Economic Crisis: No End In Sight

Worse than the Great Depression

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It's been 21 months since two Bear Stearns hedge funds defaulted setting off a series of events which have led to the gravest economic crisis since the Great Depression. No one expected the financial meltdown to hit this hard or spread this fast. The failure at Bear triggered a freeze in the secondary market where mortgage loans are repackaged into securities and sold to investors. That market is now completely paralyzed cutting off 40 percent of funding for consumer and business loans and thrusting the broader economy into a deep recession. Banks and financial institutions have been forced to curtail their off-balance sheet operations and build their reserves which have ballooned from $45 billion to nearly $700 billion in the last 6 months alone. Like millions of homeowners who have seen their home equity vanish and their retirement savings slashed in half, the banks are hunkering down hoping they can outlast the deflationary hurricane ahead.

The deteriorating economic conditions have taken their toll on consumer confidence and forced businesses to lay off employees that won't be needed during the slowdown. The system is bursting with overcapacity. Demand is falling faster than any time since the 1930s. Inventories will have to be trimmed and budgets cut to muddle through the down-times. Foreign trade has slowed to a crawl, auto sales are down by 40 percent or more, and unemployment is rising at 650,000 per month. Policymakers have pushed through a $800 billion stimulus plan, but it won't be nearly enough to stop the steady rise in unemployment or take up the slack in an economy where industrial output has been cut in half, new home construction has dropped to record lows, and manufacturing has fallen off a cliff. Economists warn that when governments don't step in and provide stimulus to increase aggregate demand, consumers cut back sharply on spending and push the economy deeper into depression.

Treasury Secretary Geithner and Fed chief Bernanke have lent or committed $13 trillion trying to keep the financial system functioning, but they've only managed to plug a few holes and avoid a system-wide collapse. The financial system is hobbled and unable to provide sufficient credit to generate growth. Every sector has suffered cutbacks, layoffs and slimmer profits. The problems go beyond toxic assets or complex derivatives. The system is plagued with stagnation, overcapacity and redundancy. Economics professor Robert Brenner sums it up like this in an interview in the Asia Pacific Journal:

Robert Brenner: "The current crisis is more serious than the worst previous recession of the postwar period, between 1979 and 1982, and could conceivably come to rival the Great Depression, though there is no way of really knowing. Economic forecasters have underestimated how bad it is because they have over-estimated the strength of the real economy and failed to take into account the extent of its dependence upon a buildup of debt that relied on asset price bubbles. In the U.S., during the recent business cycle of the years 2001-2007, GDP growth was by far the slowest of the postwar epoch. There was no increase in private sector employment. The increase in plants and equipment was about a third of the previous, a postwar low. Real wages were basically flat. There was no increase in median family income for the first time since World War II. Economic growth was driven entirely by personal consumption and residential investment, made possible by easy credit and rising house prices. Economic performance was weak, even despite the enormous stimulus from the housing bubble and the Bush administration's huge federal deficits. Housing by itself accounted for almost one-third of the growth of GDP and close to half of the increase in employment in the years 2001-2005. It was, therefore, to be expected that when the housing bubble burst, consumption and residential investment would fall, and the economy would plunge. " ("Overproduction not Financial Collapse is the Heart of the Crisis", Robert P. Brenner speaks with Jeong Seong-jin, Asia Pacific Journal)

The economy is now in a downward spiral. Tightening in the credit markets has made it harder for consumers to borrow or businesses to expand. Overextended financial institutions are forced to shed assets at firesale prices to meet margin calls from the banks. Asset deflation is ongoing with no end in sight. Price declines in housing have reached 30 percent already and are now accelerating on the downside. This is the nightmare scenario that Bernanke hoped to avoid; a capitulation in real estate that drags the rest of economy into a black hole. Economist Nouriel Roubini and market analyst Meredith Whitney predict that housing prices will drop another 20 percent before they hit bottom. Nearly half of all homeowners will be underwater and owe more on their mortgages than the current value of their homes. That will increase the foreclosures and push scores of banks into default. According to Merrill Lynch's economist David Rosenberg:

"It would take over three years to achieve price stability (in housing) The problem is that prices do not begin to stabilize until we break below eight months' supply – and they tend to deflate 3% per quarter until that happens. So as impressive as it is that the builders have taken single-family starts below underlying sales, their efforts are just not sufficient to prevent real estate prices from falling further. In fact, even if the builders were to declare a moratorium immediately, that is, taking starts to zero, demand is so weak and the unsold inventory so intractable that it would now take over three years to achieve the holy grail of price stability in the residential real estate market."

The main economic indicators all point to a long period of retrenchment ahead. The slowdown in global trade has hit Germany, Japan, and most of Asia particularly hard. The export-driven model of growth has suffered a major setback and won't rebound for some time to come. With the US consumer unable to continue his debt-fueled spending spree, surplus countries will have to develop domestic markets for growth, but it won't be easy. Chinese workers save 50 percent of what they earn and German workers already have a comfortable life without increasing personal consumption. Higher wages and lower interest rates can help stimulate demand, but cultural influences make it difficult to change spending habits. Meanwhile, the economy will continue to languish operating well below its optimum capacity.

Capital flows have also suddenly reversed causing turmoil in the currency markets. January's TIC data indicates that net capital outflows for the US were negative $148 billion in January. Capital is now fleeing the country. Financial protectionism has triggered the repatriation of foreign investment causing a sharp drop in the purchase of US sovereign debt. This is from Brad Setser, economist for the CFR:

"The obvious implication of the recent downturn in total reserve holdings — and the $180 billion fall in q4 wasn't driven by currency moves — is that the pace of growth in the world's dollar reserves has slowed dramatically…

The obvious implication: most of the 2009 US fiscal deficit WILL NEED TO BE FINANCED DOMESTICALLY. The Fed's custodial data indicates central banks are still buying Treasuries, though at a somewhat slower pace than in late 2008. But their demand hasn't kept up with issuance. (Foreign Central banks aren't going to finance much of the 2009 US fiscal deficit; Their reserves aren't growing anymore", Brad Setser, Council on Foreign Relations)

The United States does not have the reserves to finance it own massive deficits which will soar to $1.9 trillion by the end of 2009. The Fed will have to increase its purchases of US Treasuries and monetize the debt. Foreign holders of Treasuries and dollar-backed assets ($5 trillion overseas) will be watching carefully as Bernanke revs up the printing presses to fight the recession and meet government obligations. China, Russia, Venezuela and Iran have already called for a change in the world's reserve currency. It won't happen overnight, but the momentum is steadily growing.

The S&P 500 has soared 23 percent in the last four weeks, but the current bear market rally is misleading. The prospects for a quick recovery are remote at best. The fundamentals are all weak. Corporate profits are down, GDP is negative 6 percent, housing is in a shambles, and the banking system broken. The Fed has increased the money supply by 22 percent, but economic activity is at a standstill. The velocity at which money is spent is the slowest since 1987. Nothing is moving. The banks are hoarding, credit has dried up, and consumers are saving for the first time in 2 decades. The banks' credit-conduit cannot function properly until bad assets are removed from their balance sheets. But the magnitude of the losses make it impossible for the government to purchase them outright without bankrupting the country. According to the Times Online, the IMF has increased its estimates of how much toxic mortgage-backed paper the banks are holding:

"Toxic debts racked up by banks and insurers could spiral to $4 trillion, new forecasts from the International Monetary Fund (IMF) are set to suggest.

The IMF said in January that it expected the deterioration in US-originated assets to reach $2.2 trillion by the end of next year, but it is understood to be looking at raising that to $3.1 trillion in its next assessment of the global economy, due to be published on April 21. In addition, it is likely to boost that total by $900 billion for toxic assets originated in Europe and Asia.

Banks and insurers, which so far have owned up to $1.29 trillion in toxic assets, are facing increasing losses as the deepening recession takes a toll, adding to the debts racked up from sub-prime mortgages. The IMF's new forecast, which could be revised again before the end of the month, will come as a blow to governments that have already pumped billions into the banking system."

Since banks lend at a ratio of 10 to 1; the amount of credit cut off to the broader economy will ensure that sluggish growth well into the future. If there is a recovery, it will be weak. The Obama administration will have to increase its capital injections even though they will add to mushrooming deficits. So far, financial institutions have only written down $1 trillion or 25 percent of their losses. This means the banking system is insolvent. Eventually, Obama will have to resolve the bad banks and auction off troubled assets, even though political support is rapidly eroding. According to political analyst F. William Engdahl, most of the garbage assets are concentrated in the nation's five biggest banks:

"Today five US banks according to data in the just-released Federal Office of Comptroller of the Currency's Quarterly Report on Bank Trading and Derivatives Activity, hold 96% of all US bank derivatives positions in terms of nominal values, and an eye-popping 81% of the total net credit risk exposure in event of default.

The five are, in declining order of importance: JPMorgan Chase which holds a staggering $88 trillion in derivatives (€66 trillion!). Morgan Chase is followed by Bank of America with $38 trillion in derivatives, and Citibank with $32 trillion. Number four in the derivatives sweepstakes is Goldman Sachs with a 'mere' $30 trillion in derivatives. Number five, the merged Wells Fargo-Wachovia Bank, drops dramatically in size to $5 trillion. Number six, Britain's HSBC Bank USA has $3.7 trillion. ("Geithner's 'Dirty Little Secret': The Entire Global Financial System is at Risk", F. William Engdahl, Global Research)

These five banking Goliaths are at the center of political power in America today. Their White House emissary, Timothy Geithner, has concocted a rescue plan–the Public-Private Investment Program–which will provide 94 percent funding from the FDIC for the purchase bad assets. The program is designed to keep asset prices artificially high while transferring the bulk of the losses to the taxpayer. The plan has been widely criticized and has even raised a few eyebrows even among usually-supportive members of the establishment like the Financial Times:

"US banks that have received government aid, including Citigroup, Goldman Sachs, Morgan Stanley and JP Morgan Chase, are considering buying toxic assets to be sold by rivals under the Treasury's $1,000bn (£680bn) plan to revive the financial system.

The plans proved controversial, with critics charging that the government's public-private partnership – which provide generous loans to investors – are intended to help banks sell, rather than acquire, troubled securities and loans.

Banks have three options if they want to buy toxic assets: apply to become one of four or five fund managers that will purchase troubled securities; bid for packages of bad loans; or buy into funds set up by others. The government plan does not allow banks to buy their own assets, but there is no ban on the purchase of securities and loans sold by others." (The Financial Times)

It's a multi-billion dollar shell game with myriad opportunities for fraud. In theory, the banks could create their own off-balance sheet operations (SIVs or SPEs) and use them to purchase their own bad assets taking advantage of the government's 94 percent low interest non recourse loans. It's a blatant swindle and another windfall for Wall Street.

Geithner's plan does not fix the problems with the banks, it only delays the final outcome. The next leg-down in the recession will push many of the undercapitalized banks into receivership. Geithner's PPIP won't change that. As housing prices fall and foreclosures rise, the capital position of many of the banks will become untenable leading to a rash of bank failures. An article in Monday's Wall Street Journal puts adds some historical perspective to today's financial crisis:

"The events of the past 10 years have an eerie similarity to the period leading up to the Great Depression. Total mortgage debt outstanding increased from $9.35 billion in 1920 to $29.44 billion in 1929. In 1920, residential mortgage debt was 10.2% of household wealth; by 1929, it was 27.2% of household wealth….

The causes of the Great Depression need more study, but the claims that losses on stock-market speculation and a monetary contraction caused the decline of the banking system both seem inadequate. It appears that both the Great Depression and the current crisis had their origins in excessive consumer debt — especially mortgage debt — that was transmitted into the financial sector during a sharp downturn.

Why does one crash cause minimal damage to the financial system, so that the economy can pick itself up quickly, while another crash leaves a devastated financial sector in the wreckage? The hypothesis we propose is that a financial crisis that originates in consumer debt, especially consumer debt concentrated at the low end of the wealth and income distribution, can be transmitted quickly and forcefully into the financial system. It appears that we're witnessing the second great consumer debt crash, the end of a massive consumption binge." (From Bubble to Depression? Steven Gjerstad and Vernon L. Smith, Wall Street Journal)

PARTY LIKE ITS 1929

Two leading economic historians, Barry Eichengreen and Kevin H. Rourke, have written an article "A Tale of Two Depressions" which has been widely circulated on the Internet. It illustrates (with graphs) how the global economy is plummeting faster now than during the 1930s.
http://www.voxeu.org/index.php?q=node/3421

By nearly every objective standard, the present downturn is worse than the Great Depression. Manufacturing, industrial production, foreign trade, capital flows, consumer confidence, housing, and even stocks are falling faster today than after the crash of 1929. So far, Bernanke's monetary bandaids have prevented the wholesale collapse of the financial system, but that could change. The economy continues its downhill slide and it looks like there's nothing to stop it from falling further still.