens the deflationary forces in the world economy. That increases the risks of a double-dip recession in 2010."

Referring to the debt-purge policy of US Treasury Secretary Andrew Mellon in the early 1930s, he added: "The pressure on banks to de-risk and to de-leverage is the modern version of liquidationism: it is potentially just as dangerous."

US banks are cutting lending by around 1pc a month. A similar process is occurring in the eurozone, where private sector credit has been contracting and M3 has been flat for almost a year.

Mr Congdon said IMF chief Dominique Strauss-Kahn is wrong to argue that the history of financial crises shows that "speedy recovery" depends on "cleansing banks' balance sheets of toxic assets". "The message of all financial crises is that policy-makers' priority must be to stop the quantity of money falling and, ideally, to get it rising again," he said.

He predicted that the Federal Reserve and other central banks will be forced to engage in outright monetisation of government debt by next year, whatever they say now.

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