What is the Difference between a Depression and a "Slow Recovery"? Bernanke gets his "pink slip"

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Question: What is the difference between a full-blown Depression and an excruciatingly "slow recovery"?

Answer–Inventories and a bit of fiscal stimulus.

On Friday, The Bureau of Economic Analysis (BEA) reported that 3rd Quarter GDP rose by 2% meeting most analysts expectations. The real story, however, is hidden in the data. Inventories added 1.44 percentage points to the 3Q real GDP, which means that–absent the boost to existing stockpiles– GDP would be well-below 1%. If it wasn't for Obama's fiscal stimulus (ARRA), the economy would be sliding back into recession.

Improvements in consumer spending were too meager to indicate a "rebound", and residential investment dropped off sharply following the expiration of the firsttime homebuyer credit. The economy is in a coma and desperately needs more government support. But if Tuesday's midterm elections turn out according to predictions–and the GOP retakes the House of Representatives–there won't be any more stimulus. Instead, the economy will sputter along at a snail's pace until festering bank woes (this time, the foreclosure crisis) trigger another contraction.

There's no doubt now, that the Fed's efforts to engineer a sustained recovery have failed. The fact that Fed chairman Ben Bernanke is planning to resume his dubious Quantitative Easing (QE) program is an admission of failure. That said, I expect the Fed to "go large" on November 3, and purchase another $1.2 trillion of long-term Treasuries adding roughly $100 billion per month to the money supply. That should placate Wall Street and keep stock markets sufficiently "bubbly" for the foreseeable future. After 12 months of QE, unemployment will still be stuck at 10%, the output gap will have narrowed only slightly, and confidence in the Fed will have plunged to historic lows. Monetarism alone cannot fix the economy.

The fiscal remedies for recession are well known and have effectively implemented with great success for over a half century. QE is a pointless detour into uncharted waters. It is like treating a hangover with brain surgery when the bottle of aspirin sets idle on the bedstand. Why bother?

Bernanke is convinced that pouring money into the system will produce the results he wants. This is how the Fed chair pays homage to the great monetarist icon, Milton Friedman. Friedman had unwavering faith in the power of money. Here's what he said about Japan in

1998:

“The Bank of Japan can buy government bonds on the open market…” he wrote in 1998. “Most of the proceeds will end up in commercial banks, adding to their reserves and enabling them to expand…loans and open-market purchases. But whether they do so or not, the money supply will increase…. Higher money supply growth would have the same effect as always. After a year or so, the economy will expand more rapidly; output will grow, and after another delay, inflation will increase moderately.”

So, how would Friedman explain the fact that the Bank of Japan implemented many rounds of QE and came up snake-eyes—no measurable improvement at all? The economy is still in the grips of deflation nearly 20 years later. This is from Bloomberg today:

Government reports today reinforced signs of a worsening economy that indicate the Bank of Japan needs to do more, with September consumer prices and industrial production sliding more than forecast. Japan’s inflation-linked bonds signal investors don’t anticipate the nation will end deflation, with prices seen falling an average of about 0.78 percent in the next eight years.

“The BOJ is totally behind the curve,” said Junko Nishioka, chief economist at RBS Securities Japan Ltd. in Tokyo, who used to work at the central bank.

“Japan will likely need ‘helicopter money drops’ to ensure a full escape from the Great Deflation,” Citigroup Inc. Chief Economist William Buiter. (Bloomberg)

There won’t be any helicopters because that would provide money to ordinary working people rather than bankers and speculators. That’s a no-no. On top of that, the Bank of Japan is planning to purchase privately-owned securities as well as government bonds in its next phase of QE. That will keep asset prices artificially high and prevent stockholders and bondholders for taking losses on their bad bets. The program is designed to transfer the red ink onto the public in terms of a depreciating currency and years of needless agony.

Is there any doubt as to why Japan is still mired in a depression after all these years? When capital is diverted into broken financial institutions, personal consumption and private investment invariably suffer. The same rule applies to the Bernanke method. QE will prevent restructuring of debt for underwater banks, but hurt households and consumers by lifting commodities prices and perpetuating high unemployment.

In the next few months, jobless benefits will end for more than 1.2 million workers. QE will do nothing for them nor will the Republican-led House of Representatives which is already on the record as being opposed to emergency extensions. This is from the National Employment Law Project:.

“Of the 1.2 million workers at risk of losing federal benefits, 387,000 are workers who were recently laid-off and are now receiving the six months (26 weeks) of regular state benefits. After exhausting state benefits, these workers would be left to fend for themselves in a job market with just one job opening for every five unemployed workers and an unemployment rate that has exceeded nine percent for 17 months in a row—with no federal unemployment assistance whatsoever.”

At the same time, housing prices have resumed their downward plunge wiping out billions in home equity and leaving another 5 million homeowners facing the prospect of foreclosure.

Typically, personal consumption and housing lead the way out of recession. This time, the rebound was spurred by gigantic injections of fiscal and monetary stimulus, dodgy accounting practices (blessed by the SEC) and unlimited funding guarantees by the Central Bank. Now the stimulus is running low, the equities markets are tilting sideways, retail investors are exiting the markets in droves, wages are contracting, businesses are hoarding over $1 trillion (for lack of profitable outlets for investment), and deflationary headwinds are beginning to gust with increasing ferocity. So, what is Bernanke's remedy?

Rather than push for more fiscal "pump priming" so households can continue to pay-down debts and rebuild their savings, the Fed chair is planning to flood emerging markets with hot money, increasing currency volatility and forcing trade partners to clamp down on capital controls so they don't drown in the surge of greenbacks fleeing the US. He's merely adding to the turmoil.

MUDDLED POLICY IS EXTENDING THE SLUMP

This week, interest rates on 5-year inflation-protected bonds went negative for the first time while two-year Treasury yields set a record low. What does it mean? It means that investors are so utterly flummoxed that they're betting on inflation and deflation at the same time. No one really knows what the hell is going on because the policy is so muddled. And, when uncertainty grows, long-term expectations change and investment slows. QE is undermining the prospects for recovery. It's time to fire Bernanke.

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