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Green Shoots or Stinkweeds? Why economic recovery has not begun

Green Shoots or Stinkweeds?
 Why economic recovery has not begun
 By Jack Rasmus

In spring 2008, the investment bank Bear-Stearns had just been "rescued." Remaining banks were going to raise enough private capital to offset continuing losses and write-downs due to collapsing residential mortgages, i.e., the notorious subprimes. Earlier, Congress had just passed a \$165 billion stimulus bill. Rising unemployment had appeared to slow. Exports were still strong. Oil and commodity prices were experiencing a bubble in anticipation of future growth, it was argued.

Fast forward to spring 2009. The U.S. government's stress tests of the big 19 banks holding 70 percent of all assets in the banking system showed only a handful were in need of further assistance. Banks were once again raising sufficient private capital, it was noted, thus proving they were not insolvent. The Obama administration and Congress had again passed a stimulus bill, this time providing \$180 billion for 2009 in new government spending.

What follows is an explanation why the current economic crisis is not over, why Federal Reserve Chair Bernanke's talk of economic "green shoots" are more like financial stinkweeds and crabgrass, and why Obama's "glimmers of hope" may more resemble the flickering of a worn out light bulb before it goes permanently dark.

Ten Reasons Why the Economy Will Deteriorate

At the heart of the decline of the real economy are two primary forces which the Obama administration has hardly addressed to date: rising joblessness and continuing deterioration of the residential mortgage markets.

1. Twenty-two million jobless by year end 2009. With 7.1 million officially unemployed in December 2007, by November 2008, more than 10 million were jobless when properly calculated to account for the involuntary part-time underemployed, discouraged workers who had given up looking for jobs, but were not counted as officially unemployed, and other so-called marginally attached unemployed. Starting in November, mass layoffs at the rate of nearly 1 million a month, properly calculated, began to occur. By March 2009 in excess of 16 million were jobless. Then in April and May, government statistics reported unemployment losses had slowed, citing this as evidence a bottoming out, with recovery around the corner.

However, while officially only 539,000 new jobs were lost in April, the actual number was more than 700,000. The federal government had added 72,000 temporary census takers for the 2010 census. This one-time event could hardly represent recovery in the general economy. Then there were more than 225,000 statistically-adjusted to the jobless numbers from what is called the "business birth-death model" adjustment. The U.S. Department of Labor assumes every month, based on long-term historical averages, that new business formations (small businesses mostly) occur—even though small businesses may be laying off workers in massive numbers in the short term (the actual case for at least the last eight months). The government uses historical averages, not actual figures of small business closures. Considering just the birth-death model and temporary census hires, it means the unemployment for April likely totaled more than 825,000—not including underemployment, discouraged, and others jobless but not counted.

In May, the official job losses were even less at 345,000. Once again the government added 220,000 nonexistent jobs due to the business birth-death model. So the actual number for May was really 565,000. It is important to note that the 565,000 number comes from one of the two surveys used by the government to estimate unemployment. It is called the Establishment Survey and excludes entire categories of unemployed. The other source, the Current Population Survey is the survey from which actual unemployment rates are calculated. So why does the government give us the jobless results from the survey that doesn't calculate unemployment? Because in May, for example, while the Establishment Survey registered only 345,000 new unemployed, the Current Population Survey indicated 787,000 new unemployed. Jobless ranks have continued to rise in April-May at a rate of at least 700,000 to 800,000 when properly accounted for. Consequently, we can predict a jobless rate of 22 million by year end.

2. Foreclosures rising to eight to ten million. The second major drag on recovery is the housing market collapse. Foreclosures and delinquencies in the residential housing market are continuing to rise. More than 350,000 foreclosures were recorded in March alone. More than 5.4 million have occurred or are in progress to date. The corporate rating agency, Moody's Inc., predicts foreclosures will rise to eight million. Our prediction is more than ten million. That's 18-22 percent of the outstanding 45 million mortgages in some stage of foreclosure in the U.S. As a result, housing prices will continue to fall another 20 percent beyond the already 25-30 percent collapse (higher in some markets). It is clear that a second wave in foreclosures is now hitting the market, no doubt driven primarily by the rising joblessness. Currently, it's not only subprime mortgages—of which \$500 billion in losses by banks still remain to be written off. But soon it will be the less risky Alt-A and even prime mortgages, the latter representing the fastest rising defaults currently.

Much has been made that new home construction has turned the corner. But the minor recovery in new housing starts reflects the Obama administration's decision to subsidize new home building companies and their mortgage lenders and servicers, with a \$75 billion injection from the Obama Housing Affordability Act passed last February. Virtually nothing of this \$75 billion is being spent, however, to aid the rising millions of households entering foreclosure. The one crumb thrown to those eight to ten million in foreclosure—i.e., a provision authorizing judges to negotiate mortgage loan modifications—was in turn quickly thrown out by the Senate after intense banking lobbying in May. The \$75 billion is pork, targeting the builders, lenders, and mortgage servicers—80 percent of which is handled by the top 5 banks. Foreclosed and delinquent homeowners are being left to fend for themselves.

3. Continuing fall in home equity value. The collapse of consumer spending that began last October, due to rising joblessness and foreclosures, is being driven as well by a host of other factors. One is the continuing fall in home values. More than 15.4 million—more than a third of all homeowners—owe more on their home loans than their homes are worth. That kind of negative wealth affects consumers with mortgages, who then spend less.

4. Continuing loss in 401k pension value. In addition to home equity values falling, consumers have experienced the loss of more than \$4 trillion to date on their 401k personal pension plans. Like the fall in home values, the collapse of pension balances also translates into less consumption and therefore a negative drag on economic recovery. Many defined benefit pension plans are also in trouble. One estimate is that even the largest, supposedly most stable companies—those constituting the S&P 500—have on average lost a third of their value. The same applies for most public sector (state and local government) defined benefit pensions. Defined benefit pensions are a ticking time bomb that will eventually explode in 2010-11.

5. Credit card spending retreat. Still another drag on recovery gaining momentum is the retreat of spending via use of credit cards. Not only have credit card rates risen from single digit to as high as 29.99 percent on balances owed to credit card companies, but credit card companies have raised fees and penalties dramatically as well. Millions of cards have been terminated. U.S. Federal Deposit Insurance Corporation data indicate credit card company lines of credit were reduced by \$406 billion alone in the first quarter of 2009. Credit card losses and write-offs have been averaging nearly \$40 billion a quarter since late 2008. Credit card spending has fallen the last seven consecutive months, for the longest drop on record since reporting began in 1968.

6. Falling hours of work and wages. Still another factor driving declines in consumption—and preventing recovery—is the continuing fall in hours worked and weekly earnings. Hours of work have declined to their lowest average level on record since the 1970s to barely 33 hours per week. That's so-called full-time employment. More than six million workers have been converted to part-time work since the recession began.

Government data on average hourly wages grossly underestimates the extent of wage cutting underway. First of all, wages, according to government data, include two-thirds of the income of business proprietors. That means two-thirds of the earned income of doctors, business consultants, and single business owners is included in the government's definition of wages. That boosts the average wage significantly. So it is necessary to look at average hourly wage gains for the 110 million nonsupervisory production and service employees, not wages in general, though even that more accurate category doesn't cover all reductions in compensation due to higher costs of health care premiums, deductibles, and the like. Benefit cuts are part of pay cuts. Today there is also a growing trend, both in public and private sector employment, toward mandatory furloughs: that is required days off

without pay every month or week. This amounts to a wage reduction for workers that is not reflected in hourly wage data.

7. Business capital spending. Points 1 to 6 represent major factors depressing consumption into the foreseeable future. Consumption represents around 70 percent of the economy. Another 15 percent comes from business capital spending on structures, equipment, inventories, and the like. Surveys for the coming year show business plans to reduce capital spending by somewhere between a fourth to a third. The Obama administration and the Federal Reserve have made much of the fact that business spending on inventories began to rise in the spring of 2009. But recoveries from a recession as deep as today's cannot occur based on inventory spending alone. Also, it was to some extent inevitable that inventory spending would rise in recent quarters, given the record \$132 billion collapse in inventories in the fourth quarter of 2008. By falling less than the \$132 billion in a subsequent quarter, according to government GDP accounting, a rise occurs in inventory spending, thus giving the false appearance of a rise in inventories and recovery.

8. Global exports collapse. The third sector of the economy is called net exports (the difference between export sales to other countries by U.S. companies and the sales of companies in other countries to the U.S.). One of the hallmarks of the current economic crisis, however, is the synchronization of economic downturns across countries. That synchronization represents a collapse of world trade and exports that has been underway for some months. Some countries, like Japan, Germany, and even China, are highly dependent on exports to the U.S. Japanese exports in early 2009 fell by 50 percent. Germany and China registered similar drops in exports. U.S. export sales have fallen accordingly as well. In short, it means production on exports will continue to fall in the U.S. as global trade falls.

9. State and local government fiscal crisis. A mere \$27 billion of the Obama \$787 billion stimulus package was earmarked for job creation in 2009. Funding to states in the stimulus is similarly unimpressive given the scope of the crisis. For example, it is projected that only \$130 billion of the \$787 is designated for the states; moreover, that \$130 billion is distributed over the next three years. But collectively, state governments anticipate budget shortfalls of \$230 billion, according to a June 3, 2009 report by the Wall Street Journal. Virtually all state tax revenue sources across the board are falling faster than originally projected. This will cause higher state and local taxes and fees that will depress consumption still further. At the same time, a larger percentage of total future layoffs will inevitably come from state, local government, and school districts in the remaining months of 2009, while hours, wages, and take home pay for public sector workers will fall as well.

10. Federal stimulus package: too little too late. The \$180 billion government spending this year, like the \$165 billion stimulus in 2008, will slow the economic decline a little but only for a few months—perhaps to the end of the summer. But it will dissipate, as it did in 2008. It should not be forgotten that only \$487 billion of the \$787 billion is actual government spending. The \$300 billion tax cut portion of the total stimulus package will be hoarded by consumers and businesses alike, used to retire debt, saved, or held until claimed at later dates. A third U.S. stimulus bill will likely be required sometime within the next 12 months.

Why Financial Instability Has Not Abated

The economic crisis today has two great dimensions: the financial and non-financial real economy. Thus far a skewed focus has been on the financial side—the banks, insurance companies, hedge funds, private equity, mutual funds, credit card companies, and the like. If left unaddressed by policymakers, the real economy's continuing collapse will

eventually feed back into yet another, even more serious, financial-banking crisis in 2010-2011. Which brings this analysis to a consideration of why the financial side of the economy is also still very much in crisis, despite all the proclamations to the contrary.

11. Phony stress tests and continuing bank insolvency. Last spring's bank industry stress tests were clearly engineered by banks and the government in a series of back room dealings to buy time. At least 15 of the 19 "too-big-to-fail" banks are still technically insolvent despite the tests. Germany's finance minister, Peer Steinbrück, publicly stated the tests were "worthless" because their results were altered by negotiations behind the scenes between the banks, the Federal Reserve, and Treasury prior to public announcement. The banking system, in other words, is still incredibly fragile and some unforeseen crisis event could easily come out of left field and cause yet another banking panic.

12. Coming bust in commercial property markets. The financial sector also remains fragile because three new financial bombs will have eventual negative impact on banking. These will prove at least as equivalent in magnitude as the subprime mortgage bust. The first is the developing implosion in commercial property markets. Commercial property prices have fallen 30 percent as of June and are projected to fall at least another 20 percent. The 19 bigger banks alone hold \$600 billion of such assets on their books. It is reasonable to assume they will soon lose at least \$100 billion of that. Harder hit will be the thousands of regional and community banks. According to the business research firm Foresight Analytics, the banking sector could suffer losses as high as \$250 billion and more than 700 banks could fail as result of commercial real estate losses in the coming months.

13. Regional and community banks deteriorating. There are more than 8,200 regional and community banks also deeply involved in auto, personal, and small business loans. Analysts estimate at least another \$200 billion in losses for 900 small and medium banks in this sector.

14. Consumer credit markets at crossroads. The consumer credit markets include auto loans, student loans, and credit cards. Once a trillion dollar market for securitized assets, that market collapsed in 2008 to less than \$50 billion. With the collapse, many banks and shadow banks were stuck with investments worth on average a mere ten cents on the dollar. Values continue to collapse as rising unemployment and declining consumption results in further rising delinquencies and defaults. Credit card financing has been particularly hard hit, with auto loan delinquencies rising sharply. Credit card write offs are running at \$150-\$200 billion a year and auto loans could be at least as great. The Federal Reserve set aside \$1 trillion in the spring of 2009 to try to resurrect these markets via its Term Auction Lending Facility, or TALF. The Fed hopes to do this by getting the shadow banking sector—hedge funds, private equity, and the like—to come back into the market and purchase the bad securities. These shadow banking folks caused much of the current financial instability in the first place by excessive speculation in securitized assets; and now, according to the Fed's plan, they are going to bail us out. But there has been little interest thus far on their part in the TALF program. The Fed will therefore probably fail in its effort to resurrect these markets, resulting in hundreds of billions of more losses hitting bank balance sheets within the next 18 months.

15. The imploding PPIP rescue program. While the Fed fails with TALF, the other cornerstone of the Obama administration's bank rescue, Public-Private Investment Program (PPIP) is also already on its last legs. PPIP had two elements. One was to have the FDIC provide subsidies to banks to sell their bad loans, not to be confused with the bad securitized assets above being handled by the Fed through TALF. Per the PPIP, the FDIC makes up what banks might lose as result of selling bad loans at market prices. But, once again, as has been the case since the financial crisis began, the banks do not want to sell the bad loans despite FDIC

subsidies. The reasons for so doing are several, but primarily their desire to avoid restrictions on their executive pay if they take government, FDIC, subsidized funding. This means that once additional losses from the developments noted above erode that newly raised capital once again, they'll be right back where they were in terms of the need to record further losses, further write downs, and deeper technical insolvency.

16. Record corporate defaults coming. Despite the tremendous instability remaining in the banking-finance sector due to continuing losses and write downs, an even greater financial tsunami is gathering in the non-financial corporate sector. Hit by unavailable or high cost credit for almost two years now on the one hand, and collapsing demand for their products on the other, record numbers of businesses are predicted to default and go into bankruptcy in the near future. That will mean even further, still unestimated major losses and write downs for banks. High on the list will be thousands of companies dependent on the junk bond markets. These are companies already on the brink or they wouldn't be borrowing for extended periods in this high interest rate market. Some now pay up to 20 percent interest for such borrowing. Moody's Inc., the business rating agency, predicts defaults by junk bond dependent companies will rise from current 5 percent levels to 15.9 percent in the next 12 months. According to a June study published by the research department of Allianz, the giant global finance company, there was a 27 percent increase in corporate bankruptcies in 2008 that will be exceeded in 2009 by another 35 percent increase. Corporate bankruptcy figures rarely record more than a 10 percent increase a year. Two years of 27 percent and 35 percent are unprecedented. This historic increase in business defaults and bankruptcies will translate into still further losses.

17. Euro banks and sovereign debt default. Turning to the international scene, serious banking instability could very easily re-ignite in the U.S. in the wake of a major collapse of a large European bank or a default by a sovereign investor in Eastern Europe. Banks in the Euro periphery—i.e., Ireland, Iceland, Spain, Greece, etc.—have been among the most exposed. However, to date the EU has been able to contain the crises in those locales. The EU and U.S. have indicated they will fund the International Monetary Fund (IMF), with more than \$1 trillion to bail out Eastern Europe banks and economies. But raising that amount has proved difficult. The U.S. Senate will likely not approve the U.S.'s \$100 billion-plus contribution. This failure increases the likelihood of serious European banking crises. At present, banking instability continues in the UK and German banks face more than \$1 trillion in potential write downs. The most unstable developments, however, include the Eastern European and Baltic countries financial systems. Austrian banks are exposed in terms of loans to the Ukraine, while Swedish banks are similarly heavily exposed to Latvia and the Baltic countries. A chain effect of bank collapses could easily arise in Europe in the next 12 months, repercussions of which would eventually be felt as well in the U.S.

18. The dangerous bubble in U.S. treasuries. In late May, U.S. Treasury Secretary Geithner made a trip to China. The specific purpose was to allay growing Chinese Central Bank and government concern that the U.S. dollar was headed for a major, long-run decline. Holding more than \$1 trillion in U.S. assets, mostly U.S. Treasury Securities, China was understandably concerned its holdings would collapse in value along with the dollar. To fund the U.S. deficit of more than \$2 trillion in the coming year, the U.S. Federal Reserve had declared it was prepared to print money if necessary. In addition, the Fed had declared months earlier it would enter the mortgage markets to buy up to \$300 billion in long term bonds in the U.S. in order to keep interest rates on mortgages low. The Fed intimated as well it might commit up to \$1 trillion more if necessary to get mortgage interest rates to fall. But this kind of injection of money raised the spectre of a major bout of inflation in the future, which would translate into a serious fall of the dollar. This meant in turn growing China concern. In his June visit Geithner assured the Chinese he would

not let this happen. While Geithner was assuring the Chinese, Federal Reserve Chair Ben Bernanke was testifying before Congress reiterating Geithner's message to the Chinese. Bernanke declared the U.S. would reign in the coming U.S. deficits, deficits projected to exceed \$1 trillion a year on average for the next decade.

The above scenario revealed the major contradiction faced by U.S. policymakers today with regard to either stabilizing the real economy at the expense of destabilizing the financial system or stabilizing the financial system at the expense of the real economy.

By refusing to purchase the \$300 billion in long-term Treasuries in U.S. markets that the Fed said earlier in 2009 it would do to bring down mortgage interest rates, and instead supporting Geithner in China and thus the U.S. dollar, the Fed in effect gave the green light for residential mortgage rates to rise, cutting off economic recovery in that market. But if the Fed had decided to monetize the deficit, then China likely would not continue to purchase as many U.S. bonds, needed to finance the deficit. U.S. policymakers Geithner-Bernanke chose once again to support the banking and financial system at the expense of the real economy.

One should not be surprised that the two bankers—Geithner and Bernanke—chose the banks and financial system over the rest of the economy. It's the basic strategy that U.S. policymakers have been pursuing since the crisis first erupted in the summer of 2007. Throw whatever liquidity is necessary at the banks to keep them alive and fill the banks' ever expanding losses and write-downs with government-taxpayer money transfers until the system stabilizes itself. That failed strategy is why the current economic crisis, both in its financial and real economic dimensions, has continued to drag on so long. It is also why the current crisis is far from over and why, in some ways, it may have only just begun.

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The Edge... there is no honest way to explain it because the only people who really know where it is are the ones who have gone over.
Hunter S. Thompson

"The bad news is, the aliens have landed. The good news is, they eat Mormons and piss gasoline!"
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