London Banker: “The market has failed, and officialdom is perpetuating that failure.”

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Ever since the two Bear Stearns hedge funds defaulted 17 months ago triggering a global financial crisis, the Federal Reserve has been busy putting out one fire after another. Fed chief Ben Bernanke has slashed interest rates to .25 percent, handed out billions in emergency funding to teetering insurance companies and mortgage lenders, and provided $8.3 trillion in loan guarantees to keep the financial system from collapsing. Unfortunately, nothing the Fed has done has either stabilized the markets or stopped the contagion from spreading to the broader economy where consumer spending has fallen sharply, unemployment has skyrocketed, manufacturing has slipped to a 30 year low, and housing prices have plummeted. Bernanke, the Princeton academic who is an expert on the Great Depression, is limited in his understanding of the crisis by his “monetarist” bias. He believes that the only way to fight credit contraction is by flooding the financial system with liquidity (“quantitative easing”). But this remedy focuses more on reducing the symptoms rather than curing the disease. Christopher Wood sums it up in an article in the Wall Street Journal article “The Fed is Out of Ammunition”:

“The origins of the modern conventional wisdom lies in the simplistic monetarist interpretation of the Great Depression popularized by Milton Friedman and taught to generations of economics students ever since. This argued that the Great Depression could have been avoided if the Federal Reserve had been more proactive about printing money. Yet the Japanese experience of the 1990s — persistent deflationary malaise unresponsive to near zero-percent interest rates — shows that it is not so easy to inflate one’s way out of a debt bust.”

Bernanke’s strategy may provide some temporary relief, but it won’t fix the underlying problems. The debts will have to be brought forward and written off, insolvent institutions will have to be shut down, indictments will have to be served to those who defrauded investors, and transparency will have to be reestablished. Bernanke and his colleagues at the US Treasury believe they can bypass these confidence-building measures by simply opening the liquidity-valves and waiting for the economy to come charging back to life, but it won’t work. Liquidity is not credibility and it’s the lack of credibility that has investors racing for the exits.

Last week, the yield on the 3 month Treasury went negative, which is to say, the buyer of the bond would actually lose money at the date of maturity. So, why would an investor buy a T-bill for $100 when he knew he would only get $99 back?

Fear; pure, unadulterated fear. The same fear that has pushed 30 year Treasurys to historic

lows, kept the VIX "the fear gauge" in the stratosphere for months on end, and sent global stock markets into the biggest swoon since the 1930s. Bernanke's liquidity injections don't address the panic that has spread from the trading pits to every hearth and hamlet across the country where the tremors from the credit crunch are now being felt.

The problem isn't just money either, but how quickly the money is turned over. The Fed has increased the money supply at an unprecedented pace and expanded its balance sheet to $2.25 trillion, but velocity is down. Activity in the secondary markets has slowed to a crawl. Wall Street is leading the economy into recession. In 2005 through 2007, nearly 60 percent of the banks revenues came from securitized loans, that is, loans that were passed on to the big investment banks where they were repackaged and sold to foreign investors and hedge funds as securities. According to the Wall Street Journal, " the issuance of nonagency mortgage-backed securities (MBS) in America has plunged by 98% year-on-year to a monthly average of $0.82 billion in the past four months, down from a peak of $136 billion in June 2006. There has been no new issuance in commercial MBS since July. This collapse in securitization is intensely deflationary."

This point is usually ignored by the pundits. Securitization increased velocity which added significantly to GDP, but that part of the market is now frozen–the investment banks are gone and the hedge funds are in distress–and the commercial banks are not capable of making up the difference. That means credit will continue to contract no matter what the Fed does. The recession will be long and deep.

Obama's economic team has signaled that they will try to revive consumer spending with a gigantic $1 trillion stimulus package. But $1 trillion barely covers the $800 billion that homeowners withdrew in home equity in 2007 alone. (Today home equity withdrawals have nearly disappeared altogether) But stimulus doesn't deal with the deeply-rooted problems either; its just another band-aid for a sucking chest wound. Besides, as chief blogger at Naked Capitalism points out, it is unlikely that economist John Maynard Keynes would have approved of the stimulus which Obama is championing:

"Now to my doubts about the proposed remedies, namely monster stimulus and monetary easing. First, as mentioned before, the analogy is to the US in the Depression, which we have said repeatedly before is questionable. The US in the 1920s was the world's biggest creditor, exporter, and manufacturer. Our position then is analogous to China's now. Indeed, Keynes in the 1930s urged America to take even more aggressive measures, and argued that it was not reasonable for the US to expect over-consuming, debt-burdened countries like the UK and France to take up the demand slack. So even though most economists are invoking Keynes, it isn't clear he'd prescribe such aggressive stimulus for the US and UK now."

Treasury Secretary Timothy Geithner and presidential adviser Lawrence Summers believe they can fire off a massive stimulus salvo and put the economy back on track, but it will take more than that. The financial system needs fundamental structural reform and both men rose to power because they proved themselves loyal defenders of the status quo. Geithner and Summers may nibble at the edges and make grandiloquent proclamations about rebuilding the system, but when its time to pull the trigger, they will subvert every attempt to regulate or oversee the system which they feel is the sole province of the establishment elites who own the big financial institutions. There's bound to be plenty of blasting trumpets and celebratory confetti to greet Obama's economic whiz kids. Just don't

expect change. Barring a complete economic meltdown, the rot at the heart of the system will continue to fester and grow under Obama just as it did under Bush and Clinton.

How can one maintain a free market system when financial institutions are not allowed to fail?

And how can such a system function properly without stop signs, guard rails, speed limits or rules that determine what side of the road one can drive?

And how can confidence be strengthened when no one pays for predatory lending, ratings manipulation, malfeasance, fraud, or any other white collar crime? So far, not one indictment has been served in the biggest financial swindle of all time. That's not how a "rules-based" system is supposed to operate.

Meanwhile, the economy continues to deteriorate faster than anyone expected. Companies are cutting back on investment, slowing production and laying off workers. Corporations are unable to finance ongoing operations or expansion because of widening spreads on corporate bonds. The volume of debt issued around the world plunged by 75% in the last three months, according to the Bank for International Settlements (BIS). "Net issuance of bonds and notes by corporations, financial institutions and governments fell to 247 billion dollars (195 billion euros) from 1.086 trillion dollars in the second quarter." US households have begun paying down debt for the first time since the Fed kept records in 1952, another setback for an economy that depends on consumer spending for 72 percent of GDP. Also, the unemployment rolls have surged by 573,000 in November, creating 1.5 million jobless in the last 6 months. All of the economic data, including reinvestment and earnings, is showing weakness while asset prices across the spectrum–stocks, real estate and commodities–continue to lose altitude. The prospects for a quick recovery are slim to none.

Undeterred by the pervasive signs of deflation, Bernanke is planning even bolder moves to stimulate spending and get credit flowing through the system. The Central Bank is purchasing securitized debt from Fannie Mae and Freddie Mac, buying $200 billion of credit card and student loans from finance companies, and has stated its intention to buy US Treasurys to keep long-term interest rates artificially low. Buying Treasurys is the equivalent of trying to cover a bank overdraft by issuing a check to oneself. This is the point at which monetary policy and lunacy intersect. Nevertheless, the scholarly Fed master is convinced that with a little ingenuity and a well-oiled printing press, success is certain.

The economic headwinds Bernanke is facing are ferocious. Consumer debt is at an all-time high, more than $13 trillion. And, as journalist Stephen Lendman notes, "As a per cent of GDP, total credit market debt is now double its 1929 level at about 350%." We have reached peak credit, a tipping point where consumers are forced to curtail spending and hunker-down for leaner times. The conventional strategy of pump-priming with low interest credit or stimulus checks from Uncle Sam will only soften the blow from the hard landing ahead. The fear of job loss, insolvency and even destitution is gnawing away at the psyche of maxed-out consumers. Hardship is reshaping attitudes towards spending. Bernanke's "zero down", "no doc", "adjustable rate" easy money is out of step with the times. Profligate consumption is no longer cool. With Housing prices crashing and the Dow Jones on track for its worst year since the Great Depression, people are no longer feeling flush. In fact, tumbling property values have chopped a hefty $4 trillion from household balance sheets already while wages have continued to stagnate.

The Fed's persistent price-fixing and market interventions can only succeed as long as there's a reliable pool of speculators willing to borrow capital and put it to work to turn a profit; that's the basic premise of bubblenomics. With the financial system deleveraging, the broader economy contracting, and commodities, stocks and housing flat-lining; there are fewer and fewer opportunities for even the most risk-tolerant investor. That's why Bernanke is planning to force-feed credit into the system via untested methods that, many believe, will engender Weimer-like hyperinflation when the recession winds down. If the economy kicks in faster than Bernanke figures, he'll have to mop up $8.3 trillion of liquidity or watch while the dollar gets torn to shreds.

For now, the problem is deflation; steadily falling asset prices which are shrinking profits, increasing layoffs and forcing fire sales of distressed assets. As unemployment soars, aggregate demand falls even more, causing a vicious downward cycle. Once deflation becomes entrenched–as Japan discovered during its "lost decade" in the 1990s—it becomes more difficult to eradicate. Between 1994 to 1999, Japan initiated 7 stimulus packages which amounted to hundreds of billions of dollars. All of them failed to restart the flagging economy. According to the Wall Street Journal: "Only in this decade, with a monetary reflation and prime minister Junichiro Koizumi's decision to privatize state assets and force banks to acknowledge their bad debts, did the economy recover."

By allowing the banking giants to conceal their mountainous debts, Bernanke and Paulson are following the same spotty path to disaster creating a zombie financial system that depends on regular infusions of state largess to maintain operations and avoid liquidation. It's a lose-lose situation.

The latest essay by London Banker, "Deflation has become Inevitable", has been widely circulated on the Internet, but is worth reprinting here to underline the glaring and, perhaps, fatal flaws in Bernanke's thinking:

"For a while now I have been on the fence on the inflation/deflation issue …. I'm now coming down on the side of deflation for a very simple reason: there is no longer any incentive to save or invest, and so debt and investment cannot increase much beyond current bloated levels….

The determination to avoid any accountability for failed banks, failed business models, failed regulatory systems and failed academic rationales for all the above invites anyone with spare cash – an increasingly select crowd – to withhold it from further depredations. It is this instinct, more than confidence in the government, which is driving so many to seek the temporary safety of short-dated government securities.

The result of discouraging domestic and foreign creditors and investors must be inevitable deflation as debt levels become increasingly hard to finance and ultimately contract. Irresponsible central banks and governments can try to bail out the failed banks, businesses and municipalities at the centre of every popped bubble, but the bubble economies are ever more certain to deflate with each bailout. Each bailout further undermines the market discipline which is bedrock to a saver or investor's decision to part with hard-earned cash by trusting it to the intermediation of the management of a bank or business.

It's this simple: I won't invest in a country that bails out failure and punishes savers. I won't invest in the US or UK until they change course and protect savers and investors, ensuring a reasonably predictable positive return.

It is now clear to me that policy makers in the West are determined to apply every available resource to underpinning failure, misallocation and executive excess. As this discourages the honest saver from parting with cash, policy makers are ensuring that deflation will wreak its havoc on the financial and real economies of the world. Only when that deflation has played out and rational policies that reward market-based management and returns are restored will it be worthwhile to invest again. In the meanwhile, any wealth saved securely from state seizure will "swell" to buy more assets in future – a key aspect of deflation and a key means of restoring the control of the economy into the hands of more farsighted savers and investors.

Some day soon savers will revolt at financing further depredations. They will refuse to buy even government securities, gagging at the quantities of issue forced upon them under terms of only negative return. When that final massive bubble bursts, deflation will follow its harsh corrective course and clean out deficit-financed "unproductive works".

The market has failed, and officialdom is collaborating in perpetuating that failure." (London Banker)

Well said.

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