The next bank crisis

New wave of loans going bad?

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THE conventional wisdom for months now has been that a combination of bail out money and low interest rates (next to zero) has ended the banking crisis. Yet evidence is growing that the banking system is far from healed -- that the crisis could very well make a comeback.

Yes, the nation's largest banks and financial firms, likeCitigroup and Bank of America, are healing -- or at least show no signs of imploding as they did a year ago. Shares of the major financial firms are up (even longtime basket case Citigroup) since the market tanked in March.

And, yes, even legendary pessimists like James Grant now think the economy is set for a "V-shaped" recovery -- a strong and fast pickup after the sharp downturn.

But other analysts are starting to fear that we're in for Round Two of the banking crisis. The worrying intensified last week, when (despite the hundreds of billions the feds have spent on "economic stimulus") unemployment rose to an alarming 9.8 percent. Many economists predict that it's easily on its way to at least 10 percent, despite the economic "recovery" that's said to be all but a done deal.

It's called a "jobless recovery": Businesses are making money by cutting -- jobs and inventory -- to survive. Even the firms that*could* expand their workforce remain hesitant: They see too great a risk of higher taxes, much higher government spending, and thus higher interest rates.

After all, Congress is looking to pass a government takeover of the health-care system*and* a jobs-crushing "cap-and-trade" energy bill policy. Both portend higher costs for businesses -- particularly the cash-strapped smaller businesses that do the most hiring.

As a result, profits rise and GDP grows -- but unemployment stays high, as it is now.

All this underscores the folly of the president's stimulus plan: It was*supposed* to not just put people back to work, but also help people pay off loans and mortgages -- all the stuff the banks need to get healthy again.

The president's supporters will tell you that without the $800 billion spent on job growth, the employment situation would be worse. Maybe so -- but the Obama administration's prediction that unemployment would stop at 8.5 percent was clearly way off the mark. (Big surprise -- stimulus packages have proved pathetically ineffective going all the way back to the Great Depression.)

Yet all the stimulus spending means more borrowing -- and, at least on the margin, higher interest rates to attract borrowers to buy our debt. And *that* means fewer homes loans and less consumer borrowing -- and a slower economy down the road.

Now, back to the banks: They're still holding trillions of dollars in ailing mortgage loans and commercial-real-estate debt that they have yet to fully write down. They're hoping they won't have to -- but continued joblessness is squeezing those portfolios.

The banks will tell you that they've written down a good chunk of their consumer loans. But the problem, according to banking analysts like Mike Mayo, becomes acute if unemployment passes 10 percent and nears 11 percent.

That's the point, according to many economic models, that American consumers start defaulting on loans in such a way that trillions of dollars in consumer-related loans and debt that haven't been written down start to implode.

And that doesn't account for the trillions in commercial-real-estate loans and bonds that have yet to take any significant hit at all -- but (most analysts predict) will be crashing in the months ahead even if unemployment stabilizes at 10 percent.

Bottom line: If unemployment goes higher than 10 percent, the banks' numbers get even worse. As losses begin to mount, the big banks may well find themselves back begging the government for *more* bailout money.

As one major Wall Street CEO told me: "If the consumer comes back, the banks will be safe -- but if the consumer begins to implode, so will the banks."

But will unemployment head toward 11 percent? Well, former Fed Chairman Alan Greenspan (whose lax monetary policy helped lead us into the financial crisis) warned last week that America should brace for it to cross the 10 percent level.

Prominent banking analyst Meredith Whitney, who all but predicted the banking crisis, recently laid out why unemployment is likely to keep rising: For all the talk of recovery, banks are cutting back on loans to small businesses, which make up nearly half of the country's workforce and a massive chunk of the GDP -- close to 40 percent.

Of course, President Obama and the stock market might be right -- unemployment isn't climbing as fast, so jobs will start coming back as business profits return. Problem is, President Herbert Hoover said just about the same thing back in 1932.

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