Joblessness Will Hinder U.S. Recovery

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In his semi-annual congressional testimony on the state of the U.S. economy, Federal Reserve Chairman Ben Bernanke highlighted the risk the exceptionally weak labor market poses to U.S. economic recovery. And the furious pace of payroll reduction by employers during the second quarter suggests his fears are well founded.

High unemployment could constitute a strong headwind against a vigorous U.S. economic recovery for three reasons: consumption, credit and housing.

Wages and Consumption
High unemployment already is exerting considerable downward pressure on wages, which is constraining the growth in household incomes. Should high unemployment continue to prevent household income from growing in a meaningful way, there would be little basis to expect significant growth in household consumption, which constitutes approximately 70% of U.S. aggregate demand. This would be particularly true at a time when households are attempting to increase their savings in response to the substantial decline experienced over the past year in household equity and housing wealth. Ominously, consumption was one of the weakest factors in the government's initial second-quarter GDP forecast released Monday.

Financial-Sector Effects
Historically, high levels of unemployment have been closely associated with high levels of household loan defaults on credit cards, auto loans and home equity lines of credit. Maintenance of a double-digit unemployment rate in 2010 would compound the problem of impaired assets in the U.S. banking system, which would induce banks to continue their reluctance to extending credit. It now seems probable that by year's end, unemployment will have exceeded the 10.3% rate that had been assumed by the U.S. Treasury as its "worst-case scenario" in the stress tests it administered to the country's 19 largest banks.

Housing Crisis
High unemployment rates are associated with an increased incidence of mortgage loan defaults. Maintenance of double-digit unemployment rates can be expected to compound the country's foreclosure crisis, which could delay the stabilization of the U.S. housing market. Despite the government's efforts at promoting mortgage loan modification, foreclosures are presently running at an annual rate of over 2 million homes.

Employment Prospects
Unemployment is a lagging economic indicator and as such it tends to continue rising for several quarters after the economy has bottomed out. Moreover, experience of recent economic recoveries (particularly following the brief 2001 recession) suggests the possibility of a "jobless recovery." The chance of a jobless economic recovery this time around is heightened by the tendency of companies to reduce employees' working hours and to bolster their reliance on part-time workers.

The prospects for unemployment are closely linked with the overall economic outlook. Both the International Monetary Fund and the Organisation for Economic Co-operation and Development are projecting that U.S. unemployment will peak at around 10.25% in the first half of 2010 and decline only very gradually thereafter. More pessimistic forecasters, such as the famously bearish New York-based economist Nouriel Roubini (see his Forbes columns here), are projecting unemployment will peak at around 11%.

Outlook
The U.S. unemployment rate has already risen to a level that is reminiscent of that in the 1981-'82 economic recession, and is likely to move higher and remain in double digits throughout 2010. This will prevent a rapid economic rebound, and is likely to heighten calls for a second fiscal stimulus package.

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