Deflation Smackdown: Bernanke's Madcap Money Printing Fails to Boost Inflation

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Global Research, May 31, 2013
Counterpunch

Region: USA
Theme: Global Economy

"Under a fiat money system, a government… should always be able to generate increased nominal spending and inflation, even when the short-term nominal interest rate is at zero."
Ben S. Bernanke, "Deflation: Making Sure It Doesn't Happen Here", November, 2002

The US economy is in a liquidity trap which means that the demand for credit is weak even though the Fed is increasing the monetary base (via the creation of reserves at the banks) and interest rates are at zero. This is a serious problem. When the private sector (businesses and consumers) reduces its borrowing, activity slows, output shrinks, unemployment rises, and the economy slips into recession. That hasn't happened yet, mainly because government fiscal support and transfers have kept growth in the black. But there are signs that deflationary pressures are starting to build. The consumer price index (CPI) has dropped for two consecutive months, revolving credit is showing new signs of weakness, and deposits at banks still exceed loans by a significant margin. Add the $85 billion across-the-board budget cuts, (sequester) and the prospects for a second-half double-dip look quite good. Here's a clip from an article in Reuters that helps to explain what's going on:

> "Consumer credit recorded its smallest increase in eight months in March, a possible hint that Americans are still trying to pare their debts….Revolving credit, (credit cards) fell by $1.71 billion after rising $453 million in February. Credit from depository institutions fell in March…
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> …student loans have been the driver of any growth in credit to households," said Julia Coronado, chief North America economist at BNP Paribas…
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> Nonrevolving credit in March, which includes auto loans and student loans made by the government, rose $9.68 billion in March. That followed an $18.18 billion increase in February. ("Consumer credit posts smallest gain in eight months", Reuters)

So credit growth is flagging and Obama's contractionary economic policies have only made matters worse. It's clear that slashing government spending when the economy is still weak–and the only areas of credit growth are student loans and subprime auto loans– is pure folly. (Note: Economists estimate that growth would be almost 2 percentage points higher if Congress and the administration put off the tax hikes and budget cuts until the economy was stronger.) The decline in credit card usage further illustrates that working people are still in deep distress and cutting-back wherever possible. Naturally, when consumer borrowing falters, aggregate demand weakens and companies scale back on business investment, which is apparent by the reduction in equipment and software purchases which slipped by 4.6% in the first quarter.

More worrisome, is the fact that consumer spending has gone up recently, even though the resumption of the payroll tax has reduced every American workers' wages by 2 percent. The impact of these cuts have not yet been felt, mainly because consumers have been digging deeper into savings and raiding their 401Ks to make up the difference. According to a recent study released by Bankrate.com, "nearly one in five Americans admit raiding their retirement accounts during the past 12 months to cover expenses". (NBC News) Clearly, this pattern is unsustainable. Overextended consumers will eventually be forced to cut back in the second half which will further reduce GDP.

According to Bloomberg:

> "The saving rate dropped to 2.3 percent in the first quarter, compared with an initial estimate of 2.6 percent. It followed a 5.3 percent rate in the fourth quarter. Disposable income adjusted for inflation dropped at an 8.4 percent annualized rate from January through March… the biggest decline since the third quarter of 2008." ("Economy in U.S. Grew at 2.4% Rate, Less Than First Estimated", Bloomberg)

It's all bad. Personal savings and disposable income are vanishing at the same time that desperate families are draining their retirement accounts just to scrape by and put food on the table. How long can that go on before something snaps?

And let's not forget the erosion in corporate profits. Earnings have been steadily retreating for the last eight quarters due to chronic weak demand which is the unavoidable result of high unemployment, flatlining wages and a tax and regulatory system that's blatantly-skewed in favor of the uber-rich. Check out this blurb from Zero Hedge:

> "Morgan Stanley reminds us that corporate profits have been declining not for one or two quarters, but for two full years now. "For net margins, March 2013 quarter-end results showed the top 1500 US equities at 7.15%, below the peak achieved in the June quarter of 2011. In fact, net margins have declined for the top 1500 companies every quarter since June 2011″… ("The New Tapering Normal Optimism In Charts", Zero Hedge)

So, why are stocks at all-time highs when earnings and revenues are headed sideways?

Ahhh, that's the secret of the new financial alchemy, wherein equities soar to new heights on ho-hum economic data, historic levels of margin debt, massive stock buybacks and an ocean of central bank liquidity. Earnings and revenues are a thing of the past. Get a load of this:

> "Aggregate Buybacks: Dollar-value share repurchases amounted to $93.8 billion over the fourth quarter and $384.3 billion for 2012 … Dollar-value buybacks amounted to 79.1% of free cash flow on a trailing twelve month basis, which is the largest value since Q3 2008." ("Corporate Share Buybacks: How timely are they?", Mish's Global Economic Trend Analysis)

Companies are buying back their own shares hand-over-fist; nearly $400 billion in 2012 alone. Is it any wonder why stocks have surpassed their 2007 peak? The buyback craze is entirely attributable to Fed policy. Corporate kingpins clearly believe that Bernanke will continue to support the markets with as much liquidity as needed to keep equities in the stratosphere. This is also why margin debt has exploded in the last 12 months. Check this out from this week's Wall Street Journal:

> "Investors ramped up their borrowing against brokerage accounts in April, taking margin debt to its highest-ever level. Investors borrowed $384.4 billion against their investments in April, a 1.3% gain from the previous month, and a 29% rise from the same month last year, according to the New York Stock Exchange.
>
> That exceeds the record high of $381.4 billion in debt held against investments, known as margin debt, from June 2007.
>
> The rising level of debt is seen as a measure of investor confidence, as investors are more willing to take out debt against investments when shares are rising." (NYSE: Margin Debt Hits Record High in April", Wall Street Journal)

So, there's your 15% year-to-date stock-market rally in a nutshell: $400 billion in stock buybacks, $400 billion in margin debt, and a whopping $85 billion per month subsidy via Bernanke's bond buying bonanza. Is it any wonder why stocks, bonds, CLOs, CDOs, MBSs, junk bonds, and every other dodgy financial asset is pumped up like birthday piñata while the real economy is still stuck in the doldrums?

The fact is, there's no transmission mechanism to move liquidity from the financial system to the economy, mainly because households and consumers refuse to borrow. As the credit report suggests, most people are not feeling flush enough to resume their pre-Lehman borrowing binge. In fact, a number of surveys indicate that most people will never return to their old ways. Those days are over. Unfortunately, less borrowing means higher unemployment, anemic business investment and sluggish growth. Monetary policy alone cannot fix this situation because–as British economist John Maynard Keynes noted more than 60 years ago–monetary easing in a liquidity trap is like "pushing on a string". It doesn't increase demand, lower unemployment or even boost inflation because the money doesn't get to the people who will spend it and increase economic activity. That's why QE has been such a spectacular flop, because adding to base money (bank reserves) has not increased the amount of money in circulation. All it's done is pump up asset prices which merely makes rich speculators even richer.

But while QE may not have sparked another credit expansion, at least it hasn't hurt the economy, has it?

Yes, it has, according to economist-blogger Frances Coppola who not only thinks that QE is "deflationary rather than inflationary", but, also, that "it is one of the biggest policy mistakes in history." Coppola backs up her claim with a number of charts and graphs all of which show how inflation fell during periods when central banks were buying sovereign bonds and boosting reserves at the banks. (Remember, the point of QE is to raise inflation expectations, not lower them.) Here's a bit of what Coppola says in a recent post titled "Inflation, Deflation and QE":

> "Both UK and US governments believe that monetary tools such as QE can

> offset the contractionary impact of fiscal tightening. But this is wrong. Fiscal tightening principally affects those who live on earned income. QE supports asset prices, but it does nothing to support incomes. So QE cannot possibly offset the effects of fiscal tightening in the lives of ordinary working people – the largest part of the population. In fact because it seems to discourage productive corporate investment, it may even reinforce downwards pressure on real incomes. And when the real incomes of most people fall, so does demand for goods and services, which puts downward pressure on prices, driving companies to reduce costs by cutting hours, wages and jobs. This form of deflation is a vicious feedback loop between incomes, sales and consumer prices, which in my view propping up asset prices can do little to prevent." ("Inflation, Deflation and QE", Frances Coppola, Coppola Comment)

Coppola's logic is unassailable: How can goosing stock prices (QE) offset the impact of budget cuts (austerity) when most people don't own stocks?

It can't, which is why unemployment is still above 7 percent, demand is weak, business investment is flagging, wages are flatlining, inequality is at levels not seen since the Gilded Age, and inflation is dropping like a stone. QE does zilch, in fact, it may be "discouraging productive corporate investment (which) reinforces the downward pressure on real incomes" (as Coppola says.)

Consider this: Bernanke has increased the monetary base by $3 trillion, but inflation is still going down. Ha! What more proof of failure do you need? (According to the Bureau of Labor Statistics the consumer price index (CPI) dropped 0.4% in April after a 0.2% decline in March…. its lowest level since November 2010.)

QE has not reversed the disinflationary trend or mitigated the impact of contractionary fiscal policy. If anything, it's exacerbated things by creating the false hope that turbo-charged stocks can lead the way to economic recovery. They can't. The whole "wealth effect" meme is another bogus remake of "trickle down"; the insane notion that if you give away enough money to filthy-rich plutocrats, some of the excess lucre will filter-down to working stiffs. What a joke. The chasm between rich and poor has never been wider, and it gets bigger by the day. Now, get a load of this from Lance Roberts at StreetTalk Live:

> "A wave of 'disinflation' is currently engulfing the globe as the Eurozone economy slips back into recession, China is slowing down and the U.S. is grinding into much slower rates of growth. Even Japan, despite their best efforts through a massive QE program, cannot seem to break the back of the deflationary pressures on their economy. This is a problem that has yet to be recognized by the financial markets.
>
> The recent inflation reports show deflationary forces at work. Wages continue to wane, economic production is stalling and price pressures are falling. More importantly, there are downward pressures on the most economically sensitive commodities such as oil, copper and lumber all indicating weaker levels of economic output…
>
> It is very difficult to have a "general rise in price levels" amidst a lack of consumer demand driven by suppressed wages, high levels of unemployment and little demand for credit by businesses. The lack of demand exerts downward pressures on the pricing of goods and services keeping businesses on the defensive. This virtual spiral is why deflationary environments are so dangerous and very difficult to break." (The Fed's Real Worry – A Pick Up In Deflation, Street Talk, Zero Hedge)

Bingo. Monetary flim-flam alone will not defeat deflation, not when households refuse to borrow. No borrowing, no credit expansion. No credit expansion, no recovery.

The way to get out of our economic funk is to boost wages and hire more workers. Printing money alone doesn't work; just look at CPI.

Deflation is NOT a problem when labor gets its fair share of productivity gains. When workers are fairly paid, they have sufficient income to buy the things that industry produces. That prevents prices from falling.

That's how you beat deflation when you're in a liquidity trap. Not with a printing press.

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