Economic Storm Clouds on the Horizon
by Paul A. Rahe  BigGovernment.com, 12/10/10

The experts charged with determining when recessions begin and end tell us that the latest of these unpleasant events ended a while ago. Technically, they are no doubt right. But that does not mean that the economic crisis we have been facing is over. I suspect that we have thus far only seen its first act. The drama to come may be far, far worse. To see why, one must recognize that economic downturns come in two different forms.

The economists who study recessions tend to think about them in turns of the business cycle – and rightly so, for in most cases it is the business cycle that produces the downturn. In the course of such a cycle, boom builds upon boom and bust upon bust. It is a bit like a game of crack the whip. Downturns occasioned by the business cycle are caused by overproduction. When businesses have more stock than they can sell, they stop producing and lay off workers. The workers laid off and no longer getting paychecks cut back on their consumption, and this in turn reduces the demand for goods and services and causes other businesses, which find their products and services no longer as much in demand, to curtail their efforts and lay off another set of workers. And so the recession grows, building on itself, until some businesses find that they have underproduced or underprovided for the services in demand. Then, the same process takes place in reverse with stepped-up production and a stepped-up provision of services requiring stepped-up employment, which occasions more consumption requiring another round of stepped-up production and provision of services and a further increase in employment and so forth – until production and provision once more overshoot demand. In the absence of perfect knowledge, human beings living in commercial societies are fated to suffer from an oscillation of this sort – between boom and bust.

When Barack Obama became President, his economic advisors appear to have been on automatic pilot and to have taken it for granted that this was the sort of recession that they were up against. And so they opted for a remedy that – if applied in the proper fashion, at the proper time, and in the proper amount – might serve to hasten an economy’s recovery from a recession occasioned by the business cycle. That is, they sought to prime the pump – to increase consumption by artificial means, to borrow money from the future, put it in the pockets of certain citizens, and hope that they would spend it right away and thereby put others back to work.

Such was, at least, their pretense. In practice, of course, the so-called “stimulus bill” was a targeted measure – a massive pay-off designed to reward the public-sector employees and unionized workers involved in infrastructure construction who make up core constituencies within the Democratic Party and to do so at the expense of those whose taxes the Democrats intended in the future to raise. Obama’s advisors did not worry much about the manner in which the “stimulus” was to be applied, its timing, and amount, however. For they took it for granted that the expenditures would do no immediate damage to anyone and that the economy would bounce back quickly in any case, as it always does when the downturn is caused solely (or at least primarily) by the business cycle.

But, of course, this did not happen. The economy did not bounce back. On 10 January 2009, Christina Romer – Chairman of President Obama’s Council of Economic Advisors – predicted that, if the so-called “stimulus bill” were passed, it would save 3.5 million jobs, that unemployment would stay below 8%, and that joblessness would quickly decline from that level. In the twenty-three months that have passed since Romer made this prediction, we have lost something like 3.5 million jobs, unemployment has climbed to about 10%, and it has not appreciably declined from that level. The chart posted below, which first appeared on Business Insider and on Calculated Risk, illustrates nicely the difference between the ordinary course of a recession and the course taken by our most recent downturn.
The only defect of this chart is that it fails to capture the full level of distress. To the 15.1 million Americans seeking employment (the basis for putting it at 9.8%), one has to add, as Irving Stelzer recently pointed out, the 2.1 million who have given up looking for work and the 9 million who have been kept on but only part-time. What the chart does show, however, is that we are not experiencing an ordinary downturn.

There is, as it happens, another type of recession not rooted so firmly in the business cycle, which you might call it a fiscal recession. The last one we experienced in the United States began in 1929, and it was a doozy. Fiscal recessions are a function of the level of indebtedness. The one in 1929 was preceded by an extended period in which the Federal Reserve Board, supported by the Secretary of the Treasury, followed an easy-money policy. Interest was low; money was lent to all and sundry on easy terms; home-buyers and consumers took out loans they could not manage; and investors with borrowed money took great risks in attempts to make a quick buck. Bubbles appeared; and when the stock market finally crashed and the unemployment rate went up, the number of bankruptcies was legion. Those able to manage their debts concentrated on paying them down; and, for a good long time thereafter, Americans were very, very reluctant to take on debt.

This is not the whole story, to be sure. After the crash in 1929, the Federal Reserve Board kept interest rates high; Herbert Hoover and the Republican Congress increased taxes and tariffs; and Franklin Delano Roosevelt and the Democrats compounded thereafter the damage that their predecessors had done by sustaining their policies and by raising taxes further. In all other respects, however, the current downturn is more like the Great Depression than it is like any recession subsequent to World War II.

One other qualification deserves mention. No recession is ever purely fiscal, and even in recessions produced by the business cycle, those who have taken on excessive debt or who have lent foolishly go bankrupt. I have been speaking in terms of ideal types. What one needs to focus on right now, however, is the fact that policies which might help to turn
around an economy suffering a downturn rooted primarily in the business cycle will backfire if that downturn is chiefly caused by an excess of indebtedness – which is precisely what is happening right now.

Between them, Alan Greenspan and his successor Ben Bernanke – with the support of two Presidents from different parties and a series of Secretaries of the Treasury appointed by both Presidents – ran an easy-money policy for something like two decades. In the process, home-owners, consumers, investors, states, and municipalities ran up massive debts that they had little hope of paying off. Under George W. Bush, the federal government did so, on a lesser scale, as well; and then, under Barack Obama, the federal government did so on a scale unprecedented in peacetime.

We have now been left holding the bag. Something like 2.1 million houses are in foreclosure. States like Illinois, New York, and California are insolvent. And the powers that be have colluded in delaying the day of reckoning. The banks have not yet fully recognized their losses; the real estate market has not cleared; and nothing has been done to balance the budgets of some of our largest and most important states. In the meantime, Barack Obama and his party have lead the federal government into what economists call a fiscal trap.

In the next couple of years, the banks will have to face the music, and those houses will be dumped on the market – which will drive housing values down further and encourage those who find that they owe more than their houses are worth to join the millions who have stopped paying their mortgages and, in effect, abandon ship.

In the next couple of years, as Walter Dean Burnham has recently argued, Illinois, New York, and California are going to have to declare bankruptcy, give their bondholders a haircut, cut salaries and benefits, and let go a great many public-sector workers.

Moreover, in the near future, as Lawrence Lindsey has recently pointed out, interest rates are going to rise, and the federal government is going to find the cost of servicing its debt harder and harder to sustain.

These are separate matters, but the odds are good that the second housing crash, the recognition of state insolvency, and the fiscal crisis of the federal government will coincide. To date, everything that the Obama administration has done has served only to delay the arrival of our day of reckoning and deepen the fiscal crisis on the horizon. If the unemployment rate is not coming down, it is because employers see through the charade and are intent on not getting caught short when the entire structure comes tumbling down.

The next few years are going to be grim, and those in charge do not inspire confidence. Would you entrust your welfare to Jerry Brown, Andrew Cuomo, Pat Quinn, and Barack Obama? We have to hope, however, that these men wake up, swallow their preconceptions, and without delay move decisively in the direction of balancing the budgets of California, New York, Illinois, and the United States.

I myself very much doubt that they will do so. Unless these men – our President above all – demonstrate qualities that they have never before evidenced, we are in for a truly terrible ride. There is only one silver lining; and welcome though it might be in ordinary circumstances, it is hardly worth the cost. Politically, this means that Barack Obama is likely to be remembered for having done to the Democratic Party what Herbert Hoover did to the Republicans.