Time for Introspection and Retrospection

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Understanding the Causes & Consequences
U.S. Structural Imbalances: Living Beyond Our Means

- U.S. private consumption binge (driven on credit) reached an all-time high
- Correspondingly, U.S. personal savings (as a percentage of disposable income) was low (<3%)
- Excessive leveraging by U.S. hedge funds, private equity firms, investment banks and corporations
- Lax underwriting & credit rating standards, followed with massive debt (sub-prime mortgage, credit card, autos, etc.) securitization.
- Prolonged financial sector “deregulation” initiated in 1980 during the Regan Administration under the disguise of encouraging financial sector “innovation” eventually led to the creation of a fragile “house of cards” financial system in the country.
U.S. Structural Imbalances: Fiscal & Current Accounts

- U.S. budget deficit under the Bush Administration became alarmingly large caused by a combination of ill-conceived tax cuts for the rich on the revenue side and unfunded “wages of war” on the spending side.

- Massive spending/consumption, hence increased imports, contributed to unsustainable levels of current account deficits -- in U.S. balance of payments, thereby causing the dollar to weaken.

- The need to finance the twin imbalances (deficits) above led to serious dependence on foreign savings (from Asia in particular).

- In summary, U.S. consumers, corporate America, and the federal government were all binging on credit and living beyond their means for a very long time. But, other countries (e.g., China, Japan, Taiwan, Germany, Saudi Arabia and other oil-rich Middle Eastern countries) were willing to finance such risky behavior.
American Economy at Risk

U.S. CONSUMPTION BINGE

U.S. Personal Consumption Expenditure: % of GDP 1960-2010
Scale Matters ($ Billions)

Private Consumption 2010

Consumption Share of GDP

Not So Frugal. Americans aren’t paying off debt so much as banks are forgiving it

HOUSEHOLD DEBT APPEARS TO BE FALLING...

Total household debt
$12 trillion

$1.1 trillion reduction

$8.5 trillion

$730 billion

$710 billion

$670 billion

$530 billion

$340 billion

MORTGAGE

CREDIT CARD

AUTO

HOME EQUITY

STUDENT

OTHER

... BUT MUCH OF THAT DROP IS DUE TO WRITE-OFFS

Write-offs $695 billion

Consumers paying off debt $375 billion

TIME March 14, 2011
Tax cuts and military spending (for operations in Iraq and Afghanistan), bailouts and stimulus packages have increased the federal deficit.
... with no sign yet of reductions in global trade imbalances

Current Account Balances In Billions of Dollars


Source: International Financial Statistics - IMF
United States: Gross Federal Debt
($ billion and % of GDP)

As percentage of GDP

*Estimates

Source: The Budget of the U.S. Government 2010
U.S. Gross Federal Debt by Administration
($ Billions and % of GDP)

*Estimates
Source: The Budget of the U.S. Government 2010
The U.S. has been living beyond its means...

The federal government has spent more money than it has taken in during most of the past four decades.

Sources: Office of Management and Budget, Congressional Budget Office; OECD; Standard & Poor's; Department of the Treasury
RAISING THE DEBT CEILING...
... putting its credit rating at risk ...

Before the deal, ratings agencies were seeking a $4 trillion deficit cut to avoid the risk of a downgrade.

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RANKED BY DEBT AS A PERCENTAGE OF GDP

- AAA RATING
- AA RATING
- A+ RATING
- BBB-/BBB+ RATING
- CC RATING

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... but the new plan only scratches the surface

The big decisions still have to be made.

- $14.3 TRILLION Debt in 2011
- $77.9 TRILLION Unfunded future Social Security and Medicare obligations (2010 est.)
- $2.1 TRILLION Deficit cuts under the new plan by 2021
### Outlook Downgrade

The S&P lowered its outlook on the U.S. government’s debt to ‘negative’ from ‘stable.’

<table>
<thead>
<tr>
<th></th>
<th>Long-Term Credit Ratings</th>
<th>Long-Term Credit Outlook</th>
<th>Gross Debt as a Percentage of GDP, 2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Japan</td>
<td>AA-</td>
<td>Stable</td>
<td>220.3%</td>
</tr>
<tr>
<td>U.S.</td>
<td>AAA</td>
<td>Negative</td>
<td>91.6</td>
</tr>
<tr>
<td>Canada</td>
<td>AAA</td>
<td>Stable</td>
<td>84</td>
</tr>
<tr>
<td>France</td>
<td>AAA</td>
<td>Stable</td>
<td>81.8</td>
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<tr>
<td>Germany</td>
<td>AAA</td>
<td>Stable</td>
<td>80</td>
</tr>
<tr>
<td>U.K.</td>
<td>AAA</td>
<td>Stable</td>
<td>77.2</td>
</tr>
<tr>
<td>Brazil</td>
<td>BBB-</td>
<td>Stable</td>
<td>66.1</td>
</tr>
<tr>
<td>Spain</td>
<td>AA</td>
<td>Negative</td>
<td>60.1</td>
</tr>
<tr>
<td>Norway</td>
<td>AAA</td>
<td>Stable</td>
<td>54.3</td>
</tr>
<tr>
<td>Argentina</td>
<td>B</td>
<td>Stable</td>
<td>47.8</td>
</tr>
<tr>
<td>Australia</td>
<td>AAA</td>
<td>Stable</td>
<td>22.3</td>
</tr>
<tr>
<td>China</td>
<td>AA-</td>
<td>Stable</td>
<td>17.7</td>
</tr>
</tbody>
</table>

Sources: Standard & Poor’s (long-term credit); International Monetary Fund (debt)
Debt mountain

Public gross debt
2011 estimates (% of GDP)

229% Japan

100% USA

97% Belgium

83% UK

73% Israel

64% Spain

US sovereign ratings

AAA
S&P sovereign rating

AAA
Moody’s

AAA
Fitch

AAA
Dagong

Negative outlook
A+

Negative outlook
AAA

Sources: IMF; US Treasury; Thomson Reuters Datastream

10-year US Treasuries
Yield (%)

3.8

3.6

3.4

3.2

3.0

2.8

2.6

2.4

2.2

Major foreign holders of US Treasury securities
Feb 2011 ($bn)

China 1154
Japan 890
UK 296
Brazil 194
Taiwan 156
Russia 131
Hong Kong 125
Switzerland 110
Canada 93
Luxembourg 81
The Credit Crisis and Corporate Bailouts

- Concern over financial sector’s systemic risk and its impact on the real economy
- Public outrage over financial sector’s privatized profit (heads I win!) and socialized risk (tails you loose!)
- Introduction of prudent financial sector regulations and supervision (back to basics?): improved lending standards, deleveraging, prudent securitization & corporate compensation, and proprietary trading
- Corporate bail-outs: commercial banks, investment banks, insurance companies, and auto manufacturers -- all too big to fail? Need for “living will.”
- Lessons for Emerging Market Economies: Since the financial sector is the “heart” of an economy, liberalization of that sector should be gradual and well thought out with enforcement of prudent regulations and smart supervision that prevent excessive risk taking by financial institutions. Mimicking developed economies may not be appropriate nor will “open” financial systems be right for all emerging economies.
Consequences of overindulgence in the U.S.

- Over dependence on foreign savings to boost investment and maintain economic growth
- Gradual move away from the dollar to euro, Swiss franc, Chinese yuan and gold as choice international reserves
- Increased private capital flows to Asia’s emerging economies will propel growth abroad
- Inflation potential and rising interest rates could lead to economic stagnation in the U.S.
- Income inequality in the U.S. is likely to continue rising
- Asia’s emerging economies could become strategic competitors to U.S. as our investment in education, infrastructure and health care deteriorate along with the shrinking size of the middle class.
Capital is flooding into emerging markets...

Emerging market equities (rebased in local currencies, 2001=100)

...forcing countries with dollar pegs to increase reserves

International reserves rebased (2000=100)
Currency composition of developing countries’ reserves

% U.S. Dollars

% Euros

Years: 1999 to 2008
Income Distribution

Two Decades, Widening Gaps

The Gini coefficient, developed by Italian statistician Corrado Gini, is used to measure income inequality. Below is the percent change in the Gini coefficient for the Group of 20 nations. —Evan Applegate

Turkey
Mexico
France
Japan
Italy
South Africa
India
South Korea
Germany
Canada
Indonesia
Brazil
Argentina
U.S.
Australia
China
U.K.
Russia

Some nations started to reverse their inequality gaps starting in the 1990s.

Russia saw an 84% increase in its inequality score over the past 20 years, caused by uneven wealth gains in the immediate post-Soviet era.
US income distribution
Share of total income accruing to each group (%)

- Top 1% (incomes above $352,000 in 2010)
- Top 1-5% (incomes between $150,000 and $352,000)
- Top 5-10% (incomes between $108,000 and $150,000)
Tax rates by income group

Average (%)

50

40

30

20

10

1960 65 70 75 80 85 90 95 2000 05 10

Top 0.1%

Top 1%

Middle 20%

Sources: Joint committee on taxation; Atkinson; Piketty; Saez; National Economic Council
**Tax Loopholes: The High Cost of U.S. Tax Breaks**

### The big bucks

Largest tax expenditure categories in fiscal year 2012, $bn

<table>
<thead>
<tr>
<th>Category</th>
<th>$bn</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employer health insurance</td>
<td>171</td>
</tr>
<tr>
<td>Capital gains and dividends</td>
<td>97</td>
</tr>
<tr>
<td>401(k), IRA and self-employed pension plans</td>
<td>93</td>
</tr>
<tr>
<td>Mortgage interest</td>
<td>87</td>
</tr>
<tr>
<td>Accelerated depreciation</td>
<td>76</td>
</tr>
<tr>
<td>Employer pension plans</td>
<td>44</td>
</tr>
<tr>
<td>Deferral of tax on foreign profits</td>
<td>42</td>
</tr>
<tr>
<td>Charitable contributions</td>
<td>33</td>
</tr>
<tr>
<td>State and local taxes</td>
<td>33</td>
</tr>
<tr>
<td>Municipal bond interest</td>
<td>29</td>
</tr>
</tbody>
</table>

Sources: Office of Management and Budget; Tax Policy Centre; The Economist
What Next? Structural Adjustment Policies (Austerity)!
Thank You!

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