Lost decades: The making of America’s debt crisis and the long recovery

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Jeffrey Frieden, professor at Harvard University’s Department of Government, presented the book titled “Lost Decades: The Making of America’s Debt Crisis and the Long Recovery”, which he wrote with Menzie Chinn, Professor at LaFollette School of Public Affairs and the Department of Economics of the University of Wisconsin. The presentation was followed by comments from Daniel Gros, Director of CEPS, and a lively general discussion. The event was chaired by Zsolt Darvas, Research Fellow at Bruegel.

The title refers to the fear that the US, after having lost the last decade of growth because of massive borrowing both by the private and public sector, which culminated in the 2007 crisis, will also lose the current decade due to poor crisis management policies. In order to understand this perplexity regarding future possibilities of growth, it is essential to go back to the core of the crisis.

At its beginning, the 2007 crisis was perceived as a particular strong manifestation of a cyclical crisis, like that occurred in 2001. This wrong diagnosis led to take wrong policy actions. By the end of 2008, the federal government owed foreigners almost $4 trillion; foreigners owned about two-thirds of the government’s publicly held debt. The country faces a severe foreign debt crisis.

In the middle of and late 1990s, it was the productive sector who borrowed and troubles came after the burst of the “.com” bubble. In 2000 and 2001 the federal budget showed a surplus. This surplus was considered as inappropriate, as there was a fear that the federal government will pay back its debt and the Federal Reserve will not be able to perform open market operations. Now this fear sounds strange but it was a serious issue that time. Following this reasoning, the 2001 and 2003 tax cuts under the Bush administration reverted the federal budget tendency, passing from a 2% GDP surplus in 2000 to a 4% deficit in 2003 – with an insufficient improvement afterwards.

The tax cuts are also at the origin of the housing market bubble, which started in 2005. Between 2004 and 2006, the US economy borrowed an amount equal to 6% of its GDP from abroad. Government and households were the borrowers, taking the place of technology and producing sector.

Notwithstanding the IMF alarms, borrowing was simply seen as a flow of money going towards both the tradable and the non-tradable sectors. The implications of this capital inflow became visible soon. Imports increased in the tradable sector, price exploded in the non-tradable one. In 2007, the relative price of tradables was 30% lower than in 2004.

The main question, hence, simply becomes why has been so hard to figure out a way to go out of the crisis? Each time that there is a debt crisis, policymakers should immediately think about how the burden of the crisis will be distributed. Indeed the actual debate in the US concerns who is going to pay.

At global level, since 2003 countries have started to split up into two categories: those accumulating surpluses and those piling up deficits of balance account. In order to exit the crisis, deficit countries (like the US and the UK) will need to cut their foreign borrowings. One way to do this is to improve domestic savings. But who should save more? The answer highly depends on the income distribution of the population. In the US, for example, population in the top 10% of the income distribution is always more and more delinked from
the other 90% of the total population. Inequality has increased even in good times. To give a dimension of this phenomenon, 2/3 of the income growth realised before 2007 went to population at the top 1% of the income distribution.

The impact of the crisis has been equally uneven between social classes. The unemployment rate for the bottom 1/3 of the labour force (i.e. that earning less than twenty thousand US dollars per year), plus involuntary part time, plus those who left the labour force correspond to 35%. The unemployment rate for the top 1/3 of the labour force amounts to just 8%.

As a result, population at the top of the income distribution does not want to go on with measures addressing the crisis because it has hardly impacted by it. That is why there is no consensus about the opportunity for the US federal government to undertake additional fiscal stimuli. In ultimate analysis, the current crisis is difficult to address because of its irregular impact generated different opinions about how to deal with it. If policymakers do not find the right way to go, however, it will be unlikely to have growth in the present decade.

Daniel Gros first focused on the parallelism between the EU and the US used by the authors. In his view the 2007 crisis was not a US crisis that has been transmitted to the EU. The elements that provoked the burst of the crisis were equally present in the EU and the US. In this regard, it is sufficient to look for the levels of housing prices and banks debts on the two sides of the Atlantics at the beginning of the crisis. He also highlighted that the analogy to Japan’s lost decade is not ideal, since Japan’s GDP/working age population is the highest in the world.

Both the EU and the US economies have been set on growth models with large capacities in the non-tradable sector and both needs time to switch towards a more export-oriented model, which will be a very time-consuming process. The US, though, has more time to restructure its debt and can do it at micro level. Countries of the EU periphery, on the contrary, will struggle more to repay their debt, given the relative size of the institutional investors owning the debt.

The following discussion was centred on the role of institutions and policymaking. Alan Greenspan’s policy of too low interest rates for too long time did participate in creating the housing bubble. 2001 and 2003 tax cuts pumped capital into the system, watering down asset quality. Many of the financial sectors operations were allowed to be done off the budget. As a result, after an initial boom, the economy busted and triggered a Keynesian situation. What policymakers could do now is to coordinate the mismatches in labour markets, for instance helping skilled workers to pass from the traditional non-tradable sector to the tradable sector which is lastly enjoying a period of growth.