Dead Man Walking

Mike Whitney

Credit is everything. Without credit expansion there's no recovery because there's no pick-up in overall demand. But credit growth is going backwards. The banks have tightened lending standards and the pool of credit-worthy applicants has vanished. Bank lending is off 14 per cent since October 2008. Private credit is presently decreasing at a 10.5 per cent annual rate. The situation is getting worse, not better.

From the UK Telegraph:

"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...

"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-Second World War era, we have deflation in credit, wages and rents and, from our lens, this is a toxic brew,'he said. (Ambrose Evans-Pritchard, "US credit shrinks at Great Depression rate prompting fears of double-dip recession", UK Telegraph)

Foreclosures, delinquencies and defaults are all up. Foreclosure activity is currently at 300,000-plus per month and rising. A huge shadow inventory is being kept off-market to maintain prices. The drip, drip, drip-effect of excess inventory dumped onto the market will keep housing in the doldrums for a decade. Homeowners are unable to borrow on underwater homes. Everything points to a long-term slump in spending.

Corporations are finding it harder to roll over their debt, bank loans are defaulting at a historic pace, and commercial real estate is imploding. Credit destruction is unprecedented, massive and ongoing. The capital hole is bigger than the Fed and bigger than the Treasury. It can't be plugged with liquidity alone.

For now, the government can fiddle GDP with $800 billion infusion of stimulus, but what happens when the political will for more deficit spending dissipates? What happens when foreign investors demand the Fed stop writing checks on an overdrawn account?

The Fed has fixed nothing. The banks are still underwater, output is at record lows, and unemployment is climbing towards 10 per cent. Fed chair Ben Bernanke's multi-trillion dollar rescue programs have kept a wobbly system upright, but nothing more. The economy's underlying problems are still the same. The Fed's quantitative easing (monetization) program has sent stocks surging, but done nothing to stimulate the economy. That's because equities bubbles have negligible impact on aggregate demand; there's no knock-on effect. The real economy is still flatlining while Wall Street parties on. Bernanke's plan has been a total wash.

The government cannot deficit spend forever. Eventually, GDP will have to depend on wage growth and credit expansion. Given the political and institutional bias against labor, (and opposition to wages that rise with productivity) the only way to fuel the economy is through credit growth. And there's the rub. Households have lost nearly $14 trillion in wealth since the crisis began and are in no position to resume borrowing at pre-crisis levels. Consumers are cutting back on spending and paying down debt. They have no other choice.

This is from Bloomberg News:

"Americans plan to refrain from boosting their spending even after the biggest drop in consumption since 1980, signaling concern about the direction of the economy over the next six months.

"Only 8 per cent of U.S. adults plan to increase household spending, almost one-third will spend less, and 58 per cent expect to 'stay the course,' a Bloomberg News poll showed. More than 3 in 4 said they reduced spending in the past year.

"Underscoring consumers' austere attitudes, 77 per cent of respondents said they have cut back on spending during the past year, 59 percent said they have made a bigger effort to pay off debts and 48 percent have put more money aside as savings."
(Bloomberg News)

Savings are up and spending is down. The economy is headed into a long-term funk; the "new normal". The Fed's sleight-of-hand programs and Obama's stimulus elixir haven't changed the prevailing downward trend. If anything, they have made matters worse. Consider this from Janet Tavakoli, author of "Dear Mr. Buffett" in an interview with Max Keiser:

"Regarding the outlook, my analysis is grim. I am not a doomsayer, I follow the cash, and so far, I've been correct, and the government has been wrong. Here's the situation. We are at greater risk of a total meltdown due to a deflationary collapse than we were in 2007. After the greatest Ponzi scheme in the history of the capital markets, we've seen history's greatest fiscal and monetary expansion, but it hasn't worked. Debt levels of consumers and business exceed the capacity to repay." (Janet Tavakoli On The Edge With Max Keiser)

The Fed has done nothing to restructure the financial system so the same problems which killed Lehman and thrust the global economy into a tailspin, persist today. When the stimulus runs out and the Fed ends its $1.25 trillion purchase of (Fannie and Freddie) mortgage-backed securities and $300 billion in US Treasuries, interest rates will rise, housing prices will tumble, and the economy will nosedive. Bernanke will be forced back to the printing presses, the only hope for reversing the deflationary spiral. This will trigger the next crisis, a run on the dollar.

This is from an article by Alice Schroeder of Bloomberg News:

"In all the talk of inflation because the Treasury is printing so much money versus deflation because it may not print enough, there is one type of inflation that is rarely discussed. This is the mega-inflation caused by a sudden currency devaluation. Currency is like any financial innovation, an obligation secured by assets. When the obligation is perceived to have increased far beyond the level justifiable by the assets, which in this case make up a country's economy, a bubble has formed......Right now, the American economy is worth less than the value implied by the market value of its obligations." (Gold Tells You U.S. Bubble Hasn't Popped Yet: Alice Schroeder, Bloomberg)

The system crashed because it was built on the false assumption that an unregulated shadow banking system could generate an infinite amount of credit without sufficient capital. This proved to be wrong. Capitalism requires capital. The trillions of dollars in loans, complex debt-instruments, off-balance sheet operations and derivatives contracts were all stacked atop a tiny scrap of capital which eventually collapsed beneath the weight of the debt. This system (securitization) which created the mess, cannot be restored. It required a strong currency, artificially low interest rates, and credulous investors who were unaware of the inherent risks of illiquid assets. Those conditions no longer exist, nor have they for more than two years. Even so, the Fed continues to pump blood into a corpse hoping for some fleeting sign of life. This is why an even bigger crisis cannot be too far off.

Mike Whitney lives in Washington state, and can be reached at fergiewhitney@msn.com. Looks like he got back from France in one piece.