

*Bill Watkins*

*September 17, 2009*

Everybody knows that current economic conditions are extremely weak. However, many also think that we are on the cusp of a strong recovery. Unfortunately, they are likely to be wrong.

Before we look forward, it is worthwhile to take a look back and see what has transpired over the past year. It is also important to consider the human costs. To the extent that policy contributed to the recession, and to the extent that policy retards recovery, bad policy has real impacts on real people.

From August 2008 to August 2009, the United States lost 6 million jobs, ending with approximately 131,000,000 jobs. During that time, unemployment climbed from approximately 9.5 million to approximately 14.8 million, an increase of 5,343,000. The number of people not in the labor force, presumably because of discouragement, has increased by about 2.5 million. The number of people involuntarily employed part-time has climbed 3,000,000. The number of long-term unemployed, those unemployed in excess of six months, has climbed by over 3 million. It looks like the number of unemployed, underemployed, or discouraged workers has increased by ten million.

Those are distressing numbers. Recovering from an extended period of unemployment is extremely difficult. Many will never recover. Behind the unemployment numbers are thousands, perhaps hundreds of thousands, of ruined careers, ruined marriages, ruined families, and ruined lives.

While this recession has not remotely approached the seriousness of the depression, it has been the worst recession since the depression. Unfortunately, the human cost of this recession will persist for some time, even as some indicators of economic activity will show some signs of improvement.

We have seen signs that the decline is slowing down. The rate of decline in capacity utilization has slowed and most recently actually ticked up. The rate of job losses is declining. Indeed, third-quarter gross domestic product may show a small increase.

The United States economy, however, is still fundamentally weak. Even after the recent rise in stock markets, the country has experienced a huge loss in asset values. The result has been overleveraged balance sheets for banks, businesses, and consumers. There can be no strong recovery until those balance sheets are improved. That could take a long time.

Bank lending is a fundamental component of any economic recovery. It is also a fundamental component of effective monetary policy. Since last October, bank loans have been declining. The result has been an ineffective monetary policy, as both the money multiplier and velocity declined. Given the current rate of bank charge-offs, existing leverage ratios, and increased regulatory scrutiny, it is difficult to envision a scenario where banks will be able to contribute to either a more robust monetary policy or to a robust recovery within the forecast horizon.

Businesses and consumers are hardly better off. The decline in asset values has been deep and widespread. While financial institutions and consumers bore a large portion of the initial pain, falling commercial real estate values and continued losses from operations are increasing the stress on businesses throughout the economy and across the country. Whatever the initial financial condition of a business, unrelenting losses over months and quarters eventually erode balance sheets. At this point many, perhaps most, businesses are ill-prepared to assume additional debt to fund expansion, even if consumers were in a position to increase their spending.

Consumers are not in a position to increase their spending significantly. For most consumers, their home is their largest single source of wealth. At this point that wealth is far less than it was a couple of years ago. Furthermore, consumers are unlikely to see a recovery in real estate values in the near future. Foreclosures are still high. Extended unemployment means that loans that were initially good are now delinquent. Home ownership rates are still relatively high. The inevitable conclusion is that most residential markets will not see significant improvement anytime soon.

Demographics are exacerbating the economic impact of the consumer's weakness. Baby boomers are past their peak spending years, and after the shocks of the past year, they are focused on building equity for retirement.

There are other concerns. The ineffectiveness of monetary policy, that is the inability of the Federal Reserve to generate inflationary expectations, means that the risk of deflation has to be taken seriously. To the extent that deflation is a serious concern, the consumer has little incentive to spend on anything but necessities.

We can only conclude that the weaknesses outlined above will be a persistent hindrance to any robust economic recovery.