Girding for a Depression

Another 663,000 Jobs Lost in March

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Today, the Labor Department reported the economy lost 663,000 payroll jobs in March. The economy is shifting to permanently lower levels of production and employment, as the recession nears turns into a depression.

Unemployment reached 8.5 percent, and adding in discouraged adults who have left the labor force and part-time workers who would prefer to work full time, the real unemployment rate is closer to 17 percent.

Simply, investors and employers lack confidence in the overall likely effects of Treasury Secretary Geither's plans to stabilize banks and President Obama's stimulus package and budgets proposals.

Lacking confidence that the demand for what Americans make and sell will recover significantly, anytime soon, businesses are girding for a long siege—slashing employment and dividends and other hunkering down. They are preparing for a depression and the eclipse of American leadership.

The economy has shed 5.1 million jobs since December 2007, as the full weight of the banking crisis and trade deficit on oil and with China punish employment in autos, other manufacturing, construction and the broader economy. This drives down employment, wages and consumer spending and is creating a negative feedback cycle that threatens to cast the U.S. economy into something akin to Japan's lost decade or worse.

Fundamental structural problems—poorly managed banks, wasteful uses for imported oil and the lopsided rules for competition with China and other Asia mercantilists—have come home to roost and threaten to topple American prosperity.

Unemployment increased to 8.5 percent in March and is headed for 10 percent. In 2009, unemployment and the trade deficit are reducing GDP by some $400 billion or about $2500 per worker.

Factoring in discouraged workers, unemployment is about 11 percent. Add workers in part time positions that cannot find full time employment and the hidden unemployment rate is about 16.7 percent.

A Permanent Contraction and Double Digit Unemployment

The economy contracted at about a 6.3 percent annual rate in the fourth quarter of 2008, and will contract further through most of 2009. The huge stimulus package will lift GDP a

few percentage points in 2010 and 2011, but it will likely not prove enough to halt contraction over all. Even if the economy grows for a time, thanks to stimulus spending, it will fall back into recession.

The stimulus package will temporarily add about 2 to 2.5 million jobs, and only slow the pace of job losses. Unemployment will shoot past 10 percent once the effects of stimulus spending wears off in 2012, and perhaps sooner.

Increasingly, the economic slowdown looks more like a depression than a recession. Recessions are like stock market corrections—after a time, equity prices rebound without government intervention.

Federal Reserve interest rate cuts and stimulus spending and tax rebates shorten recessions and ease their impact. However, those policies will not end the current slump, because it is grounded in fundamental structural dysfunctions in U.S. banking, energy and trade policies.

A depression is not self-correcting. The economy shifts down to permanently lower levels of production and sales, high unemployment rates become chronic, and federal deficits become narcotic—federal deficits dull the senses but don't cure the disease.

Employers in high tech, retailing, manufacturing, publishing, and elsewhere are not temporarily furloughing workers; rather they are restructuring employment downward, permanently, for what they expect to be smaller markets for their products for several years.

Without systemic reforms, the more than six million jobs lost in 2008 and 2009 will not be regained for many years. The crisis requires quick and bold action, and it requires more than a politically conceived stimulus package. It also compels radical changes in how Washington regulates banks and fosters international competition and wealth creation.

Unfortunately, the stimulus package is poorly structured and will prove too expensive for the 2 to 2.5 million jobs it creates for two years and then again disappear. The banking and trade policies President Obama is pursuing will drive the U.S. economy deeper in debt to Middle East oil exporters, China and other foreign creditors, throw the economy deeper into recession and destroy as many as 10 million jobs before the calamity has completely run its course by the middle of the next decade.

The Face of a Modern Depression

The economy need not reach the depths of the Great Depression to encounter permanent stagnation and evoke the pathos of vanished dreams—leaving older Americans without retirement incomes and scrounging for menial jobs and young workers without hope of promising careers.

Yet, without systemic reforms, unemployment will soar well above 10 percent, many college graduates will not find meaningful work, high school graduates will be trapped in low wage jobs and dependent on federal government largess, and older workers, abandoned by companies without adequate health care and pensions, will accept low wage jobs to supplement social security and work beyond the age of 70. Retirement will be for government workers and a few otherwise fortunate private sector workers but more generally, retirement will be the stuff of history books.

Roosevelt Administration stimulus spending—huge deficit spending—eased the pain but failed to end the Great Depression. Roosevelt's policies did not put the U.S. economy on a track for growth, and President Obama's policies will force Americans to relieve those frustrations.

In the 1930s, the economy suffered three false recoveries only to fall back into depression, because New Deal policies worsened structural problems that pulled the economy down in the first place. For example, the New Deal proliferated monopoly pricing, extended the life of undersized farms, raised structural savings rates, and created a system of home lending too dependent on federally sponsored banks—a system that ultimately contributed to the current crisis.

World War II and the Vietnam wars gave the U.S. economy reprieves from repeated downturns, but President Truman endured two recessions, President Eisenhower two recessions, Kennedy one recession and Nixon two recessions. Then surging oil prices created the Great Inflation. Only when President Carter began deregulation of the economy with the airlines, and Presidents Reagan, Bush and Clinton continued this process culminating with repeal of Glass-Steagall in 1999, did the economy enjoy the Great Moderation—an unprecedented, sustained period of growth with fewer recessions and less inflation.

During the Administration of George W. Bush, the abuse of free markets by the banks, domestically, and China, internationally through currency manipulation, high tariffs on imports and export subsidies, created the present crisis. George W. Bush ignored these threats to the benefits of free markets and open trade. Now President Obama is repeating his predecessor's mistakes by not altering approaches to banking reform and trade and appears poised to the blunders of President Roosevelt by reregulating the economy and pushing out the frontiers of the state.

It is important to remember that the U.S. economy is built on industry and innovation and doubling the Department of Education or beefing up municipal bureaucracies does little to expand manufacturing or R&D. Making the Federal Reserve the systemic regulatory does nothing to dismantle the destructive compensation practices on Wall Street.

President Obama's stimulus package is too weighed down with political baggage that will not boost employment—a bigger budget for the National Endowment for the Arts, extended welfare benefits, unemployment insurance for part-time workers—or create private sector jobs—extensive expansion of the Department of Education and fiscal relief for state and local governments that have added employment during the current contraction. Virtually all the jobs the stimulus package will create will not be permanent and those that are permanent will overwhelmingly be in government. In the end, someone has to pay taxes, but President Obama's stimulus package won't create many new taxpayers—in fact, it may leave us with few of them.

Many of the reforms proposed by President Obama, such as more welfare for the banks, restrictions on carbon emissions that apply to U.S. manufacturers but not their Chinese competitors, and the Employee Freedom of Choice Act which will eliminate secret ballots to select unions, threaten to strangle private initiative much as did the Roosevelt era reforms.

The challenges facing President Barack Obama could not be clearer. The current economic

slowdown has two structural causes—bad management practices at the large money center banks and the huge foreign trade deficit. Either address those or preside over economic decline.

Courting Armageddon

The stimulus package will give the economy a temporary lift, but after the money is spent, unemployment will rise again and continue at unacceptable levels indefinitely without successively larger stimulus packages and huge federal borrowing from China and Middle East oil states. The economy is in a depression, not a recession.

To accomplish lasting prosperity, President Obama will have to fix the banks and the trade deficit. Obama must create a bad bank to work out perform triage on mortgages—work out mortgages for homeowners that are in trouble but can be saved, foreclose on those that can't be reasonably assisted, and let mature those that will be otherwise repaid. Then the banks can sell new shares, repay their TARP assistance and once again make new loans to worthy homebuyers and businesses. Obama must make certain that banks do not continue to squander federal largess by paying outsized executive salaries and bonuses, acquiring other banks and pursuing new high-return, high-risk lines of businesses in merger activity, carbon trading and complex derivatives.

Questionable mortgage and other loan-backed securities must be completely removed from the books of commercial banks, and commercial banks must be separated in their ownership and control from other financial services, such as riskier investment banking, securities trading and hedge fund operations. Freed of these distractions, commercial banks could again raise private capital and repay TARP funds to the Treasury—essentially, purchase back the Treasury's preferred shares in the commercial banks.

The yet unspent TARP money could be used to capitalize a "bad bank" or "aggregator bank" that would provide assistance to those distressed homeowners that can be reasonably assisted, undertake necessary foreclosures where homeowners simply cannot repay even with reasonable assistance, and service the vast majority of mortgages that left alone will be repaid. This would limit foreclosures to manageable numbers and put a floor under the decay in housing values. The bad bank would likely turn a profit, as did the Resolution Trust Corporation during the Savings and Loan Crisis and the Home Owners' Loan Corporation during the Great Depression.

Instead, Secretary Geithner proposes a scheme to further enrich hedge funds and bankers instead of reforming the banking system.

Money spent on imported oil and imports of Chinese goods cannot be spent in the United States. Quite simply, those dollars don't come back to purchase U.S. exports in sufficient amounts, and the resulting trade deficits are a huge structural drag on the demand for U.S. goods and services. That is why huge federal deficits are needed to keep the economy going but can't be sustained indefinitely. Ultimately, trade deficits on oil and with China must be dramatically reduced to achieve adequate demand for U.S. production and employment and accomplish sustainable economic growth.

Most of President Obama's energy proposals entail generating, transmitting and using electricity more efficiently. However most electricity is generated using domestic coal, natural gas and nuclear power; and reducing the oil import bill will require higher mileage

standards for automobiles. Carmakers can build more efficient internal combustion engines and alternative propulsion vehicles; however, with cars lasting more than 15 years, incentives must be provided to get the gas guzzlers off the road sooner. A clunker subsidy based on the age of the vehicle and miles-per-gallon gained could encourage the rapid replacement of low mileage trucks, and SUVs; incentives to purchase fuel efficient vehicles could do more to stimulate the economy than tax rebates, increasing the budget of the National Endowments to the Arts and similar agencies, and hiring more local government bureaucrats.

China continues to print yuan and sell those for U.S. dollars in foreign exchange markets to keep the value of its currency artificially low. This makes exports artificially cheap in U.S. markets, U.S. exports artificially expensive in China, and causes U.S. manufacturers to shift production to China in industries where its low-cost labor provides little advantage, like automobiles and advanced automotive components.

If China refuses to stop currency manipulation to prop up its exports and to shut out imports, the Obama Administration should tax dollar-yuan conversion in direct proportion to China's currency market intervention.

At his confirmation hearing Treasury Secretary Geithner acknowledged China is manipulating its currency and promised to work toward a realignment of currency values. But since then, Vice President Biden backed off this position, much as did Democratic Senator Charles Schumer from his bill to take action against currency manipulation during the Bush presidency.

Near term, a stimulus package focused on infrastructure is critical for resuscitating growth. The recent round of tax rebate checks ended up in savings accounts or spent at the Wal-Mart on Chinese goods, and did little to create jobs or accelerate growth. Whereas projects to repair roads, rehabilitate schools and refurbish public buildings would create high-paying jobs at home and provide a legacy in capital improvements that assist growth now and in the future.

However, stimulus spending, alone, won't fix what's broke. Without fixing the banks, energy and trade with China, the stimulus package will give the economy a temporary lift, but then unemployment will rise again. Keeping Americans employed would then require progressively larger stimulus packages and foreign borrowing. Eventually, the foreign line of credit would run out, and widespread unemployment, depression and economic decline would follow.

Wages and Unemployment

In March, wages rose three cents per hour, or less than 0.2 percent. Wage pressures pose little threat to accelerate inflation.

The unemployment rate was 8.5 percent in March, up from 8.1 percent in February. However, these numbers belie more fundamental weakness in the job market. Discouraged by a sluggish job market, many more adults are sitting on the sidelines, neither working nor looking for work, than when George Bush became president. Factoring in discouraged workers, who have left the workforce, and those forced into part time employment owing to the lack of full time work, the unemployment rate is about 16.7 percent.

Manufacturing, Construction and the Quality of Jobs

Going forward, the economy will add some jobs for college graduates with technical specialties in business, health care, education, and engineering. However, for high school graduates without specialized technical skills or training and for college graduates with only liberal arts diplomas, jobs offering good pay and benefits remain tough to find. For those workers, who compose about half the working population, the quality of jobs continues to spiral downward.

Historically, manufacturing and construction offered workers with only a high school education the best pay, benefits and opportunities for skill attainment and advancement. Troubles in these industries push ordinary workers into retailing, hospitality and other industries where pay often lags.

Construction employment fell by 126,000 in March. This is a terrible indicator for future GDP growth. Retailing shed 48,000 jobs, and financial services lost 25,000 jobs.

Manufacturing lost 161,000 jobs, and over the last 108 months, manufacturing has shed 5.0 million jobs. The trade deficit with China and other Asia exporters are the major culprits.

Adding Up the Costs

The dollar is too strong against the Chinese yuan, Japanese yen and other Asian currencies. The Chinese government intervenes in foreign exchange markets to suppress the value of the yuan to gain competitive advantages for Chinese exports, and the yuan sets the pattern for other Asian currencies. Similarly, Beijing subsidizes fuel prices and increasingly requires U.S. manufacturers to make products in China to sell there.

Ending Chinese currency market manipulation and other mercantilist practices are critical to reducing the non-oil U.S. trade deficit, and instigating a recovery in U.S. employment in manufacturing and technology-intensive services that compete in trade. Neither Presidents Bush and Obama nor Congressional leaders like Charles Rangel and Charles Schumer have been willing to seriously challenge China on this issue.

Either President Obama must get behind a policy to reverse the trade imbalance with China, or preside over the wholesale destruction of many more U.S. manufacturing jobs. These losses have little to do with free trade based on comparative advantage. Instead, they derive primarily from currency practices that make Chinese products artificially cheap in U.S. and other markets and Chinese restrictions on imports. These Chinese policies deprive Americans of jobs in industries where they are truly internationally competitive.

Each dollar spent on imports that is not matched by a dollar of exports reduces domestic demand and employment, and shifts workers into activities where productivity is lower. Productivity is at least 50 percent higher in industries that export and compete with imports, and reducing the trade deficit and moving workers into these industries would increase GDP.

Were the trade deficit cut in half, the movement of workers and capital into more productive export and import-competing industries would increase by at least $400 billion or about $2500 for every working American. Workers' wages would not be lagging inflation, and ordinary working Americans would more easily find jobs paying higher wages and offering decent benefits.

Put another way, the trade deficit is reducing 2009 GDP by $400 billion or about $2000 billion per worker.

Manufacturers are particularly hard hit by this subsidized competition. Through recession and recovery, the manufacturing sector has lost 5.0 million jobs since 2000. Following the pattern of past economic recoveries, the manufacturing sector should have regained about 2.5 million of those jobs, especially given the very strong productivity growth accomplished in durable goods and throughout manufacturing.

Longer-term, persistent U.S. trade deficits are a substantial drag on productivity growth. U.S. import-competing and export industries spend three-times the national average on industrial R&D, and encourage more investments in skills and education than other sectors of the economy. By shifting employment away from trade-competing industries, the trade deficit reduces U.S. investments in new methods and products, and skilled labor.

Cutting the trade deficit in half would boost U.S. GDP growth by one percentage point a year, and the trade deficits of the last two decades have reduced U.S. growth by one percentage point a year.

Lost growth is cumulative. Thanks to the record trade deficits accumulated over the last 10 years, the U.S. economy is about $1.5 trillion smaller. This comes to about $10000 per worker.

The Eclipse of American Leadership

In the end, without assertive steps to fix trade with China, as well as fix the banks and curtail oil imports, the Bush years will seem like a walk through the park compared to job and real income losses Americans will suffer during the Obama years.

Had the Administration and the Congress acted responsibly to reduce the deficit, American workers would be much better off, tax revenues would be much larger, and the federal deficit could be eliminated without cutting spending.

The damage grows larger each month, as the Administration and Congress dally and ignore the corrosive consequences of the trade deficit.

The choices for the new president are simple. It’s either recovery or depression. Fix the banks, trade with China and energy policy or preside over American decline and the eclipse of American leadership at the hands of China.

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