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Financial Black Holes and Economic Stagnation

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> "Financial markets are driving the world towards another Great Depression with incalculable political consequences. The authorities, particularly in Europe, have lost control of the situation. They need to regain control and they need to do so now." George Soros, international financier, (Does the Euro Have a Future?, New York Review of Books, September 15, 2011.)

> "The [financial] crisis was not a failure of the free market system and the answer is not to try to reinvent that system. ...Government intervention is not a cure-all." President George W. Bush, Thursday November 13, 2008

> "There is no cause to worry. The high tide of prosperity will continue." Andrew W. Mellon, President Herbert Hoover's Secretary of the Treasury. September 1929

> "I believe that banking institutions are more dangerous to our liberties than standing armies. Already they have raised up a monied aristocracy that has set the government at defiance. The issuing power (of money) should be taken away from the banks and restored to the people to whom it properly belongs." Thomas Jefferson (1743-1826), 3rd U.S. President.

Presently, one has the net impression that today's governments, both in Europe and in the United States, have their fingers plugging the holes in the financial dike, but fear that that the entire dam could collapse in the not too distant future with dire economic consequences.

Let's see if we can make sense of it all.

Let's say to begin that most financial crises are the direct result of unsustainable debt levels relative to income that need to be wrung out of the economic system. It has happened in the past (notably in 1873, in 1907 and in 1931, for example), and numerous times in developing countries, and it will undoubtedly happen again in the future. The process is more often than not always the same: some large banks, corporations, consumers or governments take on too much risky debt that becomes unsustainable when economic conditions change, thus launching the entire economy into a devastating process of debt deflation. Sometimes, it may take decades to overcome such a debt deflation and it usually creates an environment of economic stagnation [http://en.wikipedia.org/wiki/Economic_stagnation] when aggregate demand [http://en.wikipedia.org/wiki/Aggregate_demand] collapses.

What makes the current financial crisis so troublesome is not only that debt levels are historically high for some countries, but also because the usual instruments and procedures to reduce the debt burden, while doing the least damage to the real economy, have been rendered inoperative, due to a large extent, to the poisonous so-called financial "innovations" that have taken place since 1999 in the general climate of wholesale financial deregulation. As a consequence, financial debt in many countries creates a sort of financial black hole that siphons off money income and prevents it from being re-circulated back into the economy. This creates a serious deficiency of demand (when consumers spend less, when corporations postpone investments and when governments adopt austerity programs) that translates into low output growth, economic stagnation and high unemployment.

In this short article, I will try to identify some of these financial "black holes" that starve the economy of the necessary funds to prosper. I will also attempt to explain why this financial crisis may turn out to be much more serious than previous ones and why governments should take drastic measures to avoid a devastating economic depression. [http://en.wikipedia.org/wiki/Depression_(economics)] —I have done this in the past, again, in 2006, and again, in 2007, and again and again in 2010, but obviously some politicians, both in Europe and in North America, don't seem to get. Instead, they seem to think that fiscal austerity and lower taxes is all that takes to stimulate the economy and lower unemployment. They cannot be more wrong in the current context. Such policies in an open economy are going to make things worse, much worse if they are applied over time.

Here is why.

Many governments had the imprudence of piling up debt upon debt over the last thirty years, but especially over the last ten years. There are four main causes for such a public binge of debt in many countries.

-First, in Europe, the creation of the Euro zone in 1999 induced some imprudent member countries to go deep into debt by taking advantage of the credibility of the euro and by issuing bonds in euros at favorable interest rates. There was, indeed, a widely held belief on the part of lenders and borrowers alike that the new monetary union provided an implicit guarantee of stability to the safety of the loans.

-Secondly, lenders were induced to lend large sums at low interest rates because borrowers could avail themselves of a newly created financial instrument, the Credit Default Swaps (CDS) that allowed them to take a low cost insurance against an eventual default on their bonds. (By the way, the financial crises on both sides of the Atlantic are closely linked due to the fact that some large U.S. banks are heavily exposed to the European sovereign debt crisis as sellers of credit default swaps.)

-Thirdly, the persistent large trade imbalances in the world meant that some countries, such as mainland China (which joined the World Trade Organization [http://en.wikipedia.org/wiki/World_Trade_Organization] in December 2001), piled up tremendous external trade surpluses and their excess funds became available to foreign borrowers. Indeed, large international banks found it most profitable to channel these newly created funds to willing sovereign borrowers around the world.

-Fourthly, some central banks, especially the American Greenspan Fed, [http://en.wikipedia.org/wiki/Alan_Greenspan] thought they were obliged to provide an environment of easy money after the events of September 11, 2001 in the U.S., and they kept interest rates unduly low for too long, thus providing an additional inducement to eager borrowers to go deeper into debt. Indeed, the housing bubble in the United States that led to the subprime mortgage crisis [http://en.wikipedia.org/wiki/Subprime_mortgage_crisis] was a creation of the Greenspan Fed with the encouragement of the Bush-Cheney administration.

A first conclusion, therefore, is that many institutional factors and policies contributed into encouraging some governments (and also some consumers and investors) to take on more debt than was prudent, often to finance unproductive spending such as military spending. Today, for example, there are dozens of countries whose gross general government debt stands above 100 percent of their gross domestic product (GDP). Moreover, when a high proportion of this debt is foreign-owned, money to service such debt flows out and this, of course, creates a drag on the domestic economy. Servicing an unproductive foreign debt is one of the financial "black holes" I have in mind here.

But what's even more important, the financial and banking systems have evolved in such a way over the last ten years or so that it has become very difficult, if not technically impossible, to solve a sovereign debt crisis through the traditional means used in the past.

How come? Because debt restructuring (a fancy term for reducing the capital owed by a debtor through debt write-downs that reflect actual market values and/or the extension of a debt's maturity and/or a lowering of interest rates) has been made most difficult by the fact that banks and other lenders have been "insured" against a debt default and are thus expecting to receive 100 percent of a loan and interests, no matter how risky their loans have turn out to be and how low their current value.

In the past, when a government faced a debt crisis, it usually did two things: 1- It petitioned its lenders for a restructuration of its debts if the latter wished to avoid a complete default; and, 2- it would devalue its currency to boost its economy's competitiveness and stimulate its economy after an unavoidable capital outflow.

For a country like Greece, a member of the European Union (EU) that is heavily in debt, these two options to alleviate its crushing debt burden are not easily available: -it cannot coerce large international banks and other lenders to voluntarily take a loss on its so-called "insured" debt, and, -it cannot devalue the euro which is a common currency to sixteen other countries. The principal venue left is to keep borrowing at high costs from other members of the euro zone, the so-called the European financial stability fund, [http://ec.europa.eu/economy_finance/eu_borrower/efsm/index_en.htm] (N.B.: this is equivalent to borrowing from Peter to pay Paul!), and to impose a draconian fiscal austerity program on an economy that has been declining at more than five percent over the last two years.

The paradox is that the more austerity the government applies, the more the economy contracts and the higher is its fiscal deficit and its needs to borrow even more. This is a self-reinforcing spiral down. —That's really a true recipe to produce an economic depression. And, if many governments elsewhere follow the same foolish route for too long, this could lead to a worldwide economic depression.

There are two other major financial black holes that act to starve the economy of needed funds.

First, in the United States, it is the $1.5 trillion in excess reserves [http://research.stlouisfed.org/fred2/series/XRCB?rid=19] that banks hold at the Fed and find to their advantage not to lend to the economy. Some of that money came from American taxpayers when the Bush-Cheney administration put forward its TARP [http://en.wikipedia.org/wiki/Troubled_Assets_Relief_Program] program to salvage large banks from bankruptcy in the fall of 2008. (N. B.: Part of it came also from the general public and from holders of U.S. dollars around the world when the Fed pushed short term interest rates to close to zero.) Secondly, also in the United States, it is another $1.5 trillion in cash that large U.S. corporations hold abroad in their subsidiary companies while parking it in tax havens where there are no taxes at all. They refuse to repatriate these funds for fear of paying taxes at home on their foreign earnings. (N. B.: The U.S. corporate income tax is imposed on all income no matter the country in which it was generated. However, the code allows for U.S. taxes to be deferred as long as the foreign earnings are kept abroad.)

Conclusion

So, don't look elsewhere to understand why there is so much economic stagnation around and why unemployment remains so high. It is because of all these financial black holes that suck money from the economy without putting it back. The correct policies would be to close these financial black holes, and the quicker the better. (The alternative would be even more massive government deficits!)

—But don't hold your breath before such appropriate policies are implemented. Too many politicians have been bought lock, stock and barrel by the same interests that profit greatly from the existence of these financial black holes.

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http://www.amazon.com/Code-Global-Ethics-Humanist-Principles/dp/1616141727/ref=sr_1_1?ie=UTF8&s=books&qid=1262398544&sr=1-1

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