Crystal Ball Gazing: The Future Is Deflation

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There should be a modest uptick in GDP in either in the 4th quarter 2009 or the 1st quarter 2010. This will mark the end of the current 20 month-long recession, but not the end of the crisis. The blip in growth doesn't mean that the troubles are over or that the economy is on the way to recovery. It simply means that Obama's $787 billion fiscal stimulus is beginning to kick in, giving a boost to consumer spending and generating short-term economic activity. Regrettably, when the stimulus runs out, the economy will slide back into negative territory. That's because the US consumer has crossed an important threshold and no longer has the ability to drive the economy through debt-fueled consumption. The data indicates a critical change in consumer behavior which portends a shift away from the current model for economic growth. It's a whole new ballgame.

From the mid-1980s to 2007, the ratio of debt-to-GDP rocketed from 165% to to over 350%; more than doubling in that same period. The build-up of personal debt follows the exact same trend-line as the aggregate profits of the financial sector; they're opposite sides of the same coin. Financial institutions increase profitability by expanding credit and inflating asset bubbles, not by allocating capital to productive enterprises. Their business model is inherently flawed. Speculative bubblemaking is Wall Street's method of shifting wealth from workers to the investor class. It never fails. It's the reason why 42 states are now facing budget shortfalls, unemployment has risen to 9.5 percent, and $45 trillion has vanished from global equity markets. Financialization has created a global crisis, crushed consumer demand, increased systemic instability, and put the economy into a nosedive.

In the last decade, the shifting of wealth from one class to another has greatly accelerated due to deregulation and the Fed's low interest rates. Stagnant wages have forced reluctant participants into the market seeking a better return on their savings, while lax lending standards and easy credit have seduced workers into increasing their personal debt-load. All of this has been done by design to ensure the profits for the few over the well-being of the many.

Wall Street has conjured up myriad complex debt-instruments (derivatives and securitization) which have been used to enhance leverage by many trillions of dollars so that financial mandarins and hedge fund managers can skim lavish bonuses and salaries on the front end before the Ponzi scam implodes. In the present crisis, the situation came to a head when two Bear Stearns hedge funds defaulted in July 2007, creating pandemonium in the stock markets while credit markets froze over. As housing prices fell and unemployment rose, households were left with little choice but to slash spending to pay-down debts. The sharp downturn has dramatically changed consumer behavior and lifted the savings rate to 6.9% in the last month, a 15-year high. Savings are expected to continue to increase despite the Fed's attempts to restart the economy with zero-percent interest rates. A recent "Economic Letter: US Household Deleveraging and Future Consumption Growth" by the

Federal Reserve Bank of San Francisco outlines the conditions which have triggered this dramatic change in consumer behavior. Here's an extended excerpt:

"U.S. household leverage, as measured by the ratio of debt to personal disposable income, increased modestly from 55% in 1960 to 65% by the mid-1980s. Then, over the next two decades, leverage proceeded to more than double, reaching an all-time high of 133% in 2007. That dramatic rise in debt was accompanied by a steady decline in the personal saving rate. The combination of higher debt and lower saving enabled personal consumption expenditures to grow faster than disposable income, providing a significant boost to U.S. economic growth over the period.

In the long-run, however, consumption cannot grow faster than income because there is an upper limit to how much debt households can service, based on their incomes. For many U.S. households, current debt levels appear too high, as evidenced by the sharp rise in delinquencies and foreclosures in recent years. To achieve a sustainable level of debt relative to income, households may need to undergo a prolonged period of deleveraging, whereby debt is reduced and saving is increased.

Beginning in 2000, however, the pace of debt accumulation accelerated dramatically…Rising debt levels were accompanied by rising wealth. An influx of new and often speculative homebuyers with access to easy credit helped bid up prices to unprecedented levels relative to fundamentals, as measured by rents or disposable income. Equity extracted from rapidly appreciating home values provided hundreds of billions of dollars per year in spendable cash for households that was used to pay for a variety of goods and services….Rapid debt growth allowed consumption to grow faster than income.

Since the start of the U.S. recession in December 2007, household leverage has declined. It currently stands at about 130% of disposable income. How much further will the deleveraging process go?

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. ("U.S. Household Deleveraging and Future Consumption Growth, by Reuven Glick and Kevin J. Lansing, FRBSF Economic Letter")

Household wealth has dipped $14 trillion since the crisis began. Wages are slowly retreating and unemployment is at 9.5% a 25 year high. Also, the percentage of home equity has fallen below 50% for the first time on record. And—since one-third of homes have no mortgages (100% ownership)–the remaining homes have only 12% equity. If prices continue to drop in 2010, the vast majority of homeowners will be underwater presaging a sharp rise in the number of foreclosures.

In the last 18 months, the ratio of debt to disposable income has only eased to 128%, which means that it will take at least a decade to rebuild balance sheets enough to resume spending at pre-crisis levels. It's going to be a long hard slog even if the stimulus works according to plan, especially since unemployment is headed for 10% by the end of September and higher by 2010. Household deleveraging will continue regardless of positive developments in the markets, which means that the economy will reset at a lower level of activity. This precludes any chance of a strong recovery. According to David Rosenberg, chief economist for Gluskin Sheff :

"By our estimates, there is up to another $5 trillion of household debt that has to be eliminated in coming years and that process is going to require that consumers go on a semi-permanent spending diet. Companies see this, which is why they are not just downsizing their payroll, but have also cut the workweek to a record low of 33.1 hours. Fewer people are working and those that are still working have seen their hours dramatically cut this cycle….

The op-ed column by Bob Herbert in the Saturday New York Times really hit the nail on the head on this whole 'green shoot' issue — how can there be 'green shoots' when the labour market is deteriorating at such a rapid clip fully nine months after the Lehman collapse. The full brunt of the credit collapse may be behind us, but please, the other two shocks, namely deflating labour markets and deflating home prices, are very much still front and centre. For every job opening in the USA, there are more than five unemployed actively seeking work vying for those jobs. That is unprecedented and nearly double what we saw at the depths of the 2001 recession. The official ranks of the unemployed have doubled during this recession to 14 million and if you take into account all forms of labour market slack, the unofficial number is bordering on 30 million, another record. For those who still believe that we somehow managed to avoid an economic depression this cycle because of a 13% fiscal deficit/GDP and a pregnant Fed balance sheet, the Center for Labour Market Studies at Northeastern University estimates that the real unemployment now stands at 18.2%, which is actually higher than the posted rate at the end of the 1930…

What makes this cycle "different" is that three-quarters of the workers that were fired over the last year were let go on a permanent, not a temporary basis. A record 53% of the unemployed today are workers who were displaced permanently — not just temporarily because of the vagaries of the traditional business cycle. This means that these jobs are not going to be coming back that quickly, if at all, when the economy does in fact begin to make the transition to the next expansion phase." (David Rosenberg chief economist Gluskin Sheff)

Rosenberg's comments should be carefully considered in relation to the scaremongering about inflation by conservatives and alarmists in the media. Inflation is not serious danger for the foreseeable future. The velocity of money has collapsed and deflation is pushing down asset prices and wages. Every sector is contracting. Without stimulus, the economy will remain in negative GDP. Here's Scott Patterson from the Wall Street Journal:

"A rule of thumb is that inflation doesn't become sticky until the unemployment rate dips below 5%. Since 2001, the Nonaccelerating Inflation Rate of Unemployment, or NAIRU, the rate at which economists estimate the labor market can trigger inflation, has stood at 4.8% unemployment, according to the Congressional Budget Office.

In the first quarter, the spread between the NAIRU and the actual unemployment rate averaged 3.3 percentage points, the widest spread since 1983, when unemployment hovered around 10%. A high spread suggests the labor market needs to get stronger before inflation is a concern." ("Inflation fears? Not in this job market", Scott Patterson, The Wall Street Journal)

The inflation hobgoblin is a political ploy by the Republicans to derail Obama's recovery plan. And, in some respects, it's working. Public support for a second stimulus package has withered, and with it, any hope for sustained rebound. Pressure on wages and prices are growing while the effects of deflation are becoming more and more apparent. Delinquencies, defaults, bankruptcies and foreclosures are all up, while state budgets buckle and joblessness mushrooms. The Republicans are following the neoliberal handbook, trying to crash the economy so that public assets can be privatized and public services terminated They're being helped in their campaign by bailout-weary citizens who don't understand that short-circuiting government spending during a deep recession can precipitate a bigger catastrophe.

That said, liberal economists have made poor case for more stimulus. Stimulus is not a panacea; it's merely a bridge from Point A to Point B. Government spending can take up the slack in demand, but it can't fix the economy's underlying problems. That takes policymakers who are willing to do-battle with the big banks and re-regulate the financial system. No one in the Obama administration is willing to perform that task, so the economy will continue its downward drift.

Presently, the banks have more than a $1 trillion in toxic assets on their balance sheets and the wholesale credit markets (securitization) are in a shambles. Nothing has been done to separate commercial from investment banks, force all derivatives onto regulated platforms, unwind insolvent financial institutions, establish prices for complex securities, increase capital requirements, or put an end to off-balance sheet operations.

If the underlying problems are not going to be fixed, than why are liberal economists so eager to use their talents to minimize the effects of the recession? They're just making it easier for Wall Street huckster's to start gaming the system again. The job of progressive economists is to promote a more equitable system that reduces inequality and provides for the basic material needs of all its citizens. There's no sense in cheering on stimulus if it just perpetuates the same dog-eat-dog system.

The subtext of the financial crisis is class warfare, a fact that mainstream economists would rather ignore than invoke the musty imagery of disheveled revolutionaries and Soviet-era repression. Nevertheless, during the Bush years, the chasm between rich and poor widened to levels not seen since the Gilded Age. Now the top 1 percent of wealth holders own more than twice as much as the bottom 80% of the population. All of the real gains in national income, total net-worth, and overall growth in financial worth have gone to the same 1 percent.

But the strides in personal enrichment have come at great cost. The US consumer, long considered an inexhaustible resource, is tapped out. Without job security and access to easy credit; consumer spending will slow, prices will fall, demand will flag and the economy will tank. There won't be a recovery, because pre-crisis levels of consumption will not return; that much is certain. Sustainable growth requires higher wages and longer working hours; neither of which are likely anytime soon. The economy is headed for a protracted slowdown with persistent high unemployment and growing social unrest. The future is deflation.

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