Economy On The Ropes

Bankruptcies and Soaring Unemployment

By Mike Whitney
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The economy continued to shrink in the first quarter of 2009 at an annual pace of 6.1 percent, making it the worst recession in more than 50 years. Gross Domestic Product slipped into negative territory from January to March for back-to-back quarters of negative 6 percent growth. The news of falling GDP was preceded on Tuesday by a dismal housing report which showed that housing prices have continued their historic downward plunge with only modest improvement. Since their peak in July 2006, housing prices have dropped 31 percent, falling 18.6 percent in the last year alone. The rate of decline has decelerated slightly but–on their present trajectory–prices are on target to tumble 45 to 50 percent from their 2006 highs. Another 20 percent loss in home equity means another $4 trillion loss for US homeowners.

The news on the employment-front is equally bleak. In the week ending April 25, initial jobless claims increased by another 631,000, bringing the 4-week moving average to 637,000. Ongoing unemployment claims are now at 6.27 million, an all time record.

According to the Associated Press:

Unemployment rates rose in all of the nation's largest metropolitan areas for the third straight month in March… The Labor Department reported Wednesday all 372 metropolitan areas tracked saw jobless rates move higher last month from a year earlier."

Consumer spending also fell more than forecast with purchases decreasing 0.2 percent in March and wages and benefits rising at the slowest pace in three decades.

GDP is falling, unemployment is soaring and business and residential investment are at their nadir. Even so, the stock market has continued its 7 week surge on signs that the market may be bottoming.

Although the bad news continues to mount, Northern Trust economists Asha Bangalore and Paul Kasriel have issued a report "US Economic and Interest Rate Outlook" asserting that the worst is over and that the huge quarterly contractions to GDP should gradually improve ending in positive growth by the forth quarter of this year. Kasriel is a first-rate economist and his work should be taken seriously. Still, whether there is a uptick in business activity in the near-term or not, deeper economic problems persist and are likely to get worse before they get better. There is no doubt, however, that Fed chief Ben Bernanke's massive injections of liquidity have had an effect on stabilizing the financial system and reviving the sluggish economy. The Fed chief has committed or loaned $13 trillion in public funds to avoid an impending disaster and to restart speculation in the equities markets. Barron's Randall W. Forsyth provides an original account of Bernanke's intervention:

"THE FEDERAL RESERVE has been roundly castigated in some quarters — even former high officials of the central bank — for its aggressive and unprecedented steps to combat the credit crisis.

But data just released by the Bank for International Settlements suggest that, if anything, the expansionary measures taken by the Fed (and in concert with the Treasury) were dwarfed by the record contraction in the global banking system brought on by the crisis. According to the BIS, which acts as a central bank for central banks, total bank claims shrank by $1.8 trillion in the fourth quarter, or 5.4%, to $31 trillion. This was the largest decline ever recorded.

In other words, there never was a global run on the banking system such as the one seen in the final three months of 2008, which followed the bankruptcy of Lehman Brothers and the near-collapse of American International Group in September. The numbers serve to confirm the extent of the tsunami the swept through the world's financial system….

…Unlike in the 1930s, when central banks actually aided and abetted the collapse of the banking system, today's leaders responded to the unprecedented crisis in the fourth quarter with equally unprecedented force…..

To be sure, banks, including the I-banks, have benefited from the actions of the Fed and the Treasury. But that is separate from the question of the macroeconomic impact of their actions.

Those who contend that the expansion of central bank balance sheets is inflationary ignore the contraction of balance sheets in the banking system, as well as the so-called shadow banking system of assets and liabilities not recorded on banks' books. This analysis is very different from arguments that appeal to the "output gap," the difference between the economy's potential output and actual production. That analysis effectively says that high unemployment will hold down wages and prices, which manifestly did not happen in the stagflationary 'Seventies.

Inflation, as Milton Friedman taught, is always and everywhere a monetary phenomenon. Yet the current central-bank expansion is offsetting the contraction in the banking system — which Friedman criticized the Fed for failing to do in the 1930s.The new BIS data bear out the justification for the Fed's actions, notwithstanding the critics' claims." ("Fed Fights a Record Global Bank Run", Randall W. Forsyth, Barrons)

Whether one approves of the Fed's price-fixing, market-distorting, business-friendly policies or not; Bernanke's emergency actions probably pulled the financial system back from the brink of annihilation, thus, preventing a full-blown meltdown. Bernanke has spared no expense to save Wall Street and the banking cartel. The Fed's bias is clear by the amount of money it has devoted to fixing the financial system as opposed to relieving unemployment, slowing foreclosures or providing debt relief. The Fed's loyalties have never really been in doubt.

While Bernanke may have avoided a global bank-run, the bleeding continues in housing, business investment, manufacturing, industrial capacity, and global trade. Every sector is falling precipitously with no end in sight. Even worse, nothing has been done to remove the trillion dollars of toxic assets from the banks balance sheets which is causing credit to tighten even more. Treasury Secretary Timothy Geithner has failed to take advantage of the uptick in investor confidence to resolve the problem of underwater banks. Instead, he has stubbornly stuck with his Public Private Investment Program (PPIP) which has made less than $6 billion in transactions so far. Unless the banks are restored to health and their balance sheets repaired, a sustainable recovery will not be possible. According to Bloomberg, 6 of the 19 largest banks (which contain 75% of the system's total assets) are insufficiently capitalized:

Bloomberg: "At least six of the 19 largest U.S. banks require additional capital, according to preliminary results of government stress tests, people briefed on the matter said. While some of the lenders may need extra cash injections from the government, most of the capital is likely to come from converting preferred shares to common equity, the people said. The Federal Reserve is now hearing appeals from banks, including Citigroup Inc. and Bank of America Corp., that regulators have determined need more of a cushion against losses." (Bloomberg)

Geithner continues to nibble at the edges, using unreliable accounting maneuvers instead of addressing the problem head-on and forcing a debt-to-equity swap that would recapitalize the banks by giving bond holders a haircut. Geithner thinks that if he stalls long enough, the rotten assets will regain their original value and the banks will be fine. He's ignoring the fact that many of the mortgage-backed securities (MBS) are collateralized with fraudulent loans to borrowers who have no way of paying the money back. The losses need to be accounted for and written down while there's still a glimmer of optimism in the market. The IMF believes that the losses on securitized assets may reach $4 trillion by the end of 2010 and that banks will be on the hook for roughly 61% of the writedowns. Nonperforming loans at the big banks are skyrocketing. "Bank of America Corp. bad assets increasing 229 percent to $25.7 billion. Problem assets at New York-based Citigroup Inc. rose 128 percent to $27.4 billion, and San Francisco-based Wells Fargo & Co.'s jumped 180 percent to $12.6 billion." (Bloomberg) There's no way to sweep losses of this magnitude under the rug.

In an article in the Financial Times, economics editor Martin Wolf fleshes-out the projected costs of the financial system bailout in eye-popping detail:

"These are not the only sums required. Governments have so far provided up to $8,900bn in financing for banks, via lending facilities, asset purchase schemes and guarantees. But this is less than a third of their financing needs. On the assumption that deposits grow in line with nominal GDP, the IMF estimates that the "refinancing gap" of the banks – the rollover of short-term wholesale funding, plus maturing long-term debt – will rise from $20,700bn in late 2008 to $25,600bn in late 2011, or a little over 60 per cent of their total assets. This looks like a recipe for huge shrinkage in balance sheets. Moreover, even these sums ignore the disappearance of securitised lending via the so-called "shadow banking system", which was particularly important in the US." (Fixing bankrupt systems is just the beginning", Martin Wolf, Financial Times)

Fixing the banking system will be a continual drain on public resources ensuring that any rebound will be slow and any recovery weak. Even if the equities markets show signs of life, the real economy will stumble listlessly from one quarter to the next unable to make up the losses from unemployment and under-consumption. Working people will feel as if they are in the grips of another Great Depression whether GDP shows marginal gains or not. Housing prices will stay flat for a decade or more, plundered 401ks will force elderly workers to stay on at their jobs longer than they planned, and reduced credit-availability will force consumers to set aside more of their wages in savings accounts. 10% unemployment and 10% personal savings is the nightmare scenario that economists dread. The 10-10 combo will send the economy into a deflationary tailspin regardless of “green shoots” in the stock market or other fleeting signs of hope. In a bifurcated system, where most of the public resources go to the banks and investor class, the underlying economy is bound to slip into severe inertia. The Fed has become the guarantor of investor class entitlement while the working stiff gets table-scraps.

This is from an article “Income Gaps hit record levels in 2006, new data show”:

“New data from the Congressional Budget Office (CBO) show that in 2006, the top 1 percent of households had a larger share of the nation’s after-tax income, and the middle and bottom fifths of households had smaller shares, than in any year since 1979, the first year the CBO data cover. As a result, the gaps in after-tax incomes between households in the top 1 percent and those in the middle and bottom fifths were the widest on record.

Taken together with prior research, the new data suggest greater income concentration at the top than at any time since 1929.”

Among the CBO’s findings was that “The average after-tax income of the top 1 percent of the population more than tripled, from $337,000 to over $1.2 million. (An increase 256 percent) while “The average after-tax income of the poorest fifth of the population rose only from $14,900 to $16,500” (an increase of 11 percent.)

The CBO shows that the same inequality thrives in the tax system which is blatantly regressive:

“Households in the bottom fifth of the income spectrum received tax cuts averaging $20” whereas “within the top 1 percent, those with incomes exceeding $1 million received tax cuts averaging $118,000.” (“New data show the rich-poor gap tripled between 1979 and 2006.” Center on Budget and Policy priorities, Arlen Sherman) http://www.cbpp.org/cms/?fa=view&id=2789

Growing inequality–now more flagrant than ever given the humongous government bailouts and preferential treatment of financial institutions–is feeding the anger which is spreading nationwide. Timothy Geithner has become the face of a thoroughly corrupted system run by money-grubbing speculators, avaricious banksters and shyster fund managers. He has become a lightening-rod for all manner of criticism which should be directed at the inherent flaws of a system which provides obscene riches to crafty tycoons and securities fraudsters while the people who shine their limousines or build their homes find themselves perusing the want ads the end of an unemployment line. Every day Geithner stays in office, is another triumph for the people who want deep-structural change to the system. His presence at Treasury fuels the public rage.

The current recession is first and foremost a debt crisis brought on by a collapse in private financial intermediation. The breakdown in securitization was triggered by the meltdown in subprime mortgages which led to multi-trillion dollar asset deflation and rising unemployment. The bottom line is that credit will continue to be tight, the economy will drift sideways for longer than expected, and America’s decades-long consumption binge will end. Digging out will be a Herculean task.

POLICYMAKERS ARE AT A LOSS

Despite the 7-week bear market rally and the slight deceleration in home prices, the stagnation of the broader economy–in terms of under-consumption, unemployment and overcapacity–will persist until the massive system-wide deleveraging process abates and personal debt is again reduced to a manageable level. The Fed's loose monetary policy coupled with the banks' off-balance sheets operations, created an torrent of credit which was not backed by sufficient reserves to withstand the shock of a slumping market. When subprime mortgages began to default in the tens of thousands, the secondary market for mortgage-backed securities (MBS) froze creating a break in the chain which had been converting the gigantic capital inflows from foreign banks and investors into debt-instruments. This process of securitization–transforming pools of loans into bonds–enriched the bankers and hedge fund managers while providing more than 40 percent of the credit flowing into the economy. That process is now in ruins and beyond repair. The meltdown in subprime loans has shown that MBS and other structured debt is worth considerably less than originally believed due to the weakness of the underlying collateral. (The risks of AAA MBS are accurately reflected in current market prices which estimate that similar bonds are worth roughly $.30 cents on the dollar.) Without securitization, asset values will continue to plunge because the main cog in the credit-generating mechanism no longer functions. Bernanke can prop up the financial system with trillion dollar lending facilities and zero percent interest rates, but if the credit markets aren't working properly the economy will continue to contract and the recession will progressively deepen.

Personal consumption is ebbing just as savings have begun to grow and a new spirit of thriftiness has overtaken the country. The culture is changing. Conspicuous consumption is out. A new ethos is emerging from a generation now facing chronic joblessness, dwindling equity and grueling scarcity.

There's no way that the economy can reduce its credit by 40 percent and launch a sustained recovery. Unless the Fed and the Treasury continue to provide massive fiscal and monetary stimulus on an ongoing basis; consumption will flag, investment will shrivel, global trade will remain sluggish, and the nation will slide into a protracted downturn. And as the administration pumps more stimulus into the economy, the dual-deficits will soar and either US Treasuries will rise or the dollar will fall, one or the other. There's no free lunch. In the next year the US will have to sell $1.8 trillion of US Treasuries to fund its deficits. Only $500 billion of that sum will be sold to foreign central banks and investors. The world is capital-starved and doesn't have the money to spare. So, the dollar will fall. The dollar now faces its biggest challenge as the world's reserve currency. As goes the dollar, so goes the empire.

The Fed's quantitative easing (QE) has increased the likelihood of a disorderly run on the dollar and an extended period of currency market turmoil. There's no way to avoid the turbulence dead-ahead.

The Federal Reserve and Treasury are now staking the country's future on the belief that they will be able to revive securitization and reflate the bubble economy through complex taxpayer-funded programs (TALF and PPIP) which no one completely understands. If they succeed, then the toxic assets on the banks balance sheets will regain their original value and GDP will grow in a low interest, easy credit environment. It all depends on whether the Treasury's lavish inducements (94% government funding on non recourse loans) are enough to entice investors to purchase risky financial instruments for which there is currently no market.

> The more probable scenario, is that the equities markets will periodically rally in response to good news or the Fed's liquidity injections, while deflationary pressures continue to push down asset prices, swell the unemployment lines, and further shatter consumer confidence. The real economy is sinking fast and, with it, any hope for a quick recovery. Policymakers are completely at a loss. The public knows that things are far worse than they are being told.