Turn on the Bubble Machine

Is it possible to borrow your way to prosperity?

At the start of the 20th Century the financial industry, located at that time in London and New York, just as it is today, conceived of the idea of using borrowing as a way to cushion personal income from the ravages of periodic corrections in business affairs and in governmental affairs. Borrowing had long been an integral part of business, where it facilitated all kinds of ventures in which it is necessary to prepay for goods in anticipation of futures revenues. The explosive growth of the integrated economic world ensured that it would be a vital part of business. We not only made things in Pennsylvania for sale to the local public, we made them for sale in San Francisco and the gap in time between the commitment to produce and the moment when the proceeds of the sale would be recorded in the home office yawned wider, even the time when the creation of national markets and explosive immigration expanded the scale of industry by multiples. Borrowing oiled the wheels of industry.

But the creation of household finance and household debt was ultimately of a different kind altogether. For the first time households could spend what they did not earn. Young households, for instance, could buy homes and automobiles before their careers had caught up with their desires. This relaxation of the bonds of time was itself productive. That automobile is not only a form of consumption, it is the way most people get to work, and thus a tool without which they would be unable to get to work. The house plays an even more complicated role in the life of the family, but it functionality is evident in how it serves the children of the family. They grow up in a home they – through their parents – own. They grow up in the propertied class with all that implies about opportunity in life and stability in social milieu. They have joined the Middle Class.

Thus consumer borrowing has been every bit as transformative as industrial and commercial borrowing has been. In this environment, the task of financial intermediaries has been to grease the wheels. It has been both a noble calling and a profitable one: putting the savings of successful citizens and business to work serving the borrowing requirements of the other citizens and business. But the finance industry is no more insulated from the vagaries of consumer prosperity and business profitability that the lenders and borrowers are. The lending institutions experience inventory cycles and building cycles along with their customers. Thus the whole framework was limited as long as the savings and the lending themselves had to be finance from current cash flow. Enter the Federal Reserve System, which has the unique ability to buy what cannot afford and to lend what it has not earned. So robust is its capacity to leverage that every penny that it does earn on paper is turned over to the United States Treasury at their unique 100% tax rate. The Federal Reserve is always running on empty. But it is okay. They don’t need to earn anything; they just print whatever they need.

Bubble, bubble, No toil, No trouble.

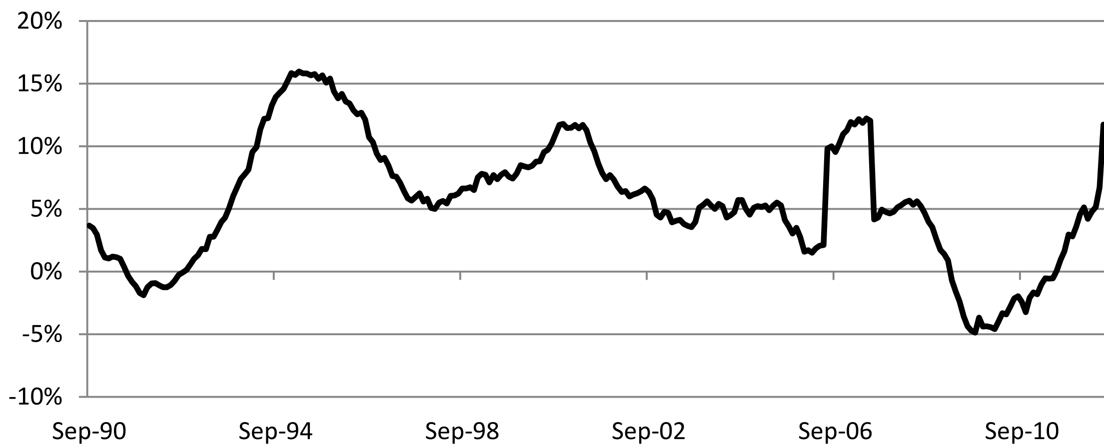
At the start, Federal Reserve meant federal reserve. That is to say, they were a passive lender of last resort to banks, which in those days were the only financial intermediaries. As the economy has grown more complex and integrated, many other intermediaries have appeared. Wall Street Broker-dealers, other lending institutions, hedge funds… The list goes on. More serious for the long run is another innovation: From supporting the banking industry, the orientation of the Fed has changed 180^0. Where they once accommodated, they now promote. In other words, they started to fight recessions with increasing aggressiveness and expansiveness. The results show up in financial bubbles which used to be the province of Wall Street and its partner banks. Now the bubbles are vastly bigger and they are nationwide, on their way to going worldwide. Only the Fed could finance that transition which results from a policy to fight, or over to anticipate, recessions by promoting borrowing. A few years ago the news of a mortgage collapse

shook the financial markets, and predatory mortgage brokers were in the crosshairs. No grand of American scoundrel was more despised and more repeatedly flogged in the headlines. But the headlines stopped far short of revealing the news, because the news was that the predatory lender of last resort, and the institution that kept the predatory loans coming was the Federal Reserve.

In the eight years, predatory lending has brought on two enormous bubbles and a significant expansion of the underlying agenda. Both in 2006 and in 2012, the lending bubbles have taken off from a launching pad of the impending national election. The accompanying chart covers the last twenty-two years of history on household borrowing.

Consumer Borrowing

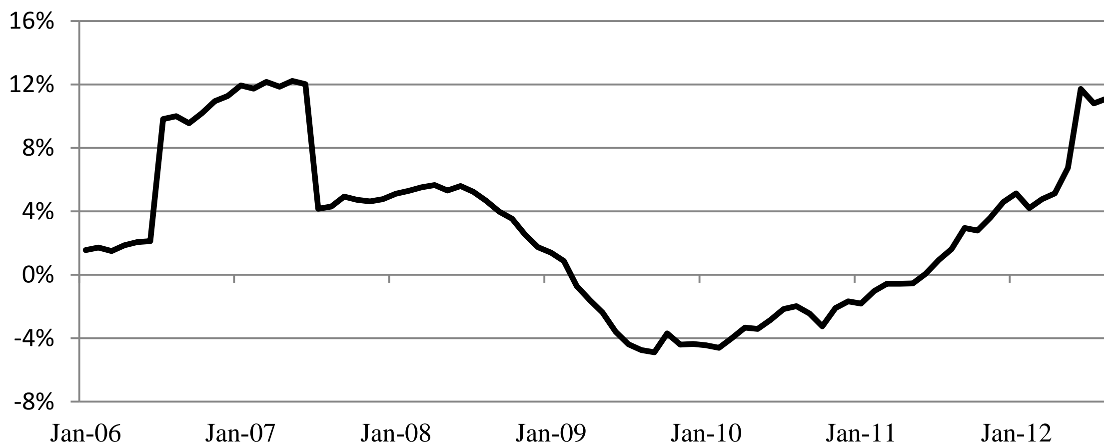
year-to-year percent change



Source: Federal Reserve Board and Logistic Research & Trading Co.

The peak in 1994 signaled the end of that counter-cyclical lending spree from the Federal Reserve under the aegis of Alan Greenspan. While aggressive, it took advantage of the post-Cold War boom in the Dollar and in world trade. The victory of Russia – which responded by holding a massive fire sale on its assets in a desperate move to stave off bankruptcy – averted the bubble by creating an environment where the surge in liquidity was absorbed by the world. The peak in 2000 however signified that the rules of the game had changed.

In 1998, the world financial markets unexpected choked on the flood of dollars from the Fed that had been building for almost a decade. Attempting to control the aftermath, the Fed caused the Crash of 2000. Consumer borrowing slowed and the economy slipped into recession. Up until 2002, the volatile component – and by far the single largest component – of household debt was credit card debt. Term debt, which includes home mortgages, car loans, and student loans, was left largely unaffected by the swings in lending and borrowing, and on the surface at least the events resembled a conventional business cycle, with contraction of credit card borrowing reinforcing retailers' inventory contraction. But things were about to change radically.



For this chart, I simply narrowed the time period to the most recent six-and-a-half years in order to highlight to two big bubbles associated with the election of 2006 and the bubble of 2012 associated with the ongoing election. The run-up of borrowing since the middle of 2009 is astounding. In the middle of 2009, household debt had contracted by four percent over the precious year – June 2008 to June 2009 – but in July 2012, household debt had grown by about 12 percent – July 2011 to July 2012.

The rapid surge of lending in 2006 was part of an aggressive, inflationary boom caused by the Fed, which showed up in the shocking inflation in the world petroleum market at the time. Coincidentally, this was the epoch in which the price of gold soared

from $600 per oz. to $1600 per oz. The inflationary implications of the commodity boom were however so dangerous that after the election – a resounding defeat for the Republicans – the Fed had to cut back. No one seems to have told the mortgage lenders of that day what was happening, or the European governments and financial institutions that were caught up in their own Euro boom. They it seems were the last to find out. They got the bad news when the world credit market collapsed in the summer of 2008.

Is this another bubble? The question answers itself, because the immense expansion of American dollars in circulation – putatively to staunch the recession caused by the commodity bubble – has failed. More dollars have not translated into more prosperity. They have translated into richer hedge fund fat-cats, which is not a small achievement I suppose. And they have ignited a new commodity bubble.

So bubble on. Cauldron boil and cauldron bubble. If the witches of Macbeth are not too engaged to notice the daily affairs of us, poor mortals, they may stop a moment to make for us a prophesy as they did for MacBeth. But if they are not moved to bless us with that boon it matters little, because we already know how bubbles end.

P.O. Box 63
Saint Joseph, Michigan, 49085
Tel: 269-408-1511
E-mail: jgibbons@logisticresearch.com
Web Site: www.logisticresearch.com