More Red Flags for the Economy

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Bonds are signaling that the recovery is in trouble. The yield on the 10-year Treasury (2.97 percent) has fallen to levels not seen since the peak of the crisis while the yield on the two-year note has dropped to historic lows. This is a sign of extreme pessimism. Investors are scared and moving into liquid assets. Their confidence has begun to wane. Economist John Maynard Keynes examined the issue of confidence in his masterpiece "The General Theory of Employment, Interest and Money". He says:

"The state of long-term expectation, upon which our decisions are based, does not solely depend, therefore, on the most probable forecast we can make. It also depends on the confidence with which we make this forecast — on how highly we rate the likelihood of our best forecast turning out quite wrong….The state of confidence, as they term it, is a matter to which practical men always pay the closest and most anxious attention."

Volatility, high unemployment, and a collapsing housing market are eroding investor confidence and adding to the gloominess. Economists who make their projections on the data alone, should revisit Keynes. Confidence matters. Businesses and households have started to hoard and the cycle of deleveraging is still in its early stages. Obama's fiscal stimulus will run out just months after the Fed has ended its bond purchasing program. That's bound to shrink the money supply and lead to tighter credit. Soon, wages will contract and the CPI will turn from disinflation to outright deflation. Aggregate demand will weaken as households and consumers are forced to increase personal savings. Here's how Paul Krugman sums it up:

"We are now, I fear, in the early stages of a third depression….And this third depression will be primarily a failure of policy. Around the world … governments are obsessing about inflation when the real threat is deflation, preaching the need for belt-tightening when the real problem is inadequate spending. … After all, unemployment — especially long-term unemployment — remains at levels that would have been considered catastrophic not long ago, and shows no sign of coming down rapidly. And both the United States and Europe are well on their way toward Japan-style deflationary traps.

I don't think this is really about Greece, or indeed about any realistic appreciation of the tradeoffs between deficits and jobs. It is, instead, the victory of an orthodoxy that has little to do with rational analysis, whose main tenet is that imposing suffering on other people is how you show leadership in tough times." ("The Third Depression", Paul Krugman, New York Times)

More than 8 million jobs have been lost since the beginning of the crisis, but President Barack Obama has made no attempt to initiate government work programs or even a second stimulus. Government spending must increase to make up for the slack in demand

and reduce unemployment. That means larger budget deficits until households have patched their balance sheets and can spend again at pre-crisis levels.   Withdrawing stimulus now, while the economy is still weak, will crimp spending, collapse state tax revenues and send unemployment skyrocketing. Here's an excerpt from an article by James K. Galbraith which helps to explain what's needed to get back on track:

"The only way to reduce a deficit caused by unemployment is to reduce unemployment. And this must be done with a substantial component of private financing, which is to say by bank credit, if the public deficit is going to be reduced. This is a fact of accounting. It is not a matter of theory or ideology; it is merely a fact. The only way to grow out of our deficit is to cure the financial crisis.

To cure the financial crisis would require two comprehensive measures. The first is debt restructuring for the entire household sector, to restore private borrowing power. The second is a reconstruction of the banking system, effectively purging the toxic assets from bank balance sheets and also reforming the bank personnel and compensation and other practices that produced the financial crisis in the first place. To repeat: this is the only way to generate deficit-reducing, privately-funded growth and employment.

To be clear: unemployment can be cured without private-sector financing, if public deficits are large enough — as was done during World War II. But if the objective is to reduce public deficits, for whatever reason, then a large contribution from private credit is essential.

One more time: without private credit, deficit reduction plans through fiscal austerity, now or in the future, will fail. They cannot succeed." (James K. Galbraith, "Why the Fiscal Commission does not serve the American People", New Deal 2.0)

The economy cannot grow without private sector credit expansion. But the banks are constrained by toxic assets and the lack of creditworthy loan applicants. At the same time, deleveraging households and consumers are less inclined to borrow at any rate. Retirement age "boomers" have lost nearly $12 trillion in net wealth since the crisis began and must save for the years ahead. They are no longer in a position to spend freely figuring that their home equity will rise 10% or 15% per year creating a cushion for the future. Those days are over. Bond yields are telling us that retail investors have lost faith in the housing and equities markets and moved their savings into the most risk adverse, low-yielding, assets available—US Treasuries. Here's what Keynes said on the topic:

"Our desire to hold Money as a store of wealth is a barometer of the degree of our distrust of our own calculations and conventions concerning the future…. The significance of this characteristic of money has usually been overlooked; and in so far as it has been noticed, the essential nature of the phenomenon has been misdescribed. For what has attracted attention has been the quantity of money which has been hoarded… supposed to have a direct proportionate effect on the price level through affecting the velocity of circulation. But the quantity of hoards can only be altered either if the total quantity of money is changed or if the quantity of current money income (I speak broadly) is changed; whereas fluctuations in the degree of confidence are capable of… modifying… the premium which has to be offered to induce people not to hoard. And changes in… liquidity preference… affect, not [consumer] prices, but the rate of interest…." (John Maynard Keynes, "1937 Quarterly Journal of Economics")

So hoarding reduces spending which leads to economic contraction. But behavior can be altered by changing incentives, raising incomes or restoring confidence. Keynes was less sanguine about increasing the money supply which he compared to “trying to get fat by buying a larger belt”. The point is to increase consumption, which means that money has to get in the hands of the people who will spend it to grow the economy. Bank reserves alone won’t do the trick. Fiscal stimulus is the way to go.

Presently–according to data collected by the Federal Reserve– companies are hoarding capital due to the lack of investment opportunities. High unemployment has led to falling demand which is stifling investment. As households cut back, more companies will opt to pay down debt rather than seek new investments. (which is what happened in Japan) This will cause a dropoff in economic activity and deepen the slump. The government must increase the deficits to offset cuts in state and private sector spending and to avoid another excruciating cycle of debt deflation.

The economy is at a tipping point. Unemployment has flattened out at 9.5%, but 650,000 discouraged workers have stopped looking for work altogether which will add to the slowdown. The cash-strapped states are laying off and furloughing workers in droves. The rate of underemployment has soared to 16.5%. There are 6 applicants for every new job created. Conservatives believe that the ongoing crisis creates a unique opportunity to crush the labor movement and to force down wages. Republican senators and congressmen have quashed a bill that would extend unemployment benefits to over a million workers. Apart from the appalling cruelty of the action, GOP obstructionism only adds to deflationary pressures. It is an entirely counterproductive move.

Nomura economist David Resler says that congress’s action will have an immediate and damaging effect on the economy and could trim GDP by 0.2 percentage point this quarter and by 0.4 point in the period from July through September. (Bloomberg) Republicans are precipitating a crisis to garner support in the upcoming midterm elections, but they may not fully appreciate the knock-on effects of their vote. Here’s a clip from economist Steven Keen who sheds a bit of light on the topic:

“The final debt-driven collapse, in which both wages and profitability plunge, gives the lie to the neoclassical perception that crises are caused by wages being too high, and the solution to the crisis is to reduce wages….

What their blinkered ignorance of the role of the finance sector obscures is that the essential class conflict in financial capitalism is not between workers and capitalists, but between financial and industrial capital. The rising level of debt directly leads to a falling worker share of GDP, while leaving industrial capital’s share unaffected until the final collapse drives it too into oblivion.” (Steve Keen’s Scary Minsky Model, Yves Smith, Naked Capitalism)

So, yes, in the short-term, falling wages may seem desirable for management, but in the long-term, it could trigger an industrywide collapse.

The FOMC’s June statement was a real stunner. The economy is losing-ground in nearly every area. Household and business spending, bank lending and home sales are all either slowing down or falling sharply. The Commerce Dept. revised its first quarter estimate of GDP from 3.0% to 2.7% due to lower than expected consumer spending. The recovery is largely a mirage created by inventory adjustments and fiscal stimulus. 46 of the 50 states are mired in huge deficits that will require substantial cuts to balance. That will be a drag on activity going forward. This is from Bloomberg News:

"States face a cumulative budget gap of $127.4 billion as 46 prepare for the start of their fiscal year on July 1, according to a report this month by the National Governors Association and the National Association of State Budget Officers. They will have to fill that hole largely on their own, as aid from the federal government under programs including President Barack Obama's $787 billion stimulus package starts to wind down.

State and local governments will have to dismiss 162,000 workers if Congress fails to extend about $24 billion of Medicaid payments, Lawrence Mishel, president of the Economic Policy Institute in Washington, said during the governors' call. Payrolls have already registered 11 straight months of year- over-year declines, the longest stretch of continuous drops since 1983, based on Labor Department data." (Bloomberg)

State budget cutting will swell the unemployment lines and slow consumer spending. With fiscal stimulus quickly running out and the deficit hawks pushing for greater austerity, the Fed will be forced to intervene in the 4th quarter resuming its quantitative easing bond purchasing program to pump more liquidity into the financial system. The recovery is not self sustaining.

In Europe, the situation is even worse. ECB head Jean-Claude Trichet has been preaching austerity while conducting a massive stealth bank bailout, providing limitless funds in exchange for dodgy collateral, overnight deposits for wary banks that no longer trust the repo market, and bond purchases of sovereign debt that is vastly overpriced given the fiscal position of the issuers. Germany is calling for additional belt tightening across the eurozone to protect against fictitious inflation. German policymakers don't understand that their trade surpluses translate into deficits in the Club Med nations, or that their solutions will only exacerbate existing imbalances, increase the budget deficits, and put the EU on course for another contraction. Here's an excerpt from the Wall Street Journal:

"Germany's unwillingness to accept higher domestic levels of inflation in order to alleviate the burden of debt elsewhere in the euro zone ultimately constrains the European Central Bank in how much it can do on the monetary side….

… governments already nursing fragile financial sectors are being forced into some of the most severe austerity programs ever planned in modern developed economies at a time of rigid monetary policy.

If policy goes through as planned, a severe depression is almost certain to follow across peripheral euro-zone countries and a significant downturn elsewhere across the continent. Even European countries with power over their own monetary policy are bound to suffer from a euro-zone slump." ("Euro-Zone Policy Sets Stage for Depression", Allen Mattick, Wall Street Journal)

After Lehman Bros. collapsed in September 2008, the world was pulled back from the brink of depression by an activist Federal Reserve that (arbitrarily) assumed the authority of congress and conducted a massive rescue operation that provided unlimited liquidity and government support for teetering financial institutions. And, while the Fed's uneven treatment of Wall Street has been widely criticized, (the banks have been allowed to carry on much as they had before) the precipitous slide into the abyss was halted. Now, congress seems eager to reverse that achievement for fleeting political gain.

It's important to understand the process so we can settle on a remedy. Economist Bradford DeLong explains what's going on with the economy in greater detail and why it would be a mistake to count on the so-called "self correcting" power of the market rather than government intervention. (additional fiscal stimulus) Here's an excerpt from DeLong's blog "Grasping Reality With Both Hands":

In our normal, microeconomic world it is not a big deal when excess demand emerges in one market and excess supply emerges in another…..But in macroeconomics things are different. The excess supply is economy-wide–throughout all commodity markets, producing supply in excess of demand for goods, services, labor, and capacity. Producers and entrepreneurs respond to an aggregate demand shortfall just as individual producers respond to a particular shortfall of demand for their products: they hold sales to liquidate inventories, they cut prices, they cut wages to try to preserve margins, they fire workers.

Thus workers fall into unemployment from the excess supply in the goods and services industries….

Wages should then fall. And when wages fall higher profits should induce employers to expand production even without any increase in spending. Eventually wages should fall low enough that the economy returns to full employment and to normal levels of production and capacity utilization even without any increase in asset supplies. Or will it? Falling wages means that households have even less money. Some of them will default on their loans. Some banks will find that their reserves are no longer large enough to provide an ample cushion because of these loan defaults……..

Relying on nominal deflation of wages to restore full employment runs the risk of creating yet another shock of excess demand in finance and excess supply in goods and services to deepen the depression. The hoped-for cure's first effect is to worsen the disease.

We trust the market to take care of a microeconomic excess-demand excess-supply situation in a few industries in a productive way in a short period of time. Do we trust the market to do the same way to a macroeconomic imbalance, to quickly resolve a depression in a productive way without help? No, we do not. Rather than relying on economy-wide deflation to eventually restore balance, we should pursue other alternatives." ("Microeconomic and Macroeconomic Excess Supply", J. Bradford DeLong, Grasping Reality With Both Hands)

True, in some perverse sense, the market is "self correcting", but in this case, it would take years, if not decades, of high unemployment, overcapacity, dwindling investment and social unrest to put the ship aright. Are we ready for that? The preferable solution is to plug the regulatory holes that allow financial institutions to speculate in massively-leveraged instruments (that have implicit government guarantees), and promote income growth so the supply/demand balance that is essential to economic growth is restored. The way out of this mess is through more jobs and better pay. But that will take a mass mobilization of working people and whopping big deficits.

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