Pink Slip Nation

by Gary North

I don't know when the term "pink slip" originated. The term is at least a century old. It refers to a "you're fired" notice.

The American economy shows no signs of reversing its relentless increase in the rate of unemployment. Jobs are disappearing at a rate not seen since the 1981–82 recession.

Companies continue to cut costs by laying off workers. This is the main source of the increase in corporate earnings – not increased output, but decreased output. How is this profitable? Because of increased output per surviving worker. In the midst of recession, businesses are learning how to cut costs. Labor in most businesses is the #1 cost. Cut labor, and you cut costs faster than by cutting anything else.

Workers see what is happening. They are working harder because they are facing pink slips.

To understand how bad things are today, and how much worse they are likely to get, we need to survey some ancient history.

RECESSIONS AND UNEMPLOYMENT

In the Reagan years, the recession was a secondary recession. The initial recession took place in Carter's final year in office, 1980. The recession was one of the reasons for his defeat.

The cause was clear: the Federal Reserve had decreased the rate of monetary inflation. First in Nixon's recession (1969–70), then in Ford's recession (1973–75), the Federal Reserve responded by pumping up the money supply. Nixon took the nation off the international gold standard on August 15, 1971. This removed any external pressure on the FED's expansion of money.

G. William Miller, who lasted a year and a half under Carter, oversaw a serious expansion of money, which was translated into prices by way of a series of OPEC oil price hikes in 1979. This seemed like a replay of the crisis of 1973.

Carter persuaded Miller to resign in August of 1979. He gave him the figurehead office of Secretary of the Treasury. He replaced Miller with Paul Volcker. Volcker and the Board of Governors decided that the only way to call a halt to escalating prices and rising interest rates was to reduce the FED's purchase of assets. Volcker announced the new policy in October. The FED would let the federal funds rate rise. It would let all other rates rise. Rates rose.

The bank prime rate rose. It hit an unprecedented 20% in April 1980. This was the mid-point of Carter's six-month recession. The rate backed off to 11% in late July. Technically, the recession was over. But then the rate started climbing again. It reached 21.5% in mid-December. It was at 20.5% the following July. It slowly declined, but did not reach 9.5% until June 1985.

The economy tanked. It could not survive on a prime rate anywhere near 20%. Volcker was determined to wring price inflation out of the economy, and he did.

Price inflation continued upward. It hit 13.5% in 1980. It took time for the FED's policy to effect a reversal.

The price of slowing prices was a rising unemployment rate. It hit 10.8% in December 1982. The recession had ended the previous month. The unemployment rate fell to 8% a year later. This is regarded as "one of the most dramatic recoveries since employment and unemployment statistics have been collected. . . . " (Bureau of Labor Statistics.)

Price inflation also fell rapidly. It was down to 3.2% in 1983. No one had predicted such a rapid decline. Unemployment declined more slowly. It was down to 7.2% in November 1984. Reagan was re-elected by a landslide.

The economy recovered. The stock market boomed from its bottom at 777 on August 13, 1982.

The Reagan recession was unique in its intensity. It came in response to the most serious U.S. price inflation of the peacetime 20th century. The solution was to slow the rate of monetary inflation, which caused the highest short-term interest rates of the 20th century. The recession was severe, but the recovery was rapid.

There was one more recession in the 20th century: July 1990 to March 1991. It cost President Bush the election. James Carville's slogan carried the electorate for Clinton: "It's the economy, stupid." Yet the election was in November 1992. The recovery was still barely visible 20 months after the recession officially ended.

When the 1990 recession began, unemployment was under 6%. It rose to 7.5% in mid-1991, when the recession technically ended (a retroactive assessment by the NBER). It continued upward. In mid-1992, it was about 8.2%. It was still at 8% by the time of the election.

This is typical. The recession ends, but unemployment keeps climbing. This was also true of the 2001 recession. See the chart.

WHAT WE CAN EXPECT

The economy is not in recovery mode. The best news that the media can present is that the rate of contraction is slowing.

There is no good news on the unemployment front. The rate keeps climbing. The statisticians have this hope: the job market will get so bad that workers presently looking for jobs will drop out. If they stop looking for jobs, they are removed from the unemployment statistics. Unemployment refers to people out of work who are looking for jobs. So, when someone drops out of the job market, he lowers the rate of unemployment. If enough people quit looking, the statistic looks better.

Then there is the underemployment factor. This is getting some attention, but not enough. Businesses have cut workers' hours. They don't want to lose workers, since there are costs of firing, such as an increase in the firms' state unemployment insurance rate. There might even be a lawsuit for discrimination.

Then there are re-hiring issues. It takes time to screen applicants. It takes time to re-train new workers. It is better to keep old workers, but cut their hours. This is being done on a massive scale. The numbers are grim. An estimate by Federal Reserve Bank of Cleveland is this: the number of total involuntary part-time workers has increased by five million, April 2006 (low point) to March 2009. It is likely higher today. Wage demands from workers are nonexistent.

This puts downward pressure on wage rates. Full-time workers know that there are part-timers in the company who would be happy to return to full-time work. There is great fear of being fired today.

The economy will recover at some point. But then we face the problem of the secondary recession. As the Alt-A mortgages come due next year and through 2011, the number of foreclosures will rise. It is now estimated that half of Americans who have mortgages will be underwater in 2011.

The post-2001 recovery was driven by the FED's monetary policies. These policies stimulated growth by lowering mortgage rates and creating the housing bubble. That bubble is now long gone. As housing continues to decline as a result of Alt-A and option ARM mortgage re-sets, the economy will need to find another source of expansion.

Today, no one seems to know what that next bubble-driven sector will be. Without it, the zero-interest policies of the Federal Reserve will not gain traction. But with it, the economy will face a replay of the Greenspan bubble-bust scenario.

An echo recession will likely appear even before the unemployment rate turns down. The lag time looks sufficiently long that it will overwhelm any recovery, which will be weak.

This assumes that there will be a strong leading sector to revive the public's faith in economic growth. There may not be.

WORSE NEWS ON THE HOUSING FRONT

Banks are not lending. They are keeping money with the FED as excess reserves. The bankers know that the next wave of residential real estate loan re-sets will hit next year. Commercial real estate is also going to fall. Vacancy rates are up. No one expects a near-term reversal.

This raises doubts about bank solvency. There are over 300 banks on the FDIC's problem list. This is probably a low-ball estimate by the FDIC. The bankers do not want to lend to high-risk borrowers. They keep their money at the FED because they see no borrowers. This includes the U.S. Treasury. They could buy safe 2-year T-bonds and lock in 1.2%. This is ten times what they are paid by the FED. They refuse.

Will they lend to mortgage holders who are facing the re-set problem? Of course not. The price of real estate is unlikely to rise. The underwater mortgages are rising. The borrowers will want to borrow the money they paid for their homes. They want a rollover. But their homes are worth 20% less or more, depending on where they live. In the re-set states of California, Nevada, Florida, and Arizona, homes are down 40% or more.

The bankers will not roll over these loans at face value. Then what?

If they evict these people, they will have to register the losses. They want to avoid that. But the re-sets are legally required. How can the people facing a re-set crisis get the money they need to roll over their loans? They will need to come up with cash to make up the difference between the loans' face value and the houses' resale value. These people do not have cash to do this.

The re-sets will not be re-set. The lenders will face walkaways. Not that many home owners have enough savvy to keep paying on the mortgages, on the assumption that the lenders will not foreclose.

All talk about a housing recovery should include a detailed explanation of how lenders will be willing and able to roll over these mortgages. The talk should also include an explanation of how the lenders can get away with counting defunct loans – loans that have not been re-set as the agreement requires – as not really defunct, and therefore can be legally carried on the books as good loans at face value.

These are not big bank loans. Little banks cannot exchange these loans with the FED at face value for T-bills. That benefit was available only to the big banks.

THE PINK SLIP ECONOMY

The manufacturing sector in July was still in negative territory, according to the Institute for Supply Management: 49. But this was up 4 percentage points since June: a substantial one-month increase. This is good news, even though anything under 50 is contracting.

The non-manufacturing sector got worse. It was at 46.4, down six-tenths of a percentage point from June. The non-manufacturing sector is far larger than manufacturing in terms of its impact on the labor market. It employs almost 90% of the work force. Manufacturing employs 11% of the labor force, down from 20% in 1979 (2006 figures).

The economy is still contracting. The hope is that it will reverse later this year. Bernanke has said it will. Geithner has said it will. But both have said it will be a weak recovery. Geithner has said that unemployment will peak in 2010. He did not say when in the year. This indicates that he understands the lag factor.

We are seeing the worst unemployment rate since 1982. Tens of millions of workers have no memory of that era. They have borrowed and spent on the assumption that nothing like this could happen to them. But it has.

The new psychology is one of caution. Even people who are older and in safer, high-responsibility positions know that their employers are facing severe pressures. Entire industries aimed at the consumer, especially those tied to housing and finance, are in a crisis worse than any seen since the end of World War II.

Whether this has hit younger workers is not clear yet. The ones under 30 have bounced around for a decade. This age group has not found careers. They are still insecure. This recession makes things very bad for recent college graduates, but the ones a decade older have not enjoyed stability anyway.

The workers above 35, with families and mortgages, are taking heavy hits. Their career plans have been upended by the severity and duration of this recession. The one bright spot was their homes. They were appreciating. Now these families are underwater.

The Reagan recession had been preceded by a decade of inflation. The energy markets were out of joint. The unemployment rate went up fast, but then came down fast. Interest rates fell. The economy recovered as a result. The stock market rose for 18 years, except for 1987's brief crash. The 1980's generally are regarded as boom years, despite 1980–82.

People who came into the work force in 1982 and later have never faced anything like this. They have planned their lives in terms of a world that is gone.

In 1982, there was a boom ahead. Interest rates were high because of price inflation, 1968–82. When rates fell, there was a boom. Now rates are lower than ever before, and prices are stable. Banks are not lending. Real estate is depressed. A bubble market does not recover rapidly. It takes years. Think of gold at $850 in 1980 and $256 in 2001, despite a doubling of the price level.

Where will recovery come from? What will be the boost comparable to falling interest rates after 1981? There will be none.

Then where will the jobs come from that will roll back unemployment at 9.5% today and heading higher? Where will people find a career at age 35 that will not suffer from the wage pressures from younger workers who finally settle down in career paths?

Oldsters will retire if they hate their jobs and if their homes are paid off. But that hope is fading for anyone under 55.

The pink slips will increase. The wage pressure will increase. A new economy has appeared, one busted by the attempt of Greenspan and Bernanke to come down from the monetary inflation and low rates of 2001–2004. That attempt blew up in Bernanke's face.

CONCLUSION

Bankers see what is coming: more defaults, more real estate declines, more foreclosures, and more write-downs. They remain in paralysis mode.

The economy has been hollowed out by monetary inflation, followed by a sharp decline in output. Demand is low. Caution is at the forefront.

Businesses are not going to hire new workers when things turn up. They are going to add hours to the workers who are still on the payroll.

The effect on the work force is going to be the Keynesian's nightmare: a recovery without increased spending. They will demand more Federal deficits. They will demand another stimulus. The government will absorb more investment dollars. The government will crowd out the private sector.

Recovery without new capital? It's not possible.

We now live in pink slip nation. We will live in it for a long time.

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