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The Road to Recession

Posted by [harbinger](#) on May 20th, 2010 and filed under [Alex Jones](#). You can follow any responses to this entry through the [RSS 2.0](#). You can skip to the end and leave a response. Pinging is currently not allowed.

MIKE WHITNEY

[Counterpunch](#)

May 20, 2010

Debt woes in Greece have sent bond yields soaring and increased the prospect of sovereign default. A restructuring of Greek debt will deal a blow to lenders in Germany and France that are insufficiently capitalized to manage the losses. Finance ministers, EU heads-of-state and the European Central Bank (ECB) have responded forcefully to try to avert another banking meltdown that could plunge the world back into recession. They have created a nearly-\$1 trillion European Stabilization Fund (ESF) to calm markets and ward-off speculators. But the

contagion has already spread beyond Greece to Spain, Portugal and Italy where leaders have started to aggressively cut public spending and initiate austerity programs. Belt-tightening in the Eurozone will decrease aggregate demand and threaten the fragile recovery. We are at a critical inflection point.

From *American Banker*:

“Bank stocks plunged last week under the theory that banking companies will take large losses in Europe. The theory is correct. Banks will get hurt,” Richard Bove of Rochdale Securities LLC wrote in a research note.

Bove wrote in a separate report last week that “big American banks have a bigger stake in this drama than thought.” He estimates that JPMorgan Chase has \$1.4 trillion of exposure across all of Europe alone, while Citigroup Inc. has \$468.4 billion.

Analysts said large U.S. banks have opaque ties to the region through their overseas counterparts. U.S. money-center banks trade derivatives, orchestrate currency swaps and handle other transactions with large European banks. U.S. banks may not hold a lot of sovereign debt in Europe, but those European institutions do. If Greece defaults, that could create a crisis of confidence in the European banking market that would spread to large U.S. banks.

“Obviously, the European banks have exposure to Greece. The U.S. banks have loans out to those banks,” said Keith Davis, an analyst with Farr Miller & Washington. “There are a number of different ways they can have exposure — it’s not hard to imagine how a wildfire can spread.” (Europe’s debt Crisis, US Banks Exposure”, Paul Davis and Matt Monks, *American Banker*)

China and the United States have begun to hunker down and pursue deflationary policies. China has already been blindsided by a steep 14.5% rise in the renminbi over the euro in the past 4 months which is beginning to hurt exports. But China’s leaders are also trying to unwind a real estate bubble that was created by loose monetary policies and the massive \$600 billion fiscal stimulus package. Rather than drain liquidity by raising interest rates, (which would strengthen the renminbi) China is tightening lending standards to put more pressure on speculators. It’s a circular strategy to deal with a serious problem. This is from *The People’s Daily* online:

“On April 16, the State Council rolled out a series of measures to curb the domestic housing market amid concerns over asset bubbles. These measures include a 30 percent down payment for first time buyers for houses larger than 90 square meters, 50 percent down payment and lifting mortgage interest rate for second home buyers. The government has also imposed a temporary ban on mortgage applications for third or above home buys and cross-city purchases. Shanghai will be the third region after Beijing and Shenzhen to have rules governing property buys,” said Sun.

By tapping on the brakes, China will likely limit the fallout from the burst credit bubble, but will also slow investment which is the main driver of growth. That leaves the experts divided about what the future holds in store; many now believe that China is headed for a “hard landing”. Here’s an excerpt from hedge fund manager Hugh Hendry with a particularly grim forecast:

“The composition of China’s growth has undergone a potentially treacherous change: in the absence of expanding foreign demand for its exports, it has instead come to rely on a massive surge in domestic bank lending to fuel its growth rate. Indeed, when measured relative to the size of its economy, the 27pc point jump in bank loans to GDP is unprecedented; at no point in history has a nation ever attempted such an incredible increase in state-directed bank lending.



“What a turnaround: from an export juggernaut to a credit addict. Who would have thought it necessary back in 2001, the year everything all started to work out for China?...China has become the world’s biggest creditor, after amassing nearly \$2.3 trillion of foreign exchange claims on us. However, the specter of a creditor nation running persistent trade surpluses has ominous historical portents. It has happened only twice before, with the US economy in the Twenties and with the Japanese economy in the Eighties.” (“China: Hugh Hendry warns investors’ infatuation is misguided” UK *Telegraph*)

China’s economy is reeling from over-investment, under-consumption, and razor-thin profit margins. A slowdown in China will only deepen the downturn in the EU by reducing the amount of liquidity in the system. This will lead to tighter credit and falling demand. Deflationary pressures continue to mount.

Developments in China and Europe come at a bad time for the United States, where recovery is so weak that the Federal Reserve hasn’t raised rates from zero in more than 14 months or sold any of the assets in its \$1.7 trillion stockpile of “toxic” inventory. If there was even a flicker of light at the end of the tunnel, the Fed would have raised rates by now. As it stands, Fed chair Ben Bernanke has refused to sell any of the mortgage-backed securities (MBS) he purchased from underwater banks. He’s worried that even a small auction—of say \$20 or \$30 billion—would divert liquidity from the markets and send stocks into a nosedive. Bernanke’s timidity underscores the severity of the slump. He’s not taking any chances.

The recent uptick in Personal Consumption Expenditures was the result of government transfers, otherwise PCE remained flat. Obama’s \$787B fiscal stimulus has not restored consumer spending to pre-crisis levels or created the foundation for a self-sustaining recovery. By the end of the third quarter, the stimulus will diminish (excluding another asset bubble) and the contraction will resume. The stock market bubble—largely engineered by Bernanke’s monetization program (QE) and liquidity injections—has not decreased unemployment, increased economic activity, or halted encroaching deflation. Here’s an excerpt from Gluskin Shef’s chief economist David Rosenberg who gives a good summary of the economy:

There are classic signs indeed that the recession in the U.S. ended last summer ... But the depression is ongoing...Real organic personal income is nearly \$500 billion lower now than it was at the peak 16 months ago and this has never occurred before coming out of any technical recession....

Outside of the lagged impact of all the government stimulus and the impact of inventory accumulation, the economy is not growing....if you take the government data at face value, the past four quarters have averaged a mere 1.38% in terms of real final sales, which goes down as one of the very weakest post-recession trajectories in recorded history....the government has done everything it can to perpetuate a consumer spending cycle even though such expenditures command a record of over 70% of GDP.....Moreover, once the foreclosure moratoria is over, and the government no longer tries to play around with market forces and allow for price discovery, home values are back on a downward track, now evident in all the data series. There is... an excess of five million vacant housing units across the U.S. acting as a continued dead-weight drag on house prices....

The National Federation of Independent Business small business survey is showing that economic

growth is stagnant at best. (“Why the depression is ongoing”, David Rosenberg, Gluskin Sheff & Associates)

Nearly-\$800 billion in fiscal stimulus has barely pushed the economy into positive territory. Apart from inventory restocking, GDP measured a mere 1.38% (as Rosenberg notes) “one of the very weakest post-recession trajectories in recorded history.” In the US, consumers face an uphill slog; meager employment opportunities, mushrooming personal debts, flat wage growth, and dwindling access to credit. Consumers are too strapped to pull the economy out of the muck and Wall Street knows it. That’s why Bernanke has defended high-risk debt-instruments and securitization so ferociously, because they represent the only means of maintaining profitability in a stagnant economy. The battle over derivatives is the battle for the future of capitalism itself.

No one has written more brilliantly or persuasively about the stagnation that grips mature capitalist economies than UCLA historian Robert Brenner. In the introduction to his 2006 book, “The Economics of Global Turbulence”, Brenner explains the structural flaw inherent to capitalism which inevitably leads to crisis. Here’s an excerpt (although the piece should be read in its entirety):

“The fundamental source of today’s crisis is the steadily declining vitality of the advanced capitalist economies over three decades, business-cycle by business-cycle, right into the present. The long-term weakening of capital accumulation and of aggregate demand has been rooted in a profound system-wide decline and failure to recover the rate of return on capital, resulting largely—though not only—from a persistent tendency to overcapacity, i.e. oversupply, in global manufacturing industries. From the start of the long downturn in 1973, economic authorities staved off the kind of crises that had historically plagued the capitalist system by resort to ever greater borrowing, public and private, subsidizing demand. But they secured a modicum of stability only at the cost of deepening stagnation, as the ever greater buildup of debt and the failure to disperse over-capacity left the economy ever less responsive to stimulus....”

To deal with pervasive stagnation, Brenner says that the Fed embarked on a plan that would use “corporations and households, rather than the government, would henceforth propel the economy forward through titanic bouts of borrowing and deficit spending, made possible by historic increases in their on-paper wealth. themselves enabled by record run-ups in asset prices, the latter animated by low costs of borrowing. Private deficits, corporate and household, would thus replace public ones. The key to the whole process would be an unceasing supply of cheap credit to fuel the asset markets, ultimately insured by the Federal Reserve.” (“What’s Good for Goldman Sachs is Good for America: The Origins of the Current Crisis”, Robert Brenner, Center for Social theory and comparative History, UCLA, 2009)

The present crisis is not accidental. The system is performing as it was designed to perform. The low interest rates, lax lending standards, leverage-maximizing derivatives, even blatant securities fraud have all been implemented to overcome the basic structural flaw in capitalism—it’s long-term tendency to stagnation. Naturally, this lethal policy-cocktail has generated greater systemic instability and increased the likelihood of another meltdown.

GREAT DEPRESSION PART TWO?

There are many similarities between today’s crisis and events that took place during the Great Depression. As journalist Megan McArdle points out, the Great Depression also had “two parts”; the stock market crash of 1929 followed a year and a half later by the deeper dip in 1932. Phase 2 of the Depression began in Europe. Here’s an excerpt from the article:

The Great Depression was composed of two separate panics....the economic conditions created by the first panic were eating away at the foundations of financial institutions and governments, notably the failure of Creditanstalt in Austria. The Austrian government, mired in its own problems, couldn’t forestall bankruptcy (and) the contagion had already spread. To Germany. Which was one of the reasons that the Nazis came to power. It’s also, ultimately, one of the reasons that we had our second banking crisis, which pushed America to the bottom of the Great Depression, and

brought FDR to power here. (“Why Should You Be Freaked Out About Greece? Remember, The Great Depression Had Two Parts”, Megan McArdle, businessinsider.com)

With the implementation of austerity programs throughout Club Med (Greece, Portugal, Spain, and Italy) German surpluses will shrivel and the EU’s GDP will shrink. Efforts to cool China’s economy will have equally damaging effects on global growth by choking off liquidity and slowing overall investment. The constraints on spending will adversely impact fiscal stimulus in the U.S. and accelerate the rate of deterioration. The political climate has changed in the U.S. and there’s no longer sufficient public support for a second round of stimulus. Without another boost of stimulus, the economy will lapse back into recession sometime by the end of 2010.

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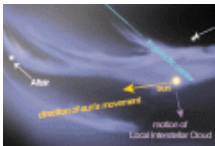
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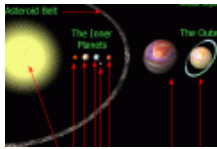
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