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Want to Fight deflation? Give a worker a raise

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The slight rebound in housing looks a lot different when one considers how much the Fed is meddling in the market. Fed chair Ben Bernanke has purchased $240 billion in US Treasuries to keep long-term interest rates artificially low while–at the same time–buying $740 billion in Fannie Mae and Freddie Mac mortgage-backed securities (MBS) to provide the financing for new home buyers. It's the double-whammy; and that's not all. Bernanke plans to continue buying agency MBS (monetization) until he reaches $1.45 trillion, which will make Uncle Sam the biggest player in the housing market by far. How's that for central planning?

Ironically, the funds for Bernanke's housing market rescue plan were never approved by Congress, which means that the Fed committed nearly-$2 trillion with "no down" payment. That makes the Fed's Treasury buyback program the biggest subprime loan of all time.

The fact is, all the recent gains in home sales are all the result of direct government intervention. If interest rates were allowed to rise (as the would naturally) or if Congress withdrew its $8,000 first-time home-buyer subsidy, or if FHA tightened its loosey-goosey financing (which requires just 3.5% down payment and low FICO scores, the same as subprime!) home prices and sales would continue to drop at a 10 to 15 percent year-over-year rate. Housing has stopped plummeting for one reason alone; the Fed bought the market.

The same rule applies to the stock market, where the Fed's quantitative easing (QE) and liquidity injections have sparked a 6-month bear market rally sending equities to the moon. It's all Fed intervention. A recent report by Egan-Jones Ratings And Analytics traces the Fed's lavish liquidity handouts pointing out the precise sectors of the market that have been most effected:

"Massive monetary stimulus is good for asset prices (stocks, bonds, houses, commodities) in a weak pricing environment and soft economy. The Federal Reserve has doubled its balance sheet from $1 Trillion to $2 Trillion effectively adding $1 Trillion to our economy. In addition, the Fed has through an alphabet soup of facilities i.e. Term Auction credit, Asset Backed Commercial Paper Money Market Mutual Fund Liquidity Facility, Term Asset Backed Securities Loan Facility, Primary Dealer and other Broker Dealer Credit, Other Credit Extensions, Term Facility, Maiden Lane LLC one, two and three, Money Market Investor Facility, added approximately $3 Trillion in loans and over $5.5 Trillion in guarantees of private investments. While these latter funds are technically loans, they get renewed regularly.

So where has all the money gone? The chart below shows the rise in the stock market causing the valuation to be somewhat extended in our view – some liquidity found a home here. Large rises in just the last month in small cap stocks, plus 17%; most shorted stocks, plus 17%; stocks with the lowest analyst rating out performing those with the highest rating by 380 basis points, all suggest some speculation……

Commodities have had a nice rebound from their lows with copper hitting new highs. High yield bonds have out performed investment rated bonds as investors are willing to bet on a faster recovery and start to reach for yield.

These are indications of excess liquidity finding outlets." ("Fundamentally…Disconnected" Egan-Jones Ratings And Analytics, hat tip zero hedge.com)

Let's summarize: The Fed is goosing the stock market and subsidizing the housing market. Bernanke has slashed interest rates to zero percent, underwritten the entire financial system with $12.8 trillion in loans and guarantees, and flooded the financial system with liquidity. The Fed has also doubled its balance sheet to $2.08 trillion which is the equivalent of dropping the Fed Funds rate to -1 percent. As Mark Gongloff of the Wall Street Journal opines, "The Fed is essentially paying people to borrow money."

Indeed, the Fed has done its level-best to keep the market from correcting, but isn't it a bit of a stretch to call it a "recovery"?

In truth, Bernanke is in a pitch-battle with deflation and the outcome is still uncertain. Deflation has spread to every sector of the economy; retail, travel, luxury items, autos, building supplies, home furnishings, electronics. No business has been spared. The C.P.I. inflation-gauge has slipped into negative territory and is now at -2.1 percent. Prices are headed down and spending is falling fast. Unemployment is soaring, wages are dropping, and the average work-week has been sliced to just 33 hrs. And, as we noted, housing prices have flattened out, but only because of unprecedented government intervention into the market. Otherwise, real estate would still be stretched out on a marble slab.

Most people think it should be easy to beat deflation. They think all the Fed has to do is flip a switch and print more money. But there's more to it than that, especially when trillions of dollars in credit suddenly vanishes in a poof of smoke. That's what happened last September when Lehman Bros imploded and reduced the financial system to rubble. Global stock markets crashed, interbank lending collapsed, capital flows stopped, and payrolls and inventories were slashed. The gigantic credit-purge thrust the economy into deflation, a condition which persists to this day.

Economist Irving Fisher tackled the problem of deflation 76 years ago in his masterpiece "Debt-Deflation Theory of the Great Depression". Fisher showed how over-indebtedness eventually triggers a chain of events beginning with debt liquidation and ending in distress selling, huge capital losses, and violent economic contraction; the same challenge that Bernanke faces today.

Irving Fisher:

> "Unless some counteracting cause comes along to prevent the fall in the price level, such a depression as that of 1929-33 tends to continue, going deeper, in a vicious spiral, for many years. There is then no tendency of the boat to stop tipping until it has capsized….
>
> On the other hand, it is always economically possible to stop or prevent such a

> depression simply by reflating the price level up to the average level at which outstanding debts were contracted by existing debtors and assumed by existing creditors, and then maintaining that level unchanged." (Irving Fisher)

Clearly, Bernanke is following Fisher's advice and doing everything in his power to reflate asset prices and avoid a bigger crash. But it's still too soon to tell whether his strategy will work. We're still in the early innings of a humongous systemwide credit-implosion event.

The term "deflation" relates to a drop in the general price level, something not seen in the United States since the Great Depression. As economist John Bellamy Foster points out, deflation squeezes corporate profits even if costs and productivity remain the same. When profits fall, heavy layoffs and wage reductions ensue.

John Bellamy Foster: "But the real fear of deflation has to do with the enormously bloated financial structure and the huge debt load of the economy… In a deflationary economy, debt has to be paid back with bigger dollars (worth more over time). This then creates a debt-deflation spiral, enormously accelerating financial meltdown. As Fisher put it, "deflation caused by the debt reacts on the debt. Each dollar of debt still unpaid becomes a bigger dollar, and if the over-indebtedness with which we started was great enough, the liquidation of debt cannot keep up with the fall of prices which it causes." Stated differently, quoting from The Great Financial Crisis (p. 116), "prices fall as debtors sell assets to pay their debts, and as prices fall the remaining debts must be repaid in dollars more valuable than the ones borrowed, causing more defaults, leading to yet lower prices, and thus a deflationary spiral." (Interview of John Bellamy Foster on the Great Financial Crisis, Monthly Review) http://www.monthlyreview.org/mrzine/foster270209.html

It is this "deflationary spiral" that Bernanke is trying to avoid at all cost, even if he destroys the currency in the process. (Which he appears to be doing) Despite the Fed chairman's steely resolve, the economy has continued its historic nosedive. Consumer spending is falling and households are limiting themselves to the bare essentials. (US households lost $14 trillion in wealth in the last year alone.) Families everywhere are paring back their credit, paying down their debts and rebuilding their nest eggs with what's left from their skimpy paychecks. Unfortunately, what's good for the family balance sheet is poison for the economy.

From Bloomberg News: "U.S. consumer credit plunged more than five times as much as forecast in July as banks maintained more restrictive lending terms and job losses made households reluctant to borrow.

Consumer credit fell by a record $21.6 billion, or 10 percent at an annual rate, to $2.5 trillion, according to a Federal Reserve report released today in Washington. Credit dropped by $15.5 billion in June, more than previously estimated. Credit fell for a sixth month, the longest series of declines since 1991. (Bloomberg)

US households and consumers have never been as strapped as they are today. They're dealing with recession the only way they can, by pulling back and hunkering down. That will make it even harder for Bernanke to resuscitate the economy. There's simply no way to force people to borrow when they're not interested.

Bernanke's deflation-fighting strategy needs to be revamped. The country doesn't need another credit bubble. The surge in delinquencies, defaults and personal bankruptcies all suggest that the era of easy money and lax lending standards is over. Why not "hang it up" for good. The Fed should be focused on rebuilding the economy from the ground up, paying particular attention to aggregate demand. Demand is what keeps the mighty GDP-flywheel in motion. Wall Street likes to stimulate demand through credit expansion and bubblenomics so they can skim fat bonuses on the front end and then bail out before stocks crash. But this perennial "boom and bust" cycle get's old for ordinary working people, who just want a little stability and a paycheck that keeps pace with inflation. The best way to avoid "demand shock"–which is at the heart of every recession–is through wage growth and full employment. It's that simple. When workers get better pay, they buy more more stuff and the economy thrives. Everybody wins!

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