



## FACING UP TO THE Nation's Finances

A nonpartisan project on the long-term challenges of the federal budget

### ***Deficits in a Time of Crisis: Short-Term, Long-Term and Unimaginable Sums***

#### ***An Overview***

Scary, dire and grim: such adjectives only begin to describe the U.S. and global economic crisis—and its immediate effects on America's public finances. U.S. stock markets plunged by more than 50 percent between October 2007 and March 2009, the steepest drop since the Great Depression of the 1930s. Americans' net worth fell by 23 percent in 2008, on the heels of an already sluggish period of economic growth during the early 2000s.

Job losses, home foreclosures, soaring personal debt and bankruptcies, failing corporations, collapsing and corrupt financial institutions, massive job loss, plummeting manufacturing and trade, and pervasive fear—these defined America and much of the global landscape in early 2009.

There were many diagnoses for this seemingly sudden fall from an apparently healthy economy of rising house and financial asset prices, a booming consumer market and at least a decent job market. But for economists, two things were not in question. The first was that the economic storm of bad debt and business mismanagement caused the nation's credit markets to "freeze," meaning that banks and brokers simply stopped lending money. Without credit, very little happens in the economy, and the risk of a second Great Depression loomed as a real possibility.

The second point economists agreed on was that if the private sector couldn't act, the federal government would have to – even if the federal budget was already on shaky ground.

In response to this crisis, which rippled out from U.S. credit markets to roil almost every aspect of the economy, the Bush administration in late 2008 and the Obama

administration in early 2009 reached into the nation's nearly empty pockets for several trillion dollars of federal money to revive a gravely ill economy.

These, in short, are the opening frames of a macroeconomic and federal fiscal drama whose final reels have yet to be hoisted into the projector of American history. The federal government, which rode to the rescue under Franklin Roosevelt in the 1930s, with limited success, was back in the business of trying to save and stimulate the U.S. economy.

No one had stopped saying the rising federal debt and deficits were bad. Rather, the context had changed so radically that almost no one—Democrat, Republican, business leader or citizen—questioned that the U.S. government needed to act quickly, decisively and on a massive scale.

Thus, in the waning days of the Bush administration, a \$700 billion Troubled Assets Relief Program (TARP) was launched to enable the U.S. Treasury to purchase debt obligations and other failed financial instruments from some of the nation's largest and most prestigious financial institutions. Meanwhile, the Federal Reserve announced that it would buy \$2.4 trillion in commercial paper (the short-term loans many businesses rely on to meet their monthly bills), and the Federal Deposit Insurance Corporation said that it would provide \$1.4 trillion to guarantee bank-to-bank loans.

But even that hasn't been the full extent of the bailouts. Earlier last year, the Bush administration had extended a lifeline of several hundred billion dollars to Fannie Mae and Freddie Mac, essentially putting the government in charge of the mortgage giants that backed more than \$5 trillion in U.S. homeowners' mortgages.

And just a few months before that, the Feds began bailing out insurance behemoth AIG to the tune of \$150 billion and providing JPMorgan Chase with \$29 billion to salvage investment bank Bear Stearns. Tens of billions of additional federal dollars followed to keep America's once-mightiest bank, Citigroup, from crumbling and General Motors and Chrysler (and their huge supply chain) from biting the dust.

The problem is that when this crisis hit and began requiring massive new government expenditures to fend off the collapse of the financial system, the nation was already sitting atop a huge mound of national debt. As a nation, we were just *beginning* to face up to the need to bring that debt under control, before the baby boomers retired and started drawing down on Medicare and Social Security. Clearly, we would have been much better off had we come to terms with our national finances in a more responsible way -- long before the financial crisis hit.

And this was all before Barack Obama was sworn in as the 44<sup>th</sup> President of the United States. Promising to intervene even more aggressively, the Obama administration proposed and won passage of a \$787 billion economic stimulus bill in February 2009. Following closely on its heels were the outlines of a plan to provide hundreds of billions

of dollars to buy “toxic assets,” a \$75 billion homeowner stability initiative, a mortgage subsidy program, a \$1.2 trillion Federal Reserve plan to purchase government bonds and mortgage-backed securities using newly printed money, and a 10-year \$634 billion health care reform plan.

The bottom line: trillions of federal dollars were being spent at a time when the government was already in the red, the economy was withering and tax receipts were going down. Despite the Obama administration’s recognition of the need for new revenue and savings from other government programs, no one would be so politically foolish as to frankly call for broad-based tax increases at a time like this; beyond the likelihood of letting some Bush tax cuts expire, the public just wasn’t prepared to swallow more economic pain.

Thus, gross public debt, which stood at about \$10.6 trillion when President Obama was inaugurated, was projected to rise by \$1.6 trillion during the first year of his presidency alone. Deficits were to balloon to at least \$1.2 trillion on an unprecedented \$3.6 trillion fiscal year 2010 federal budget.

There were a few small saving graces: Interest rates had fallen to nearly zero, sharply reducing the cost of federal borrowing. Plus, Obama’s new budget ended the preceding administration’s fiscal hanky-panky of hiding costs for the Iraq and Afghanistan wars and other supplemental spending bills, as well as the post-1983 practice of borrowing “off budget” from the Social Security trust fund.

Just as in Stanley Kubrick’s wickedly clever subtitle to “Dr. Strangelove or: How I Learned to Stop Worrying and Love the Bomb,” the financial crisis turned almost everyone in Washington and on Wall Street into boosters of massive new federal spending that had quickly taught them “how to learn to love deficits.” It may seem counter-intuitive that the way out of an economic crisis caused by mountains of bad debt would be to borrow more money, but most economists across the political spectrum believe that’s the case. And the U.S. government is the only institution that can borrow on a scale massive enough to make a difference.

There are critics. Some wonder if the Obama administration's stimulus package will make a difference quickly enough, or whether the money is being put behind the right options. Many of the construction projects and programs being funded will take a year or more to actually get under way and create jobs. Others argue that the stimulus needs to be even bigger. And there's fierce controversy over bailing out banks that made the bad loans in the first place, saving, and perhaps even rewarding, those who created the crisis.

But the consensus among policymakers remains: whether by spending a lot of money or cutting taxes, the federal government simply has had no choice in 2008 and 2009 but to stimulate demand and get the U.S. (and global) economy moving and back onto a highway of growth.

This, however, does not preclude the need to address long-term fiscal imbalances. The famous economist John Maynard Keynes—and the Obama administration, in its pledges to address long-horizon threats to America’s fiscal health, stemming from out-of-control health-care and entitlement program spending—recognized that deficits can be run in the short term for the same purposes that they are now, but with the long-term goal of achieving fiscal balance.

That is why it is so important to disentangle the hopefully short-term massive debt incurred to help stimulate the U.S. economy (which would be a good thing) from the potentially even more massive long-term debt that would be accumulated during the coming decades (which would be a bad thing), without dramatic reforms in health-care spending, Medicare, Social Security, and Medicaid entitlement programs, other government spending, U.S. tax policy, and the federal budget process. These reforms need to happen quickly. The 2008-09 financial crisis has changed the context of this story, but it is the latter story that we must address.

For more information on **Facing Up to the Nation's Finances** and **Students Face Up to the Nation's Finances** – nonpartisan educational and civic engagement projects on the budget deficit and the national debt – go to **FacingUp.org** or contact Shaheen Hasan at 212-686-6610, extension 50, or via e-mail at [shasan@publicagenda.org](mailto:shasan@publicagenda.org).