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Policy Brief

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The U.S. Economy Faces Tough Challenges

Introduction

On November 6, 2012, Americans will head to the polls. Many commentators have referred to the 2012 general election as the most important ever. The stakes are certainly high, not just in the contest for the White House but also in the most crucial congressional elections in memory.

The economy is the issue that worries voters most. Three years into the recovery, uncertainty prevails, economic growth has once again slowed and many U.S. businesses have put their plans for hiring, expansion and investment on hold. Millions of Americans remain unemployed and the housing market is still hobbled by foreclosures and distressed sales. The strong headwinds blowing in from Europe are a constant reminder of the fragile state of the recovery.

More economic damage will ensue if the U.S. goes over the fiscal cliff. By year end, Congress will have to make some difficult decisions on a plethora of tax cuts that are set to expire and spending cuts that are set to kick in. Congress will also need to take into account the nation's long-term fiscal challenges. "As is well known, U.S. fiscal policies are on an unsustainable path, and the development of a credible medium-term plan for controlling deficits should be a high priority."[1]

There are no easy solutions. With uncertainty piling up, the worst thing Congress could do is punt.

1 Ben S. Bernanke, Chairman of the Board of Governors of the Federal Reserve System. "*Semiannual Monetary Policy Report to the Congress*," statement before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Washington, D.C. July 17, 2012. Chairman Bernanke presented identical remarks before the Committee on Financial Services, U.S. House of Representatives on July 18, 2012.

The Canadian Chamber is committed to fostering a strong, competitive and profitable economic environment that benefits all Canadians. This paper is one of a series of independent research reports covering key public policy issues facing Canada today. We hope this analysis will raise public understanding and help decision-makers make informed choices. The papers are not designed to recommend specific policy solutions, but to stimulate public discussion and debate about the nation's challenges.

The U.S. Economy Is Still Having Trouble Gaining Traction

This year started with promise, but as winter turned into spring, the U.S. economy lost momentum. In recent months, activity decelerated further as business and consumer confidence deteriorated, hiring cooled, household spending stalled, manufacturing production slowed and businesses pulled back from investing in capital equipment.

A number of factors are affecting sentiment and economic activity including the crisis in Europe, still-tight borrowing conditions for some businesses and households, and heightened uncertainty about the fiscal and regulatory direction of the country.

Tepid Economic Growth Is Weighing on the Job Market

As many Americans are too painfully aware, finding a job in this economic climate is difficult. Getting the millions of unemployed Americans back to work, particularly the long-term unemployed, is a daunting challenge.

Only 45 per cent of the nearly 8.8 million jobs lost during the recession have been recovered. More than 12 million Americans are looking for work. The average duration of unemployment has climbed from 17 weeks in mid-2008 to 39 weeks. Another 8.2 million workers are classified as "part-time for economic reasons," meaning their hours have been cut back or they are unable to find a full-time job. The unemployment rate remains stubbornly high at over eight per cent.[2]

In his testimony to the Senate Banking Committee, U.S. Federal Reserve Chairman Ben Bernanke bemoaned that the reduction in the unemployment rate is likely to be frustratingly slow given the projected moderate economic growth going forward.[3]

High unemployment will bedevil whoever occupies the White House for the next four years.

2 U.S. Department of Labor. Bureau of Labor Statistics. "The Employment Situation." July 2012.

3 Ben S. Bernanke, Chairman of the Board of Governors of the Federal Reserve System. "*Semiannual Monetary Policy Report to the Congress*," statement before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Washington, D.C. July 17, 2012. Chairman Bernanke presented identical remarks before the Committee on Financial Services, U.S. House of Representatives on July 18, 2012.

The Housing Market Is Slowly Healing but Recovery Is Not yet Guaranteed

The health of the housing market also looms large for voters as they weigh their choice. This is the first postwar economic recovery that has not been led by a pickup in housing. Many would-be buyers are deterred from purchasing a home because they are unemployed or worried about their finances or about the economy more generally. Other perspective buyers cannot obtain mortgages due to tighter lending standards or impaired creditworthiness or because they are in a negative equity position. More than 11 million households with mortgages—about one in four—are “underwater,” meaning they owe more than their homes are worth.[4]

While the U.S. housing market is showing some signs of life, it still has a long way to regain full health. Only a very small fraction of the nearly $7 trillion in household wealth that was erased due to the collapse of the housing bubble has been recovered.[5] Nationwide, house prices remain 33 per cent below their pre-recession peak. Average home prices in cities like Las Vegas, Phoenix and Miami are still down 50 per cent to 60 per cent from their pre-recession highs.[6]

There are 2.8 million properties seriously delinquent, in foreclosure or bank owned. Of these, 1.5 million properties are being held off the market (the so-called shadow inventory).[7] Working through this inventory is crucial to a sustained recovery in the housing market and to the overall health of the economy. “Housing usually plays a significant role in economic recovery, both through construction itself and related industries, but also because higher house prices increase consumer wealth and promote consumer spending.”[8]

4 CoreLogic. “CoreLogic Reports Negative Equity Decreases in First Quarter of 2012.” *Press Release*. July 12, 2012.

5 Board of Governors of the Federal Reserve System. “The U.S. Housing Market: Current Conditions and Policy Considerations.” *White Paper*. January 4, 2012.

6 S&P/Case-Shiller Home Price Indices.

7 CoreLogic. “CoreLogic Reports Shadow Inventory Fell in April 2012 to October 2008 Levels.” *Press Release*. June 14, 2012.

8 U.S. Federal Reserve. “Transcript of Chairman Bernanke’s Press Conference.” June 20, 2012.

The U.S. Fiscal Situation Poses a Significant Risk to the Outlook

The primary obstacle to an increase in confidence is the elevated uncertainty concerning U.S. fiscal policy. We all remember the fiasco that played out in Washington last year over the debt ceiling and the devastating blow it had on public confidence and the economy in general. Well, it looks like the U.S. will hit the debt ceiling again before the year is out. Another protracted debate over raising the debt ceiling would certainly increase market volatility and undermine already frail public confidence. "The greatest danger in times of turbulence is not the turbulence; it is to act with yesterday's logic."[9]

The other storm cloud on the economic horizon is the so-called fiscal cliff. A number of previously enacted tax reductions are due to expire at the end of 2012, including those enacted under the George W. Bush Administration.[10] Additionally, large spending cuts will take place automatically at the start of 2013 as agreed to as part of last summer's deal to raise the debt ceiling. If no legislative action is taken, the confluence of tax hikes and spending cuts amount to $607 billion in fiscal 2013, a substantial withdrawal of income from the economy.

Republicans have called for a quick, temporary across-the-board extension for all the Bush-era tax cuts that are due to expire. President Obama is agreeable to an extension for all but the highest earners. Under the Obama plan, the Bush-era marginal tax rates on the first $250,000 of a person's taxable income will not change, but new, higher rates would apply on additional dollars earned above this amount. At the same time, both parties want to reform the tax code.

U.S. Federal Reserve Chairman Ben Bernanke recently noted the uncertainty swirling around the fiscal cliff has already caused some businesses to curtail investment and hiring, especially those dependent on government contracts.[11]

The non-partisan Congressional Budget Office has warned a recession would occur early next year and about 1.25 million fewer jobs would be created in 2013 if the full range of tax increases and spending cuts were allowed to take effect.[12]

Still, the crisis in Europe has made clear the peril of public finances that have spun out of control. By the end of 2012, the Congressional Budget Office projects the U.S. federal debt will exceed 70 per cent of GDP, the highest percentage since shortly after World War II, and could balloon in the coming years as demographic pressures escalate, unless lawmakers take action.[13]

Congress faces a delicate balancing act in deciding how quickly to implement policies to reduce the budget deficits. It needs to ensure that any immediate spending cuts or tax increases do not hurt the already fragile recovery while at the same time putting in place a credible plan to ensure the nation's finances are sustainable over the long-term.

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9 Drucker, Peter. *Managing in Turbulent Times*. New York, NY: Harper & Row. 1980.

10 If Congress does not act, the top tax rate for ordinary income will increase to 39.6 per cent from 35 per cent. The top tax rate on capital gains will rise to 20 per cent from 15 per cent, and dividends would be taxed as ordinary income (i.e. at a top rate of 39.6 per cent, up from 15 per cent). The Medicare tax on high-income taxpayers will rise from 2.9 per cent to 3.8 per cent.

11 U.S. Federal Reserve. "Transcript of Chairman Bernanke's Press Conference." June 20, 2012.

12 Congressional Budget Office. "Economic Effects of Reducing the Fiscal Restraint That Is Scheduled to Occur in 2013. May 2012.

13 Congressional Budget Office. "The 2012 Long-Term Budget Outlook." June 2012. Altogether, the aging of the population and the rising cost of health care would cause spending on the major health care programs and Social Security to grow from 10.4 per cent of GDP today to 15.8 per cent of GDP 25 years from now. That combined increase of more than 5 percentage points for such spending as a share of the economy is equivalent to about $850 billion today.

States and Local Governments Also Face an Unprecedented Fiscal Situation

Spending cuts at the federal levels could mean even less revenue for states, which rely on federal grants for almost a third of their revenue to provide public services as well as essential infrastructure. With state governments required to balance their operating budgets under their constitutions, governors and legislatures face a difficult juggling act as they try to maintain essential services while meeting their budgetary obligations.

A reduction in state aid would also have serious spillover effects on local governments that rely on state aid for about 30 per cent of local revenues.

The State Budget Crisis Task Force stressed that "states and their localities face major challenges due to the aging of the population, rising health care costs, unfunded promises, increasingly volatile and eroding revenues, and impending federal budget cuts."[14] The Task Force estimated that state and local governments face unfunded pension liabilities of $3 trillion while healthcare liabilities for public-sector retirees exceed $1 trillion.

"The ability of the states to meet their obligations to public employees, to creditors and most critically to the education and well-being of their citizens is threatened…The problems affect the national interest and require the attention of national policymakers."[15]

14 State Budget Crisis Task Force. "Report of the State Budget Crisis Task Force." July 17, 2012.

15 Ibid.

In Summary

A great deal of uncertainty is hanging over the U.S. economy, and expectations for growth have been lowered. Most private sector forecasters now predict the U.S. economy will grow by around 2.0 per cent in both 2012 and 2013. With the bulk (73 per cent) of Canadian exports heading to the U.S., the continued moderate recovery in private demand south of the border and the still-strong Canadian dollar are expected to continue to hold back the performance of Canada's export sector.

The question remains: Can America forge the consensus it needs to respond effectively to its growing challenges?

To paraphrase Christine Lagarde, Managing Director of the International Monetary Fund, we need strong political leadership over brinksmanship, cooperation over competition, action over reaction.[16]

The stakes could not be higher. The U.S. Congress and the Administration need to demonstrate they are willing to take urgent and decisive action to remove the cloud of uncertainty and achieve strong, stable and balanced global growth.

Indeed, "if America is to restore its competitiveness it will need to do many things, few of which will be possible without a much more efficient federal government. In today's world, smart government is a critical ingredient of national competitiveness."[17]

16 Lagarde, Christine. "Global Economic Challenges and Global Solutions." An Address at the Woodrow Wilson Center. Washington, DC. September 15, 2011.

17 Luce, Edward. *Time to Start Thinking: America in the Age of Descent*. New York, NY: Atlantic Monthly Press. 2012

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