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The US economy after Bush

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Policy Brief

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The U.S. Economy after Bush

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The U.S. Economy after Bush

Abstract

The Bush – Cheney years have been marked by extremely poor economic performance, reflected in a business cycle expansion that is by many measures the weakest since World War II. Moreover, not only has the expansion been weak, it also looks to be ending with a severe financial crisis and the possibility of a prolonged economic slump.

Putting a bottom to the slump will be the next president's most immediate task. That task will not be easy. However, there is a deeper question about how to restore sustainable growth that generates shared prosperity. That question implicitly asks whether the Bush administration's economic failure was due to specific policy failures, or whether it was due to exhaustion of the economic growth paradigm that has framed policy over the last 30 years?

The paper argues that the economic paradigm that has shaped economic policy for the past thirty years is flawed and exhausted. It has never been able to produce growth with shared prosperity, and now its capacity to produce growth with inequality is also exhausted. However, political resistance to changing the paradigm may still be too strong, and intellectual awareness of alternative possibilities not sufficiently developed. The implication is the U.S. could face an extended period of economic stagnation and political discontent.

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I Introduction

This November, U.S. voters will go to the polls to elect a new President and Congress, and on January 20, 2009 George W. Bush will vacate the presidency of the United States. The incoming president will inherit a deeply troubled economy and faces both short term and long term challenges. The short term challenge is putting a bottom under the economy. The long term challenge is generating sustainable growth that also provides shared prosperity.

The Bush – Cheney years have been marked by extremely poor economic performance, reflected in a business cycle expansion that is by many measures the weakest since World War II. Moreover, not only has the expansion been weak, it also looks to be ending with a severe financial crisis and the possibility of a prolonged economic slump.

Putting a bottom to the slump will be the next president's most immediate task. That task will not be easy. However, there is a deeper question about how to restore sustainable growth that generates shared prosperity. That question implicitly asks whether the Bush administration's economic failure was due to specific policy failures, or whether it was due to exhaustion of the economic growth paradigm that has framed policy over the last 30 years?

Democrats are united regarding the Bush administration's failure, and there is also unity regarding many of the policies needed to jumpstart the economy. However, there is division over whether a change of economic paradigm is needed.

New Democrats believe that after the slump it will be back to business as usual. Progressive Democrats believe the current growth paradigm is exhausted. It never generated shared prosperity, and now it is also being shown to be unsustainable.

For Progressive Democrats the bursting of the house price bubble signals the end of the age of Milton Friedman. That era of market fundamentalism was launched on the back of Ronald Reagan's political rhetoric and sustained by Alan Greenspan's asset bubble monetary policies. Because of its ideological hold on the public's mind, change was not possible until the experiment had been shown to fail.

That has now happened, creating a political opportunity to revive and modernize the New Deal economic paradigm developed by Franklin Roosevelt's administration, which proved so successful in the thirty years after World War II. Such a revived policy paradigm must:

- Rebuild the wage structure and re-establish labor market mechanisms that ensure wages of ordinary workers grow with productivity;
- Commit monetary policy to full employment and break with the aversion to full employment instilled by the flawed notion of a natural rate of unemployment;
- Address the corrosive effects of globalization that have undermined employment security among workers and fostered a race to the bottom among corporations;
- Inaugurate effective mechanisms of international economic cooperation regarding

monetary policy, exchange rates and capital flows to prevent future exchange rate misalignments and global financial imbalances.

- Invest in America's infrastructure – including education and health facilities and transportation;
- Shift the American economy to a sustainable “green” trajectory that addresses the problem of climate change;
- Establish efficient mechanisms for financing Social Security and health care that do not cut benefits and ensure coverage of all, and do not raise employment costs that discourage job creation in the U.S. economy.
- Restore effective regulatory control over the financial system;
- Refashion corporate governance so that corporations again contribute to maximum sustainable shared prosperity rather than maximizing short-term profits and paying excessive salaries to top management.

II Reality and perception

One difficulty in writing about the Bush record is that despite the truly poor performance, for much of the time the U.S. has been portrayed as enjoying boom-time prosperity. This distortion reflects two factors.

First, since November 2001 the economy has formally been in expansion mode, albeit one of the weakest expansions in history. That expansion was driven by a house price bubble and consumer borrowing that fuelled an unsustainable “feel good” consumption boom. This created an illusion of sustainable prosperity that was difficult to pierce.

Second, during this period there was a recovery in stock prices that accompanied the house price bubble. Additionally, what income growth there was went largely to the top of the income distribution. Both of these developments benefitted the “chattering class” (i.e. economic pundits and the media), and this likely colored reporting of the economy.

The Bush administration pursued policies aimed at benefitting corporations and the rich, but those policies also produced an initial flourish of prosperity. That made these policies difficult to counter politically, despite their negative long term economic consequences. This is because the benefits were front-loaded, while the huge costs only come later.

III The economic record

By many measures President Bush's economic record is the weakest since World War II. Growth of national output has been far below the post war business cycle average, and the same holds for growth of business fixed investment. The business investment share of output has also fallen, which augurs poorly for the future. That is because business investment is the main driver of productivity growth and rising living standards.

In labor markets, after the end of the last recession in November 2001 there was an

extended period of jobless recovery. In past business cycles, it has taken an average of 21 months to regain the employment lost during recession. This time it took 47 months. Moreover, job losses in the last recession were not that large, which indicates just how weak this expansion was.

Another indicator of the extent of labor market weakness is the large decline in the employment/population ratio relative to its previous 2001 peak. This decline suggests there is considerable hidden unemployment that is not recorded in the official U.S. unemployment rate.

Wage and salary growth have also lagged far behind the nine other business cycles since 1948. Most tellingly, the current cycle looks like it will be the first in which median family income (i.e. the income of the family in the middle of the income distribution) fails to recover the peak level of the previous business cycle. That will be a major rupture in American history, which has always been marked by rising median family income.

Manufacturing has been an area of particular devastation. In January 2001 manufacturing employment was 17.1 million: in June 2008 it was 13.5 million. That amounts to a loss of 3.6 million manufacturing jobs, equal to 18 percent of all manufacturing jobs at the start of the administration.

Manufacturing's experience marks another first in U.S. economic history, it being the first time ever that manufacturing employment has not increased during an economic expansion. Before 1980, manufacturing jobs increased in economic expansions, and they also hit new record peaks in each expansion. After 1980, manufacturing jobs still increased in expansions, but manufacturing failed to recover all the jobs lost in the prior recession and therefore failed to recover previous peak employment levels. Since 2001, manufacturing not only lost jobs in recession, it continued losing jobs in the expansion. That is unprecedented.

With regard to the international economy, the trade deficit broke all records rising from 365 billion dollars in 2001 to 753 billion dollars in 2006, when it equaled six percent of gross domestic product.

The government budget has also been in persistent large deficit. As a result, between 2001 and 2007 the Federal debt rose from 57 percent of gross domestic product to 65 percent. This promises to complicate future fiscal policy.

Finally, there has been a continuing rise in income inequality that has come on top of the rise in income inequality experienced over the prior twenty-five years. Thus, according to Internal Revenue Service (IRS) data the top one percent of income earners received twenty-two percent of gross income in 2006, matching the previous record for inequality set in 1929. Given this rise in income inequality, it is perhaps not surprising that business profit growth has been spectacular and far above normal.

III Explaining the economy's terrible performance

Statistics provide a photo of the economy's performance, but that begs the question of why economic performance has been so weak.

The key here is the unbalanced character of the expansion. The roots of this unbalanced expansion lie in manufacturing's failure to participate in the recovery owing to the trade deficit, the over-valued dollar, and off-shoring of production by U.S. corporations.

The over-valued dollar meant that much of consumer spending drained offshore in the form of spending on imports. That created jobs in other countries, but not in U.S. manufacturing. Meanwhile, excess manufacturing capacity discouraged investment, while the steady stream of manufacturing job losses held down wages. Manufacturing investment was further undermined by corporations shifting production to East Asia to take advantage of low cost labor and the region's under-valued exchange rates.

The Federal Reserve responded to this weakness by lowering interest rates to one percent, thereby triggering a housing boom. Rising house prices and low interest rates in turn spurred a debt financed consumption boom.

This configuration generated a distorted expansion. On one hand, the trade deficit and off-shoring of production meant persistent job losses in manufacturing and weak business investment spending. On the other hand, low interest rates fuelled a house price bubble that spurred a housing construction boom. Rising house prices then provided backing for a debt financed consumption binge that sucked in even more imports.

During this period the Fed kept interest rates low for fear that if it raised them consumption spending would slow and the economy would fall back into recession. Rather than confronting the unbalanced and unsustainable nature of the expansion, Federal Reserve Chairman Alan Greenspan chose to underwrite it.

The net result was huge trade deficits that undermined manufacturing; a house bubble that pushed prices far above sustainable valuations; and an unsustainable rate of borrowing that has ultimately left consumers heavily burdened with debt.

The implosion of the house price bubble brought this process to an abrupt end. That is because it removed the asset price inflation that supported the construction boom and the borrowing behind consumer spending.

IV The economic outlook

The U.S. economy is now heavily debt burdened. It has relied on consumer spending to fuel growth, but consumers are now constrained. They have large debts, low accumulated financial saving, and the value of their principal asset (houses) is falling.

The financial sector is also extremely vulnerable. It lent heavily to finance the housing boom and now faces huge mortgage default losses. Those losses could wipe out the banking sector's net worth.

This situation is driving a credit crunch whereby credit supplies dry up, putting further downward pressure on house prices and also limiting normal business activity. This generates a vicious circle. Tight credit undermines asset prices and business activity, which strengthens the rationale for tight credit.

Under these conditions a return to the consumer-led growth model of the past two decades is highly implausible. Instead, households face growing financial stress, as does the financial sector. All indicators point to trouble. The index of leading economic indicators is falling, consumer confidence is at near record lows, house prices are falling, and the economy has lost jobs in each of the last seven months.

Inflation is also working against recovery. Energy and commodity price inflation mean that prices are rising faster than wages, and that is equivalent to a tax on consumers that weakens spending. It is also spooking financial markets, pushing up mortgage interest rates and thereby intensifying downward pressure house prices. That stands to deepen the slump in construction, consumer distress, and financial sector distress.

Balanced against this array of negatives, there are two positives that could help build an economic bottom. One positive is the past fall in the dollar which has made the U.S. more internationally competitive. This should contribute to strong export growth, and it could also strengthen manufacturing investment if corporations relocate back to the U.S. to take advantage of America's renewed international competitiveness. The downside is a weaker dollar could undermine other economies that rely on exports to the U.S. market.

A second positive is the reversal of the recent speculative spike in oil and commodity prices. That should reverse some of the adverse inflationary pressures described above.

V Recommendations for the next President

The next president will face two immediate challenges. The first is to stop the economic rot. The second is to jump start the economy.

With regard to stopping the rot, that process is already under way. The Federal Reserve has back-stopped Wall Street by giving investment banks and primary government bond dealers access to credit from the Fed. Likewise, the Fed has moved to ensure a continuing flow of credit to the housing market by giving mortgage finance giants, Fannie Mae and Freddie Mac, access to the same credit facilities. The Treasury also now has ability to provide capital to Fannie and Freddie should they need it.

Funding is also in place to help reduce the foreclosure problem that is putting downward

pressure on house prices. That is because Congress has provided funds to buy foreclosed homes and also help households negotiate mortgage reductions.

Jump starting the economy is going to require policy action on multiple fronts. One recommendation is another round of fiscal stimulus, this time more focused on infrastructure and less focused on tax cuts. Such infrastructure construction not only adds to economic activity now, it also increases future productive capacity.

Fiscal stimulus should also include federal funding assistance to state governments. Most states are constitutionally obliged to run balanced budgets, and falling state tax revenues are driving expenditure cuts that amplify the downturn. The Federal government can counter this with block grant transfers.

A second measure is to continue extending the duration of unemployment insurance (UI) benefits. UI benefits go to those who need them and who spend them, making them a twofer. That is they are targeted to the needy and they yield strong demand stimulus at small cost. Additionally, policy should further raise the minimum wage and permanently index it to the median wage so that it contributes to a robust wage floor. Increasing wages is important for reviving demand and offsetting the effects of inflation. A higher minimum wage does this, directly helping the wage of those at the bottom and also generating ripple effects up the wage structure. Moreover, this is a good time to raise the minimum wage as the decline in the dollar has relaxed pressures of international competitiveness.

Third, the next president will need to pressure the Federal Reserve to resist prematurely raising interest rates. There is now a growing group within the Fed that wants to raise rates to placate Wall Street and fight inflation. That group is wrong as higher interest rates will do little to lower inflation caused by a commodity speculation and adjustment of the dollar.

Fourth, there is continuing urgent need for China, Japan, and several other East Asian economies to revalue their exchange rates. Their under-valued exchange rates were a critical factor in distorting the economic expansion and creating an unbalanced global economy, and global balance cannot be restored until they revalue.

VI Failed policy or failed paradigm?

Whereas there is agreement on many of the policies needed to stop the rot and jumpstart the economy, there is enormous division regarding the ultimate causes of the Bush administration's failure and how to restore sustainable growth that generates shared prosperity.

On one side stand Robert Rubin, Larry Summers, and the "New Democrats". According to this group the Bush administration's economic paradigm has been basically sound. Thus, the administration has continued with trade liberalization and globalization; emphasized financial innovation and deregulation; supported the Federal Reserve's emphasis on the dangers of inflation; and promoted labor and product market flexibility.

For New Democrats, the administration's failure stems from lost budget discipline, combined with inequalitarian tax and social policy. According to New Democrats, rising income inequality is largely due to technological change that has increased the demand for skills. This calls for "helping hand" programs that offer income support and retraining assistance to those who are displaced. Such social policy should be financed with progressive taxation. In sum, the New Democrat position is if America restores budget discipline and implements helping hand programs, it can be back to business as usual.

On the other side are Progressive Democrats who maintain the current economic paradigm is fundamentally flawed. The Bush administration has been a mean spirited extension of this paradigm, but not a radical departure. Rising income inequality, wage stagnation, excessive debt growth, asset price inflation, widening trade deficits, and manufacturing decline have been features of the American economic landscape for thirty years. The Bush administration deepened these features, but they were already present in the Clinton and Reagan years.

From a progressive standpoint, the problem is a flawed economic paradigm that triumphed some thirty years ago with the elections of Ronald Reagan and Margaret Thatcher. The post-1980 U.S. business cycle has relied on financial booms and cheap imports. Financial booms have provided collateral to support increased borrowing that has financed spending on consumption. Increased borrowing has also been supported by easing of credit standards, and by financial innovations that have widened access to credit. Meanwhile, cheap imports have ameliorated the effects of wage stagnation.

This pattern contrasts with the pre-1980 business cycles that rested on wage growth tied to productivity growth and full employment. Strong domestic demand conditions combined with full employment, encouraged investment, which increased productivity and fueled higher wages.

The shift from the old to the new business cycle was the result of political change associated with Reagan's election in 1980. That inaugurated a period in which business has been ascendant and labor battered. The shift was intellectually rationalized by economists such as Milton Friedman.

The old business cycle rested on the combination of New Deal institutional innovations that strengthened labor, combined with demand-management measures pioneered in Keynesian economics. The new business cycle rests on policies that have sought to erode and repeal New Deal institutions, and demand management has been redirected to lowering inflation rather than securing full employment. Indeed, the language of full employment has been discarded.

The economic policies behind the new business cycle undercut workers and strengthen the power of corporations. Workers are boxed in on every side by the push for small government, labor market flexibility, abandonment of full employment as a policy goal, globalization, and the elevation of short-term profit over long-term gain. Neither public sector nor private sector workers can escape the pressure. The only way out is a new policy paradigm that rebalances the relationship between corporations, workers, and government.

VII Conclusion

The “failed paradigm versus failed policy” debate is critical, but it remains unresolved. That explains the deep economic policy divisions within the Democratic Party.

A major obstacle for Progressive Democrats is the intellectual dominance of neo-liberal economics, which suffocates articulation of an alternative paradigm. Thus, neo-liberalism reinterprets bad economic outcomes as instances of “market failure”, when the real issue is how to institutionally order and manage modern capitalist economies so that they produce shared prosperity.

Interestingly, a similar debate lurks in Europe, but political conditions are slightly different. George Bush is a polarizing failed president who has created political opportunity for a debate over economic paradigm. However, intellectually the U.S. is unprepared for such a debate. In Europe, the conditions are reversed. Europe’s stronger tradition of social democracy means greater intellectual readiness to engage in a debate about economic paradigm. However, Europe is still muddling along politically, which prevents a clear political framing of the problem.

To conclude, both the U.S. and Europe face a danger that the dominant economic paradigm is flawed and exhausted. It has never been able to produce growth with shared prosperity, and now its capacity to produce growth with inequality is also exhausted. Yet, political resistance to changing the paradigm may still be too strong, and intellectual awareness of alternative possibilities not sufficiently developed. The implication is that both the U.S. and Europe could face an extended period of economic stagnation and political discontent.

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