GlobalResearch
Center for Research on Globalization

Financial Crisis: The Next Leg Down

By Mike Whitney
Global Research, May 27, 2009
27 May 2009

Region: USA
Theme: Global Economy

Collapsing home prices and credit markets continue to put downward pressure on consumer spending, forcing the Federal Reserve to take even more radical action to revive the economy. Last week, Fed chief Ben Bernanke raised the prospect of further monetizing the debt by purchasing more than the $1.75 trillion of Treasuries and mortgage-backed securities (MBS) already committed. The announcement sent shock-waves through the currency markets where skittish traders have joined doomsayers in predicting tough times ahead for the dollar. Foreign central banks have been gobbling up US debt at an impressive pace, adding another $60 billion in the last three weeks alone. That's more than enough to cover the current account deficit and put the greenback on solid ground for the time-being. But with fiscal deficits ballooning to $3 trillion in the next year alone, dwindling foreign investment won't be enough to keep the dollar afloat. Bernanke will be forced to either raise interest rates or let the dollar fall hard.

Export-led nations are looking for an edge to revive flagging sales by keeping their currencies undervalued. But the strong dollar is making it harder for Bernanke to engineer a recovery. He'd like nothing more than to see the dollar tumble and reset at a lower rate. That would reduce the debt-load for homeowners and businesses and send consumers racing back to the shopping malls and auto showrooms. Perception management is a big part of stimulating the economy. That's why the financial media has been air-brushing articles that focus on deflation and shifting the attention to inflation. It's an effort to kick-start consumer spending by convincing people that their money will be worth less in the future. But deflation is still enemy number one. Rising unemployment, crashing home prices, vanishing equity and tighter credit; these are all signs of entrenched deflation.

Bernanke faces three main challenges to put the economy back on track. He must remove the hundreds of billions in toxic assets from the banks balance sheets, reignite consumer spending to offset the sharp decline in aggregate demand, and fix the wholesale credit-mechanism that provides 40 percent of the credit to the broader economy. Treasury Secretary Timothy Geithner has taken over the distribution of the remaining TARP funds, and created a new program, the Public-Private Investment Partnership (PPIP), for purchasing toxic mortgage-backed assets. The PPIP will provide up to 94 percent "non-recourse" government loans for up to $1 trillion of assets which are worth less than half of their original value at today's prices. The Treasury's plan is an attempt to keep asset prices artificially high so that the losses will not be realized until they've been shifted onto the taxpayer. Here's how John Hussman of Hussman Funds summed up Geithner's PPIP:

> "From early reports regarding the toxic assets plan, it appears that the Treasury envisions allowing private investors to bid for toxic mortgage securities, but only to put up about 7% of the purchase price, with the TARP matching that amount – the remainder being "non-recourse" financing from

> the Fed and FDIC. This essentially implies that the government would grant bidders a put option against 86% of whatever price is bid. This is not only an invitation for rampant moral hazard, as it would allow the financing of largely speculative and inefficiently priced bids with the public bearing the cost of losses, but of much greater concern, it is a likely recipe for the insolvency of the Federal Deposit Insurance Corporation, and represents a major end-run around Congress by unelected bureaucrats.
>
> Make no mistake – we are selling off our future and the future of our children to prevent the bondholders of U.S. financial corporations from taking losses. We are using public funds to protect the bondholders of some of the most mismanaged companies in the history of capitalism, instead of allowing them to take losses that should have been their own. All our policy makers have done to date has been to squander public funds to protect the full interests of corporate bondholders. Even Bear Stearns bondholders can expect to get 100% of their money back, thanks to the generosity of Bernanke, Geithner and other bureaucrats eager to hand out the money of ordinary Americans." (John Hussman, "The Fed and Treasury – Putting off Hard Choices with Easy Money, and Probable Chaos, www.hussmanfunds.com)

The second part of the Fed's plan is to fix the wholesale credit-mechanism, which means restoring the securitization markets where pools of loans are transformed into securities and sold to investors. Until Bernanke is able to lure investors back into purchasing high-risk debt-instruments comprised of student loans, mortgage securities, auto loans and credit card debt, the credit markets will continue sputter and growth will be flat. Structured-debt creates the asset base which is leveraged though traditional loans or complex derivatives. Credit expansion maximizes profit, inflates asset prices and establishes the structural framework for shifting wealth to financial institutions via speculative asset bubbles. This is the basic financial model that US banks and financial institutions hope to export to the rest of the industrial world to ensure a greater portion of global wealth for themselves and a stronger grip on the political process.

Bernanke's Term Asset-backed Securities Loan Facility (TALF) provides up to $1 trillion in non recourse loans to financial institutions willing to buy AAA-rated debt-instruments backed by consumer and small business loans. So far, the response has been tepid at best. For all practical purposes, the market is still frozen. Bernanke knows that there will be no recovery unless the credit markets are functioning properly. He also knows that the TALF won't succeed unless he provides guarantees for the underlying collateral, which is loans that were made to applicants who have no means for paying them back. Bernanke's guarantees will cost the taxpayer billions of dollars without any assurance that his plan will even work. It's a complete fiasco. From the Federal Reserve Bank of San Francisco Economic Letter, "US Household Deleveraging and Future consumption Growth" by Reuven Glick and Kevin J. Lansing:

> "More than 20 years ago, economist Hyman Minsky (1986) proposed a "financial instability hypothesis." He argued that prosperous times can often induce borrowers to accumulate debt beyond their ability to repay out of current income, thus leading to financial crises and severe economic contractions.
>
> Until recently, U.S. households were accumulating debt at a rapid pace, allowing consumption to grow faster than income. An environment of easy credit facilitated this process, fueled further by rising prices of stocks and

> housing, which provided collateral for even more borrowing. The value of that collateral has since dropped dramatically, leaving many households in a precarious financial position, particularly in light of economic uncertainty that threatens their jobs.
>
> Going forward, it seems probable that many U.S. households will reduce their debt. If accomplished through increased saving, the deleveraging process could result in a substantial and prolonged slowdown in consumer spending relative to pre-recession growth rates. Alternatively, if accomplished through some form of default on existing debt, such as real estate short sales, foreclosures, or bankruptcy, deleveraging could involve significant costs for consumers, including tax liabilities on forgiven debt, legal fees, and lower credit scores. Moreover, this form of deleveraging would simply shift the problem onto banks that hold these loans as assets on their balance sheets. Either way, the process of household deleveraging will not be painless. (The Federal Reserve Bank of San Francisco Economic Letter, "US Household Deleveraging and Future consumption Growth" by Reuven Glick and Kevin J. Lansing)
> http://www.frbsf.org/publications/economics/letter/2009/el2009-16.html)

The economy is in the grip of deflation. Commercial banks are stockpiling excess reserves (more than $850 billion in less than a year) to prepare for future downgrades, write-offs, defaults and foreclosures. That's deflation. Consumers are cutting back on discretionary spending; driving, eating out, shopping, vacations, hotels, air travel. More deflation. Businesses are laying off employees, slashing inventory, abandoning plans for expansion or reinvestment. More deflation. Banks are trimming credit lines, calling in loans and raising standards for mortgages, credit cards and commercial real estate. Still more deflation. Bernanke has opened the liquidity valves to full-blast, but consumers are backing off; they're too mired in debt to borrow, so the money sits idle in bank vaults while the economy continues to slump.

In an environment where businesses and consumers are rebuilding their balance sheets and paying off debt, there's only one option; inflation. Bernanke will keep interest rates will stay low while increasing monetary and fiscal stimulus. The ocean of red ink will continue to rise. Still, the systemwide contraction will persist despite the Fed's multi-trillion dollar lending programs, quantitative easing (QE) and Treasury buybacks. The "Great Unwind" is irreversible; the era of limitless credit expansion is over.

David Rosenberg, chief economist and strategist at Gluskin Sheff & Associates, believes that the equities markets have undergone a "gargantuan short-cover rally" and that stocks will retest the March 9th low, which was a 12 year low for the S&P 500 Index. Rosenberg said he doesn't expect the economy to recover in the second half of the year.

> "I'm seeing no revival of consumer spending in the second quarter," Rosenberg said. (Bloomberg)

The conditions that supported the explosive growth of the last decade no longer exist. The credit markets are in a shambles, the banking system is hanging by a thread, and the consumer is out of gas. Traders are clinging to the slim hope that the worst is over, but they could be mistaken. There's probably another leg down and it will be more vicious than the last.

Comment on Global Research Articles on our Facebook page

Become a Member of Global Research

Articles by: Mike Whitney