No end in sight to US jobless rise

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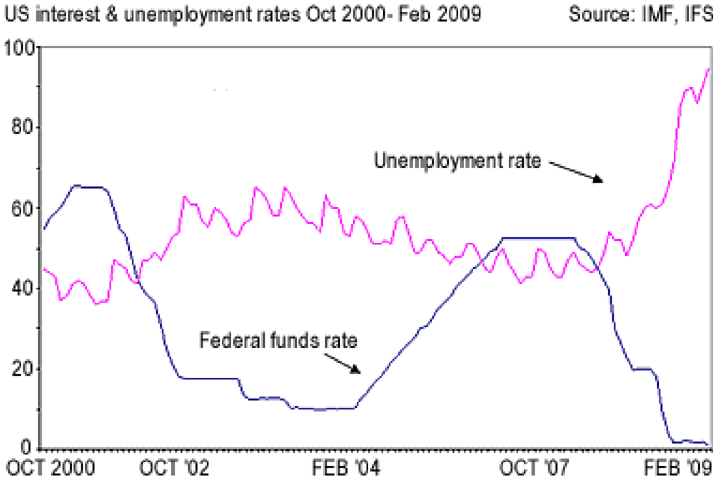
The unemployment rate in the United States rose to 9.5% in June 2009 from 3.6% in October 2000 and 4.1% in October 2006. Most puzzling, as indicated in the chart below, has been the obvious failure of Federal Reserve chairman Ben Bernanke's unprecedented aggressive monetary policy to produce the quick economic recovery that he promised at each interest rate cut.

The more he cut interest rates and the more he inflated the balance sheet of the Fed, the higher unemployment has risen. Unemployment has kept on rising even though the federal funds rate has been near zero since December 2008. The unfulfilled promise of Bernanke, a proclaimed expert of the Great Depression, has been certainly disappointing. However, Bernanke and his supporters have kept crediting themselves that, without unorthodox cheap monetary policy, the unemployment rate would have been much higher.



The climbing unemployment rate has also been puzzling in face of unprecedented expansionary fiscal policy and gigantic stimuli packages. The George W Bush administration ran large fiscal deficits which reached US$455 billion in 2008. House speaker Nancy Pelosi's stimulus package of $165 billion in 2008 was intended, with announced certainty, to bring recovery in the third quarter of 2008. The Barack Obama administration initiated its own gigantic stimuli package of $787 billion in February 2009 at a scale touted to be sufficiently powerful to force a turnaround in the economy.

With the aim of quickening the economic recovery, the Obama administration has decided to run the largest fiscal deficit in peacetime US history at 13% of GDP. Yet, in spite of record fiscal deficits, the unemployment has kept on rising. The Harvard multiplier has seemed to work in reverse, a performance that would be disappointing to Keynesians who faithfully predict that fiscal deficits turn stone into bread and multiply income and employment.

It is baffling that such extraordinary expansionary fiscal and monetary policies and gigantic stimuli have failed to at least arrest job losses. The job losses have even accelerated from 322,000 in May 2009 to 467,000 in June 2009. It would be very difficult to think of more unorthodox monetary policy or more expansionary fiscal policy in order to bring about economic recovery.

Despite deepening economic recession, Bernanke and his counterparts on the Obama team were still faithful to their prescription that unorthodox fiscal and monetary policies would eventually produce a miracle and set the economy booming again. Bernanke has recently restated his long standing view that "final demand should be supported by fiscal and monetary stimulus".

Prominent US policymakers and academicians have related economic recession and rising unemployment to the housing crisis. For instance, former Fed chairman Alan Greenspan in a recent Financial Times (FT) article firmly believed that economy recovery would take place once housing prices stabilize: "I conjectured over a year ago on these pages that the crisis will end when home prices in the US stabilize. That still appears right. Such prices largely determine the amount of equity in homes - the ultimate collateral for the $11,000 billion of US home mortgage debt, a significant share of which is held in the form of asset-backed securities outside the US. Prices are currently being suppressed by a large overhang of vacant houses for sale."

Greenspan rejected pressing calls to stabilize housing prices in 2003-2004. He let the housing bubble inflate on with cheap fuel from the Fed, inflicting trillions of dollars in losses on the banking system and triggering millions of foreclosures. In his recent FT article, he was not explicit how housing prices could be stabilized when the Fed was injecting $1.5 trillion in mortgage loans. He was also not explicit about the level at which housing prices should stabilize.

With the current Fed policy to re-inflate housing prices and the government policy to prevent foreclosures and subsidize homeowners, it would be difficult for housing prices to stabilize around a market-determined equilibrium price. Greenspan was certainly confusing causes and effects. Prices of any good or service are the result of demand and supply and policies that affect demand and supply. Hence, prices cannot be stabilized around a market equilibrium level as long as they are being distorted by monetary and fiscal policies.

Greenspan had certainly a partial view of prices. The US economy has faced not only distorted housing prices, but also distorted and speculative prices in other key markets such as food and energy markets and well currency markets. The US auto industry was hit directly by oil prices and not housing prices. Auto sales crumbled when oil prices soared to $147 per barrel. Demand for SUVs and gas-guzzling cars suddenly disappeared with consumers opting for hybrids and small cars.

In the same vein, when food prices rose by three to fourfold, food riots erupted and demand for food was squeezed; and although we are in the middle of a recession, food prices are back up again. Not only housing prices have to stabilize but all prices have to stabilize. Since housing and commodity prices are influenced by the same monetary and fiscal policies, these prices will not be stabilized until these policies are stabilized.

Contrary to Greenspan's narrow view of the recession, Irving Fisher (1933) forcefully argued that deep recession and large-scale unemployment can only be explained by, and attributed to, over-indebtedness and overly cheap monetary policy. The Greenspan-Bernanke excessively aggressive money policy has caused many distortions in the US economy, pushed the ration of credit to gross domestic product to unsustainable levels, and saddled banks with trillions of dollars in toxic assets that finally played havoc with real economy and with employment.

In other words, the rapid escalation of unemployment to 9.5% in June 2009 cannot be explained except by the aggressive cheap money policy of the Greenspan-Bernanke era. Such policy pushed trillions of dollars to subprime markets that melted down and consequently bankrupted the banking system in the US and Europe. It provided free wealth to borrowers. It set off unparalleled speculation in housing, stock, and commodity markets.

The collapse of stock prices inflicted trillions of dollars of losses in pensioners' savings. Excessive mortgage payments and rising property taxes combined with exorbitant food and energy prices have weighed dramatically on household budgets and forced real cuts in demand for both essential and non-essential goods.

The deliberate policy of Bernanke has been to re-inflate housing and asset prices instead of stabilizing these prices. The June 2009 statement of the Federal Open Market Committee reads: "In these circumstances, the Federal Reserve will employ all available tools to promote economic recovery and to preserve price stability. As previously announced, to provide support to mortgage lending and housing markets and to improve overall conditions in private credit markets, the Federal Reserve will purchase a total of up to $1.25 trillion of agency mortgage-backed securities and up to $200 billion of agency debt by the end of the year. In addition, the Federal Reserve will buy up to $300 billion of Treasury securities by autumn."

Besides reducing interest rates to nearly zero, the Fed is mounting the largest scale long-term liquidity injection under numerous lending facilities, and is also bearing directly the risk associated with these loans under these Fed facilities. Hence, with a bid to re-ignite housing speculation and send housing prices soaring again, the Fed is pushing close to $1.5 trillion in mortgage loans. Such a re-inflationary attempt cannot succeed unless banks are ready to "play it again" - making loans to borrowers who cannot service them; and borrowers put their heads in the sand yet again - taking on forbidden mortgages they cannot repay.

However, not withstanding the death of securitization, banks continue to suffer dramatic mortgage losses and homeowners remain unable to service their mortgages. Hence, banks and homeowners would hardly accept to play the Fed's game despite the willingness of the Fed to print money and bear all mortgage losses. The Fed has also established the Term Asset-Backed Securities Loan Facility (TALF) to inject $1 trillion in consumer (auto and credit card) and small business loans. The Fed wants to drown consumers in debt and make them spend out of loans instead of out of earned incomes in order to force an economic recovery.

Bernanke seems determined to further undermine the safety of the US financial system in spite of the highest default rates in consumer loans. Cheap monetary policy will in time turn out to be inflationary and distortionary and will inflict more financial losses on the banking system and on the government in form of trillions of dollars in future bailouts.

Bernanke's Fed and the Obama administration are caught in an unsustainable expansionary fiscal and monetary trap. Politicians would prevent interest rates from rising above zero or any return to stable macroeconomic policies. The US Treasury is building the highest US public debt and would oppose any rise in interest rates. Major reserve central banks would oppose any rise in interest rates and loose competitive ground relative to other countries.

Hence, the world economy could be stacked at near zero interest rates and largely negative real interest rates for a long period to come. These low interest rates will discourage real savings and private investment and therefore constrain economic growth. They would be propitious to consumption, speculation in asset and commodity markets, and preclude stability in prices.

Employment is related to real output through a physical relation called the production function. Demand for labor is a derived physical demand related directly to the real output of goods and services. Thus a fall in real output would, in turn, lead to a fall in employment. Although the Fed has all along denied inflation by considering solely core inflation that excludes food, energy, and asset prices, real demand in the US has contracted under powerful inflationary forces in housing, energy, food prices, and substantial depreciation of the dollar exchange rate.

As wages do not change quickly, pension levels are fixed, and interest income is low, the real incomes of workers and pensioners have been eroded by high inflation causing a fall in real personal spending. The latter fell by 2.75% in 2008 Q3 and 2.99% in 2008 Q4. The cooling off of food and energy prices, however, caused a slight increase at 0.95% in 2009 Q1. Although interest rates were largely negative in real terms, real private investment showed negative growth during 2006-2008 and fell dramatically by 8.2% in 2009 Q1. Such a drop in real private investment caused an interplay of the accelerator-multiplier effect and depressed real output, falling by 6.3% in 2008 Q4 and 5.5% in 2009 Q1. The record fiscal deficits will squeeze real private savings and crowd out further real private investment, thus impeding sustained economic recovery.

Milton Friedman argued in 1968 that the central bank cannot control the unemployment rate nor can it control real interest rates. It can only control money supply and credit. In turn, he called for a stable monetary policy. The Fed has so far inflicted heavy financial and economic losses and pushed unemployment to 7 million. The Fed, with a view to boosting aggregate demand and reabsorbing unemployment, has decided to inject trillions of dollars in new long-term liquidity under various lending facilities at a time when the banking has been overloaded with toxic assets and consumers were over-indebted.

The credit to GDP ratio stood at 350% in 2008 and was obviously unsustainable as it caused large loan write-downs and bankruptcies. Forcing this ratio further up will only compromise the safety of the banking system. As the mountainous liquidity being injected by the Fed will not be hoarded in mattresses, it will eventually cause runaway inflation, stifling economic growth and employment as has been the experience since August 2007.

The Fed has created immense distortions in the economy and has pushed private debt to still higher levels. The Obama administration has decided to push public debt to levels that would have been unimaginable a year ago. Unsustainable private and public debt will constrain economic growth for many years to come. Historically, unsustainable fiscal and monetary policies have not been conducive to growth and employment. High uncertainties prevail in the economy and discourage private investment and employment expansion. Unsafe credit has been a factor in every financial crisis, including the Great Depression and the recent financial crisis.

Financial crises have called for new regulation, including the Pearl Act in 1844 in the United Kingdom and the Roosevelt administration regulations in 1935. Yet, these regulations did not, and could not, prevent crisis when central banks deliberately undermined them. Inflationists have taken advantage of costless money-printing to debase money and push unsafe credit with a view to boosting aggregate demand and employment. Demand policies are insufficient to achieve sustainable economic growth; supply side policies are also needed. It would appear that the US economy is trapped in disorderly fiscal and monetary policies that could delay recovery and employment creation for some time to come.

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