Credit where Credit is Due

Economic Recovery? We're not out of the woods yet.

By Mike Whitney
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The financial channels are abuzz with talk of a recovery, but we're not out of the woods yet. In fact, the deceleration in the rate of economic decline is not a sign of recovery at all, but proof that the economy is resetting at a lower level of activity. That means the recession will drag on for some time no matter what the Fed does. The problem is the breakdown in the securitzation markets which has cut off the flow of easy credit to consumers and businesses. The credit-freeze has caused a sharp drop in retail, auto sales, furniture, electronics, travel, global trade etc. Every sector has been hammered. Fed chief Ben Bernanke's lending facilities have helped to steady the financial system and Obama's fiscal stimulus will take up some of the slack in demand, but these are not a cure-all for a broken credit system. If the system isn't fixed, asset prices will continue to plunge and hundreds of financial institutions will face bankruptcy.

From Tyler Durden at Zero Hedge:

> "In order to fully understand currency and price movements, one has to realize that the securitization of debt, and creation of derivatives amounted to a huge virtual printing press, primarily fueled by a massive increase in risk appetite which allowed for a huge expansion in the value of claims on financial assets and goods and services. It is worth pointing out, that the Fed has little to no control over this "printing press" at this point, which at last count was responsible for over 90% of the liquidity in the system." ("The Exuberance Glut or the Dollar-Euro Short Squeeze Race" Tyler Durden, Zero Hedge)

The faux-prosperity of the last decade was largely the result of a wholesale credit system which created a humongous amount of credit via sketchy debt instruments, off-balance sheet operations, massive leverage and derivatives. (The Fed's liquidity and conventional bank loans play a very small part in the modern credit system) Securitization–which is the conversion of pools of loans into securities–is at the center of the storm. It formed the asset-base upon which the investment banks and hedge funds stacked additional leverage creating an unstable debt-pyramid that couldn't withstand the battering of a slumping market. After two Bear Stearns funds defaulted 20 months ago, the securitization markets froze, credit dried up and the broader economy went into a tailspin. Now that investors know how risky securitized instruments really are, there's little chance that assets will regain their original value or that the market for structured debt will stage a comeback.

Bernanke's Term Asset-backed Loan Facility (TALF) is a attempt to restore the crashed system by offering participants generous government funding to purchase securities backed by mortgages, student loans, auto loans and credit card debt. But skittish investors have stayed on the sidelines. The severity of the downturn has dampened the appetite for risk. So

Bernanke has cranked up the money supply, cut interest rates to zero and flooded the financial system with liquidity. His actions have convinced many of the experts that the country is on the fast-track to hyperinflation, but that may not be the case, as explained in the Hoisington Investment Management's Quarterly Economic Review:

> "Despite near term deflation risks, the overwhelming consensus view is that "sooner or later" inflation will inevitably return, probably with great momentum.
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> This inflationist view of the world seems to rely on two general propositions. First, the unprecedented increases in the Fed's balance sheet are, by definition, inflationary. The Fed has to print money to restore health to the economy, but ultimately this process will result in a substantially higher general price level. Second, an unparalleled surge in federal government spending and massive deficits will stimulate economic activity. This will serve to reinforce the reflationary efforts of the Fed and lead to inflation.
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> (But) let's assume for the moment that inflation rises immediately. With unemployment widespread, wages would seriously lag inflation. Thus, real household income would decline and truncate any potential gain in consumer spending…
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> Inflation will not commence until the Aggregate Demand (AD) Curve shifts outward sufficiently to reach the part of the Aggregate Supply (AS) curve that is upward sloping…..Therefore, multiple outward shifts in the Aggregate Demand curve will be required before the economy encounters an upward sloping Aggregate Supply Curve thus creating higher price levels. In our opinion such a process will take well over a decade….
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> The statement that all the Fed has to do is print money in order to restore prosperity is not substantiated by history or theory. An increase in the stock of money will only lead to a higher GDP if V, or velocity, is stable. V should be thought of conceptually rather than mechanically. If the stock of money is $1 trillion and total spending is $2 trillion, then V is 2. If spending rises to $3 trillion and M2 is unchanged, velocity then jumps to 3.
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> … The historical record indicates that V may be likened to a symbiotic relationship of two variables. One is financial innovation and the other is the degree of leverage in the economy. Financial innovation and greater leverage go hand in hand, and during those times velocity is generally above its long-term average.
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> As the shadow banking system continues to collapse, velocity should move well below its mean, greatly impairing the efficacy of monetary policy…The problem for the Fed is that it does not control velocity or the money created outside the banking system. "(Hoisington Investment Management Quarterly review, thanks to Leo Kolivakis, of Pension Pulse, "Is Inflation inevitable?")

Bernanke can print as much money as he wants, but if the banks are hoarding, consumers are saving, businesses are cutting back, and all the money-multipliers are set to "Off"; there will be no inflation. Demand has to pick up, so that money begins to change hands quickly leading to vast amounts of new money competing for the same number of assets. But that won't happen while the economy is shedding 600,000 jobs a month, housing prices are tumbling and consumer balance sheets are being repaired.

So if inflation is not an immediate risk, and the economy continues to shrink, isn't Bernanke doing the right thing by trying to restart the securitization markets?

Opinions vary on this topic. On the one hand, Wall Street's method of deploying credit appears to be more efficient than conventional (bank) loans because the money is provided by investors who are looking for higher yield rather than bankers tapping into reserves. The problem is that securitization creates incentives for fraud by rewarding loan originators who lend to applicants who have no way of repaying the debt. Unless the system is heavily regulated to insure that traditional lending standards are maintained, speculative bubbles will reemerge and there will be more financial disasters in the future. The former head of the FDIC, William Seidman, anticipated this problem way back in 1993 after cleaning up the S&L crisis. Here's what he said in his memoirs:

> "Instruct regulators to look for the newest fad in the industry and examine it with great care. The next mistake will be a new way to make a loan that will not be repaid." (Bloomberg)

If regulators had heeded Seidman's advice, they could have steered the country away from the present calamity.

The problem with an unregulated credit system is that investment banks and hedge funds can skim lavish salaries and bonuses for themselves on the front end before anyone discovers that the loans are fraudulent and the securities worthless. Even so, neither congress nor the Treasury nor the Fed have taken steps to re-regulate the financial system or to hold any of the main players accountable. It's "anything goes". Bernanke has acted as Wall Street's chief enabler by underwriting shoddy non performing loans, propping up rotten assets with low interest funding, and bailing out investment giants with trillions in taxpayer-backed loans. None of the $12.8 trillion Bernanke has loaned or committed to financial institutions has been approved by Congress. The Fed operates beyond any mandate and outside of any law.

The debate about securitization goes beyond questions about the quality of the underlying loans to focusing on the process itself. Securitization greatly amplifies leverage by repackaging debt into complex instruments. It's a way of turbo-charging credit expansion. Joseph Stroupe summarizes the issue in a recent Asia Times article:

"Remember that there are two fundamental camps with respect to the answer to the question of what lies at the root of the present crisis. One camp holds that America's new generation of financial assets that resulted from the recently invented financial process known as "securitization" are fundamentally sound in value, and that an over-reaction on the part of investors to the subprime crisis has resulted in a panic-induced collapse in their valuations.

This camp believes that the securitization model can and should be revived, and that when investor confidence is restored in financial assets now seen as "toxic", then all will be well again, almost magically, as toxic assets become valuable and attractive once again. All that need be done, it is believed, is for the government to work with Wall Street to jump-start securitization, a model this camp vehemently denies has failed, even though many trillions of dollars both spent and committed already have so far failed to get securitization's heartbeat going again.

The other camp believes that the toxicity is inherent in the very nature of the newly developed financial assets themselves, and that once investors recognized this fact, then that is why their values collapsed. This camp sees the securitization model as fundamentally flawed, based as it is upon artificial inflation of assets, the shortsighted growth of serial asset bubbles created by an unholy de facto alliance of government, big Wall Street banks and credit-rating agencies whose credibility and integrity were profoundly compromised, and unsustainable negative real interest rates (the creation of a massive credit excess), without which the securitization model simply won't run." (Asia Times, Profits Mask the Coming Storm, W. Joseph Stroupe)

Bernanke says that the securitization markets are "frozen" and that the toxic assets should eventually regain much of their original value. But this is just wishful thinking. Investors aren't shunning these assets because they're afraid, but because the banks want too much for them given their implicit riskiness. Stroupe's analysis is closer to the truth; prices have collapsed because investors recognize the inherent toxicity of the assets themselves. The market isn't driven by fear, but by common sense. $.30 cents on the dollar is probably all they are worth.

PUTTING CREDIT BACK WHERE IT BELONGS

Do people realize that the reason their home equity is vanishing, their 401ks have been slashed in half and their jobs are at risk is because Wall Street was gaming the system with leverage and financial innovation? The current downturn is not really a recession at all; it's more like a self-inflicted wound perpetrated by avaricious speculators who put a gun to the economy's head and blew its brains out. The banks and Wall Street have created a capital hole so vast that the entire economy is being sucked into the abyss. And it all could have been avoided.

Credit production is too important and too lethal to entrust to profit-driven vipers whose only motivation is self-enrichment. The whole system needs rethinking and public input before Bernanke wastes trillions more trying to revive the same crisis-prone business model. If "credit is the economy's life's-blood," as President Obama says, then it should be distributed through a government-controlled public utility. The real lesson of the financial crisis is that privatizing credit has been a disaster.