From Recession to Collapse: The Bush Administration and the Over-Valued Dollar

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Introduction

Accounts of the economic policy in the George W. Bush administration usually center on the tax cuts in his first year in office and the economic collapse in his last year, a result of his failure to effectively regulate housing finance. While these policies are important in the context of Bush's presidency, most discussions miss the underlying dynamics of the economy in the Bush administration. The key here is a backdrop of "secular stagnation" that had its basis in the large U.S. trade deficit. The trade deficit was an enormous drain on demand, which could only be filled by large budget deficits or asset bubbles. This trade deficit was in turn the result of a severely over-valued dollar, which can be dated to the Clinton Administration's design of the International Monetary Fund (I.M.F.) bailout of countries affected by the Asian financial crisis.

There are two reasons this discussion may appear somewhat at odds with most assessments of the Bush administration's economic record. The first is that it doesn't fit well with the story either political party likes to tell. Republicans would like to tell a story whereby the tax cuts put in place in 2001 and 2002 boosted the economy out of recession. By contrast, Democrats pitch a tale where the Bush administration threw away the budget surpluses from the Clinton years with unneeded tax cuts and expensive wars. This analysis is at radically at odds with both perspectives.

The other reason that this account differs with those more frequently told about the Bush administration is that it accepts that an economy can suffer from secular stagnation, defined as a prolonged period where output is limited by inadequate demand. The idea that the economy could suffer from an ongoing problem of inadequate demand has a long history, with Keynes being the most prominent proponent. However, this perspective was largely drummed out of the profession with the development of the neo-classical-Keynesian synthesis in the years after World War II.

In the synthesis view, shortfalls in demand could only occur during recessions. Recessions are relatively short-term and self-correcting. The government may or may not be able to speed up a recovery, but its action is certainly not necessary, since the economy would return to full employment even without government action. From this perspective, secular stagnation is essentially ruled out as a possibility, so there was no point in looking for it.

Now that we seem to be experiencing a prolonged period of below full employment levels of output, secular stagnation is again an acceptable view within the economics profession. This analysis puts it at the center of the economy's problems during the Bush years.

The Origins of the Trade Deficit: The Asian Financial Crisis and the Run-Up in the Value of the Dollar

In the standard textbook story of international trade, capital is supposed to flow from rich countries, where it is relatively abundant, to developing countries, where it is scarce. The logic is that capital will get a low return in slow-growing rich countries, but can get a much higher rate of return in fast-growing developing countries. The outflow of capital corresponds to rich countries running trade surpluses with developing countries. (An outflow of capital corresponds to a trade surplus.) This can be thought of as a story where rich countries effectively allow poorer countries to meet their consumption needs as they borrow to finance their development.

The world economy to a large extent fit this story in the early and mid-1990s. There were large flows of capital from the rich countries, taken as a whole, to the developing world. The United States was a net borrower even in this period, but its trade deficits were relatively modest, hovering around 1.0 percent of GDP. This situation changed in the wake of the Asian financial crisis in 1997. The crisis hit the fastest growing region of the world. The Asian "tigers" had been experiencing rapid growth for decades, with the richest countries in the group, Taiwan and South Korea, approaching European standards of living.

The panic from the crisis left the countries of the region desperate for new capital, as private capital fled as quickly as it could. The I.M.F. stepped in to engineer a bailout, but it imposed onerous terms on the countries of the region. It insisted that debts must be repaid in full. In order to get the foreign exchange needed to repay the debts, the countries of the region had to switch from running trade deficits to running massive trade surpluses. This was accomplished with a huge depreciation of the values of their currencies against the value of the dollar, which made their goods far more competitive in the world economy and U.S. goods and services much less competitive.

It was not just the Asian countries that switched course following the financial crisis. Countries throughout the developing world began to accumulate massive amounts of foreign reserves in order to protect themselves against the situation the Asian countries had found themselves in. This meant that they also sought to depress the value of their currencies against the dollar.

The net effect of these actions by developing countries was a tremendous increase in the value of the dollar. The real broad index constructed by the Federal Reserve Board, which adjusts for differences in inflation rates, shows that the value of the dollar rose by 17.8 percent between August of 1996 and August of 1998, measured against the currencies of our trading partners. This rise in the value of the dollar had the predicted effect on the U.S. trade deficit: it expanded from 1.2 percent of GDP in 1996 to 3.7 percent of GDP by 2000.

However, this trade deficit was not associated with a lack of demand, because it coincided with the rise of the stock bubble. (The growth spurred by the bubble undoubtedly also partly fueled the rise of the trade deficit.) At its peak, the ratio of stock prices to trend corporate earnings was well over 30 to 1. This is more than twice the historic average of 14 to 1. The wealth generated by the stock bubble led to what was, at the time, an unprecedented boom in consumption. The saving rate fell to 4.2 percent of disposable income.[1]

In addition to the demand generated by bubble-driven consumption, the stock bubble also generated demand through its impact on investment. This was a rare period in which there was a substantial amount of investment being financed by the direct issuance of shares. (More typically, companies first go public when the original shareholders want to cash out part of their investments.) There was a huge amount of capital available to finance all manner of ill-conceived Internet and technology ventures. Non-residential investment peaked at 14.6 percent of GDP in 2000. This compared to a peak of just 12.7 percent of GDP in the 1980s business cycle.

The demand generated by the stock bubble ensured the economy remained strong, in spite of the growing trade deficit, through the Clinton administration. However, after the bubble began to collapse in 2000, the demand it had generated disappeared as well. Consumption and investment both fell sharply in 2001, throwing the economy into a recession. The collapse of the bubble and the resulting recession were, of course, the main reasons that the Clinton budget surpluses disappeared, while the stimulus provided by Bush tax cuts and the rise in military spending associated with the administration's wars were both positive from the standpoint of generating demand in the economy.

This does not mean that the tax cuts and the wars were the best ways to boost the economy. Tax cuts that were more oriented towards the poor- and middle-income households certainly would have led to more demand per dollar than the Bush tax cuts, which disproportionately went to high-

1 The saving rate may have even been lower than the official data indicate. Income-side GDP sharply outpaced expenditure-side GDP. If the error in measurement was on the income side, for example from capital gains showing up as normal income, then the true saving rate would actually be lower, since true income for GDP purposes would have been less than reported income. This issue is discussed in Rosnick, David and Dean Baker, 2011. "When Numbers Don't Add Up: The Statistical Discrepancy in GDP Accounts." Washington, DC: Center for Economic and Policy Research, http://www.cepr.net/index.php/publications/reports/when-numbers-dont-add-up.

income taxpayers. On the spending side, investments in infrastructure and education would have had a larger demand-side effect, in addition to increasing productivity in future years. Nonetheless, if the option was between the Bush tax cuts and military spending versus no stimulus, there can be no doubt that the administration's tax cuts and spending increased growth.

It is important to recognize that even with the benefit of expansionary fiscal policy, the recession was still quite severe from the perspective of the labor market. Measured in output terms, the 2001 recession was the mildest of the post-war era, but its impact on the labor market was arguably the largest. While the recession officially ended in December of 2001, the economy continued to lose jobs through 2002. It didn't start to create jobs again until September of 2003. Even then, the pace of job growth was very weak, unlike the strong rebounds from prior downturns. The economy did not gain back the jobs lost in the recession until January of 2005. Until the more recent recession, this was the longest period without job growth since the Great Depression. As is now recognized, it is not easy to recover from a recession caused by the collapse of an asset bubble.

When the economy did begin to create jobs again, it was on the back of the housing bubble. By 2002, home prices had already grown far out of line with their trend values. At that point, home prices were already more than 30 percent above trend values, with no plausible explanation in the fundamentals of the housing market.[2]

On the demand side, income growth had slowed sharply with the onset of the recession in 2001. The country's demographics were certainly not well-suited for a housing boom. Overall population growth had slowed and the huge baby boom cohort was already in their 40s and 50s, ages when many were looking to downsize into smaller houses or apartments. While many did argue that there were supply constraints, such as environmental restrictions, that were pushing up prices by limiting building, the data contradict this argument. The country had near record rates of housing construction over the years from 2002 to 2006. Neither demand nor supply conditions supported a run-up in home prices based on the fundamentals of the market.

The rental market provided further confirmation that there was a bubble in the market, rather than fundamentals increasing the cost of housing. If the fundamentals of supply and demand were driving up the cost of housing, then we should have expected to see an increase in rents that paralleled the rise in sale prices. While the two would not necessarily move in tandem, if excess demand for homes was causing the unprecedented rise in house prices, then surely there would also be a substantial increase in rents as well. In fact, rents were doing exactly nothing. The consumer

2 The situation of the housing market at the time is discussed in Baker, Dean (2002), "The Run-Up in House Prices: Is It Real or Is It Another Bubble?" Washington, DC: Center for Economic and Policy Research, available at http://www.cepr.net/index.php/reports/the-run-up-in-home-prices-is-it-real-or-is-it-another-bubble/.

price index measure of owner equivalent rent (which excludes utilities) rose almost exactly in step with the overall rate of inflation over the years 2000 to 2006.

If we needed additional confirmation of the bubble, we could also look to vacancy rates. These were at record highs as early as 2002. Record vacancies are not consistent with a story of home prices being driven up by a shortage of housing. They are consistent with a story of speculative demand pushing up home prices. People will be prepared to hold a house and let it sit empty if they expect the price to rise 15 to 20 percent a year, as was actually happening in many parts of the country.

In spite of the evidence of a dangerous housing bubble as early as 2002, the overwhelming majority of economists in the country insisted that nothing was wrong. Somehow it was difficult for economists to accept the idea that large markets could be subject to bubbles, even though we had just witnessed the collapse of a massive bubble in the stock market. Most probably accepted the views expressed by Alan Greenspan, who stated that the market was being driven by fundamentals.[3] This was certainly the case with the public statements of the economic officials in the Bush administration. They applauded the fact that ownership rates were rising, especially among moderate-income families and minorities. Rather than being troubled by the spread of subprime lending and exotic mortgage products, they argued these developments were examples of innovation in the financial sector. This was all part of the growth of the "ownership society."

The fact that the bubble grew undetected and the abuses in the industry went unnoticed is simply inexcusable. The gap between home prices and their longer term trend levels continued to grow larger, finally peaking at more than 70 percent in 2006. All of this time, rents remained essentially even with inflation and the national housing vacancy rate continually hit new levels. The deterioration of mortgage lending standards was also hardly a secret. The "NINJA" loan became a common joke in the industry. NINJA stood for "no job, no income, and no assets." The basic numbers told the story. Subprime loans grew from 8 to 9 percent of the market in the late 1990s to a peak of 25 percent in 2006.

Perhaps even more striking was the explosion in Alt-A loans. These went from being 1 to 2 percent of the market in normal years to 15 percent at the peak of the bubble. This category is notable because ALT-A borrowers are, in principle, people with good credit who can't qualify for prime mortgages because they lack proper documentation of their income or assets. The conventional view is that these borrowers are often small business owners who can't show evidence of their true income because they failed to report all of their income on their tax returns. They pay a high price

3 Greenspan expressed this view in testimony presented to the Joint Economic Committee of Congress in April of 2002 [http://www.federalreserve.gov/boarddocs/testimony/2002/20020417/default.htm].

for the lack of documentation, typically being charged 1-2 percentage points' higher interest than they would pay on a prime mortgage. When the number of loans in this category exploded, it was a clear warning sign that there were serious problems in the mortgage market. Still, no one in a position of authority in the Bush administration seemed to notice or care.[4]

While the danger signs were flashing everywhere, the housing bubble did sustain a moderately healthy recovery. Of course, there were the direct effects noted earlier. There was a huge expansion in residential construction, with housing rising from its normal level of 3 to 4 percent of GDP to a peak of 6.5 percent of GDP in 2005. Unsurprisingly, the wealth created by the bubble also led to a surge of consumption through the housing wealth effect. The saving rate hit an all-time low of 2.5 percent of disposable income in 2005.[5] The combined effect of higher construction and higher consumption due to the wealth effect was equal to more than 4.5 percentage points of GDP at the peak of the bubble. Assuming a multiplier on this spending of 1.5, the bubble was giving an annual stimulus of close to 7.0 percentage points of GDP (at $1,260 billion in the 2015 economy) at the peak of the bubble.

When the bubble began to collapse in 2006, all of this demand disappeared. In fact, the demand from housing more than disappeared**,** as the enormous overbuilding of the bubble years led to several years in which construction was far below its normal level. Remarkably, the falloff in consumption following the collapse of the bubble was treated as somewhat of a mystery as economists sought to explain it by the rise in debt as opposed to the simple and obvious explanation that we had lost close to $8 trillion in housing wealth.[6] It should not have been a surprise to anyone that bubble-generated wealth had been driving consumption; Alan Greenspan himself had co-authored several papers on the topic as he touted the virtues of cash-out refinancing**,** which was taking place on a large scale during the bubble years. Apparently, economists had forgotten basic facts that had been widely known and discussed just a few years earlier.

4 Incredibly, Alan Greenspan told a *Washington Post* reporter that he just became aware of the surge in subprime loans in January of 2006, just as he was ending his tenure as Fed chair ("Bubble," Washington *Post*, June 15, 2008). If true, this would indicate an astounding degree of negligence on his part. It would be comparable to the Secretary of Defense not noticing the attack on Pearl Harbor in December of 1941.

5 There was also a large negative statistical discrepancy in the GDP accounts in the peak years of the bubble, which is consistent with the view that capital gains in the housing market were showing up as income. If we pull the statistical discrepancy out of income, then the saving rate at the peak of the bubble was essentially zero.

6 For example, see Mian, Atif and Amir Sufi, 2014. *House of Debt: How They (and You) Caused the Great Recession and How We Can Prevent It From Happening Again*. Chicago: University of Chicago Press.

The Exploding Trade Deficit

Although the housing bubble was propelling residential construction and consumption to record shares of GDP, the economy remained relatively weak through the recovery. Even at its peak in 2007, the employment to population ratio (EPOP) was more than a full percentage point below the levels reached in 2000, corresponding to a decline in employment of more than 2.3 million compared to a scenario in which the EPOP had remained constant. Real wage growth turned negative as the labor market weakened in 2002. By 2007 the labor market had just gotten tight enough to produce some very limited real wage growth, as nominal wages were just edging ahead of inflation.

In short, even with the enormous boost provided by the housing bubble, the economy was far from overheating. The reason for the continued weakness was the drain on demand from the trade deficit. The trade deficit had grown rapidly in the last four years of the Clinton administration, propelled by both rapid economic growth, which spurred imports, and even more so by the run-up in the value of the dollar following the Asian financial crisis. The latter made U.S. goods and services less competitive internationally.

The trade deficit rose from just over 1.0 percent of GDP in 1996 just 4.0 percent of GDP by the fourth quarter of 2000. This would have led to an enormous shortfall in demand had it not been for the demand spurred by the stock bubble. After the bursting of the stock bubble led to the 2001 recession, the trade deficit fell back slightly to 3.2 percent of GDP in the fourth quarter of 2001. But as the economy recovered, the trade deficit began to grow again. It hit 4.3 percent by the fourth quarter of 2003 and rose further to a peak of 5.9 percent in the fourth quarter of 2005. The trade deficit remained at roughly this level through 2006 before falling back modestly in 2007 and 2008.[7]

As noted earlier, the dynamic behind the trade deficit was the over-valuation of the dollar that had originated with the Asian financial crisis. The dollar actually did give up much of its gains during the housing bubble years. The Federal Reserve's broad real index peaked at a value of 111.5 in July of 2001. This compares with a level of 89.8 at the start of 1997, before the Asian financial crisis.[8] The dollar then fell through most of the years of the housing bubble, hitting 99.3 in December of 2003

7 These data can be found in the Bureau of Economic Analysis, National Income and Product Accounts, Table 1.1.5.
8 These data can be found at the Federal Reserve Board's website [http://www.federalreserve.gov/releases/h10/summary/indexbc_m.htm].

and crossing 90 in October of 2007.

While this drop in the value of the dollar was a step in the right direction, the dollar did not fall far enough fast enough to prevent the run-up in the trade deficit through 2005, nor to bring it down rapidly in the last years of the Bush administration.[9] The reason was that developing countries, most notably China, were buying massive amounts of dollar assets in order to keep up the value of the dollar against their currencies and sustain their large trade surpluses.

China's current account surplus, which had been just 1.3 percent of GDP in 2001, rose to more than 10.0 percent of GDP in 2007.[10] This pattern is completely at odds with what would be expected from a rapidly growing developing country. Typically, it would be expected that a rapidly growing country like China would be a huge importer of capital, as investors turn to the country to seek better returns. Instead, the country was a massive exporter of capital. This was due to the deliberate actions of China's central bank, which was buying several hundred billion dollars a year of U.S. government bonds.

One of the oddities of this period was the confusion surrounding the actions of China and other developing countries. While they had stated policies of pegging their currencies, and openly bought up vast amounts of U.S. assets, many analysts argued that somehow relative currency prices reflected market values. For example, it was often maintained the high demand for the dollar was due to its status as the world's reserve currency. This argument ignored the fact that the ratio of reserve holdings to GDP was soaring for China and other developing countries in this period.[11] If anything, the growing efficiency of the world financial system should have allowed for a falling ratio of reserve holdings to GDP.

Alan Greenspan also expressed confusion about the behavior of financial markets during this period, famously complaining about the "conundrum" that, even as he had begun raising short-term interest rates in the summer of 2004, the long-term interest rates that drive the housing market and other interest-sensitive sectors of the economy remained low. This was much less of a conundrum to anyone who paid attention to the behavior of the central bank of China and other developing-country central banks. They were effectively practicing quantitative easing, buying up large amounts

9 In addition to the impact of the dollar, the trade deficit also rose because of a sharp run-up in the price of oil. Oil had been selling for less than $15 a barrel in 1998. It had reached more than $70 a barrel in 2007 at the time recession hit [http://www.eia.gov/dnav/pet/pet_pri_spt_s1_a.htm]. While the direct effect of higher oil prices for the United States is an increase in the trade deficit, it would be expected that this rise would lead to a fall in the value of the dollar so that we increase net exports of other goods and services.

10 These data are taken from the International Monetary Fund [http://www.imf.org/external/pubs/ft/weo/2014/02/weodata/weorept.aspx?pr.x=57&pr.y=9&sy=1997&ey=2019&scsm=1&ssd=1&sort=country&ds=.&br=1&c=924&s=BCA_NGDPD&grp=0&a=].

11 Baker and Walentin, 2001. "Money for Nothing: The Increasing Cost of Foreign Reserve Holdings to Developing Countries." Washington, DC: Center for Economic and Policy Research.

of long-term U.S. government debt. In this context, it should hardly have been a surprise that long-term interest rates in the United States remained low, allowing the housing bubble and the resulting distortions to grow ever larger.

The key policy mistake in this period was to look the other way as these imbalances were growing ever larger, as though they would somehow correct themselves with no major impact on the economy. Ideally, the Bush administration would have negotiated with China and other developing countries to arrange a lower value for the dollar. This could have brought the trade deficit down far more quickly, eliminating the gap in demand it was creating.

Failing action on reducing the dollar's value, it would have been desirable to take steps to stop the growth of the housing bubble instead of denying its existence, which was the policy of the Bush administration and the Greenspan's Fed. Having just seen the collapse of the stock bubble in the years 2000 to 2002, it should not have required too much imagination to understand that bubbles burst, and that when they do, the story is not pretty.

It also was 100 percent predictable that the fallout from the collapse of the housing bubble would be far worse than the fallout from the collapse of the stock bubble. This is both due to the fact that housing is a much more widely held asset and also that is much more heavily leveraged. In terms of holdings, the vast majority of stock is held by people in the richest quintile of the population, with the top 10 percent accounting for more than half. By contrast, roughly two-thirds of households are homeowners, a number that expanded to 70 percent at the peak of the bubble.

Even in normal times, it is standard for people to buy homes with a 20 percent down payment. During the bubble years, down payment ratios plummeted, with many homebuyers putting down zero or less.[12] In this context, it was virtually guaranteed that large numbers of mortgages would go into default when the bubble burst, as homeowners would have great difficulty making payments on mortgages that vastly exceeded the price of the home. It is difficult to understand how people in policy positions and economic analysts could have been surprised by the financial stress resulting from the bubble's collapse. While the exact course of the crisis would have required a detailed knowledge of which institutions were holding and/or guaranteeing debt, the fact that there would be massive losses for the financial system should have been obvious.

In short, the failure to recognize the housing bubble and the economic turmoil that would be caused by its collapse is an astounding and inexcusable failure of the Bush administration's economic policy.

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12 The National Association of Realtors reported that 43 percent of first-time homebuyers had down payments of zero or less in 2005 [http://usatoday30.usatoday.com/money/perfi/housing/2006-01-17-real-estate-usat_x.htm].

The fact that most of those outside of government did not perform better on this score than the Bush administration is not an excuse. There has been an enormous amount of needless suffering due to this massive failure of public policy.

The Bailout

The last major act of economic policymaking by the Bush administration was pushing the Troubled Asset Relief Program (TARP) through Congress. By all accounts, this was a rushed effort. The financial turmoil following the collapse of Lehman Brothers caught officials at both the Federal Reserve (Fed) and the Treasury Department by surprise. This is also difficult to understand since government officials surely recognized the turmoil in financial markets. Earlier in the year, Bear Stearns, the huge investment bank, had been pushed to the edge of collapse and was only saved by a Fed-engineered takeover by J.P. Morgan. Fannie Mae and Freddie Mac had both been pushed into conservatorship the prior week. And, the spreads on even short-term lending were going through the roof.

In these circumstances, it is difficult to imagine that the Fed and Treasury could be surprised that the markets would react poorly to seeing a major investment bank pushed into bankruptcy. However, somehow they were.

Their response was to rush to Congress to demand a $700 billion fund to buy up bad loans. The original proposal from Treasury Secretary Hank Paulson was just three pages. Most of the space was devoted to saying that the actions of Treasury would not be subject to future lawsuits. Congress was not about to give a $700 billion blank check, but they were told that speed was essential, as the whole financial system was near collapse.

There was much debate around the measure, which was eventually approved by Congress in a considerably more detailed bill, after first having been voted down by the House of Representatives. While a full discussion of the debate is beyond the scope of this paper, it is worth noting a major deception that was at the center of the debate.

The ostensible gun to the head of Congress as it voted on the bill was that the commercial paper market was shutting down in the wake of the collapse of Lehman. Insofar as this was true, it really would have implied an economic collapse, since even completely healthy companies were dependent on the commercial paper market for financing their ongoing operations. Had they not been able to issue debt in the market, it would have meant they were unable to meet their payroll, pay for

supplies, and meet other ongoing obligations. Based on this fear, Congress approved a bill that provided the money to keep the major banks in business, while requiring no major changes in their operation.

In fact, this action by Congress was completely unnecessary if the goal was to ensure the continued operation of the commercial paper market. The Federal Reserve Board had the ability to act unilaterally to support the commercial paper market. It demonstrated this fact by establishing the Commercial Paper Funding Facility. The Fed announced plans to establish this facility on October 14th, the weekend after the House of Representatives had voted to approve the TARP. It is almost certainly the case that next to no members of Congress were aware that the Federal Reserve Board had this authority at the time they cast their votes.

This was an extraordinary act of deception in which both the Fed and top officials in the Bush administration were obviously complicit. They did not want Congress to know that a rushed passage of the TARP was not necessary to ensure the continued operation of the commercial paper market and to avoid an economic collapse. Their deception helped to ensure that Congress would not consider large-scale reforms as a condition of bailing out the banking system. Instead, Congress allocated the necessary funds, allowing the banking system to survive in its pre-crisis form.

Conclusion

The economic record of the George W. Bush administration is without a doubt the worst of any president in the post-World War II era. He presided over a weak recovery from one recession and then set up the conditions for the worst downturn since the Great Depression. Finally, in the last major action of the Bush presidency, the administration conspired with the Federal Reserve Board to conceal essential information from Congress, ensuring a taxpayer bailout of the Wall Street banks with few strings attached.

The lone consolation is that the Bush administration's greatest errors were bipartisan in nature. The leadership of the Democratic Party was completely accepting of the over-valuation of the dollar and the massive trade deficit that it caused. In fact, they had engineered it during President Clinton's terms in office. They were also in complete support of the deregulation of the financial sector, which had been put in place during the Clinton years. Top Democrats were every bit as eager to ignore the housing bubble as the Bush administration and to applaud the spread of homeownership among moderate-income and minority households. Finally, the bailout of the major banks was an entirely bipartisan affair, with a larger percentage of Democrats supporting the bill than Republicans.

In short, the economic failure of the Bush administration was bipartisan in nature. The major errors in policy were all jointly authored. This hardly exonerates the Bush administration's economic policy, but it does mean that the leadership of the Democratic Party does not have much standing as critics.