How Much More "Debt Recovery" can the Economy Take?

State of the Union Junk Economics, 2010

By Prof Michael Hudson
Global Research, January 26, 2010
26 January 2010

Region: USA
Theme: Global Economy

It's make or break time for Democrats since the January 19 defeat in Massachusetts. At stake is Mr. Obama's credibility as an agent for change. Exit polls show that voters see his main change to be favoritism to Wall Street, to a degree that the "old Democrats" would not have let a Republican administration get away with. Rivalry over just what party is more Wall Street friendly prompted Jay Leno to joke that Mr. Obama has done the impossible: resurrected the seemingly dying Republican Party and given it the coveted label of the "Party of Change" running against Wall Street.

Some politicians are hoping that the effect of Massachusetts has been an oxymoron, a "fortuitous calamity" in the form of a wake-up call to Washington. The question is, will the party be able to drag Mr. Obama away from the Corporate Democrats? This is the setting for what must certainly be a hastily rewritten State of the Union message. Instead of celebrating a Republican- and Lieberman-approved health care bill, Mr. Obama finds himself obliged to respond to voters who celebrated his first anniversary in office by choosing a Republican as their designated voice for change. That was supposed to be his line.

My reading of last week's election is that voters who felt duped by Mr. Obama's promise as a reform candidate did not really turn Republican, but at least they could throw out the Democrats for failing to make a credible start fixing the debt-strapped economy. The President has begged the banks to start lending again. But this means loading the economy down with yet more debt. The $13 trillion bailout was supposed to help them do this, but they have simply taken the money and run, paying it out in bonuses and salaries, stepping up their lobbying efforts to buy Congress, and buying out other banks to grow larger and increase their monopoly power.

The contrast between Wall Street's recovery and the failure of the "real" economy to recover its employment and consumption levels has enabled Republicans to depict Mr. Obama and his party as stalling against financial reform. Instead of fulfilling his election promise to become an agent of change, the past year has seen a continuity with the widely rejected Bush policies. Even the personnel remain the same. Over the weekend, Mr. Obama reiterated his endorsement for reappointing Helicopter Ben Bernanke as Federal Reserve Chairman.

As ex officio lobbyist for high finance, Mr. Bernanke's money drop seemed to land only on Wall Street. Now that it has emptied out the government's credit in an unparalleled deficit, Mr. Obama is saying, "No more. I'm drawing the line. No further deficit." There goes any hope for stimulating the "real" economy. Treasury apparatchik Tim Geithner, backed with his armada of administrators on loan from Goldman Sachs, is unlikely to support indebted labor, consumers or their companies in any way that does not benefit Wall Street first.

Even worse has been Mr. Obama's rehabilitation of Clinton Rubinomics deregulator Larry Summers as chief advisor, sidelining Paul Volcker until he was hurriedly flown back from political Siberia, as if to soften the leak by the Wall Street Journal on January 15 that Mr. Obama and the Democrats were not unhappy to see Elizabeth Warren's Consumer Financial Products Agency die stillborn, despite Mr. Obama promise that the agency was "non-negotiable."

Democrats insist that politics had nothing to do with the timing of Mr. Obama's 180-degree turn and sudden infusion of passion for the "Volcker rule" to re-separate commercial banking from its casino capitalist outgrowth. The photo-op with Mr. Volcker was intended to provide at least a semblance of regulation of the sort that was normal before Mr. Summers and other Clinton-Gore era "Democratic Leadership Committee" operatives had backed Republicans to repeal Glass-Steagall. They are now back in the White House, and the Democrats have failed every litmus test involving finance, insurance and real estate – the FIRE sector, which remains the major campaign contributor and lobbyist for both parties.

Democrats up for re-election this November are jumping ship. On Friday, within just 72 hours of the Massachusetts vote, Barbara Boxer and other Democrats on the Senate Finance Committee came out against reappointing Mr. Bernanke. Republican leaders already had taken a head start on opposing him. Still, many Democrats have found enough born-again populism to sacrifice Mr. Bernanke, and perhaps Messrs. Summers and Geithner as well.

It is bad enough that Mr. Obama has not joined in the criticism of Mr. Bernanke for having refused to regulate mortgage fraud or slow the bubble economy even when the law required him to do so. And it is bad enough that Mr. Bernanke has been so willfully blind as to deny that the Fed was fueling the Bubble with low interest rates and a refusal to regulate fraud. What he calls the "free market" is what many consider to be consumer fraud.

The widening public perception of Mr. Obama's first year as being a Great Continuity with the Bush Administration has enabled Republicans to position themselves for this year's mid-term elections – and 2012 – by reminding voters how they opposed the bank bailout back in September 2008, when Mr. Obama supported it. Now that support for Wall Street has become the third rail in American politics, they may appoint a standard bearer who voted against the bailout.

This is ironic. George W. Bush ran for president saying: "I'm a uniter, not a divider," and proceeded to divide the country (needing only 50 Senate votes plus the Vice Presidential tie-breaker to do it). Mr. Obama promised change, but then decided that he wants to be bipartisan (and insisting that he needs 60 votes; many are asking whether, if he had them, he then would say that he needed 90 votes to get the Baucuses and Bayhs, Liebermans and Boehners on board for his promised change). On Tuesday he is scheduled to invite Republicans to participate in a joint committee on the budget deficit – to get Republicans on board for tax increases to finance future giveaways to their mutual Wall Street constituency. They probably will say "no." This should enable him to make a clean break. But then he would not be who he is.

For opportunists in both parties, the trick is how to wrap pro-Wall Street policies in enough populist rhetoric to win re-election, given that the FIRE sector remains the key source of funding for most political campaigns. The contrast between rhetoric and policy reality is the basic set of forces pulling Wednesday's State of the Union address this Wednesday – and for the next two years. The real question is thus whether Mr. Obama's promise to make an about-face and back financial reform will remain merely rhetorical, or actually be substantive?

Putting Mr. Obama's speech in perspective

Spending a year hoping to get Republicans to sign onto health care almost seems to have been a tactic to give Mr. Obama a plausible excuse for stalling rather than to address what most voters are mainly concerned about: the economy. Subsidizing the debt overhead and the debt deflation that is shrinking markets and causing unemployment, home foreclosures and a capital flight out of the dollar has cost $13 trillion in just over a year – more than ten times the anticipated shortfall of any public health insurance reform or an entire decade of the anticipated Social Security shortfall.

Not only are voters angry, so are the community organizers and Mr. Obama's former Harvard Law School colleagues with whom I have spoken. Instead of providing help in slowing the foreclosure process or pressuring banks to renegotiate, his solution is for the Fed to flood the banking system with enough money at low enough interest rates to re-inflate housing prices. What Mr. Obama seems to mean by "recovery" is that consumers once again will be extended Bubble-era levels of debt to afford housing at prices that will rescue bank balance sheets.

It is an impossible dream. American workers now pay about 40% of their take-home pay on housing, and another 15% on debt service – even before buying goods and services. No wonder our economy has lost its export markets! Debts that can't be paid, won't be.

The moral is that the solution to any given problem – in this case, how to make Wall Street richer by debt leveraging – creates a new problem, in this case bankruptcy for high-priced American industry. The cost of living and doing business is inflated by high financial charges, HMO and insurance charges, and debt-inflated real estate prices. This has made Mr. Obama's Wall Street constituency richer, but as the Chinese proverb expresses the problem: "He who tries to go two roads at once will get a broken hip joint."

Banks have not paid much attention to Mr. Obama's urging them to renegotiate bad mortgages. Their profits lie in driving homeowners out of their homes if they do not stay and fight. What is needed is to help debtors fight against junk mortgages issued irresponsibly beyond their reasonable means to pay.

When homeowners do fight, they win. In Cambridge, Massachusetts, I spoke to community leaders who organized neighborhood protests blocking evictions from being carried out. I spoke to lawyers advising that victims of predatory mortgages insist that the foreclosing parties produce the physical mortgages in court. (They rarely are able to do this.) These people feel they are getting little help from Washington.

And last Friday, Nomi Prins, Bob Johnson and other financial insiders voiced fears that the "Volcker Rule" separating commercial banking from casino derivatives gambling will end up being gutted by so many loopholes (such as letting banks write their contracts out of their London branches) that it will end up merely rhetorical, not substantive. Financial lobbyists have the upper hand in detoothing and disabling attempts to reduce their power or even to enact simple truth-in-lending laws.

Two opposing lines of advice to Mr. Obama

Over the weekend Sen. John McCain suggested that Mr. Obama should reach out to Republicans in his State of the Union address. Bush advisor Karl Rove advised him to move to "the center" – what most people used to call the right wing of the spectrum. The Republicans blame Mr. Obama's deepening unpopularity on his alleged move to the left.

It is more realistic to say that he has been perceived as being too little for change, too centrist while the economy is polarizing. It certainly seems unlikely that he will now turn on his FIRE-sector backers. His plan is that real estate prices can be re-inflated on enough credit – that is, enough more mortgage debt – to enable the banks to work out of the negative equity position into which their loan portfolios and investments have fallen.

The inherent impossibility of this plan succeeding is the main problem that we may expect from this Wednesday's State of the Union address. Mr. Obama will promise to cut taxes further for working Americans, but his financial policy aims at raising the cost of their housing, their debt service and the cost of buying pensions. Some trade-off!

America's debt overhead exceeds the means to pay. Rhetoric alone cannot solve this problem, even when delivered with Mr. Obama's rhetorical élan. Its solution requires a policy alternative more radical than his current advisors are willing to accept, because the inevitable solution must be to write down debts to reflect the capacity to pay under today's market conditions. This means that some banks and creditors must take a loss.

In the 2008 election campaign, Rep. Dennis Kucinich kept spelling out precisely what law he had introduced to Congress to effect each change he proposed. Mr. Obama never descended to this concrete level. But after spending a year treading water, he now must be asked to do so.

For starters, the litmus test for commitment to change should be to rapidly push through the Consumer Finance Protection Agency while the Democrats still have their political Viagra fillip from last Tuesday – and before Wall Street lobbyists wield their bankrolls.

There is talk in the press about the Democrats not even pressing forward with the Consumer Financial Protection Agency. The argument is that if they can't get their health care plan by the Senate in the face of HMO and drug company lobbyists, what chance do they have when it comes on to taking on predatory Wall Street lenders?

It is a false worry – or even worse, an excuse to continue doing nothing. Republicans were able to mobilize populist opposition to the health-care bill by representing it as adding to the cost of relatively healthy young adults forced into the arms of the HMO monopolies. But it is much harder for the Republicans to buck financial reform and still strike their pose as opposing Wall Street. Proposing strong legislation against Wall Street will force politicians of both parties to show their true colors. If they don't jump on board the best and most popular law the Democrats can draw up, they will lose their ability to pose. And what is populist politics these days without such a pose?

If the Democrats do not force the debt reform issue, we must conclude that they don't really want financial restructuring. This is what Celinda Lake, pollster for the losing Democratic senate candidate last Tuesday, found that most voters believed to be the case: "When six times more people think that the banks benefited from the stimulus than working families, you've got a problem. And it's not just a problem with what Martha Coakley did in her campaign"[1] she wrote in her day-after report. "Voters are still voting for the change they voted for in 2008, but they want to see it. And right now they think they've got economic policies for Washington that are delivering more for banks than Main Street."

Mr. Obama needs to signal a change of heart by replacing his failed deregulatory-era trio of Summers, Bernanke and Geithner with advisors who will focus more on the "real" economy than on Wall Street's shadow economy.

I don't see him doing this. I will discuss how to pierce what I expect to be Wednesday evening's rhetorical fog in Part II of this article tomorrow.2,370 words

Note

[1] "Pollster Lake attacks WH for Coakley," *Huffington Post*, January 21, 2010,

http://www.huffingtonpost.com/2010/01/19/coakley-pollster-defends_n_428600.html

---