Managing the Crisis |

USA Country Report

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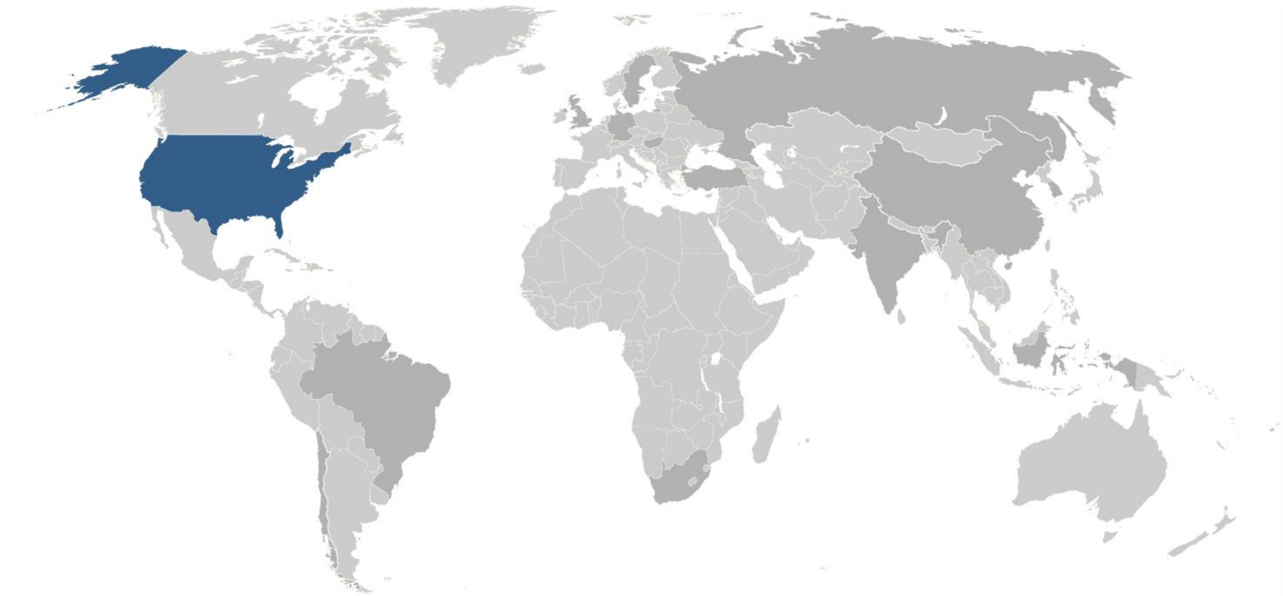

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1. Risk Exposure at the Outset of the Crisis

- What was the structure of demand (e.g., share of private/state consumption, gross capital formation, exports and imports in GDP/GNI)?
- To what extent was the economy exposed to macroeconomic imbalances (e.g., foreign debt, trade or fiscal imbalances)?
- Was/is the financial system primarily bank- or market-based?

Economic structure and macroeconomy

The domestic consumption driving U.S. economic growth before the crisis was fueled by unsustainable credit expansion and lax monetary policies that were introduced after the dot-com bubble burst in 2001. The Bush administration also pursued an expansionary fiscal policy, which led in 2008 to a budget deficit of 3.1 percent of GDP. Though seemingly manageable by itself, this budget deficit is unsustainable, given the growth of entitlement spending in health care and retirement, and the demographic trends associated with a retiring baby-boomer cohort.[1] The Clinton administration had left office with a budget surplus of 1.3 percent. In this sense, the United States was ill-prepared for the onslaught of the financial crisis and lost any chance of balancing its budget in the near and medium term. As the crisis began to unfold and the U.S. government introduced stimulus programs and bank bailouts, national debt as a percentage of GDP jumped from 40 percent in 2008 to nearly 70 percent a year later. By 2010, the budget deficit had shot up to 10 percent of GDP.

While these figures are daunting, the U.S. economic system's greatest liability is to be found in the weaknesses of the private sector's balance sheets. Private households continued to reduce their savings, given the increase in asset prices, particularly real estate. Households as well as companies are today rebuilding their balance sheets; the household savings rate is increasing, slowing consumption and investment and helping to produce the severe economic contraction that began in the last quarter of 2008.The counterparts of the dissavings by household in the run-up to the crisis was the growing current account deficit and the growing trade deficit.[2] By the end of 2009, the trade deficit reached an unprecedented figure of $821 billion, and the

[1] See Congressional Budget Office, *A Preliminary Analysis of the President's Budget and an Update of CBO's Budget and Economic Outlook* Historical Budget Data, Washington: March 2009, 11; http://www.cbo.gov/doc.cfm?index=10014 (accessed February 10, 2010)
[2] Simon Johnson, "Testimony to the Senate Budget Committee Hearing on The Global Economy: Outlook, Risks, and the Implications for Policy," January 29, 2009, 7-9; http://baselinescenario.files.wordpress.com/2009/01/global-economic-forecast-for-senate-budget-committee-jan-28-2008-final.pdf (accessed February 10, 2010)

current account deficit reached $731 billion, about five percent of GDP.[3] With the collapse of the economy and consumption, and the weakening of the dollar, self-correcting forces have been set in motion, but a real correction will happen only if surplus countries consume and import more. Having said this, the expected halving of the current account deficit in 2009 is an achievement.

As alluded to above, the current account deficit, which is attributed to the low savings rate of U.S. households and the government, numbers among the most important macroeconomic imbalances for the national economy. The current account deficit was necessary to continue financing consumption and investment and should be seen as one of the most important aspects of the macroeconomic context to the financial crisis, as the necessary inflows of funds fueled the credit boom, particularly in real estate and related securitized products.

The financial system is primarily based on capital markets. Indeed, U.S. companies finance their operations primarily through stocks and bonds in international capital markets.

- What was the government's economic record (e.g., growth, unemployment rate, inflation and fiscal position) prior to the crisis?
- What was on the economic agenda prior to September 2008 (e.g., anti-inflation, efficiency-oriented, redistributive, supply vs. demand-side policies)?

Policy priorities prior to crisis

The Bush administration's policy record prior to the crisis was mixed. In the years prior to the crisis, growth was solid at roughly three percent annually, and inflation under control, hovering between two percent and three percent per year. Even the budget deficit as a percentage of GDP was decreasing, and unemployment at five percent was quite moderate. Nevertheless, fiscal policy was too lax given the demands made on the budget by an aging population and two unfinished war efforts. Most of the deficit under the Bush administration came about because of Bush-supported policy changes—not as a result of the business cycle.[4] The real problem was with monetary policy, which had been quite loose since the shallow recession in 2001, and which fueled the boom in asset prices, particularly in real estate. Although the Federal Reserve (hereafter, "the Fed") had begun tightening, it refused to

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[3] Dick Nanto et al., *U.S. International Trade: Trends and Forecasts*, Washington 2009: March 6, 2009, 4, 15-17; http://opencrs.com/document/RL33577/2009-03-06/
(accessed February 10, 2010).

[4] Alan J. Auerbach and William G. Gale, "The Economic Crisis and the Fiscal Crisis: 2009 and Beyond.
An Update," Brookings Institution: September 2009, 7;
http://www.brookings.edu/papers/2009/0219_fiscal_future_gale.aspx
(accessed February 10, 2010).

prick the asset price bubble. It based its refusal on the theory that it is hard to identify a bubble and that the role of monetary policy is to deal with the consequences of a burst bubble.

During its second term, the Bush administration did not have a well-formulated economic policy. In the first term, it pursued a deliberate supply-side policy, with two massive tax cuts primarily benefiting upper-income tax payers, in part justified by the recession of 2001. In the second term, the administration had run out of steam, although rhetorically it hinted at further tax cuts. One redistributive policy was the extension of health services under Medicare, in the form of free prescription drugs for the elderly. As the measure did not contain any cost-containment elements, it added massively to the budget deficit.

- How stable was the executive branch in the years/months prior to September 2008 (e.g., credibility/legitimacy of leaders/parties in government, cabinet stability/reshuffles, parliamentary/electoral support)?
- How much room did fiscal conditions provide for a major stimulus (e.g., budget surpluses/deficits, conditions for issuing additional treasury bonds)?
- How much room was there for monetary policy initiatives (e.g., pre-crisis level of interest rates, required reserve ratios, flexibility of foreign exchange rate regime)?

Executive, fiscal & monetary capacities to respond to downturn

Once elected, governments in the U.S. presidential system are quite stable, as they are not dependent on a legislative majority. However, the legitimacy and credibility of the Bush administration's economic (and foreign) policies suffered several blows during the president's second term in office. Despite an acceptable record on growth and unemployment, average real income for workers dropped by about 1.5 percentage points during President Bush's tenure.

The administration's economic team underwent decisive change with the appointment of Goldman Sachs CEO Henry Paulson as treasury secretary in May 2006, arguably a good choice if financial markets were to show strain or crisis. However, by the 2006 midterm elections, the administration's policies had lost steam, a factor—together with the consequences of the Iraq war—that contributed to the Republicans' loss of legislative majorities.

Monetary policy had been fairly loose before the crisis, particularly in the context of an emerging bubble. Nevertheless, the Fed began tightening as of 2005, and the discount rate by 2008 stood at 4.75 percent. Thus, when the crisis hit in 2008, the Fed did have room to maneuver, and embarked on a course of drastic interest rate cuts.

The dollar did not depreciate to the same degree, due to the safe-haven phenomenon, with foreign investors seeking the safety of U.S. government bonds.

- To what extent has the country been exposed to global financial market risks, particularly contagious/toxic financial instruments (e.g., open capital account, floating or pegged/fixed currency)?
- How important was/is the financial sector for the national economy? What was/is the extent of interdependence between the financial sector and real economy?
- To what extent was the economy integrated into regional/global trade flows? How dependent was the economy on foreign demand for manufactures and commodities?
- Did property, equity or other markets display excessive growth and a bubble-like situation prior to September 2008?
- In what condition was the banking sector (e.g., size/structure of banking sector, non-performing loans, capital adequacy ratios of major banks, if available)?

Exposure to specific market and trade risks

Given that the U.S. financial market is at the core of global finance, most of the toxic assets and the instruments that distributed them globally originated in the United States. The U.S. financial sector grew tremendously throughout the 1990s and into the beginning of the new century, generating 20 percent of corporate profits by 2005.[5] The financial sector also attracted the most capable and talented graduates in business and other areas, threatening to set off a brain drain from other sectors in the economy. The financial sector was at the core of economic growth, directly in the form of increasing profits and burgeoning transactions, and indirectly as it fueled a housing and construction boom that in turn drove economic growth and employment in the United States.

The United States is fully integrated into the world economy, through free capital accounts and as an international financial hub. Before the crisis, it was not so much dependent on foreign demand for its products as it was dependent on capital imports to finance its current account deficit.

Prior to September 2008, asset prices in real estate markets experienced unsustainable growth rates. Starting in 2002, the Case-Shiller Index, reflecting the real estate price developments of the top 20 major metropolitan areas, grew by more than 10 percent before the onslaught of the crisis. This led to overbuilding and an oversupply of housing units, as well as to an extension of home-ownership to social groups that were unable to afford it. Home ownership rates reached 71 percent in 2007.

[5] Simon Johnson, “The QuietCoup,” Atlantic Monthly, May2009, http://www.theatlantic.com/magazine/archive/2009/05/the-quiet-coup/7364/ (accessed February 10, 2010).

As the crisis broke, the situation of regular banks and deposit-taking institutions was relatively stable, due to strict regulation. The real problem arose with unregulated mortgage brokers on the state level, which were at the heart of the so-called subprime crisis.[6] Banks were also thought to benefit from the process of securitization, as they could off-load loans from their balance sheet and gain more capital for increased lending. However, the problem was that banks themselves invested in these securities and structured investment vehicles (SIVs), legally separate entities that were not part of their balance sheet. In most cases these SIVs had no capital reserves of their own and were financed by short-term loans from the money market. When homeowners defaulted on their mortgages, the SIVs became insolvent and sponsoring banks were forced to take them back on their balance sheet.

- Did policymakers/executive agencies have any experience in handling financial crises? Did this experience play a role in the 2008-09 policy response?
- Were there independent regulatory institutions or prevention/response schemes in place to contain financial risks?
- Were there internal veto players (e.g., federalist powers, courts) or international obligations that thwarted swift action on the part of the government?
- Have executive powers been extended in times of crisis? Has this been based on formal or informal mechanisms?

Structural or policy advantages and disadvantages

In terms of drawing upon past experience in handling financial crises, the savings and loans crisis that hit the United States in the 1980s could not serve as a useful precedent because it bore a different structure than the crisis of 2008 and had little impact on the real economy. The former came about after the financial deregulation of deposit rates, which meant that savings and loans institutions began to attract deposits that bore interest rates competitive with money market funds. As the savings and loans were also tied to fixed low interest rates on their loan portfolio, this led to the insolvency of most institutions, which then had to be bailed out by the taxpayer.

It should be noted that in the United States, there have been no regulatory institutions or prevention schemes that wield effective oversight over entities such as SIVs and other innovative financial instruments. In particular, bank leverage has increased dramatically, with too little in reserves to back up lending.

Central to the story of the financial crisis is the failure of regulation in the United States, which began almost twenty years ago, in the early 1990s. Democratic as well as Republican administrations are implicated here, as are policymakers of both parties in the two houses of Congress. In fact, the crisis

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[6] Edward Gramlich, *Subprime Mortgages. America's Latest Boom and Bust*, (Washington: Urban Institute Press, 2007).

is attributable to the virtual capture of government and financial regulators by the financial sector.[7] This capture must be explained in terms of ideology, influence-peddling associated with massive campaign contributions, and the appointment of financial sector representatives to strategic positions in the executive. Under both Democratic and Republican administrations, secretaries of the treasury came from Goldman Sachs. The temptation for politicians to acquiesce to financial liberalization and lax regulation was strong, as financial sector strength promised prosperity and rising tax revenues, particularly from increasing capital gains taxes, which even left-of-center governments could then justify as a basis for the expansion of social programs.

In terms of veto players capable of thwarting government measures to counter the effects of the crisis, neither the Bush nor the Obama administrations faced any real attempts to block the rescue packages they have proposed and implemented. There was some reluctance on the part of Congress to bail out banking institutions at the same time that homeowners and small investors were incurring massive uncompensated losses. But after the Lehman insolvency, Congress authorized the Troubled Asset Relief Program (TARP).

Since the crisis has unfolded, executive power in the United States has been extended dramatically and in unprecedented ways. Not only has the U.S. government bailed out major financial institutions, it has also become the temporary majority stockholder in automobile companies (General Motors and Chrysler). The executive branch also worked with the Federal Reserve Board in encouraging the Fed to buy assets from banks, give emergency loans and expand its balance sheet dramatically. Congressional scrutiny and oversight was marginal, particularly regarding specific decisions. Both administrations implemented stimulus packages, the Bush administration by giving tax rebates, the Obama administration by devising a comprehensive program of expenditure and tax cuts. However, the size and composition of Obama's program has been subject to Congressional debate and influence, which has resulted in lower spending and a greater proportion of tax cuts than initially proposed.

- How strongly has the national economy been hit during the period under review? Where has it been hit most severely thus far (e.g., growth rate, production, trade, employment)?

Initial impact of economic downturn

This is an economic crisis that has affected the entire economy, with the exception of the high-tech sector. Growth, production, employment and trade have all been hit: Growth contracted by 6.2 percent in the fourth quarter of

[7] See Johnson, Quiet Coup,

2008, the worst such fall since 1982; unemployment rose to 7.6 percent in January 2009, reached 10 percent by September 2009, and remains stubbornly high.[8]

2. Agenda-Setting and Policy Formulation

- When did state organs (e.g., government, central bank) begin setting a crisis response agenda? How long did it take to adopt the first crisis measures?
- Who were the driving forces (e.g., government, central bank, foreign actors, media, trade unions, employers` associations) in getting stabilization/stimulus policies started?
- Were these measures launched as executive orders or parliamentary laws? How closely did constitutional bodies (e.g., executive, legislative, central bank) cooperate?
- What kind of role did sectoral or regional lobbies play in policy formulation?

Agility and credibility

The government and the Fed were swift and resolute in their response. In fact, policymakers were quick to acknowledge and anticipate the depth and impact of the crisis. Attempts to address problems in the months beforehand had had only limited impact, as evinced by the weak effects of the Bush administration's stimulus program introduced in the spring of 2008. By summer 2008, it was clear that more drastic steps had to be undertaken. Indeed, by September, when Lehman Brothers filed for bankruptcy and the threat of the entire banking sector failing became imminent, the Bush administration announced with bipartisan support in Congress the $700 billion TARP program to buy assets from troubled financial institutions.[9] Policymakers were also aware that this was a systemic crisis that would have far-reaching consequences domestically and internationally.

By December 2008, the Fed had reduced the federal funds rate significantly from 5.25 percent in 2007 to a target range of between zero percent and 0.25 percent. In addition, the Fed has used several new facilities to lend directly to financial institutions, leading to outstanding loans of more than $3 trillion. The Fed has also bought commercial assets worth about $800 billion, including mortgage-backed securities.[10]

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[8] See Congressional Research Service (CRS), *Economic Stimulus: Issues and Policies*, Washington D.C., February 27, 2009, 2, http://opencrs.com/document/R40104/2009-02-27/ (accessed January 30, 2010); and Bureau of Labor Statistics, *Employment Situation Summary*, Nov. 6, http://www.bls.gov/news.release/empsit.nr0.htm (accessed January 30, 2010).

[9] CRS, *Economic Stimulus*, 3.

[10] CRS, *Economic Stimulus*, 1.

The primary actors in driving the United States' policy response have been desperate bankers, government agencies and the Fed. Some legislators, such as Barney Frank, chairman of the Financial Services Committee in the House of Representatives, also played a prominent and constructive role. The media, particularly the cable business news channels with close ties to Wall Street, also helped in emphasizing the serious nature of the crisis, so that average citizens and investors (50 percent of all Americans own shares) were aware of what was happening. Because the stock and financial markets are of great concern to average Americans, there was heightened public attention to the crisis.

Most measures (e.g., TARP, stimulus programs) were proposed by the governing administration and the Federal Reserve, but were then passed by means of legislation. However, the laws left executive decision makers considerable discretion; for instance, TARP was originally designed to bail out financial institutions, not automobile companies. Reserve bank action, however, did not have to rely on legislation, but could take advantage of an expansive use of instruments used in the past such as the purchase of government bonds.

Sectoral lobbying came primarily from the banking sector and the big auto companies and their unions. The financial sector could take advantage of the too-big-to-fail syndrome—that is, the idea that the failure of any of the big banks constituted a systemic risk for the financial sector and the economy as a whole. Indeed, policymakers had little choice but to offer support. Lehman Brothers constituted an exception to this, and the interpretation today is that Lehman *had* to fail in order to underline the gravity of the situation. Political considerations clearly underlie the Obama administration's bail-out of General Motors and Chrysler. The U.S. car industry is based in Michigan, a state important for Democrats and the Obama administration. Autoworkers and their union belong to the traditional constituencies of Democratic politicians.

- Did policymakers actively consult domestic and/or foreign experts outside of government?
- Did the government actively seek collaboration with other governments or international organizations?
- Did the government participate in multilaterally coordinated rescue efforts?
- Was the government curtailed in its response through IMF support programs?

Consultation with external experts and openness to international collaboration

Because of the openness of the U.S. political process and the tendency to recruit experts from think tanks and universities for high-level positions within the administration, the network of relationship between executive policymakers and outside experts is very closely knit. Examples include Larry Summers, a professor of economics and former president of Harvard

University, who heads President Obama's National Economic Council, and Greg Mankiw, a prominent academic from Harvard, who was President Bush's Council of Economic Advisors chairman. In addition, both American administrations have pursued an intense course of international consultation, bilaterally and through multilateral institutions and groupings such as the G-8.

The U.S. government has also reached out internationally and employed all available avenues in underscoring the dramatic nature of the financial crisis, including the G-7, the G-20, the IMF and the OECD. It alerted partner governments early on that the nature of this crisis was global, that growth would contract everywhere, and that drastic countermeasures were in order. At the same time, the U.S. government also pointed out weaknesses in the European banking sector. These claims frequently drew denials from allies such as Germany, which initially denied that the crisis would have any effect on its economy, although the denial may have been a tactical maneuver in the context of upcoming federal elections.[11]

Insofar as there were coordinated multilateral rescue efforts in the immediate aftermath of the crisis, the United States government not only participated in every effort, but was the driving force behind such efforts.

3. Policy Content

- How large is the stimulus package as expressed as a percentage of GDP (including compensations to those hit particularly hard by the crisis through social/labor policies)?
- The stimulus is spread over a period of how many years?

Scope of stabilization and stimulus policies

The stimulus package initiated by the Obama administration amounts to $787 billion, or roughly 5.8 percent of GDP and is to be spread over a 10-year span, with about half of the budget authority granted for 2009. The Congressional Budget Office (CBO) estimated that only $120 billion would be spent in the first year. By 2010, 70 percent of the stimulus package should be spent. The tax provisions are to extend over 10 years.

[11] Simon Johnson, "Steinbrück's Peers," The Baseline Scenario, May 16, 2009; http://baselinescenario.com/?s=Peer+Steinbr%C3%BCck (accessed February 10, 2010).

- How is stimulus spending distributed across sectors? How and to what extent is the financial sector supported (e.g., through loans, guarantees, capital injections)?
- Which industrial and structural policies (e.g. corporate tax cuts, subsidies, company bail-outs) can be observed?
- What kinds of measures target the expansion of public spending on infrastructure? Which ones are designed to sustain business and consumer spending?
- Are policies in support of businesses adequately targeted and delineated (e.g., at creating employment, supporting competitive firms)?

Targeting and coverage of policy tools

With 64 percent of the stimulus funds earmarked for spending projects and 36 percent for tax relief, the Obama administration's distribution of funds has come under considerable fire.[12] Financial sector support was organized through the TARP program, which was almost fully committed by spring 2009. If one adds up TARP, the American Recovery and Reinvestment Act (ARRA), and the stimulus program, roughly 40 percent of the total accrues to the financial sector.

The U.S. government has introduced policies addressing structural or industrial issues, albeit not overwhelmingly so. In fact, industrial policies were explicit only in support for the automobile sector under TARP. Given that business tax provisions amounted to a revenue loss of $6.2 billion over the 10 previous years, immediate tax relief for businesses was introduced in 2008, quickly reaching a total of $8.5 billion. Structural policies have been pursued through an extension of a tax credit for renewable energy production ($13.1 billion), as well as funds for investment in new energy transmission networks and health information technology ($25.1 billion).[13]

Infrastructure spending amounts to $120 billion, as well as an additional $40 billion for investments in energy infrastructure (particularly so-called smart grid technology).

In terms of policies supporting business, these are generally reasonably well targeted, but it is too early to evaluate their impact. With the exception of the automotive bailout, support has focused on industries of the future (i.e., energy, environment, health care). Government employment at the state level has suffered severe cuts, thus restricting state government fiscal maneuverability.

[12] CRS, *Economic Stimulus*, 8.
[13] ibid, 7-8 on the composition of ARRA.

- Are stimulus measures influenced/limited by pre-crisis development strategies (e.g., industrial policies) or have novel/additional (e.g., environmental) policy objectives been inserted?
- Is the response to the crisis grounded in a broader developmental perspective (i.e., crisis as development opportunity) or predominantly short-term political constituency logic?
- Do stimulus policies address prevailing structural deficits and future growth potential?

Development as an objective of stimulus policies

In general, the stimulus strategies pursued have not been constrained by earlier policies. The Obama administration has focused primarily on novel and future objectives in formulating its strategies. It has also maintained a long-term perspective in formulating its recovery program, which comes, however, at the expense of the stimulus spending's timely impact. This is particularly true for spending on energy, the environment, health and a portion of that earmarked for education. In terms of addressing prevailing structural deficits and future growth potential, the ARRA did little to address the former, but did raise the current deficit by one percentage point of GDP. Some of the spending allocated through the ARRA might enhance the economy's growth potential, but only minimally so.

- Has the stimulus included "buy national" clauses? Have import-restricting mechanisms been newly established or re-established?
- Has the country's executive/central bank manipulated the exchange rate or intervened in the foreign exchange market (if so, in which direction)?
- Have there been measures to prop up export industries (e.g., tax rebates, direct export subsidies)?

National bias and protectionism

The ARRA mandates that public procurement under the stimulus package's infrastructure spending component must conform to America's international obligations (i.e., WTO, NAFTA). However, most of the state governments that actually award contracts operate under "buy America" provisions.[14]

Although difficult to verify, the U.S. administration and the Fed are suspected of being interested in a lower dollar, but there has been no attempt at manipulating exchange rates. As a matter of fact, the dollar rose early in the financial crisis because of the safe-haven phenomenon. Since then, the dollar has depreciated, and U.S. policymakers see a benefit in this.

[14] Gary Hufbauer and Jeffrey Schott, "Buy American: Bad for Jobs, Worse for Reputation," Institute for International Economics, Policy Brief 09-2, Washington: 2009; http://www.iie.com/publications/interstitial.cfm?ResearchID=1114 (accessed February 10, 2010)

However, as the Chinese currency is pegged to the dollar, the dollar-renminbi exchange rate remains a problem, leading to parallel depreciation.

No explicit measures to prop up export industries have been put in place.

- Which labor market policies have been enacted (e.g., unemployment benefits, rise in public-sector employment)?
- Which social policies have been included (e.g., expansion of support, additional investment in health and education system)?
- Which measures have been taken to support purchasing power (e.g., consumer checks, tax cuts, cash transfers)?

Social protection

Social protection accounted for a large proportion of the ARRA, amounting to roughly $80 billion (counting transfers such as increased levels of food stamps). However, no direct subsidy of private sector wages was undertaken (as with the *Kurzarbeitergeld* or "wage support payments" in Germany). The results in terms of job creation have been disappointing.

Health and education policies have also fared well under the ARRA, with $14.2 billion earmarked for health care programs and $106 billion for education. An additional $4 billion have been allocated for pre-school education.

In order to support purchasing power, the government's most significant measure has been the $106 billion "Making Work Pay" tax credit, followed by the child tax credit of $14.8 billion. The earned income tax credit has been increased by $4.7 billion.

4. Implementation

- Does the government actively communicate and justify the rationale/goals of its stimulus policies to the public?
- Over time, how has the public responded to the government's management of the crisis (e.g., consumption/investment trends, public opinion polls)?

Political communication

The government has done a decent job of communicating the rationale behind its stimulus policies. However, because unemployment has remained stubbornly high, the effectiveness of its policies has been elusive to most Americans. Stung by Republican assertions that the stimulus program had failed to create jobs, the White House produced statistics that the $787 billion stimulus package has created or secured 3.6 million jobs. But the stimulus has thus far yielded paltry results in terms of jobs. Indeed, hardly any private sector jobs have been created, and infrastructure spending has not led to significant new employment. In addition, the expenditure on science and health information technology of roughly $32 billion will not be felt until 2011. In short, there was simply too little emphasis on labor-intensive spending that would register immediately and provide the government with a so-called quick-win.[15]

Consumption and investment have stabilized at low levels, and public opinion polls show a growing disenchantment with the stimulus package. Obama's approval rating on handling the economy was down to 50 percent in October 2009 from a high of 60 percent in February of that year, while a full 48 percent disapproved of his handling of the economy.[16]

Modes and time frame of implementation

- How large has the time lag been between adoption and implementation of selected major stimulus components?
- What are the reasons for delay in implementation (e.g., legal barriers, insufficient capacities, corruption)?
- Have sectoral or regional interest groups influenced the workings of policy implementation in any way?

The time lag between the adoption and implementation of policies has not stemmed from legal barriers, insufficient capacity or corruption, but rather from the nature of measures enacted. Many of these measures have been time-consuming to implement—requiring research programs and long-term "investments" such as environmental and health care technologies. In this sense, these measures have been the wrong choice for a stimulus program. They were designed to define the new administration's signature structural policy changes rather than to have an immediate stimulus effect.

Sectoral and regional interest groups have had no more influence than is usual in the geographic constituency-based U.S. system. The faults and defects of the stimulus package cannot be attributed to sectoral or regional lobbying.

[15] See Alec MacGillis, "Why aren't President Obama's job-creation efforts more direct?" Washington Post, November 8, 2009 on http://www.washingtonpost.com/wp-dyn/content/article/2009/11/06/AR2009110601900_2.html?sid=ST2009110604712 (accessed February 10, 2010).

[16] Washington Post-ABC News Poll, October 18, 2009; http://www.washingtonpost.com/wp-srv/politics/polls/postpoll_101909.html (accessed February 10, 2010).

- Beyond emergency stand-by programs with the IMF, has the government collaborated with other governments or international organizations in implementing its response to the crisis?

International or regional cooperation

All the programs in response to the crisis within the United States have been implemented nationally and without international or regional cooperation.

5. Funding, Tax and Monetary Policies

- Has the government initiated tax reductions/incentive schemes?
- Have these been aimed at the private and/or the corporate, domestic or the foreign sectors?

Tax policies in support of stimulus/ stabilization

About 36 percent of the ARRA was devoted to tax cuts, with the bulk going to private households. Specific business tax cuts amounted to less than $10 billion.

- What kind of policies did the central bank contribute to the national crisis response? Which unconventional measures were used to fight the crisis?
- If an independent national monetary policy is not feasible, were there substituting measures in the country's exchange rate policy?

Monetary and currency policies in support of stimulus/ stabilization

The Federal Reserve has been lowering interest rates aggressively, with the federal funds rate close to or at zero percent. Unconventional measures have included quantitative easing, the policy of buying Treasury bonds and securities with newly created money.[17] The United States maintains an independent national monetary policy, without recourse to exchange-rate-based substitutes.

[17] Simon Johnson and James Kwak, "The Radicalization of Ben Bernanke," Washington Post, April 5, 2009; http://www.washingtonpost.com/wp-dyn/content/article/2009/04/02/AR2009040202573.html (accessed February 10, 2010).

- Relative to conditions at the outset of the crisis, does stimulus funding have a solid foundation in monetary policy or in bond/credit markets?
- Is the program part of the normal budget/integrated into the budgetary cycle, or is it financed primarily from sources outside of the formal budget?
- Is there cross-level burden-sharing between center and regions (e.g., debt issuance, fund transfers)?
- Is financial aid given to banks/companies/households in a discretionary way or based on well-defined formulas (e.g., conditionalities)?
- Did the government make credible commitments to terminate its expansionary fiscal and monetary policies under (what kind of) post-crisis conditions?

Credibility of funding mechanisms

The stimulus package, which was funded through normal budgetary channels, is estimated to have increased the federal debt by $1 billion. There is no indication that bond or credit markets are rattled by the size of the package, but budget consolidation is clearly on the agenda. As all of the funding for the stimulus package comes from the federal level and a significant amount is channeled through the states, state governments are beneficiaries.

Given that the U.S. government's response to the crisis was driven by panic in the financial sector, every systemic institution with the exception of Lehman Brothers was given assistance, whether a bank or non-bank. Lehman was allowed to fail, bringing the financial system close to a meltdown. As noted earlier, in hindsight, analysts agree today that Lehman was allowed to fail in order to underline the seriousness of the crisis and prod Congress to pass TARP. Lehman had to die so global finance could live.[18]

As the deficit is projected to reach $10 billion in the next few years, the United States government has recognized the need to return to a credible fiscal path, but no credible commitment has been made. In fact, the passage of health reform legislation puts such a commitment in doubt.

[18] See Joe Nocera, "Lehman Had to Die So Global Finance Could Live," New York Times, September 11, 2009; http://www.nytimes.com/2009/09/12/business/12nocera.html (accessed February 10, 2010).

6. Feedback and Lesson-Drawing

- Have there been revisions or additions to the original policy packages or a sequence of distinct stimulus policies in response to unexpected new developments?

Policy feedback and adaptation

Because of stubbornly high unemployment, there has been talk of a second stimulus program. However, there is little support for this, in part because its effectiveness would be limited.[19]

- Has major institutional reorganization/capacity-building been undertaken in financial supervision?
- Do we find new institutions that were not in place prior to the crisis (e.g., bad banks)?

Institutional restructuring

There has been no major institutional reorganization underway in Washington, although existing institutions, particularly the Fed, have taken on new tasks and capacities. No sweeping overhaul of financial regulation and oversight has been undertaken, although a myriad of reform proposals have been proffered. New institutions such as "bad banks" have not been established as part of the government's response to the crisis.

7. Tentative Economic Impact

- What do major economic performance indicators tell us about the short-term effectiveness of the crisis response (e.g., growth rate, unemployment rate, industrial output, private consumption, consumer/producer confidence, inflation, exports, bank balance sheets, credit squeezes)?
- How has the political logic of crisis management (i.e., crisis as an opportunity to broaden political support) worked out for the major decision-makers so far? How has the reputation of major government leaders at the center of the crisis response evolved (e.g., based on polls, election results, backing within their political party)?

Economic and political effectiveness of the crisis response

The U.S. economy returned to growth by the third quarter of 2009, growing at an annualized rate of 1.6 percent, and is expected to grow by 2.0 percent in 2010. Unemployment remains high, at 10.2 percent in October 2009. Core inflation is unlikely to reach two percent in the near future, and measured by the PCE inflator is still negative at -0.5 percent. Exports returned to growth

19 See IMF, *World Economic Outlook 2008*, Washington 2008, Ch. 5: 159-196; http://www.imf.org/external/pubs/ft/weo/2008/01/index.htm (accessed February 10, 2010).

in the third quarter. Consumer confidence remains at very weak levels, but business confidence indicators are positive again. House prices and construction activities have stabilized.[20]

So far, the government's crisis management efforts have had mixed results for the reputation of central decision makers. In the polls, the Obama administration has lost support for its handling of the economy. The Democrats lost two regional elections in November. The basic crux of criticism has been the persistence of high unemployment.

Structural distortions

- Is there early evidence that the structure of the economy will change (e.g., greater role of the state, changes in sectoral shares in GDP)?
- Could old structural imbalances be aggravated? Can we already identify new structural imbalances? Have previously existing imbalances been tackled?

It is clear that the economic dominance of the financial sector will have to change in favor of a greater role for health care, environmental technologies and the modernization of transportation networks. But there are no signs yet that such corrections are underway. In addition, fiscal imbalances in particular have been aggravated. The current account imbalance may be self-correcting as Americans reduce consumption.

8. Concluding Remarks

The United States has shown tremendous leadership in overcoming the current crisis and instigating a nascent recovery, leading to a bounce-back from near total financial collapse in the winter and spring of 2008 – 2009. Three factors played a role here:

- A globally coordinated monetary stimulus, spearheaded by the Federal Reserve and its decision to keep interest rates low.
- A globally coordinated fiscal policy, led by a willingness to incur a fiscal deficit in the United States of about 10 percent of GDP. In this context, the recovery act played an important role in stimulating the U.S. economy and setting a precedent for other countries.
- Unconditional support for major financial institutions, as demonstrated by the implementation and interpretation of the stress test.

[20] For the data, see OECD, *What is the Economic Outlook for OECD Countries? An Interim Assessment*, Paris , September 3, 2009; http://www.oecd.org/dataoecd/10/32/43615812.pdf and OECD, *Economic Outlook Explore*, November 2009, http://stats.oecd.org/economicoutlook/ (accessed February 10, 2010).

One of the drawbacks to the government's response is found in the design of a stimulus program with components that have not targeted immediate stimulus spending, but rather structural changes in health, education, energy and environmental policies—all of which will be implemented only after great lags in time. The second drawback to the response was the failure to implement any direct wage subsidies. As a result, the stimulus has had relatively little impact on unemployment in the private sector. Although the issue of wage subsidies has been the subject of controversy in academic circles, it is clear that had they been introduced, they would have had a more direct impact on employment. The failure to channel the bulk of the stimulus funds to state governments or to increase the amount made available to states to prevent lay-offs, where most of the pro-cyclical cuts were occurring, constitutes a third drawback to the United States' crisis response. The administration's own accounting showed that most of the jobs created (or rather saved) were to be found on the state level in public employment. The stimulus was therefore suboptimal in its specifics.

The second major problem with the crisis response is related to bank bailouts: With the bailouts, the administration and the Fed signaled that banks continue to be too big to fail. Large bailed-out banks can continue to borrow at just 170 basis points above Treasury bond rates. The implicit government guarantee is therefore distorting incentives and the incentive structure for banks and traders has not been altered. The dangers of excessive risk-taking and of new financial collapse remain imminent. Too-big-to-fail (TBTF) guarantees increase incentives to invest funds in risky trades.[21]

The financial regulatory framework has remained unchanged. In addition, there are no attempts to control the size of institutions, or to require a break-up even if they are taken over by a resolution authority. It remains unclear as to what a systemic risk regulator (the Fed?) would do and whether large institutions should carry higher regulatory costs (in the form of higher capital requirements). There is no clear procedure for resolving insolvent or depleted institutions.[22] The danger of a boom-bubble-bust-bailout scenario being repeated persists. In this regard, the current monetary stance is problematic: By ensuring that deposit rates are low, and the spread between deposit rates and loan rates is high, there is a massive transfer to the banking sector underway.

[21] Alex Berenson, "A Year Later, Little Change on Wall St.," New York Times, Sept. 11, 2009; http://www.nytimes.com/2009/09/12/business/12change.html?_r=1 (accessed February 10, 2010).

[22] Martin Baily and Robert E. Litan, "Regulation and Resolving Institutions Considered 'Too-Big-to-Fail,'" Brookings Institution, May 6, 20009, 6-8; http://www.brookings.edu/testimony/2009/0506_too_big_to_fail_baily_litan.aspx (accessed February 10, 2010).

To effect real policy change, it will be necessary to curtail the influence that the banking sector has over regulation and supervision. In addition to closer regulation, the breakup of major TBTF-institutions should also be considered. The efficiency argument for size is not convincing. Syndication is available for larger transactions. Requests for additional help should be turned down, such as those from GMAC, the financing arm of GM, and bond holders should be forced to take losses if better incentives for the future are to be created. Non-banks which operate without deposit insurance but which have access to the Federal Reserve's discount window should pay a substantial annual fee to compensate taxpayers for this access.

Last but not least, fiscal consolidation should become the order of the day, and the stimulus spending should be withdrawn over five years. An annual budget deficit of 10 percent of GDP is unsustainable, as is a deficit on the order of four percent to six percent, which the CBO forecasts until 2020. The fiscal adjustment will therefore be in the range of six to eight percentage points, depending on the assumptions and policies regarding longer-run medical costs.

Study Context

The Bertelsmann Stiftung has a long tradition of assessing the quality of governance and devising evidence-based policy strategies for decision makers.

The **Transformation Index (BTI)** monitors political management, democratic quality and economic development around the world. The BTI encompasses all 128 developing nations and countries in transition that have a population of more than two million inhabitants, and have not yet attained fully consolidated democracy and a developed market economy.

The **Sustainable Governance Indicators (SGI)** offer a complementary focus on the OECD member states. The SGI evaluate the sustainability of political action in 15 different policy fields (from economy, labor, and education to environment, research and development), the quality of democracy and questions of strategic management capability in each of the 31 OECD countries.

The study *Managing the Crisis* is a joint initiative of the two projects.

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