Pernicious Anemia? A couple of years ago it was all the rage to describe the shape of the coming recovery as looking like an L, V, W, etc. My favorite was George Soros’s “inverse square root sign,” whose meaning still eludes me. My own entry was the “lazy V” whereby the deep decline would be followed by a modest recovery.

So far, the Lazy V seems to be the most accurate description of what has happened since the economy bottomed out in June of 2007. Real GDP has grown only about 3 percent per year. During the first half of this year, GDP growth slowed to less than 2 percent (annual rate), raising some fears that we might be headed back into recession (the “double dip” W). As discussed last time, 3 percent is less than half-as-fast as the first two years of recovery from the deep recession of the early 1980s. The unemployment rate fell about 3.5 percentage points then compared to one percentage point during the current recovery.

Last time I also discussed in some detail that only one in five of the 8.7 million jobs lost during the so-called “Great Recession” has been regained so far. Meanwhile, corporate profits have more than recouped all their losses and the Dow Jones average is almost back to its 2007 peak.

Why so slow? Economic indicators were quite disappointing for much of the second quarter. Jobs were essentially flat in May and June. Federal Reserve Chairman, Ben Bernanke, contended that a part of this softness results from two temporary drags that have been reversing themselves: oil prices and the supply disruptions from the Japanese earthquake.

However, this economic anemia is looking more and more chronic. Researchers who have studied the aftermath of financial crises find that it takes a long time for economies to fully recover. A main reason is the need to “de-leverage” which is time-consuming. For example, households have to save more (spend less) as they work off their debt burdens, especially for mortgages.

There’s also a large amount of public sector de-leveraging taking place. During July, worries intensified over the possible spread of debt problems in Europe. Concern focused on Italy, which is much larger than Greece and, therefore, much more problematic for the global economy. At the same time, the solvency of several smaller municipalities in Rhode Island was being questioned.

Financial markets fret that debt problems could become contagious or, to use the currently popular phrase, “go viral!”

Excluding the temporary census workers, 350,000 government jobs have disappeared in the U.S. during the past year – almost all at the state and local level. In some jurisdictions, wages and benefits of public employees have been cut as well. While these actions yield budget savings, in the short-run they have negative multiplier effects on the economy.

Housing is another serious ongoing drag. During past cycles, the residential sector led the economy out of recession, as construction and sales responded to falling interest rates and rising jobs. Today, with millions of homes near or in foreclosure, housing has not rebounded, except for a brief bounce when the homebuyer’s tax credit was implemented. There has been considerable criticism of Washington for not trying harder to ease the log jam by promoting remedial actions like mortgage modifications.

Many economists, myself included, feel that the fiscal stimulus actions of the past several years were not large enough and not focused enough on near-term activities with large multipliers. I know this is controversial, but there is ample evidence that fiscal measures can work. Of course, they increase the deficit, but that’s what they’re supposed to do in the short run. The Europeans are finding out that austerity measures imposed on a weak economy are likely to have minimal impact on budget deficits but a major negative effect on unemployment. Quite simply, in the short run the austerity measures weaken the economy which, in turn, weakens tax receipts.

Musings & Amusings

“Whitey Bulger’s brother was a politician. So one brother was operating in a world with no morals, dealing with the lowest of the low, and the other one was a mobster.” –Craig Ferguson

“Democrats warned that if the debt ceiling isn’t raised, the government would cease to function. How would you be able to tell?” –Jay Leno

“American fathers are spending more than twice the amount of time with their children than they used to... Experts say it’s due to a sweeping new trend called ‘Unemployment.’” –Conan O’Brien
While there may be insufficient aggregate demand, there is certainly an excess supply of uncertainty. Some blame this lack of confidence on the uncertainties caused by the recently enacted health care bill and the Dodd-Frank financial regulation legislation. I would add the debate over extending the U.S. debt ceiling. Most economists, myself included, believe that failure to do so in a timely fashion would throw the United States and the rest of the world into financial chaos.

**What's next?** Assuming we get though the debt ceiling fiasco and European sovereign debt problems relatively unscathed, economic activity should start picking up a little. However, it will be difficult to get much above 3 percent GDP growth for all the reasons mentioned above plus a few more.

Three percent is a very good trend rate of increase for the United States when the unemployment rate is at acceptable levels of, say, 5 percent. But at present, 3 percent means a painfully slow decline in the unemployment rate – probably no more than half a point per year.

Such slow growth with high unemployment also makes us more vulnerable to shocks from oil, natural disasters, and the like. It also makes it more difficult to reduce government and private debt burdens. Furthermore, the longer people remain unemployed, the rustier their skills get. In short, this chronic anemia lowers our resistance, aggravating other ailments and making us susceptible to new ones as well.

After the debt ceiling, there are additional fiscal issues that must be addressed in 2011. The law temporarily extending unemployment benefits to 99 weeks expires in December. So does the temporary reduction of payroll taxes (mostly Social Security) paid by employees enacted last year. Unless extended, billions of dollars of purchasing power will disappear from the economy, making it difficult to maintain 3 percent GDP growth. Don’t be surprised, however, if the Congress renews and even enlarges these. After all, 2012 is an election year. But don’t be surprised if they don’t! With this bunch, anything is possible.

But won’t measures to reduce the budget deficit help the economy this year? If the expenditure cuts or tax increases start soon, then it is hard to see how this stimulates an economy with 9 percent unemployment. Sure, help could come from falling long-term interest rates, but the decline in yields is apt to be small given how low they are right now. Suppose, as some hope, that a return to fiscal prudence strengthens the dollar exchange rate. Surely, a “strong dollar” has to be good for the United States. Sadly, the opposite is true: a *strong* dollar means *weak* exports!

It would also reduce the value of earnings repatriated by U.S. multinationals! So, be careful what you wish for. Root for a weak dollar when you’re running a huge trade deficit that has to be financed by borrowing from foreigners.

Along with my “Lazy V,” I predicted that inflation would not be a problem. Oil prices have driven the overall Consumer Price Index (CPI) up during the past year, but the core (ex. food and energy) has remained well-behaved, rising at less than a 2 percent annual rate. Recent data on wages show very modest increases, underscoring the powerful restraint exerted by high unemployment on labor costs. Growing signs of global economic cooling, especially in China, are already reducing commodity costs. Hence, 2 percent or so CPI is a still a good best bet for the next couple of years.

As for interest rates, I now believe that the Federal Reserve will keep short-term interest rates at their present levels of close to zero well into next year. Long-term bond yields are much more difficult to forecast. Low inflation and slow economic growth will serve to limit any “cyclical” rise in yields. At some point, however, the Fed has to start winding down its Quantitative Easing (QE) program. Over the past thee years, the Fed has purchased close to $2 trillion in Treasury bonds and mortgage-backed securities in QE1 and QE2. As announced in advance, the Fed stopped new purchases in June, but continues to re-invest the interest and principal repayments. However, when they halt re-investing and start selling off the portfolio, bond yields could climb. I don’t think the Fed will be in any hurry to do that as long as unemployment remains high and inflation low. There may even be a QE3 if the economy slows enough.