A Protracted Period of "Economic Adjustment": How Bad Will It Get?

Collapse in Consumer Spending

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The U.S. economy is at the beginning of a protracted period of adjustment. The sharp decline in business activity, which began in the summer of 2007, has moderated slightly, but there are few indications that growth will return to pre-crisis levels. Stocks have performed well in the last six months, beating most analysts expectations, but weakness in the underlying economy will continue to crimp demand reducing any chance of a strong rebound. Bankruptcies, delinquencies and defaults are all on the rise, which is pushing down asset prices and increasing unemployment. As joblessness soars, debts pile up, consumer spending slows, and businesses are forced to cut back even further. This is the deflationary spiral Fed chairman Ben Bernanke was hoping to avoid. Surging equities and an impressive "green shoots" public relations campaign have helped to improve consumer confidence, but the hard data conflicts with the optimistic narrative reiterated in the financial media. For the millions of Americans who don't qualify for government bailouts, things have never been worse.

Kevin Harrington, managing director at Clarium Capital Management LLC, summed up the present economic situation in an interview with Bloomberg News: "If we have a recovery at all, it isn't sustainable. This is more likely a ski-jump recession, with short-term stimulus creating a bump that will ultimately lead to a more precipitous decline later."

Reflecting on the Fed's unwillingness to force banks to report their losses on hard-to-value illiquid assets, Harrington added, "We haven't fixed the problem. We've just slowed down the official recognition of it."

In the two years since the crisis began, neither the Fed nor policymakers at the Treasury have taken steps to remove toxic assets from banks balance sheets. The main arteries for credit still remain clogged despite the fact that the Bernanke has added nearly $900 billion in excess reserves to the banking system. Consumers continue to reduce their borrowing despite historically low interest rates and the banks are still hoarding capital to pay off losses from non performing loans and bad assets. Changes in the Financial Accounting Standards Board (FASB) rules for mark-to-market accounting of assets have made it easier for underwater banks to hide their red ink, but, eventually, the losses have to be reported. The wave of banks failures is just now beginning to accelerate. It should persist into 2011. The system is gravely under-capitalized and at risk. Christopher Whalen does an great job of summarizing the condition of the banking system in a recent post at The Institutional Risk Analyst:

> "The results of our Q2 2009 stress test of the US banking industry are pretty grim. Despite all of the talk and expenditure in Washington, the US banking industry is still sinking steadily and neither the Obama Administration nor the Federal Reserve seem to have any more bullets to fire at the deflation monster. With the dollar seemingly set for a rebound and the equity and debt markets looking exhausted, one veteran manager told The IRA that the finish of 2009 seems more problematic than is usual and customary for the end of year.
> Plain fact is that the Fed and Treasury spent all the available liquidity propping up Wall Street's toxic asset waste pile and the banks that created it, so now Main Street employers and private investors, and the relatively smaller banks that support them both, must go begging for capital and liquidity in a market where government is the only player left. The notion that the Fed can even contemplate reversing the massive bailout for the OTC markets, this to restore normalcy to the monetary models that supposedly inform the central bank's deliberations, is ridiculous in view of the capital shortfall in the banking sector and the private sector economy more generally." (2ndQ 2009 Bank Stress Test Results: The Zombie Dance Party Rocks On" Christopher Whalen, The Institutional Risk Analyst)

It's not just the banking system that's in trouble either. The stock market is beginning to teeter, as well. Bernanke's quantitative easing (QE) program has provided enough liquidity to push equities higher, but he's also created another bubble that's showing signs of instability. According to Charles Biderman, CEO of TrimTabs Investment Research, the Fed's bear market rally has run out of gas and company insiders are headed for the exits as fast as they can.In a Bloomberg interview Biderman said:

> "Insider selling is 30 times insider buying, while corporate stock buybacks are non-existent. Companies are saying they don't want to touch their own stocks."..."When companies are heavy sellers (of their own stocks) and retail customers are borrowing to buy stocks; that's always been a sign of a market top."

The best-informed market participants believe that the 6-month rally is beginning to fizzle out. The consensus is that stocks are grossly overpriced and the fundamentals are weak. Bernanke's strategy has improved the equity position of many of the larger financial institutions but, unfortunately, there's been no spillover into the real economy. Money is not getting to the people who need it most and who can use it to get the economy moving again.

The economy cannot recover without a strong consumer. But consumers and households have suffered massive losses and are deeply in debt. Credit lines have been reduced and, for many, the only source of revenue is the weekly paycheck. That means everything must fall within the family budget. The rebuilding of balance sheets will be an ongoing struggle as households try to lower their debt-load through additional cuts to spending. But if wages continue to stagnate and credit dries up, the economy will slip into a semi-permanent state of recession. Washington policymakers–steeped in 30 years of supply side "trickle down" ideology–are not prepared to make the changes required to put the economy on a sound footing. They see the drop in consumption as a temporary blip that can be fixed with low interest rates and fiscal stimulus. They think the economy has just hit a "rough patch" between periods of expansion. But a number of recent surveys indicate that they are mistaken, and that "This time it IS different". Working people have hit-the-wall. Consumers will not be able to lead the way out of the slump.

According to a recent Gallup Poll:

> "Baby boomers' self-reported average daily spending of $64 in 2009 is down sharply from an average of $98 in 2008. But baby boomers — the largest generational group of Americans — are not alone in pulling back on their consumption, as all generations show significant declines from last year. Generation X has reported the greatest spending on average in both years, and is averaging $71 per day so far in 2009, down from $110 in 2008….
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> Gallup finds significant declines among all generations in average reported daily spending in 2009 compared to 2008. Given that consumer spending is the primary engine of the U.S. economy, it's not clear how much the economy can grow unless spending increases from its current low levels. But spending may not necessarily be the best course of action for baby boomers as they approach retirement age and prepare to rely on Social Security and their retirement savings as primary sources of income. Indeed, the two generations consisting largely of retirement-age Americans consistently show the lowest levels of reported spending. ("Boomers' Spending, like other Generations, Down Sharply", Jeffrey M. Jones, Gallup)

It no longer makes any sense for people to spend more than they can afford, nor is it possible. US households doubled their debt in the last seven years to nearly $14 trillion. The massive borrowing binge fueled economic growth and pushed assets–particularly housing–steadily higher. But the spending-spree was only possible because of low interest rates, lax lending standards and deep-pocketed trading partners who were only-too-eager to purchase boatloads of US securities, bonds (Fannie and Freddie) and Treasuries. Now conditions have changed; funding has dried up and central banks and foreign investors have limited their purchases to Treasuries. Consumers are left to fend for themselves in a hostile environment where both jobs and credit are scarce.

Household budgets have never stretched as far as they are today. Housing prices have dropped 33 percent from their peak in 2007, but household deleveraging has only just begun. There's a lot of belt-tightening to do if families plan to reduce their aggregate debt by roughly $2.5 trillion and return debt-to-equity ratios to their normal trend-line. Policymakers need to focus on debt-relief and mortgage-principle writedowns to ease the transition and get people back on their feet again.

The current recession has exposed the fault-lines dividing the classes in the US. Neither party represents working people. Both the Democrats and the Republicans are supportive of "social engineering for the rich"; regressive taxation and economic policies which shift a greater portion of the wealth to the richest Americans. The question of inequality, which has grown to levels not seen since the Gilded Age, will dominate the national conversation as the recession deepens and more people slip from the ranks of the middle class. The vast chasm between the mega-rich and everyone else is explored in a recent report by University of California, Berkeley economics professor Emmanuel Saez, who concludes that income inequality in the United States is at an all-time high, surpassing even levels seen during the Great Depression. The report shows that:

> "The top 1 percent incomes captured half of the overall economic growth over the period 1993-2007″ …The top 14,988 households received 6.04% of income, the highest figure for any year since the data became available. The top 1% of households received 23.5% of income, while the top 10% received 49.7% of

> income (the highest on record.)"

Why does this matter? Apart from the moral question of whether a handful of people deserve to live like kings while others live in squalor; there is the political question: Are our politics being driven by plutocrats whose only interest is to fatten the bottom line and increase their own power? Don Monkerud addresses the issue in his article "Wealth Inequality Destroys US Ideals" (Consortium News):

> "Over 40 percent of GNP comes from Fortune 500 companies. According to the World Institute for Development Economics Research, the 500 largest conglomerates in the U.S. "control over two-thirds of the business resources, employ two-thirds of the industrial workers, account for 60 percent of the sales, and collect over 70 percent of the profits."
> Corporations systematically created a wealth gap over the last 30 years. In 1955, IRS records indicated the 400 richest people in the country were worth an average $12.6 million, adjusted for inflation. In 2006, the 400 richest increased their average to $263 million, representing an epochal shift of wealth upward in the U.S." (Don Monkerud "Wealth Inequality Destroys US Ideals" Consortium News)

The US consumer no longer has the capacity to bounce back and generate sufficient demand to produce positive growth. According to McKinsey Global Institute, Homeowners withdrew "$2.3 trillion in home equity loans and cash-out refinancings between 2003 and 2008." Most of the money was spent on personal consumption. Where will the money come from now that home equity has gone negative? The Obama administration will need a second, third and fourth stimulus just to fill the gaping hole left by the collapse of the housing market.

The Fed and its allies in the corporate/financial establishment, have killed the Golden Goose. After Obama's stimulus runs out, consumer spending will again sputter and the economy will slide back into recession. As personal consumption declines, U.S. markets will become less attractive to foreign exporters. There will be no need to continue trading in dollars.