THE GREAT RECESSION OF 2008-2009 AND GOVERNMENT'S ROLE.

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ABSTRACT

As US economy starts to show some signs of the recovery from the deep and long recession of 2008-2009 it is logically to ask some important questions: Why this recession happened? How this recession affected the US economy? What methods have been used by the U.S. Government to fight the recession? What can be said about possible scenarios of the future economic development? This article is providing some answers to above mentioned questions.

INTRODUCTION

Today we can observe more and more factors confirming that the U. S. national economy begins to show some signs of the recovery after the deep and long recession of 2008-2009. This recession recently got the name of the "Great Recession" using the analogy with the famous "Great Depression" of 1930-s. Thinking about the events of such magnitude that affect lives of millions of people it is logical to try to investigate why this recession happened and what was the Government's role in the creation of the economic environment that has stimulated the recession and also its' role in the recent recovery efforts.

MICROECONOMICS CAUSES OF THE RECESSION.

Most economists and politicians are naming as two main causes of the recession the collapse of the real estate market after the housing market prices bubble has burst in 2007, and the crisis of the financial system that has benefited by financing of this bubble.

I think that it is right but we should also look at the two other macroeconomic causes of that crisis not broadly discussed so far by the economists. But first let briefly look at the well analyzed today main mistakes in the regulation of the housing and financial markets that have been made during the last twenty years that provoke the recession. Befor1990-s in the USA there was the system of the strict standards used by banks when they have provided mortgages to their clients. Among them was the good credit history, the permanent job with the stable income, the ratio of the mortgage payment to the total income, and the amount of the down payment. But in 1990-s the political goal of the broader access to the home ownership for people from lower income groups forced the Government to find ways to make it happened. Two most obvious strategies were the support of the process of the households' income growth and the pressure on banks to induce the "relaxation" of the banking standards in mortgages approval.

The growth of the net income per capita in the USA during the period of 1990-2000 was about 25%. Income has increased (in 2000 dollars) from $20,336 to $25,472. (Census 2000 Demographic Profile Highlights. Available at: http://factfinder.census.gov/servlet/). (1) But these data shows the average income growth per capita. Starting the middle of 1980-s there was the emerging trend of the faster income

growth among the households belonging to the high income earning group. According to the US Census Bureau, in 2001 40 percent of low income households earned only 12.2% of the total income earned by all households or $21,639 per household. At the same time 20 percent of highest income earning group of households earned 50.2% of the total income. Obviously, this level of income is not sufficient to buy a house in many states. So, the change in the standards of the mortgage issuance became the Government's leading strategy.

According to Stan Liebowitz, the statistical analysis of the mortgage requests rejections made and published in 1992 by the Federal Reserve Bank of Boston has shown that applicants who belonged to minority groups had the higher percentage of rejections than other applicants. That report has been used as the main argument in the demand to change the basic standards of the mortgage approval criteria for all banks (Liebowitz, Stan. 2008. Anatomy of a Train Wreck. Causes of the Mortgage Meltdown. The Independent Institute. The Independent Policy Report. October 3, 2008, 6-10) (2). In addition the Department of Housing and Urban Development has mandated that a certain percentage of Freddie Mac and Fannie Mae loans must be for low – or moderate-income, underserved, and special affordable borrowers.

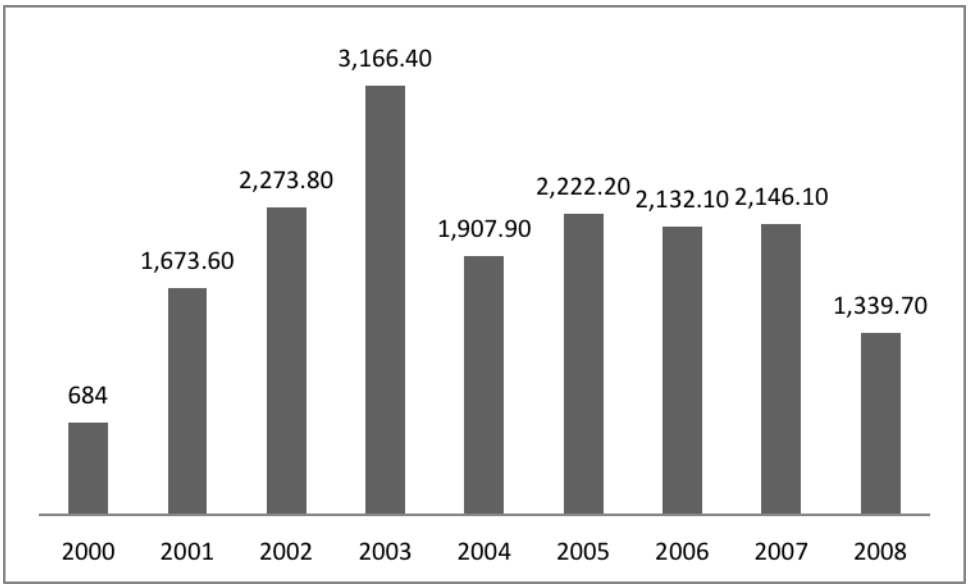
As the result of the easiness in the mortgage requests approvals the percentage of the home owners in the USA has increased from the year of 2000 to the year of 2004 from 66.2% to 69%. At the same time lower standards made possible to get financing also for people who want to buy a larger house, or to purchase the second home for the vacation purposes, or the house for the future retirement. The quick increase in the demand for houses created their fast price appreciation. During the ten year period from 1995 till 2005 homes prices in constant dollars almost doubled.

Because the mortgages are collateralized loans, banks became interested to use them as the base for the issuance of other categories of profitable securities. To make the base for these securities broader banks have developed new kinds of mortgages: mortgages with "zero down", adjustable interest rate mortgages (balloons), and no or low documentation mortgages. As the result of the intense process of the securitization of residential mortgages new derivatives that worth trillions of dollars has been injected into the U.S. and global financial markets. The banks' main benefit in this situation was not the interest from mortgages but the market value of new created securities: CDO – collateralized debt obligations. CDOs are practically results of the second securitization of the "mortgage backed securities" – MBS. The investment bank after the creation of CDOs would receive the commission for the issuance of them and also the commission for their management when they are still on the market. The bank was not responsible for their profitability and liquidity. So, banks were interested in the volume of circulating securities not in their value and reliability. Risks have been transferred to CDO buyers.

The Table 1 illustrates the process of the growth and the decline of the market of CMO – collateralize mortgage obligations which are the same CDOs issued on the basis of the mortgages pools during 2000-2008.

It shows that during the period of 2002-2006 when the real estate market has grown especially fast the market of CMOs was in vicinity of 2-3 trillion dollars. But in 2008 when the real estate market has collapsed the volume of CMOs issued has dropped more than 30 percent to 1.4 trillion dollars.

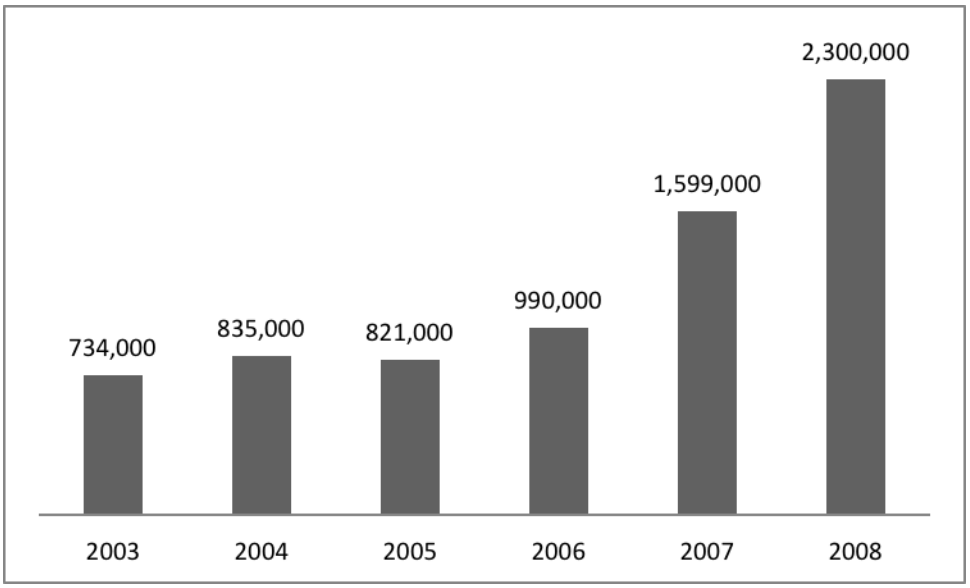
Table 1. The volume of CMO issued during the period of 2000-2008.



Source: Securities Industry and Financial Markets Association.

When real estate prices have been grown CMOs were more profitable than U.S. Treasuries. Having a rating of AAA from S&P and Moody and Fitch they became one of the most popular investment instruments for many American and European financial institutions, banks and pension funds. But by year of 2006 the housing market became oversaturated by the new buildings and slowed down its growth. About the same time balloon type ARMs have increased monthly mortgage payments for many home owners forcing some of them to stop mortgage payments and leave houses to banks. Because the market value of CMOs inversely related to the level of the risk to loose invested money, mortgage defaults and foreclosures of houses skyrocketed in 2007 and 2008 and wiped out the market value of CMOs converting them into the "toxic assets".

Table 2. Number of houses owned by banks as the result of mortgage defaults (2003-2008).



Source: National Mortgage Bankers Association

Table 2 shows the rapid grows of houses that has been owned by banks as a result of mortgage payments defaults and houses foreclosures. Growing supply of new constructed houses and houses offered by banks has pushed the housing prices sharply down. In some states: Nevada, Florida, and California prices have decreased by 60 percent. The value of CMOs dropped to the zero level. Assets of millions of investors worth about 2.2 trillion dollars have been lost. As the result the blooming financial crisis gave a birth to the longest and most painful recession in the U.S. history since the Great Depression.

MACROECONOMICS CAUSES OF THE RECESSION.

No doubt that the housing crisis was the leading microeconomic cause of the Great Recession but what was or were macroeconomic reasons of it? I think that we should also look at the two major macroeconomic causes of this recession not yet broadly discussed by economists. The first is the change of the economic development strategy in the 1980-s. The second is the choice of the wrong role in the emerging Global Economy that in thirty years period has converted the USA that being the global manufacturing super power house after the World War II into the global super consumer of the cheap imported goods.

The economic strategy before 1980-s has been built on the ideas of the full employment and the wages growth as the result of the growth of productivity. The full employment and the wages growth have stimulated the increase in the demand for goods and services. That growth has influenced the increase in the supply and has stimulated the businesses to invest into new technologies facilitating the further growth of productivity. The "stagflation" of 1970-s seriously damaged this strategy. In 1980-s the Keynesian model of the economic growth which is based on the support of the growth of Aggregate Demand has been replaced by the "neo-liberal" model of economic growth based upon the support of the growth the Aggregate Supply. Increase in demand as it follow from the classical market model supposed to increase the prices of products and services when increase in supply expected to decrease prices. Price decreases are good for consumers because their real incomes as the result of prices decreases will rise. But for producers price decreases means profits decline. To keep profitability at the same level or to increase profitability businesses should decrease costs of production.

One possible way to decrease costs of production will be in the productivity growth. The increase in productivity will drop the cost per unit of the product manufactured. The backbone of the higher productivity is the new technology which requested high capital investments and high fixed costs. But there is the second possibility: costs of production could be decreased if their components, both fixed and variable, will decline. But that became practically impossible in the USA in 1980-s because of the steady wages growth and the increase in the costs of domestic natural resources. To decrease costs manufacturing facilities can be moved closer to sources of less expensive resources, both natural and labor resources. So, the choice has been made and all large U.S. corporations transferred large part of their manufacturing facilities abroad, mostly into the developing countries.

As the result number of people employed by the manufacturing sector of the national economy during the period of the December of 1979 through December of 2007 decreased from 19.4 million to 13.9 million people – 5.5 million jobs have been lost.. At the same time number of people in sales increased during the same period of time from 10.2 to 15.4 million – 5.2 million increase. The number of people employed by the financial sector during the same period almost doubled: increase from 4.8 to 8.4 million (Economic Report of the President 2008, Table B-46). (3). The national economy that has less manufacturers and more sales people should face problems during the economic contraction phase of the business cycle. When there is less produced there is no need in so many sales people.

The loss of about the quarter of the labor force in the manufacturing sector probably has been compensated by the increase in productivity (computer revolution). But the link between the growth of the productivity and the growth of wages and as the result the growth of the consumption has been

broken. Growing supply needs demand to grow also. But where are means to finance the growth in consumption if there are less people who are creating new products and more people who are servicing the process of the distribution and inevitably adding into the products cost and the final price? It is a serious problem. The solution of this problem, was it intuitive or analytical who knows, has been found in the developing the housing market. The house is the largest and the most valuable asset for most American households. If home's market value grows the owner can cash out the appreciation of the house value by borrowing this amount from the bank. So, the housing market frenzy became the major source of the finance for the consumption growth in 1990s and the first half of 2000s. That growth in consumption has supported the growth of supply and respectfully the economic growth especially in 2000-2006.

But borrowed money sooner or later should be paid back. The households' debt starts rapidly expand. If in 1981 the household debt was equal about 48 % of the national GDP: debt - $1,507.2 billion versus GDP - $3,128.4 billion, in 2007 these two numbers became practically equal: debt - $13,765.1 billion versus GDP - $13,841.3 billion. It means that taking the inflation into the consideration the household debt has been grown 5.7 times in 26 years. This debt growth forced the saving rate to drop from 10% in 1980 to 0.6% in 2007 (Economic Report of the President 2008, Table B-30). (4)

So, during the last 30 years the household consumption – the largest component of GDP (about 70%) has been grown as the result of the increase of the rate of debt, not the rate of the income growth. To borrow money you need to provide the collateral. In the situation when for most households their house was their collateral the growing house prices in 1998-2006 allowed households to borrow more and more practically till the moment when the bubble has burst.

The new U.S. role in the global division of labor as the supplier of the technology and investments abroad and the consumer of cheap imported consumer goods not only helped economies of countries like China and Mexico to gain a new economic power building their economies by using American investments but also created at least three factors which negatively affected the U.S. national economy's growth during the last 20-25 years: 1) a substantial loss of the internal money flow to other countries for imports; 2) the loss of jobs initially in manufacturing and later also in the services providing sector; 3) a loss of investments for the domestic economy because of the growing investments abroad. Some statistical data can illustrate above mentioned statements.

Table 3. The trade balance between the USA and China in billions of USD. (Source: US Census Bureau).

1999	2000	2001	2002	2003	2004	2005	2007
-68.7	-83.9	-83.1	-103.1	-124.1	-161.9	-201.5	-256.2

The deficit in trade between the USA and China has been grown from $68.7 billion in 1999 to $256.2 billion in 2007 and $266.3 billion in 2008. The volume of U.S. imports from China $321.7 billion in 2007 was equal about 10% China GDP ($3.4 trillion in 2007).

Table 4. The trade balance between the USA and Mexico before and after NAFTA (1994) in billions of USD. (Source: US Census Bureau).

1993	1994	1995	1996	2000	2005	2007
+1.7	+1.3	-15.8	-17.5	-24.5	-49.7	-74.6

The deficit in trade with Mexico reached in 2007 $74.5 billion when in 1994 (before NAFTA) it was a surplus of $1.3 billion. GDP Mexico in 2007 was $1,034.7 billion, so U.S. imports in 2007 valued of 213.6 billion was equal about 20% of Mexico GDP.

Table 5. The U.S. Balance of Trade (trade in goods) in billions of USD. (Source: Economic Report of the President 2008, Table B-103).

1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
-198.1	-246.7	-346.0	-454.4	-427.2	-482.3	-547.3	-665.4	-787.1	-838.2

Table 5 shows that the trade deficit in ten years period from 1997 through 2006 has quadrupled. It is the illustration of the core idea of the economic strategy implemented by the U. S. Government since 1980-s: the increase consumption of imported goods paid by money borrowed by household from banks who have borrowed money from the Federal Reserve System who has borrowed the substantial part of its funds from countries who exported their products to the USA: China, Japan, Saudi Arabia, Brazil. But after the housing bubble has burst the economic model based on the premise that the growth of the consumption can be built on the real estate value appreciation and it will work over the very long period of time has shown its inefficiency in the long run. It is obvious that consumption based upon the increasing debt which has been supported by growing housing prices can not be a factor of economic growth for the long time. When housing bubble has burst households lost the ability to borrow money from banks and many of them now owe to the banks more than the market prices of their houses. Consumption has dropped, economy has contracted.

HOW THIS RECESSION HAS AFFECTED THE U.S. ECONOMY AND WHAT METHODS HAVE BEEN USED TO FIGHT THE RECESSION.

To fight this recession the U.S. Government used both fiscal and monetary policies mechanisms. First of all the U.S. Congress passed in October of 2008 The Emergency Economic Stabilization Act of 2008 which adopted the Troubled Asset Relief Program (TARP). This program gave rights to the U.S. Treasury to buy mortgages and some other financial instruments for the amount of 700 billion dollars. But TARP has not been able to recover lending activities of banks which have received monies from the Federal Government. The recession has deepened and could grow into the depression. During two quarters after Stabilization Act the growth rate of the national economy dropped a big time: the fourth quarter of 2008 – 5.4%, and the first quarter of 2009 -6.4%. Responding to that the U.S. Congress has passed in February of 2009 The American Recovery and Reinvestment Act of 2009. According to this Act 787 billion dollars should be spent to help economy to get out of the crisis, including spending on health care, unemployment, objects of infrastructure and alternative sources of energy. The stimulus package was intended to create jobs and to promote the investment and consumer spendings during the recession.

In addition to 1.5 trillion dollars that Government used to stimulate economic growth the Federal Reserve System increased the money supply by about 2.25 trillion dollars buying securities from banks and providing funds to fight possible defaults in payments of the owners of student loans, automotive loans and credit cards. No doubt, that Government took the leading role in helping economy to overcome the recession.

Two years after the Recovery Act was implemented we can observe some positive consequences of its stimulus package:

1. GDP is not falling anymore. During the last two quarters of 2009 and four quarters of 2010 GDP shows the growth. (Tables 6 and 7).
2. The rate of unemployment dropped in December 2010 compare with December 2009 from 10% to 9.7%. This is a positive but not the substantial improvement. New jobs have been created but mostly in the government sector of the national economy.
3. The extension of the terms of unemployment benefits payments up to 99 weeks helps to support families of almost 15 million Americans who lost their jobs as a result of the recession.
4. The Federal Government has provided support to state and municipal governments not only in a form of funds for the infrastructure repairs (roads, bridges) and to support jobs of teachers, police officers and firefighters but also in a form of subsidies of interest payments on municipal bonds. As result of these subsidies the interest on municipal bonds increased from 4.5% to 7%, so municipal governments have been able to obtain about 50 billion dollars of investors's money to finance local projects.

Table 6. U.S. GDP quarterly changes in 2008-2010 (percentage changes)

	08/1	08/2	08/3	08 /4	09 /1	09 /2	09 /3	09 /4	10 /1	10/2	10/3
GDP	-0.7	0.6	-4	-6.8	-4.9	-0.7	1.6	5.0	3.7	1.7	2.6

Source: Bureau of Economic Analysis. The U.S. Department of Commerce.

Table 7. U.S. GDP and its components quarterly changes in 2007-2010 (in billions of 2005 dollars).

	GDP	C	IG	G	X-M
2007 Q3	13,268.50	9,310.00	2,178.90	2,447.90	-666.6
2007 Q4	13,363.50	9,342.30	2,126.10	2,455.30	-560.4
2008 Q1	13,339.20	9,324.10	2,074.30	2,469.20	-529.9
2008 Q2	13,359.00	9,326.20	2,033.80	2,489.40	-493.8
2008 Q3	13,223.50	9,243.50	1,967.20	2,521.50	-514.8
2008 Q4	12,993.70	9,166.30	1,753.80	2,530.70	-477.7
2009 Q1	12,832.60	9,154.10	1,529.50	2,511.50	-389.2
2009 Q2	12,810.00	9,117.00	1,453.20	2,549.30	-342.0
2009 Q3	12,860.80	9,161.60	1,494.50	2,549.30	-390.8
2009 Q4	13,019.00	9,182.90	1,585.70	2,550.30	-330.1
2010 Q1	13,138.80	9,225.40	1,690.20	2,540.20	-338.4
2010 Q2	13,261.50	9,262.70	1,800.60	2,567.50	-425.9
2010 Q3	13,278.50	9,330.60	1,855.10	2,589.60	-505.0

Source: Bureau of Economic Analysis. The U.S. Department of Commerce.

Table 7 shows that despite of the stimulus program only components of" Government Expenditures" – (G) and "Net Exports "- (X-M) in the Third Quarter of the year 2010 have exceeded its value of the Fourth Quarter of the year 2007 when the Great Recession practically has started (G: $2,589.6/ $2,455.3; X-M:-505.0/-560.4). The GDP itself and components of "Personal Consumption Expenditures" – (C), and "Gross Private Domestic Investment" (IG) still did not have reached their own level before the recession has started(GDP: $13,278.5/13,363.5; C: $9,330.6/$9,342.3; IG: $1,885.1/$2,126.1). That means that the U.S. economy has not recovered yet and the double dip recession is still possible. In this context the fact that the official unemployment rate did not dropped below 9.5 percent during the year of 2010 become especially alarming. The same table also illustrates the importance of the IG component of GDP. It shows that the trend of GDP changes is following the trend of changes in IG.

POSSIBLE OPTIONS.

To recover from such deep recession economy will take more time than two years. But it looks that economy will need more help from the government. The official rate of unemployment around 10% means that the actual unemployment rate exceeds the so called "natural rate" of unemployment by 5 %. According to Okuns' Law (Arthur Okun was the economic adviser to President Johnson) the U.S. potential GDP has declined during the recession by 10% (5% x 2) or about 1.45 trillion dollars. So, if the investment (fiscal) multiplier of the government spending in the USA is about 1.5 to bridge this gap between potential and real GDP the U.S. Government should invest into the national economy about 960 billion dollars. In other words, it looks that the economy will need the additional stimulus package of about 180 billion dollars to achieve the full and speedy recovery. The additional Government's stimulus package may be one of the possible options that can be considered by the President Obama's administration. After Democrats lost the majority in the Congress it will be difficult for the Administration to get the support of this idea from the law makers. But this option is still valuable and can work if it will be implemented.

Obviously the additional increase in the Government expenditures will further increase the national debt. But when the economy should be helped to recover from the very deep recession the national debt issue can be left for the near future efforts. According to some economists estimates for the developed economies in the contrast to developing economies when the National Debt/ GDP ratio is below 90% the correlation between the national debt and the economic growth is weak. After the ratio will exceed the 90% level the growth rate will decline by 1% (Reinhart, Carmen M., Rogoff Kenneth S. Growth in a Time for Debt. January 2010. Paper was prepared for the American Economic Review Papers and Proceedings) (4). In the USA this ratio by the end of the December of 2010 is about 93.3 percent (13.9/14.9 trillion dollars). So the size of the debt is big enough to affect the speed of the economic recovery and the economic growth in the future. That is why after one more of economic stimuluses' injections the Government's major economic priority should became the management of the growing national debt.

The second option will be to stimulate" C" and "IG" components of GDP through tax cuts. The recent compromise of the Administration with Republicans on tax cuts extension is pointed out into that direction. The problem with this option is the same as the increase in Government's spending option – the

further increase of the national debt which can be left for the near future efforts as it was mentioned above.

But none of these two options has addressed the major macroeconomic problem that caused from my point of view the recent recession: the economy with the decreasing manufacturing sector and the declining labor force hired by that sector, and with increasing service providing sector and the growing labor force involved only in sales has less vitality than predominantly manufacturing economies like Chinese economy. So, it will take more time and efforts from the Government to help economy to reach its prerecession level.

In my opinion, the Government economic policy still will work and by the end of 2011 we would be able to see more progress in the jobs creation and in the economic growth. But the leading Government's effort should be in the support of new industries where the USA has competitive and comparative technological advantages. Increasing Government's spending ("G" component) into these industries to help businesses to develop the new energy sources, new means of the transportation and communications, and more efficient components of the infrastructure will not only create new jobs and help "C" component to grow, it will also help" IG" component to grow because of the capital investments, and will increase U.S. exports and positively affect the Net Exports component of GDP. When all four components of GDP will grow we will see the economy 's full recovery. That could be the best Government's economic strategy in the long run.

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