Things Could Get Ugly Fast

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Things could get ugly fast. With the Democrats backing-off on a second round of stimulus, the Fed signaling an end to quantitative easing, and Obama moaning about rising deficits; there's a good chance that the stumbling recovery could turn into another sharp plunge. Bank lending is shrinking, consumers spending is off, housing prices are falling, unemployment is soaring and the wholesale credit markets are in a shambles. This isn't the time to slash government support in the name of "fiscal responsibility". Obama needs to ignore the gloomsters and alarmists and pay attention to the Nobel laureates like Joe Stiglitz and Paul Krugman. They're the guys who know how to steer the ship to safe water.

But there are troubling signs that Obama has joined the ranks of the deficit hawks and is planning a policy-reversal that will pitch the economy into a nosedive. Here's what he said on his tour through Asia:

> "I think it is important to recognize if we keep on adding to the debt, even in the midst of this recovery, that at some point, people could lose confidence in the U.S. economy in a way that could actually lead to a double-dip recession."

So it's true. Obama has aligned himself with the faux-prophets and dollar demagogues who think that the end is nigh. But trimming the deficits now (when they should be expanding) will lead to a viscous cycle of debt deflation that will push-down asset prices, increase defaults, force more layoffs, slow consumer spending, lower earnings and send the economy into a downward spiral. The president is paving the way to a double-dip recession, a slump that could be worse than the first.

Has Obama perused the jobless figures lately? Has he noticed the Fed shoving more than a $1 trillion under the collapsing housing market with no sign of improvement? Has anyone told our blinkered accountant-in-chief that the entire financial system is propped-up with $11.4 trillion of dodgy scaffolding that could buckle in the first big gust?

Obama has either taken leave of his senses or he's spending too much time listening to the cheerless Jeremiahs on the Internet. He needs break their spell and seek the counsel of the experts who get paid to crunch the numbers—real economists. Cutting government spending and raising taxes–the two ways that deficits are paid off–is the fast-track to disaster. Don't go there.

If Obama needs more proof that the economy is still flatlining, he should thumb through Fed chair Ben Bernanke's speech to the Economic Club of New York which was delivered on Tuesday. The presentation was a sobering snapshot of lingering depression with precious few glimmers of light. Here's an excerpt:

> "The flow of credit remains constrained, economic activity weak, and unemployment much too high. Future setbacks are possible….How the economy will evolve in 2010 and beyond is less certain….
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> Access to credit remains strained for borrowers who are particularly dependent on banks, such as households and small businesses. Bank lending has contracted sharply this year, and the Federal Reserve's Senior Loan Officers Opinion Survey shows that banks continue to tighten the terms on which they extend credit for most kinds of loans…
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> Household debt has declined in recent quarters for the first time since 1951. For their part, many small businesses have seen their bank credit lines reduced or eliminated, or they have been able to obtain credit only on significantly more restrictive terms. The fraction of small businesses reporting difficulty in obtaining credit is near a record high, and many of these businesses expect credit conditions to tighten further.
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> The demand for credit also has fallen significantly….Because of weakened balance sheets, fewer potential borrowers are creditworthy, even if they are willing to take on more debt. Also, write-downs of bad debt show up on bank balance sheets as reductions in credit outstanding. Nevertheless, it appears that, since the outbreak of the financial crisis, banks have tightened lending standards by more than would have been predicted by the decline in economic activity alone.
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> Many securitization markets remain impaired, reducing an important source of funding for bank loans. In addition, changes to accounting rules at the beginning of next year will require banks to move a large volume of securitized assets back onto their balance sheets. Unfortunately, reduced bank lending may well slow the recovery by damping consumer spending, especially on durable goods, and by restricting the ability of some firms to finance their operations.
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> The best thing we can say about the labor market right now is that it may be getting worse more slowly. (Fed Chairman Ben Bernanke Speech Before Economic Club of New York)

Is this really Bernanke speaking, or is the Fed chief channeling Roubini?

Okay, so credit is tight. Consumers aren't borrowing and banks aren't lending. Unemployment is rising and deflation is pushing down asset prices while the burden of personal debt is rising in real terms. Bleak, bleak, bleak. The only sign of improvement is that "things are getting worse more slowly". Now that's encouraging.

What the economy needs is a hefty dose of stimulus aimed at job creation and strengthening demand. Only the government can provide sufficient resources to rev up economic activity and put people back to work. Unfortunately, the TARP bailout soured the public on deficit spending due to the shabby (and possibly criminal) way it was handled. That will make it harder to do what is necessary. The political support for more stimulus on Capital Hill has vanished. But, without it, another hard landing is certain.

Despite rumors in the media, stimulus works. It speeds up recovery, minimizes unemployment and stops asset prices from overshooting on the downside. Here's an excerpt from "The effectiveness of fiscal and monetary stimulus in depressions" a scholarly analysis of stimulus by economist-authors Miguel Almunia, Agustin S. Benetrix, Barry eichengreen, Kevin O' Rourke, and Gisela Rua:

> "Where tried, fiscal policy was effective in the 1930s….The details of the results differ, but the overall conclusions do not. They show that where fiscal policy was tried, it was effective.
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> Our estimates of its short-run effects are at the upper end of those estimated recently with modern data….This is, in fact, what one should expect if one believes that the effectiveness of fiscal policy is greatest when interest rates are at the zero bound, leading to little crowding out of private spending. It is what one should expect when households are credit constrained by a dysfunctional banking system. Given similar circumstances in 2008, this underscores the advantages of using 1930s data as a source of evidence on the effects of current policy." (The effectiveness of fiscal and monetary stimulus in depressions" by Miguel Almunia, Agustin S. Benetrix, Barry eEchengreen, Kevin O' Rourke, and Gisela Rua, 18 November 2009 vox)

Stimulus works in multiple ways. It also helps increase inflation expectations which is necessary to get people spending again. In a deflationary environment, consumers shut-down and stop spending. The Fed tries to spur economic activity by convincing people that the dollars they hold will be worth less tomorrow. That's why Bernanke keeps pointing out that the Fed will keep rates at zero indefinitely. Regrettably, only the goldbugs take him seriously, which is why gold prices have zoomed to the stratosphere. Personal savings rates are still rising. There's been a sharp drop-off in consumption. Bernanke's psychological experiment has flopped. The masses still believe we're in recession. Without a gigantic fiscal expansion to jolt the economy out of its lethargy, the severe contraction could drag on for a decade or more. We're becoming Japan.

Obama's deficit cutting plan is madness. It offers no hope at all. It draws from the half-baked theories of amateur economists on the Net who think that massive liquidation and years of bitter retrenchment and high-unemployment are the path to recovery. They're wrong.