US Monetary Crisis: The Crunch Time. Set the Crash-alert Flags at Half-mast

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Sharp contractions in the money supply and recession are two spokes on the same wheel. When the money supply shrinks, there's less economic activity, and the economy slows; it's as simple as that. An article in this week's UK Telegraph by Ambrose Evans-Pritchard shows that the country is sliding inexorably into the jaws of a deep recession.

From the UK Telegraph:

"The US money supply has experienced the sharpest contraction in modern history, heightening the risk of a Wall Street crunch and a severe economic slowdown in coming months. Data compiled by Lombard Street Research shows that the M3 "broad money" aggregates fell by almost $50bn in July, the biggest one-month fall since modern records began in 1959.

"Monthly data for July show that the broad money growth has almost collapsed," said Gabriel Stein, the group's leading monetary economist." (Ambrose Evans-Pritchard,"Sharp US Money Supply contraction points to a Wall Street crunch ahead", UK Telegraph)

The Telegraph confirms what many of the doomsayers have been saying for more than a year now; we're facing a severe bout of deflation. The persistent credit-drain from rising foreclosures and deleveraging financial institutions is shrinking the money supply. Now it's visible in the data. Bernanke's low interest rates haven't stopped the hemorrhaging; deflation is spreading like Kudzu. According to Evans-Pritchard, "The growth in bank loans has turned negative" (while) "the overall debt burden in the US economy is currently at record levels, raising concerns that a recession – if it occurs – could set off a sharp downward spiral."

The under-capitalized banking system has slowed its lending and consumers have stopped borrowing; all the main economic indicators are pointing down. In fact, according to the Conference Board, "weakness among the leading indicators continues to be widespread" and dropped more than 0.7% in July alone. The report is a composite of selected indicators that show the overall direction of the economy. At present, they're all in negative territory.

The Fed lowered interest rates to 2 per cent hoping to help recapitalize the banks and stimulate consumer spending, but it hasn't worked. The banks still don't have the capacity to lend, so the main artery for credit distribution remains clogged and GDP is dropping off. A python has wrapped itself around the financial system and is gradually cutting-off the oxygen supply. Naturally, when the credit system is broken, the money supply contracts. That's true here, too. What's troubling is the speed at which it is all of this is taking place.

It's "the biggest one-month fall since modern records began in 1959". The process is accelerating and will require the Fed to slash rates at its September meeting.

Economist Nouriel Roubini puts it like this:

"Over time inflation will be the last problem that the Fed will have to face as a severe US recession and global slowdown will lead to a sharp reduction in inflationary pressures in the U.S.: slack in goods markets with demand falling below supply will reduce pricing power of firms; slack in labor markets with unemployment rising will reduce wage pressures and labor costs pressures; a fall in commodity prices of the order of 30% will further reduce inflationary pressure.

The Fed will have to cut the Fed Funds rate much more as severe downside risks to growth and to financial stability will dominate any short-term upward inflationary pressures. Leaving aside the risk of a collapse of the US dollar given this easier monetary policy the Fed Funds rate may end up being closer to 0% than 1% by the end of this financial crisis and severe recession cycle."

Interest rates are going down not up as the futures market believes.

Federal Reserve chief Bernanke understands the problem, but has no way to fix it. The market is simply correcting from massive credit imbalances. The economy needs time to cool off and rebalance. Bernanke's various "auction facilities" were created to keep the banking system afloat while the government delivered "stimulus checks" to working people. The plan was designed to bypass the dysfunctional banking system and give money directly to taxpayers. Unfortunately, the strategy failed and added to the bulging fiscal deficits. Martin Feldstein summed it up like this in the Wall Street Journal:

"Recent government statistics show that only between 10% and 20% of the rebate dollars were spent. The rebates added nearly $80 billion to the permanent national debt but less than $20 billion to consumer spending....Here are the facts. Tax rebates of $78 billion arrived in the second quarter of the year. The government's recent GDP figures show that the level of consumer outlays only rose by an extra $12 billion, or 15% of the lost revenue. The rest went into savings, including the paydown of debt....Consumer outlays increased to $36 billion from $24 billion. So the additional $12 billion of consumer spending was less than 16% of the extra $76 billion of disposable personal income. By comparison, savings rose by $62 billion, or five times as much....This experience confirms earlier studies showing that one-time tax rebates are not a cost-effective way to increase economic activity."

The whole "stimulus" plan backfired. Americans did the responsible thing and used the money to pay off debts or stash it in savings instead of than wasting it Walmart or Target on more useless knick-knacks. It just goes to show that average working people can change their spending habits and making prudent choices when they see that times are tough. The culture of consumerism is the result of Madison Ave. saturation-campaigns and propaganda; there's nothing inherently wrong with the American people. Workers are constantly being blamed for "living beyond their means", but the real problem originates from flawed monetary policy and destructive commercialism. It's the prevailing "sicko" corporate culture that has created a nation of spendthrifts and speculators. Ordinary people are not at fault.

Fiscal stimulus can work if it is used properly, like if it was applied to the payroll tax. That would be the same as giving every working man and woman in America a sizable raise in pay that could used to give the economy a boost. (Couples making under $70,000 per year spend 100% of their earnings. They represent 50% of total GDP) The problem, however, is that that would violate a central tenet of neoliberalism which dictates that the payroll tax be used in the General Fund as a de facto flat tax levied against the poor and middle class to ensure that the ruling elite don't not have to pay their fair share for the maintenance of the empire. Bush and his ilk would rather run the economy off a cliff than compromise on their core values. The real reason we are faced with the current economic downturn is because wages have not kept pace with production which means that workers have had to increase their borrowing to maintain their same standard of living and keep the economy growing. If wages are flat the economy can't grow; it's as simple as that. That's why banking elites have lowered standards for lending; it's just a way to generate profits and create growth without giving workers the raise they deserve. It has the added benefit of pushing people into a life of debt-peonage. Americans are deeper in debt than anytime in history and are struggling just to make the interest payments on their loans. As a result, more and more homeowners are walking away from their mortgages and leaving the banks with huge, unanticipated debts. The architects of America's debt-slavery system are turning out to be its biggest victims.

Currently, billions of dollars are disappearing in the secondary market where bets were placed on mortgage-backed securities that are now virtually worthless. As market volatility increases, frazzled investors are moving into cash. Credit is being wrung from the system while the money supply continues to contract.

Mike Shedlock of Mish's Global Economic Trend Analysis gives this technical analysis:

"The recent plunge in M3 (ed.–M3 is the broadest measure of money used by economists to estimate the entire supply of money) makes it likely that credit lines have been fully tapped and/or banks have simply turned off the spigot. Liquidity shrinks by the day. Banks scrambling to refinance long-term debt are going to have a very tough go of it. Weekly unemployment claims are soaring. Consumers out of a job are going to have a tough time paying bills. Those looking for a bottom in these conditions are simply barking up the wrong tree."

The prospects of a deep and protracted downturn are now greater than ever. Financial institutions are either pulling back and preparing for the storm ahead or taking advantage of existing credit lines while they last. The herky-jerky market action suggests that a growing number of CEOs and CFOs can see that the walls are closing in on them. The crash-alert flag is about half-way up the pole.

Author Ellen Hodgson Brown's new book "The Web of Debt", points out some of the parallels some between our present predicament and events leading up to the Great Depression:

"The problem began in the Roaring Twenties when the Fed made money plentiful by keeping interest rates low. Money seemed to be plentiful, but what was actually flowing freely was 'credit' or 'debt'. Production was up more than wages, so more goods were available than money to pay for them; but people could borrow. …Money was so easy to get that people were borrowing just to invest, taking out short-term, low interest loans that were readily available from the banks".

Sound familiar?

Brown continues: "The Fed began selling securities in the open market, reducing the money supply by reducing the reserves available for backing loans..The result was a huge liquidity squeeze—a lack of available money. Short-term loans suddenly became available only at much higher interest rates, making buying stock on margin much less attractive. As fewer people bought, stock prices fell, removing the incentive for new buyers to purchase stocks bought by earlier buyers on margin…The stock market crashed overnight."

The money supply contracted dramatically during the first few years of the Great Depression. Free-market guru, Milton Friedman, went so far as to blame the Central Bank for the disaster. He said, "The Federal Reserve definitely caused the Great Depression by contracting the amount of currency in circulation by one-third from 1929 to 1933."

As a result, interest rates rose and credit became scarcer. To some extent, these things are taking place already. Long-term interest rates and LIBOR have been rising and are headed higher. These are much more accurate gages of the "real" price of credit than the Fed's artificial Fed Funds Rate (2 per cent) which is just a give-away to the banks.

Brown does a good job of connecting the dots and showing how the Federal Reserve engineered the Depression with their failed monetary policies and serial bubble making. In another chapter, she quotes Louis T. McFadden, Chairman of the House Banking and Currency Committee, who is explicit in his condemnation of the Fed:

(The Depression) was not accidental. It was a carefully contrived occurrence. …The international bankers sought to bring about a condition of despair here so that they might emerge as rulers of us all". (Ellen Hodgson Brown; "The Web of Debt", page 146)

Whether the present economic crisis was deliberate or not is irrelevant. The ultimate responsibility for our economic woes lies with the Fed; that's who created the speculative bubble that is now wreaking havoc on the broader economy. Millions of people will lose their homes, trillions of dollars of equity will be wiped out, and hundreds of banks will fail. Eventually, there will be more consolidation among the banks and greater concentration of wealth among fewer people. An self-regulated system run by unelected businessmen naturally gravitates towards monopoly and, yes, tyranny.

Charles Lindbergh summed up the role of the Federal Reserve like this:

"The financial system has been turned over to …a purely profiteering group. The system is private, conducted for the sole purpose of obtaining the greatest possible profits from the use of other people's money." (Ellen Hodgson Brown; "The Web of Debt")

The impending global recession has nothing to do with crafty mortgage lenders, opportunistic loan applicants, dodgy rating agencies, or crooked home appraisers. That's like blaming Lindy England for Abu Ghraib. The source of the troubles is the Federal Reserve and monetary policies that are designed to rob people of their life savings.

Abolish the Fed.

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