# A Never-Ending Economic Crisis?

## The 2008 meltdown was badly handled; the 2009 recovery may be a bubble; portents for the future are worrisome indeed

**By David M. Smick**

THE GLOBAL economy has experienced a brutal financial retraction not seen since the 1930s. The value of virtually every asset in the world was reappraised downward, led by housing in the United States. The situation has been like an unstoppable force of nature. In response, most of the world's central banks, including the Federal Reserve in the United States, slashed short-term interest rates to near zero percent and flooded the financial system with liquidity. World governments produced fiscal-stimulus packages of mind-boggling size.

Global governments spent an astonishing $17 trillion to support the world economy in the form of bailouts, guarantees, and stimulus packages. To put this number in perspective, $17 trillion represents one quarter of global GDP. Global budget deficits jumped by 737 percent over the previous year's aggregate global government deficits.

In the 12 months following the outbreak of the crisis, global trade declined by 25 percent, global investment by 15 percent, and global GDP by nearly $4 trillion, or an amazing 6 percent. Global industrial production in the advanced economies dropped a whopping 15 percent. Worldwide unemployment rates have skyrocketed, nearly doubling in the United States alone. Wage growth is nonexistent. The Obama White House says things could have been worse. It's hard to see how.

It is also hard to see why, since hitting bottom in March 2009, the Standard and Poor's stock index has rebounded by more than 60 percent, NASDAQ more than 70 percent, with emerging-market stock indexes jumping over 90 percent. The U.S. financial-services industry is up an incredible 125 percent since March 2009. Global equity markets are booming. This suggests better times ahead. The question is where? In the United States, or elsewhere in the world? The question is also whether this powerful

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equity rally is based on sound economic fundamentals. Clearly a certain type of financial bet, called a "dollar carry trade," is at work. In a dollar carry trade, investors borrow money in dollars at low interest rates to buy assets with higher yields, often offshore. Here's the danger: carry trades have a history of appearing suddenly and then vanishing just as suddenly.

A Goldman Sachs analysis argues that once the "sugar rush" of cash-for-clunkers and other forms of stimulus wears off, and industries replenish their inventories, GDP growth next year will drop to a modest 1.5 percent rate. According to the Federal Reserve staff forecast, 3 percent if everything goes perfectly, which they admit never happens. And even that projection is a dour one when you consider this: the history of recessions is that the harder the fall, the higher the rise. Growth rates of 5, 6, or even 7 percent after a steep downturn are not uncommon. Therefore, a 1.5, 2, or even 2.5 percent growth rate in 2010 would be stunningly disappointing news. And not just disappointing; it would have enormous implications for the size of future public debt. That's because the Obama administration's budget and tax-receipt forecasts assume that the economy will grow at a much higher rate, next year and for years to come.

That would be nice. But unlikely. There are two fierce headwinds that will most likely continue to hold back consumption and make this recovery disturbingly weak: the first is rising joblessness, and the second is the soaring U.S. public debt itself.

## The Jobless Crisis

The official U.S. unemployment rate has nearly doubled since Obama was elected. The so-called household survey shows an even worse jobless situation. To a certain extent, the president inherited this situation. But he also has allowed the perception to persist that if only we could get the economy moving again, fueled by his stimulus package, the jobless rate will quickly come down. Not so.

For the U.S. unemployment rate to drop from the 10.2 percent rate it hit in October to 5 percent over the next five years, which should not be an unrealistic goal, the economy would need to produce 250,000 jobs per month each month straight, according to the analyst John Mauldin. What are the chances of that happening? Probably zero. It's never happened before. Sadly, average official U.S. monthly job growth the past two decades has been 90,000. Even during the most spectacular year for job creation, 2006, average monthly job growth was only 232,000. Therefore, reducing unemployment to where it was before the crisis may be impossible. (Factor in state- and local-government layoffs in 2010 as a result of collapsing state- and local-government finances and the employment situation looks even more parlous.)

The most disturbing portent is that the economy lost twice as many jobs in the third quarter of 2009—a time when the economy, helped by the stimulus, grew at a healthy 3.5 percent rate over the previous quarter, than when the economy was contracting. A number of analysts believe that the reason for this continued retraction is the bond market. It costs about $314,000 in capital for the private economy to create a job—versus about $1.2 million per job created as a result of stimulus spending. The theory is that public-investment dollars thrown at the stimulus may have crowded out the delivery of capital to small businesses in the private sector, which create most new jobs.

This is only a theory for now. What is certain is that we had better get ready for an American workforce full of long-term anxiety and anger. And even if unemployment rates start to come down, they won't drop as much as they should. That's because the number of workers forced into part-time status has soared and the average hours in a work week have dropped. Thus, with any economic rebound, employers will lengthen the work hours of existing employees, not hire new employees.

If I sound too pessimistic, let me note for the record that the U.S. stock market has surprised the world with its performance. Economics is more an art than a science. So maybe stock-market investors, collectively, are seeing something the pessimists are missing: an explosion in "animal spirits."

The economist Lawrence Kudlow foresees a "barn burner" of a U.S. economic recovery just around the corner. Kudlow is right, but only if this remarkable equity-market rally has a positive "wealth effect" on consumers, particularly affluent consumers who are responsible for more than half of retail sales. That might happen, but the equity market seems to be responding more to a perceived pickup in global demand, spurred heavily by China, than to a robust U.S. rebound.

Indeed, the risk here is that there will be an "equity crash" when the predicted rebound does not come to pass. It may be that the reason the Federal Reserve is leaving short-term rates so low is that officials think the wealth effect generated by the stock market may be our only hope of a sustainable rebound. In other words, if the stock rally is all you've got, don't kill it, as tenuous as it might be as a stimulus for consumption. If it lasts long enough, the carry trade could also potentially attract more long-term investors now on the sidelines. So for Fed Chairman Bernanke, it's a choice between the risk of another asset bubble crash and a potentially slow, painful period of economic and financial suffocation and rising public debt.

Here's where things stand to date. As a result of the crisis, U.S. consumers experienced a $13 trillion hit to

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their collective balance sheets through stock and real-estate losses. That's a horrifying number, given that the nation's gross domestic product is only $14 trillion. The good news: Americans have gained about a third of these losses back as a result of the stock market's recent gains. Yet housing prices remain problematic.

Today Fed officials say that the global stock market boom since last March has restored about $14 trillion to global wealth. But if this $14 trillion doesn't have a sustainable effect in turning around worldwide consumer sentiment, there is little more the central banks and governments of the world can do. With the exception of China, they are largely out of fiscal ammunition. No wonder they are investing so much hope in a change for the better in the consumer's mood.

## The Public-Debt Crisis

The consumer's mood is likely to be affected, and not for the good, by the coming public-debt crisis. Take a look at the Congressional Budget Office's most recent projections. Within a decade, the CBO says, the U.S. government will be borrowing $722 billion just to pay an interest expense of $722 billion. And that doesn't include the likely borrowing needed for shortfalls in Social Security and other entitlement programs. We're about to enter a fiscal trap, chasing our tail just to pay off our creditors. That is an experience heretofore confined to Third World regimes. Their currencies lose all credibility, and they suffer from high and crushing interest rates, only to end up wards of the International Monetary Fund.

Indeed, the debt itself may be a reason for continued weak consumption and the long-term under-performance of the U.S. economy. This, of course, is the logic that buttressed the 19th-century economist David Ricardo's idea that the mere fear of rising debt can inhibit consumer confidence. Why should this be so? The anticipation of future tax hikes to pay for the debt, or inflation and higher interest rates to finance the debt, or the fear of both.

Public-opinion polls tell the tale. Americans are experiencing deep feelings of anxiety, and not solely because of short-term concerns about recession, double-digit unemployment rates, or lack of health care. They are worried about a pending national fiscal nightmare that could doom the U.S. economy to slow growth and second-rate status. Our public debt already amounts to nearly $40,000 for every living American, or $160,000 per family. And the burden is quickly rising.

Because the U.S. fiscal situation is unlikely to significantly improve any time soon, some analysts are predicting that hyperinflation is just around the corner. The Federal Reserve will be forced to monetize today's mountain of debt. This is the thinking of the so-called Austrian School of Economics—that regardless of the size of the output gap, inflationary expectations will soar once the economy begins to recover simply because of the Fed's huge monetary overhang.

These analysts make an interesting case. The inflation argument could be described as having a cinderblock at the other end of a long conference table attached to a large rubber band. You're at the far end of the table and you keep pulling on the rubber band, but the block won't budge. Then you hit a tipping point and the block flies across the room, hitting you in the face.

And yet it is difficult to find examples of hyper-inflation unaccompanied by aggressive wage inflation. With today's unemployment, it is difficult to imagine upward pressure on wages any time soon, certainly not before 2012 at the earliest. Unit labor costs just experienced their biggest decline since 1948.

The Fed is betting on exactly this: several more years of a disinflationary threat followed eventually by a potential upsurge in inflationary expectations. But nothing about this scenario can be taken with any certainty. In the 1990s the Japanese were betting that given the size of their monetary overhang and their massive debt, inflation would eventually soar. That never happened.

One has to be sympathetic toward Bernanke's predicament. To confront the financial crisis in 2008, the Bernanke Fed quickly flooded the paralyzed, credit-starved financial system with liquidity through a variety of new and highly creative methods. The Federal Reserve has more than doubled the size of the liabilities on its balance sheet. The idea was to avoid the mistake of passivity committed by Fed officials in the 1930s. But what long-term unintended economic consequences these policies will present in the future, nobody knows.

What we do know is that despite today's massive liquidity, the monetary stimulus so far has had a surprisingly

muted effect on the real economy. That's probably because the velocity of money—the speed with which money is demanded and changes hands—is declining. The question is whether this decline in the velocity multiplier is having the same effect as if the Fed reduced the money supply, limiting the economy's oxygen supply.

Here's the great mystery. The bold monetary stimulus may have helped stabilize the financial system, but its effect on prices has been modest. For example, despite the Fed's aggressive actions, from August 2008 and for the following 12 months, the Consumer Price Index in actual percentage points dropped more than three times as much as it did during the comparable period during the Great Depression. That is worrisome because if the situation were to persist, housing prices would find it difficult to reach bottom.

Sensing these persistent disinflationary pressures, the Fed has kept short-term rates at near zero. Yet long-term rates, the 10-year Treasury bond, have nearly returned to their pre-Lehman collapse levels. Many market participants believe that today's 10-year Treasury rate reflects less a confidence in a coming U.S. economic boom than a fear of a coming Armageddon of public debt as the Treasury continues to auction off ever larger amounts of government paper.

The state of U.S. monetary policy has never been more confusing. The San Francisco Fed just came out with a study concluding that the Fed funds rate would need to be 4 percent lower to have any meaningful effect in reducing the unemployment rate. That rate is already near zero percent. Their conclusion is that every $800 billion added to the Fed's balance sheet is equivalent to a 1 percent drop in the short-term rate. So the study concludes, believe it or not, that the Fed needs to add a couple of trillion dollars more to its already bloated balance sheet.

Such thinking is not completely deranged. That's because the Fed's fight to counter disinflationary pressures occurred at precisely the time that China, using a massive emergency government-lending program, was stockpiling commodities. China's actions sent most global commodity prices, including oil, through the roof (although, as far as oil is concerned, global speculators and today's liquidity conditions added significantly to the rise in prices). Thus, at the height of the financial crisis, Chinese actions helped push up global commodity prices—and they may unwittingly have kept the American economy from going over the disinflationary edge.

But now these Chinese-induced commodity bubbles, initiated by a country with enormous industrial overcapacity, may not be sustainable. Even the Chinese are worried about financial bubbles. In August, for example, Beijing announced a modest slowdown in its government lending program. And what happened to commodity prices? They tumbled. This suggests that commodity prices were merely responding to Chinese stockpiling. Today the Chinese have enough steel- and iron-ore-producing capacity to meet the needs, incredibly, of the United States, Japan, Russia, and the 27 nations of the European Union *combined.* With the U.S. consumer forced onto the sidelines, the world now seems to be looking to China, a rapidly aging society with no social safety net, to make a quick transition to a consumer-led economy. That seems a stretch. Chinese state-run banks and corporations may be loaded with cash, but Chinese consumers are not.

## The Banking Crisis

The economics profession and most of Wall Street remain deeply divided over the long-term significance of the George W. Bush/Barack Obama effort to spend $700 billion bailing out the banks. Here's the troubling part of the bank-bailout story: other nations have followed in America's footsteps, with major and growing government involvement in their banking systems. As a result of governments' growing presence in financial affairs, the world of banking will never be the same.

Today we have a dollar-based global financial system dominated by roughly 25 government-subsidized international megabanks, with some of the biggest owned by China. These giant financial institutions control roughly $50 trillion in bank assets. That's 60 percent of the world's total bank assets. Unfortunately, today only five of these 25 megabanks are American-owned, according to Leto Market Insight. We now have a global financial system largely controlled directly by foreign banks and indirectly by their governments.

When the history of this period is written, it is likely that Barack Obama and George W. Bush will probably be lumped in the same category on the subject of the banking bailout. Both offered the big Wall Street banks an incredible $700 billion in taxpayer funding with no stipulation that the banks actually lend the money, which today they aren't doing.

Before the outbreak of the financial crisis, the U.S. financial-services industry represented an incredible 40 percent of corporate profits and 30 percent of the stock market's value. This, of course, was an unsustainable situation that made little sense. The question is, what will replace this large hole in our GDP left by the shrinking of our financial-services industry? For a number of years, there probably will not be a replacement.

The perception now is that Washington has entered a new era of "political banking." The well-connected receive all the breaks. The U.S. Treasury bailed out the banking sector so that it could start lending again. But the big banks aren't lending; they are buying securities as a means of bol-

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stering their balance sheets and profiting from the steepening yield curve.

In other words, just as the Japanese banks in the 1990s, they can borrow from the central bank for next to nothing, because the large Wall Street banks have access to the Fed's discount window for cheap loans. Even a high-risk firm like Goldman Sachs now has access to the U.S. taxpayer safety net via the Fed's discount window. The banks use that borrowed money to buy guaranteed government debt, taking the difference in yields as riskless profit.

There is a reason the banks aren't lending: they don't have to add to their reserves when they buy government securities, which they would have to do if they lent to job-creating businesses in the private sector. While the U.S. banking industry's current practice of buying securities and not lending may help repair bank balance sheets, the situation is killing the U.S. economy. As an alternative to seeking bank financing, America's large corporations thankfully have had access to a healthy corporate bond market. They sold more than a trillion dollars in bonds in 2009, the fastest pace on record. But that has not been the case for medium- and small-sized companies, and entrepreneurial start-up ventures, which have been credit-starved since the outbreak of the financial crisis. President Obama himself has said that these smaller firms and start-ups are responsible for 70 percent of our economy's net new jobs. But they are barely on Washington's radar screen, even as the unemployment rate soars.

In October, a Japanese official visited my office in Washington and asked this provocative question: "Why didn't the U.S. Treasury, when the healthy bailed-out banks such as Goldman Sachs and J.P. Morgan asked to return their TARP bailout money, insist that the banks first spend the next three years lending the TARP money before returning it? Wouldn't it have been better to save the economy first and then repair the bank balance sheets? Why wouldn't American policymakers have learned from Japan's mistakes in the 1990s?" Of course, the healthy banks returned the money precisely because of the fear that if they kept the money, Washington would question their bonus and salary structure. As a result, banks are lending the smallest portion of their deposits in 15 years.

A year ago, leading bankers like Chase's Jamie Dimon and Goldman Sachs's Lloyd Blankfein and others would have lost their jobs had Washington forced the banks to clean their balance sheets of their toxic assets, as was the Treasury's original game plan. This would have been risky. There would have been blood on the floor. But the result would have been a leaner, cleaner banking sector far more amendable to lending. But the big cleanup never happened. Politically inspired timidity carried the day. Banks that are too big to fail are simply too big. Washington seems unwilling to confront the financial-services industry in the right way.

### The Innovation Crisis

The broader question is whether America has the means of getting itself out of its economic malaise. It is risky to bet against the American spirit of creative problem-solving. After the Second World War, a victorious America grew out from under a massive debt that totaled a whopping 125 percent of GDP. But that was after four years of pent-up demand followed by unprecedented optimism. By contrast, consumers today are in a gloomy period of long-term deleveraging. A year ago, Washington thought it had a credit *supply* problem, so it bailed out the banks. Turns out we also had a credit *demand* problem. Consumers aren't borrowing. At the same time, their fundamental economic expectations may have been reduced. People are experiencing a new, less materialistic sense of well-being.

If this is the new era of reduced consumption, Washington has no choice but to try to stimulate private investment and innovation. Private investment is key, but private innovation entails risk-taking. And my great fear is that we have moved from a period of reckless financial risk-taking to a situation even more dangerous, with no financial risk-taking at all as our efforts increasingly focus on stability as an end in itself.

Today if you are a brain-dead, bailed-out bank, financing is not a problem. But if you are out there alone with a brilliant idea that could someday employ thousands of people—if you are, in other words, the next Google—obtaining financing will be tough because the normal avenues of risk capital will assume you'll find it difficult to pull off a successful stock offering.

The good news is that deep economic recessions have a history of producing aggressive bouts of innovation. The Obama administration needs to encourage this process. It needs to pivot quickly to devise policies that help reignite the investment-led engines of our economy.

We also need to become serious about manufacturing, which in the United States hit a low of 13.7 percent of real GDP in 2008. In the recent fast-buck era of financial leverage, we have forgotten that a large percentage of America's research and development, and of our science and technology labor force, comes from firms engaged in manufacturing. This is why the mind boggles that the stimulus package didn't have a huge investment tax credit.

A more vibrant U.S. manufacturing sector requires a predictable global-trade and currency system that reverses today's steady march to a new mercantilism. Like never before, the world needs a new Bretton Woods-style international agreement to provide a financial doctrine of stability.

Washington wants to create more jobs. But that means coming to terms with how private-sector jobs are actually created. The issue here is not just size but also age. According to the Census Bureau, nearly all net new jobs since 1980 have come from start-ups in existence five years or less. Jobs come from the deployment of innovative ideas by start-ups that thrive in a dynamic climate of economic buoyancy.

Innovative risk-taking is a delicate process difficult to nurture. The next Google cannot be legislated into existence. Innovative breakthroughs entail the unpredictable. There is an elusive almost metaphysical process that makes planning and certainty difficult. Something as common and essential as the ballpoint pen was conceived by an insurance executive on his vacation. The automatic transmission, invented by a struggling supplier, had little to do with the massive engineering departments of Detroit's automakers.

What Washington can provide is a climate conducive to innovative risk. But that is not in the cards in today's partisan climate, where the tax, regulatory, and financial futures are as terrifyingly uncertain as at any time in postwar history.

In the end, at the heart of any economy are people. Economies are influenced by more than numbers, by more than the size of central-bank liquidity injections or the size of a fiscal-stimulus package. They are ruled by psychology. They are ruled by the speed with which people are willing to work with the liquidity the central bank provides. That's why, at the end of the day, the definition of liquidity comes down to one word—*confidence.*

If America's leaders are unable to instill that confidence, the American people are certain to find new ones who can and will. ❧