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Miami-Florida European Union Center of Excellence

The US Economy and the Great Recession

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Vol. 11, No. 5
October 2011

Published with the support of the EU Commission

The Jean Monnet/Robert Schuman Paper Series

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The US Economy and the Great Recession

Let's not pretend that things will change if we keep doing the same things. A crisis can be a real blessing to any person, to any nation. For all crises bring progress.

(Albert Einstein)

María Lorca-Susino[♣]

Introduction

Since becoming a hegemonic power, many have been praying for the demise of the United States. Currently, the US is in the middle of the worst financial and economic situation ever known, and naysayers are counting the final hours. In 2007, the US faced the start of the worst economic situation ever imagined, which spread around the world. Four years later, the political and economic systems of the world are still under pressure. Since the arrival of Pax Americana, the US's political, economic, social, and military hegemony has been constantly criticized. The US economy is currently in disarray, the political fiber is widely divided, society is hurting and the military is under scrutiny, much to the delight of some economists, politicians, and journalists**.**

Due to the current state of financial and economic affairs, the US is facing a government deficit, which has increased the government debt to the point that the debt ceiling was reached on August 2, 2011. This has sparked a heated debate on how to tackle the deficit to reduce the debt. In January 2001 total US debt stood at $5.95 trillion; in August 2011 the US debt stood at $14.3 trillion with $2.4 trillion authorized on August 2, 2011 by Congress and which raised the amount government can borrow to $16.4 trillion. Ten years and about $8 trillion later, the economy of the US is in total disarray; however, the US is not alone. The EU is also facing similar problems: a housing bubble bust, low interest rates, a rocky stock market, high unemployment, danger of inflation, debt and financial crises, and lack of consumer and business confidence in the economy. In the US, Democrats are accusing Republicans of creating the current situation, and Republicans are accusing Democrats of spending too much and not accomplishing anything. In the EU, Germany is blaming PIGS countries for their lack of fiscal austerity and PIGS are blaming Germany for lack of economic solidarity. At this point, it does not really matter who is to blame, but that the political classes on both sides of the debate have been incapable of solving the current problem.

This paper discusses the currently troubled economic situation of the US, which has become a vicious cycle, led by low consumer spending and business investment due to high unemployment, and a stagnant real estate market. Despite signs of solid recovery in 2010, financial woes continue to plague the US as of the summer of 2011. The economy is facing a dramatic setback led by a controversial sovereign credit rating downgrade. The US is suffering more than expected due to the rise of the debt ceiling without a clear cut agreement on the budget; however, the US Treasuries have become a safe haven and

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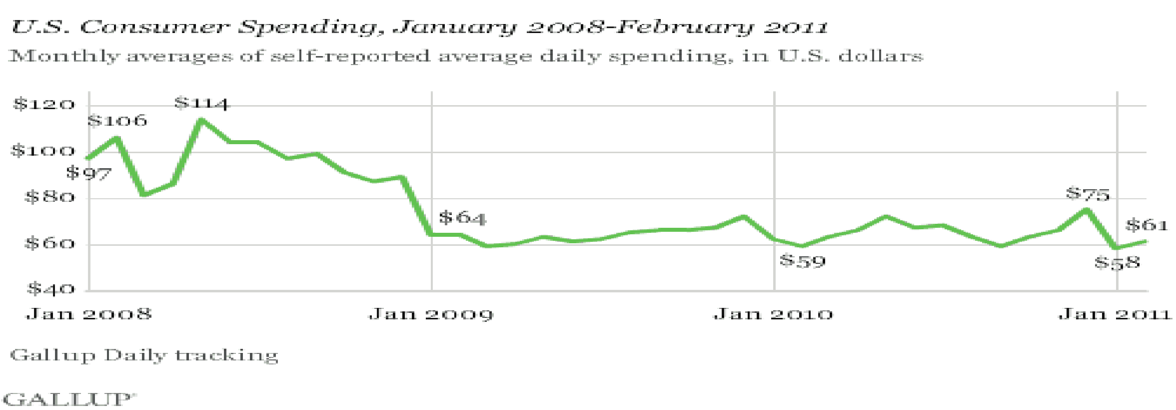
the US dollar seems to be maintaining its reign as a hegemonic reserve currency, despite the current downgrade.

The Current US Economic Situation: The Great Recession

The Presidential election is one year away and both parties are blaming each other. Two years after the $700bn[2] Troubled Asset Relief Program (TARP) for the banking and automotive industry, the $750bn American Recovery and Reinvestment Act (ARRA), two quantitative easing worth $900bn,[3] and interest rates close to zero, the economy in the US is still showing no signs of life.

In 2010, the US economy had a gross domestic product of over 3% and it seemed that the economy was back on its feet; however, a deep analysis showed that this economic growth was "passive" since it was based mainly on growth by inventory accumulation rather than consumer spending. Without consumer spending the economy lacked consumption growth, since consumer spending accounts for two-thirds of GDP and is a key driver of economic growth. In 2011, the economy has retrenched significantly, particularly since the US has had to raise the debt ceiling with no political agreement on economic measures. Political actions have led to economic uncertainty. Consequently, consumer spending has disappeared mainly because the situation in the housing and labor market is not inducing consumers to spend money; in fact, saving ratings has been on the rise for the first time since WWII.



Source: Gallup, "U.S. Consumer Spending Up Slightly in February," August 22, 2011. http://www.gallup.com/poll/146429/consumer-spending-slightly-february.aspx

To begin with, the value of homes has dropped and has lowered homeowner confidence and purchasing power. The fall in house prices has been significant to the point that it is estimated that almost 30% of houses with a mortgage are worth less than the mortgage value. This creates a huge incentive for default in the US as mortgages are "non-recourse" loans, which means that the creditor is allowed to only take the property and not any other assets; furthermore, the borrower will have a permanently damaged credit score. As a result, about 10% of mortgages are in default of foreclosure.

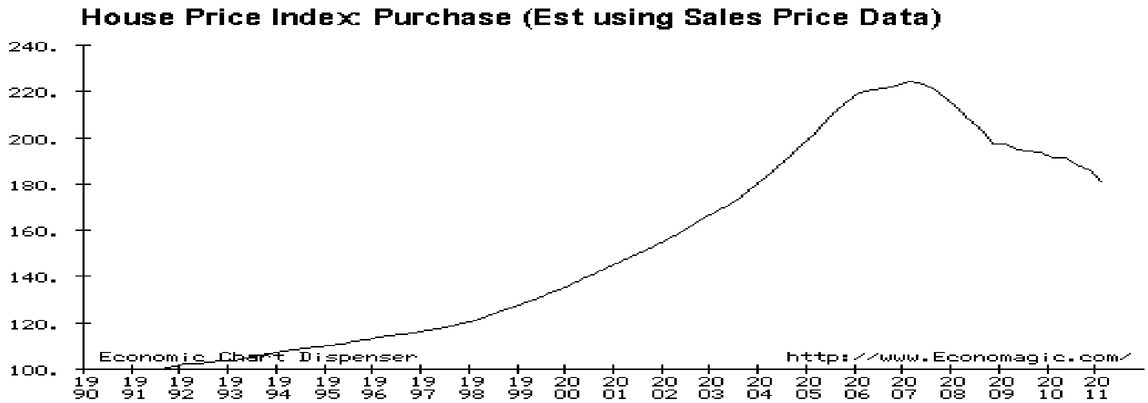
According to a study of the housing bust during the banking crisis by Reinhart and Rogoff, the average decline in home prices tends to be about 35% from peak to trough and the duration averages six years.[4] The S&P/Case-Shiller Index is down about 30% from its peak in July 2006. The graph below shows that as of 2008 the average price of a house in the US was over $220,000 while in 2011, the price

[2] Most of the money has been paid back

[3] Quantitative easing 1 involved the purchasing of $300 billion of Treasury securities, $1.25 trillion of mortgage backed securities and $175 billion of agency bonds and was in place between December 2008 and March 2010. Quantitative easing 2 involved buying $600 billion in long-term Treasuries from November 2010 to June 2011

[4] Carmen M. Reinhart and Kenneth Rogoff, This Time Is Different: Eight Centuries of Financial Folly. Princeton: Princeton University Press, 2009

is about $180,000. The housing market accounts for only five percent of GDP but its fate is closely tied to the welfare of most households.



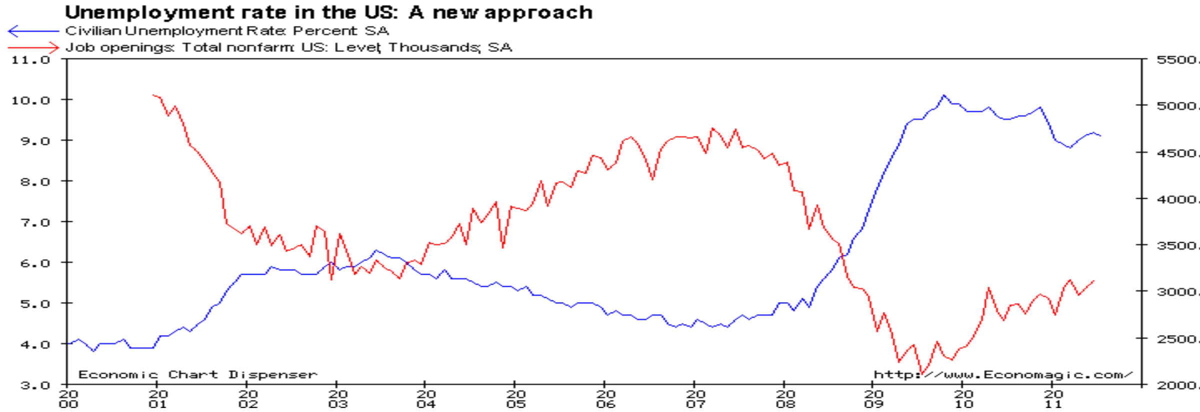
Source: Economagic. http://sub0.economagic.com/em-cgi/daychart.exe/form

Secondly, job market instability has lowered consumer confidence. Since the beginning of the Great Recession, nine million jobs have been lost and millions more are underemployed in the US**.** During this weak recovery phase, only two million jobs have been created; as a result, income insecurity has suppressed consumer spending. The US labor market is in dire straits in light of the upcoming presidential elections. President Obama has come up with many initiatives to try and improve the condition. On August 8, 2011, he announced his plan to present a major jobs initiative to improve the economy and promote job recovery.

What President Obama is expected to present in September to Congress is a modern version of the "so-called grand bargain with congressional Republicans that would combine long-term US deficit reduction through entitlement benefits cuts and tax increases, with immediate steps to boost job creation."[5] The truth of the matter is that unemployment is still over 9% and the construction sector alone is responsible for more than 2 million unemployed.

In order to alleviate the situation, unemployment benefits had to be extended on November 6, 2010, when unemployment reached over 10%. President Obama had to extend unemployment benefits an additional 14 to 20 weeks to help those who had already exhausted their benefits and could not find employment. Similarly, on December 17, 2010, the President had to extend the Emergency Unemployment Compensation (EUC) until January 3, 2012. This federal emergency extension provides up to 53 additional weeks of unemployment benefits to individuals who have exhausted regular state benefits.[6] The graph below combines the unemployment rate with job openings in the US. It shows that when the unemployment rate began to increase in 2008, the number of job openings began to decrease.

[5] Julianna Goldman, "Obama set to package US job stimulus with bigger deficit cuts," Bloomberg, August 18, 2011.
[6] United State Department of Labor, "Emergency Unemployment Compensation (EUC) Extended to January 3, 2012." http://www.ows.doleta.gov/unemploy/supp_act.asp



Source: Economagic. http://sub0.economagic.com/em-cgi/daychart.exe/form

Since consumers are not spending, businesses have responded accordingly to the weakness of consumer demand. It is mindboggling that while big corporations are reporting significant amounts of cash on their balance sheets, small and medium size firms are feeling the pinch and do not have easy access to credit. The behavior of small and medium size firms determines the outcome of a recession, particularly because these firms create jobs and break the vicious cycle. The NFIB Small Business Economic Trends reported that businesses do not expect the economy to improve; therefore, their incentive to increase employment is very low and is not helped by the credit conditions they face.[7]

The problem is that the US has used all possible tools resolve this situation. Fiscal and monetary policies have become extremely creative. The government has been forced to extend tax cuts and help has been provided and extended for the unemployed; furthermore, the Fed is stepping in with two rounds of quantitative easing, and interest rates are at historic lows. This expansionary approach cannot last forever; in fact, it is expected that both policies will become contractionary in the near future, particularly because in order to solve the debt problem, the government must cut spending and raise taxes. Also, it was expected that the economic recovery of 2010 was going to suffer a small setback during the summer of 2011. The contractionary approach and the ending of both the fiscal stimulus package enacted in 2009 and the second round of quantitative easing (QEII) in June 2011 was likely to trigger a difficult period. As of August 2011, the economy is engulfed in one of the worst economic moments since 2007, not only because of any of these reasons, but because the political class has not been able to deliver a clear message on their willingness to work together to overcome the situation.

The US Deficit: What Is It and Where Is It Coming From?

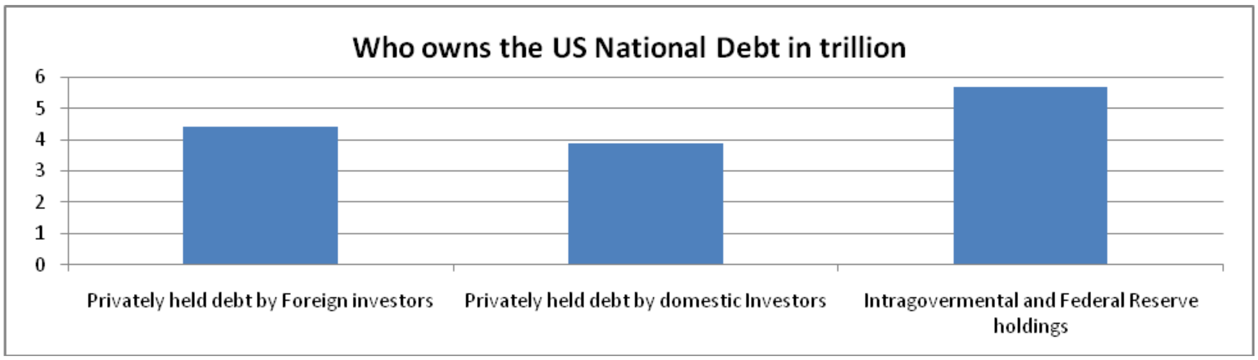
Each year the US Congress must pass a budget for the fiscal year starting October 1 and ending on September 30, which allows each authorized federal department, agency and program to spend congressionally specified amounts of money. This budget, which must be passed by Congress and signed by the President by October 1st, is composed of 13 separate appropriations. If Congress and the President fail to pass all of the appropriations bills, they will agree to a Continuing Resolution (CR) that temporarily funds the programs and agencies for which appropriations bills have not been passed.

In 2010, the democratically controlled Congress did not pass a budget for the fiscal year starting on October 1, 2010, which had to cover the country's needs until September 30, 2011. The fact that the country has been running without a proper budget made headlines on March 2011 when each political party was in charge of one chamber, and agreements on the 2011 and 2012 budgets became almost impossible. The US has been operating on short-term budgets or continuing resolutions (CR) from

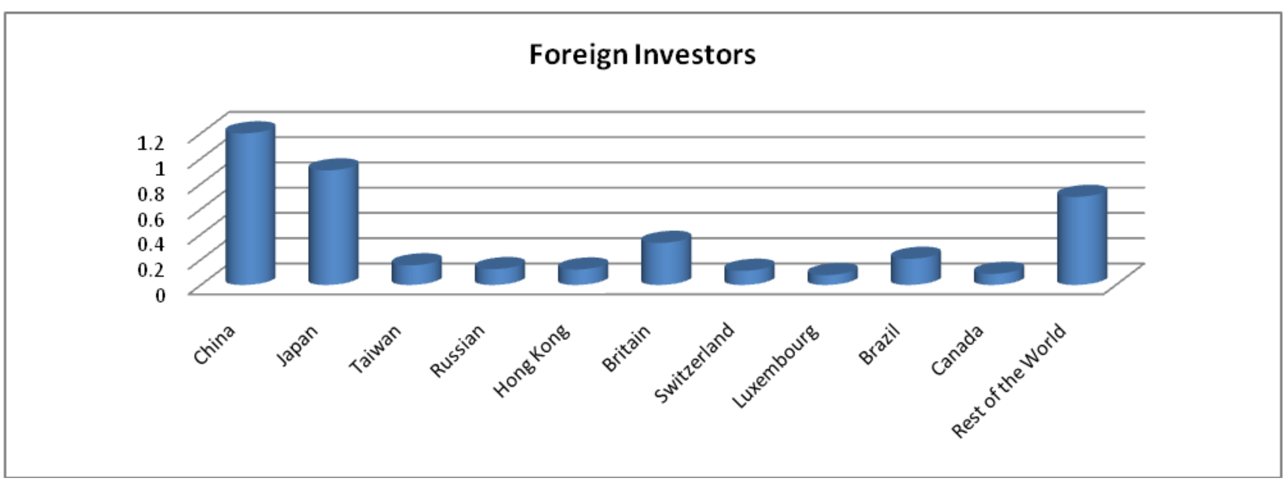
[7] William C. Dunkelberg, "NFIB Small Business Economic Trends, " National Federation of Independent Business, August 2011. http://www.nfib.com/research-foundation/surveys/small-business-economic-trends

October 1, 2010 to March 19, 2011, with a total of 2 CR passed on 2010 and 7 CR passed as of March 2011. These short-term budgets have added uncertainty to the economy based on fears of possible government shutdowns.

Furthermore, the tremendous national debt has recently reached $14 trillion and the current path of government spending needs has grown due to the critical economic situation. The problem is that the deficit must be controlled in order to reduce the debt, the reason being that, due to the economic situation, Americans depended more on government assistance in 2010 than at any other time in the nation's history. An impressive 18% of the nation's personal income was received not from an employer but from Social Security, Medicare, food stamps, or unemployment benefits. At the same time, wages accounted for the lowest share of income, only 51%. In 2010 most of the revenues needed to run the country was coming from investors who were buying treasuries. Privately held debt by foreign investor amounted to more than $4 trillion, while debt by domestic investors was less than $4 trillion.

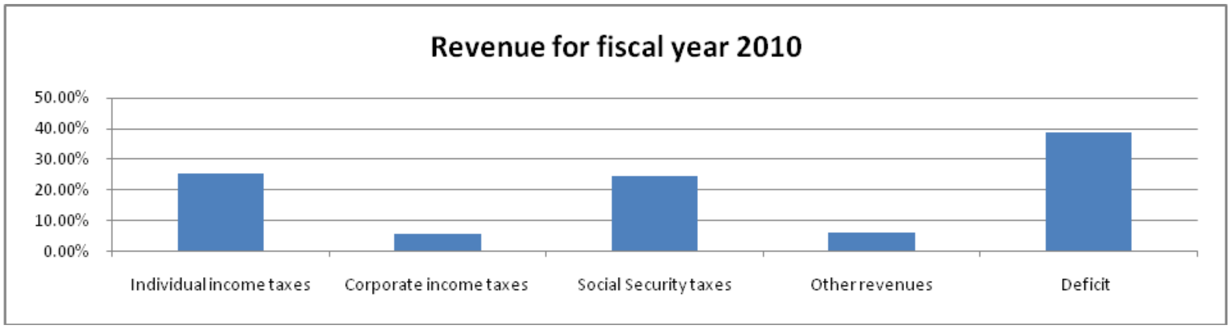


Out of those foreign investors, China ranks number one, followed by Japan. China has thus become the first source of financing for the US. In fact, immediately after the downgrade, Vice-President Biden made a four day visit to China. China expressed concerned about the state of the US's fiscal house since China is the biggest foreign holder of US Treasuries. In fact, after the downgrade, Chinese authority concerns were publicly expressed in a statement that read "The US government has to come to terms with the painful fact that the good old days when it could just borrow its way out of messes of its own making are finally gone."[8]



[8] Melanie Lee and Helen Ding, "China blasts U.S. over debt problems, calls for dollar oversight," Reuters, August 6, 2011. http://www.reuters.com/article/2011/08/06/us-china-sp-idUSTRE7750R720110806

Where is the money needed to run the country and make the budget coming from? Individual income taxes were close to 30% of the revenues and corporate income taxes were at a low of less than 10%. It was thought that the budget deficit would be smaller and pressure to cut social programs would be lower if corporate tax revenue had not declined over time relative to GDP and relative to individual tax revenues, thereby causing debate. The problem is that if corporations are taxed, they come up with innovative strategies to take advantage of overseas tax havens.

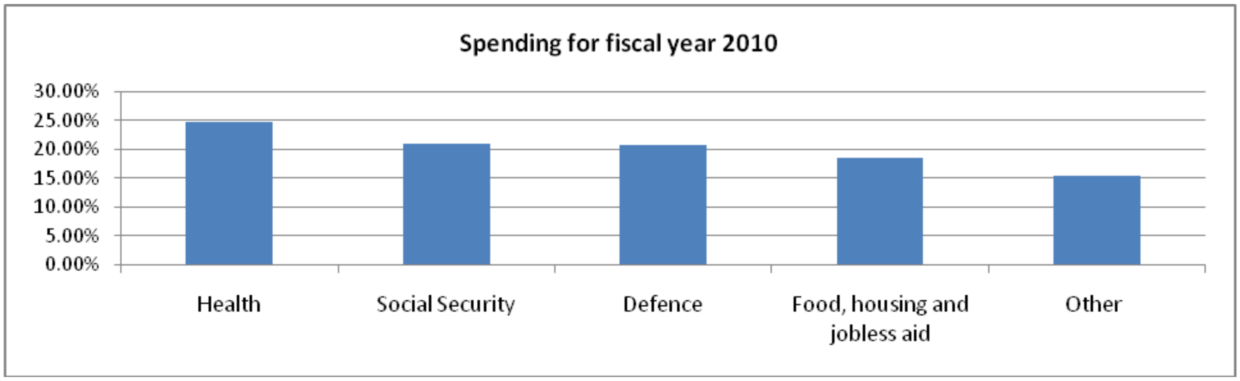


For instance, while the US has a 35 percent rate, Ireland offers a rate of 12.5 percent; this creates an incentive to move business to Ireland, which has been common practice recently. In 2008, the "Government Accountability Office reported that 83 of the 100 largest publicly traded corporations in the US had subsidiaries in jurisdictions listed as tax havens."[9] As a consequence, it is estimated that U.S. companies have $1.2 trillion overseas; moreover, the US is not receiving more than $60 billion in tax money from these corporations. Corporations argue that 35% is not a competitive rate; thus, they would rather operate from abroad. In fact, "Six hundred American companies are in Ireland and they employ 100,000 people … those are jobs that aren't here. And they moved to Ireland because of taxes."[10] If the government were to implement what is called a "tax holiday" which allows firms to repatriate part of the money they have outside the US, it is estimated that this money would create close to 2 million jobs in the US. The idea of a tax holiday is extremely controversial because not many jobs were created in the US after companies were allowed to repatriate profits attributed to their foreign operations at rate of 5.25% in 2004.

The impossibility to come up with an agreement on where the money collected should be spent explains why the US has faced a credit downgrade. In 2010, almost 25% of the money collected in the US went to health related expenses, followed by social security payments. Defense spending in time of war accounted for almost the same as social security expenses.

[9] U.S. Government Accountability Office, "International Taxation: Large U.S. Corporations and Federal Contractors with Subsidiaries in Jurisdictions Listed as Tax Havens or, Financial Privacy Jurisdictions," December 18, 2008. http://www.gao.gov/products/GAO-09-157

[10] James Roberts, "'60 Minutes' investigates why 100,000 American jobs went to Ireland," Irish Central, March 29, 2011. http://www.irishcentral.com/news/60-Minutes-investigates-why-100000-American-jobs-went--to-Ireland---VIDEO-118830494.html



The political debate has developed around discretionary and mandatory spending. Mandatory or direct spending is money that must be spent on what are called the three entitlements: Social security, Medicare, and Medicaid. Altogether, direct spending accounts for about 55% of all spending. The rest of the money is spent in discretionary spending which is divided into defense or nondefense spending.

Mandatory Spending = @ 55% (or Direct Spending) Three programs or entitlements: Social Security Medicare Medicaid	**Discretionary Spending (nondefense) = @ 20%** (such as: Law enforcement, homeland security, transportation, national parks, disaster relief, scientific research, foreign aid)
	Discretionary Spending (Defense) = @ 20%

In order to allow an increase in the debt ceiling, the US political class had to agree on spending cuts to try to reduce the deficit and, eventually, the debt. In August 2011, pressed by the urgency to raise the debt ceiling, politicians agreed on how much should be cut; however, they did not agree on what to cut, thereby causing the downgrade and economic instability.

This lack of agreement can be summarized as followed: Democrats do not want to reduce spending through the restructuring of the three entitlements and want to increase taxes, and prefer to reduce discretionary spending, particularly defense costs. On the other hand, Republicans believe that the deficit and the debt can only be solved by reforming the entitlements, and they are reluctant to increase taxes given the current economic crisis because it will reduce even more consumption. Republicans believe that just cutting on discretionary spending will not be enough. With elections around the corner, the prospect of a compromise is skewed at best.

The US Debt: The Debt Ceiling Debate

The deficit is different from the debt. In 2010, the US Government collected about $7,000 per person in taxes. This is the government revenue. The US Government spent more than $11,000 per person in 2010. This is the government expenditure. The difference between the revenue of $7,000 and the expense of $10,000 makes a government deficit of about $4,000 per person. In order to cover this deficit, the US Government must borrow the money from either domestic investors or foreign investors. It has taken 200 years of unmatched revenue and expenditure per person to reach a national debt of over $14 trillion. For this reason, it takes more than a balanced budget to eliminate the current national debt; it would take many years of budget surpluses to eliminate it. The debate on government deficit and debt is closely related. It is important to mention that incurring debt is not necessarily dangerous; the danger rests on the use of the money.

The S&P downgraded the US sovereign debt on August 2, 2011, when the US's $14.3 trillion debt ceiling was raised and a plan was introduced to enforce a $2.4 trillion in spending reductions over the next 10 years, rather than the $4 trillion expected by the S&P. The S&P notified the US government on April 18, 2011 that it risked losing the top notch credit rating it had enjoyed since 1941. Consequently, the S&P advised the US that it needed to come up with spending cuts of about $4 trillion to secure the triple-A.

The S&P is one of the three credit rating agencies. S&P gives 18 sovereign entities its top rating grade. It has been debated that this downgrade could take into consideration more than just political and economic factors. The reason is that the UK has an estimated debt-to-GDP of around 80 percent which is higher than the US, but the S&P has not downgraded it. S&P claims that "the downgrade reflects our view that the effectiveness, stability, and predictability of American policymaking and political institutions have weakened at a time of ongoing fiscal and economic challenge."[11] However, the reputation of the S&P in terms of the accuracy of its credit rating reports has been disputed; the S&P has been blamed for causing the financial crisis that engulfed the world in 2007 when it failed to acknowledge irregularities in some of the banks and countries analyzed. Thus, the US said that the S&P move to downgrade the credit rating was flawed. Curiously, less than a month after S&P downgraded the US, it was announced that S&P's president, Deven Sharma, would step down at the end of the year, and will be substituted by Citibank Chief Operating Officer, Douglas Peterson.

The downgrade comes at the worst possible moment when the confidence of consumers is lower than ever. In theory, a downgrade increases consumer borrowing costs tied to Treasury rates such as the cost of mortgages, auto loan, and other types of lending tied to the interest rates paid on Treasuries. JPMorgan Chase & Co. estimated that a downgrade would raise the nation's borrowing costs by $100 billion a year.[12] The US has already spent about $414 billion on interest expense in fiscal 2010, or 2.7 percent of GDP; thus, the downgrade will definitely increase this bill.

In the United States, the debate on the need to introduce a Balanced-Budget Amendment (BBA) has made headlines. The idea to introduce this type of amendment dates back to 1936 when Representative Harold Knutson (Rep, Minnesota) introduced the first amendment to limit federal borrowing. The closest the US has ever been to a BBA has been the introduction of the debt ceiling in 1939, which aimed to control spending. The debt ceiling has been raised 90 times since its inception, including the increase on August 2, 2011. Due to the current deficit and debt situation, the debate about introducing a stricter method to control spending has been brought to the frontline. America has a tradition of deficit spending that goes back to the founding fathers. At the end of the Revolutionary War, the federal government took on the debts incurred by the states, raising the debt to more than one third of the country's GDP; just when this debt had been paid, the Civil War broke out. Abraham Lincoln wondered how the US was going to be able to ever pay back the money borrowed to finance the Civil

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11 Standard and Poor's, "United States of America Long-Term Rating Lowered To 'AA+' Due To Political Risks, Rising Debt Burden; Outlook Negative," August 5, 2011. http://www.standardandpoors.com/ratings/articles/en/us/?assetID=1245316529563

12 John Detrixhe, "US Loses AAA rating at S&P on concern spending cuts deficient," Bloomberg, August 6, 2011.

War, as he declared that the conflict "has produced a national debt and taxation unprecedented, at least in this country".[13] The result was that the debt accumulated by the South almost made the US bankrupt, and it took more than have a century to pay it back.

Final Words

Every country in the world is facing a very difficult fiscal and debt situation. In the EU, most of the countries are facing national deficits that have forced them to incur debts which could lead to bankruptcy. Some EU members such as Greece, Portugal, Ireland, Spain and Italy are reaching debt levels that are having a negative effect on the unity of the system.

The fiscal situation in Europe caused by the debt crisis is flooding the US banks with money. Despite the debt ceiling and fiscal debate, cash held by US banks has surged 8.4% during the turbulent week ending July 27, while cash held by US branches and agencies of foreign banks fell by $65.7 billion; cash declined by $76.2 billion in domestically chartered US banks. [14] In fact, more money is expected to arrive to US lenders as the fiscal crisis in the EU becomes more complicated and as countries such as Italy and France face allegations of insolvency. From July 26 to August 9, 2011, worldwide stocks have declined significantly and an estimated $5.4 trillion[15] have disappeared in the equity market, which has driven investors to purchase gold and US Treasury Bonds.

Just when the hegemony of the US dollar as a reserve currency was placed under scrutiny, the markets have witnessed investment transfers from the EU to the US which is increasing the US dollar deposits. The euro and the British pound are very favorable for this change over and if it continues it would help the US dollar maintain its reign as the world reserve currency. Curiously, the International Monetary Fund has just released a statement in which it explains that the US currency's portion of global currency reserves had dropped to 60.7 percent in the period ending March 31, 2011, from a peak of 72.7 percent in 2001; however, some are claiming that the US dollar is maintaining its reign due to the lack of competition. In fact, the value of a reserve currency is built on strength, not typically that it is 'best among poor choices.'"[16] Nonetheless, the foreign exchange markets and the reserve currency status do not pay attention to political debates, and sometimes not even economic logic. For instance, the Japanese yen is suffering dramatic appreciation to the point that the government has been forced to intervene to stop the yen's gains, despite the tremendous debt-to-GDP ratio and the devastation of the multiple earthquakes. Thus, as Albert Einstein said, "A crisis can be a real blessing to any person, to any nation. For all crises bring progress."

[13] Stephen L. Carter, "Balanced-Budget amendment fails fiscal test," Bloomberg August 6, 2011

[14] Bradley Keoun, "Euro crisis may pack US banks with Deposits they can't use," Bloomberg August 8, 2011.

[15] Chris Anstey, "G-7 vows to take 'all necessary measures' to stabilize economies," Bloomberg, August 8, 1011.

[16] *Toru Fujioka, "*G-7 Seeks to Calm Investor Fear After World Stock Selloff," August 8, 2011.
http://www.businessweek.com/news/2011-08-08/g-7-seeks-to-calm-investor-fear-after-world-stock-selloff.html