Economy USA 2010: From the Scandalous Past to the Uncertain Future

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> "Homes rose markedly in value, especially in hot markets like Florida and New York City. Borrowers believed that home purchases were no-risk ventures certain to escalade, and they went out on a limb to buy. Lenders who had once required large down payments now permitted home purchasers to combine two and three loans to buy a home. People took out what were called "buffet" loans, which were interest-only loans that buyers were told they should refinance in three years or five years. Lenders told home buyers not to worry; homes were rising so fast in value that it would always be easy to refinance into another loan. Developers built larger houses. Why not? Borrowers wanted larger homes. They needed the space to hold all the things they were buying." —U. S. Housing market in 1928-29, in Kristin Downey, The Woman Behind the New Deal (Frances Perkins), 2009, p. 106, from Gail Radford, Modern Housing for America: Policy Struggles in the New Deal, 1996, pp.10-22
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> "I place economy (saving) among the first and most important virtues, and debt as the greatest of dangers to be feared." Thomas Jefferson: 3rd US President (1801-09)
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> "America is more communist than China is right now. You can see that this is welfare of the rich, it is socialism for the rich — it's just bailing out financial institutions. This is madness; this is insanity; they have more than doubled the American national debt in one weekend for a bunch of crooks and incompetents." Jim Rogers, American investor

After a decade plus of unchecked greed by money-changers, of the political dismantling of financial regulation, of large "too-big-to-fail" banks made larger, of artificial easy money by the central bank, of the risky securitization of all kinds of debt instruments and of leveraged buy-outs of scores of companies with their own debts by financial operators, it was no surprise that the financial house of cards came crashing down in 2007-2008. It was like a pre-programmed financial crisis. A perfect financial storm.

What lessons can be drawn from the recent unhealthy and unpalatable past? And, what is in store for the near future, considering that hardly anything in the financial environment has changed? A crisis caused by a near total absence of financial regulation, by a too easy monetary policy and by too much debt, has been met with no additional financial regulation, by an even easier monetary policy and by even more debt. In fact, the U.S. ratio of total debt ($57 trillion) to the economy (GDP: $14.5 trillion in 2009) is even higher today at 3.9, then it was before the onset of the crisis in 2007-08, when it stood at 3.4.

That is why we will argue here that the problems of U.S. financial dysfunction have not been solved. On the contrary, they have been swept under the large rug of even easier money and of even larger debts, which is only postponing the day of reckoning. For sure, the large Wall Street banks' bad debts have been transferred to the public sector (the Treasury and the Fed) and to the quasi public sector (Fannie Mae and Freddie Mac), but the overall debt load of the U.S. economy has not been reduced; it has been increased. That is why the U.S. is condemned to continue its foreign borrowing binge for some time to come.

In general, too much foreign borrowing is bad for an economy, especially if it is done to finance an excessive level of domestic consumption. When this happens, it is a sign that total domestic expenditures (government, corporations, consumers) exceed total incomes. The country lives beyond its means and the gap has to be filled with net foreign borrowings.

The principal indicator of this situation is the current account (a broader measure than the external trade balance) of the country. When a country's current account turns negative, more money for imports and interest payments is flowing out of the country than is coming in through exports and investment income. Like any individual, of course, a country can borrow abroad if its credit rating is good. The question is how much and for how long. For countries that have fully convertible currencies or, better, for countries like the United States whose national currency also serves as an international key-currency, the situation can endure for a longer period, but there is always a day of reckoning.

In general, for a normal economy, a negative current account that exceeds six (6) percent of Gross Domestic Product (GDP), especially if this is due to a negative trade balance, usually indicates a non sustainable situation of foreign borrowing and foreign indebtedness that can lead to a financial crisis. Countries like Mexico (1994-95) and Thailand (1997-98) experienced such a financial crisis in the 1990's. Such was the case also with Argentina at the turn of the century.

Since 2000, and coinciding with the arrival of the George W. Bush Republican administration, the United States has also embarked upon a policy of excessive domestic spending, resulting in larger and larger and persistent current account deficits and huge foreign borrowings. Indeed, the adoption of an imperial foreign policy of permanent war throughout the world, financed on credit, and an ideological preference for large fiscal deficits, have translated into large American current account deficits.

In 2006, the U.S. (external) current account deficit reached 6.5 percent of GDP. This was the apex of external debt sustainability and a harbinger of economic troubles to come for the U.S. economy. As a matter of fact, this induced me to write an article on October 16, 2006 entitled "Headwinds for the US Economy", in which I warned that it was a "matter of months, not years", before the U.S. economy and the U.S. dollar begin to experience some downward pressures. I repeated the warning a few months later when I wrote on May 5, 2007, (A Slowdown or a Recession in the U.S. in 2008?), that we could expect "the collapse of one and possibly several major financial institutions under the pressures of bad loans and record foreclosures… The rate of foreclosure is bound to spike in the coming months, possibly culminating in the next two years into a financial hurricane." This was said many months before the onset of the 2008-09 recession and the September 15, 2008 failure of the large investment bank Lehman Brothers.

In 2008, in the midst of the economic recession, the U.S. current account deficit was still estimated at –$706 billion (nearly all caused by a –$707.8 billion trade deficit) for a $14,441 U. S. GDP, that translated into a 4.9 percent current account deficit relative to the economy.

With the 2008–09 economic crisis and recession, the US current account deficit has since been somewhat reduced due to a drop in incomes and in imports, and partly due to a sharp decline in oil prices, but it is expected to remain above four percent of GDP. In the coming years, this ratio is likely to increase again as the long-term U.S. fiscal deficit is expected to remain at 10 percent of GDP for years to come.

The Fed’s Role in Creating Asset Price Bubbles

The causes of a financial crisis are complex and can vary from one country to the next. In general, however, they usually stem from the central bank becoming subservient to the government when the latter decides to embark upon a policy of large fiscal deficits. If the central government opts in favor of monetizing the public deficits and keeping interest rates low, an asset bubble is bound to emerge.

Unfortunately, that’s pretty much what the Greenspan Fed elected to do in maintaining an easy money policy for too long and in keeping interest rates too low, for too long, in the late 1990s and in the first part of the 2000 decade. Indeed, most economists agree that in 2003-04, the U.S. Fed should have raised short-term interest rates (pushed down to 1 percent in June 2003 from 6.5 percent in December 2000). But the then Greenspan Fed (current Fed Chairman Ben S. Bernanke has been a Fed Board member since 2002) was deeply embroiled in the Bush political agenda. Chairman Alan Greenspan publicly acknowledged this fact when he declared on September 17, 2007, in an interview with the Financial Times, that “raising interest rates sooner and faster (before the 2004 presidential election) would not have been acceptable to the political establishment given the very low (official) rate of inflation”.

In financial matters, the American central bank (the Fed or the Federal Reserve System) is a curious animal. It is an institution that is entrusted to regulate banks and other financial institutions, but it is partly owned by the large money center banks. It is in a perpetual conflict of interests. In fact, it can be said that the Fed is the banks’ own private government. In good times, large Wall Street banks, bank holding companies and other large integrated financial groups, such as AIG (American International Group), are pretty much left alone and allowed to build profitable but risky and shaky financial pyramids, with scant supervision. When things go bad, however, the Fed stands ready to bail them out with automatic discounting, zero-interest loans and other goodies, the overall cost being transferred to the general public through an inflation tax and a debased currency. We know since 2008 that the U.S. Treasury also stands ready with public money to bailout the large Wall Street banks when their gambles go sour. The $700 billion Troubled Assets Relief Program (TARP) is testimony to that effect.

A central bank can always print new money. But this is hardly a magic recipe for prosperity. If it were so, many Third World countries could claim to have discovered this magic potion. The current Bernanke Fed is tragically wrong in its belief that it can reverse the current over-indebtedness situation in the economy and its mismanagement of the financial crisis by printing money. It is not true that the real economy always respond positively to heavy doses of monetary stimulus. In fact, the contrary is usually the case. If it were true, Zimbabwe, which is an African economic basket case with an uncontrolled bout of hyperinflation, would be prosperous. The U.S. economy is not exempt from fundamental economic laws. A few years down the road, people will see why.

It is my feeling that the U.S. economy is presently in the eye of a powerful financial hurricane of debt liquidation. Such systemic crisis happens no more than twice in a century and it takes at least a decade to work itself out. In this environment, one should be wary of the stock market as a barometer of the real economy. There could be artificially created short-term “liquidity” rallies, when all the while the real economy remains in the doldrums. The 2009 liquidity-driven stock market rally has all the appearances of such a bear market rally destined to fail and trap many unwary investors. In fact, this rally looks like a mirror repeat of the 1930 stock market rally that saw stocks retrace some fifty percent of their initial 1929 losses. We know now that this was only a mirage, and that the worst was still to come.

In my last July 10 blog, I stated that there is likely to be a prolonged 2007-2017 economic stagnation period in the U.S. —I reconfirm this assessment, which is reinforced by my conviction that the Bernanke Fed is making matters worse by its unlimited printing press so-called “solution” of discounting everything but the kitchen sink. It is my contention that this imprudent Fed is paving the way for the mother load of bubble and subsequent crash. This is because, as alluded to above, they seem to have forgotten that the credit cycle and the process of debt build-up, and the subsequent debt liquidation that follows, are the primary driving forces in the underlying economic cycle.

This time the crash will be initiated in the huge bond market, will spread to the commercial loan market and ultimately to the stock market, and then will further crush the real economy in a way that few understand today but will learn the hard way in the coming years.

Let us keep in mind that in the recent past, the Fed and the U.S. Treasury did not see the subprime and housing crises coming. They were completely taken off-guard. In 2005, according to then Fed member Ben Bernanke, “there was no housing bubble”, even though everybody and his uncle could see that the real estate bubble was about to burst.

And now, let us look at the figures. At the end of 2009, reflecting a binge of printing new money by the Fed, the U.S. monetary base, i.e. money circulating through the public and banking reserves on deposit with the Federal Reserve, stood at more than $2,016,136,000,000, after having increased 146 percent in three years. This is unprecedented. —Even if one subtracts the inactive excess bank reserves at the Fed, worth more than $1 trillion (and earning interest!), the U.S.’s monetary base has grown 22 percent in three years, from a starting point of $818 billion in early 2006.

Nevertheless, Fed Chairman Ben Bernanke said in 2009, that he does not fear inflation and that, in fact, inflation could even go down from then on. He could be right for the next few months, but how about the next few years?

Those who listened to Chairman B. B. in 2005, and kept buying leveraged real estate, lost their shirt. I am of the feeling that those who believed Chairman B.B in 2009, and kept buying long-term U.S. Treasury bonds, are also going to lose their shirt. Because of the huge federal deficits and Fed policy to monetize a big chunk of them, U.S. long-term rates are bound to increase in the coming years, whether the real economy grows or not. That would be the next Fed-created bubble bursting, the bubble of artificially low interest rates, excessive money creation and artificially high asset prices for long-term Treasury bonds.

In the past, the big losers of this policy were the millions of people who lost their homes through mortgage foreclosures, the millions of people who lost their jobs through bankruptcies and the millions of retirees who saw their retirement incomes plummet with near zero interest rates. In the future, the principal losers will still be middle class families who will continue being the victims of a massive spoliation and will still have trouble making ends meet, plus retirees whose retirement capital will be further eroded. Where is AARP when we need it?

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