

# U.S. AND EUROPE: SHAPING A NEW MODEL OF ECONOMIC DEVELOPMENT

## Lessons from the Great Recession

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The Great Recession of 2008-09 has put enormous strain on the social contracts of Western economies. This paper provides an American perspective on how well the social welfare systems of the United States and the European Union countries have performed in cushioning their populations against the economic dislocations associated with the Great Recession and how effective U.S. and European policy has been in softening the severity of the recession and in creating the conditions for future socio-economic progress.

In many respects, the responses of the United States and the European Union to the onset of the Great Recession have followed very predictable patterns. With a tradition of an activist and Keynesian oriented macroeconomic policy but with a relatively weak social safety net, U.S. authorities responded with a large \$787 economic recovery program and with swift Federal Reserve action to stabilize the financial markets, including measures to buy mortgage-backed securities. By contrast, the core European economies were generally more conservative in their fiscal response, relying on the automatic stabilizers in their social welfare systems to soften the blow to the economy.

Thus, it is not surprising that while the U.S. economy show signs of a more vigorous recovery than does the European Union as a whole, the core European economies can claim to have weathered the Great Recession with less social and economic dislocation than the United States. But the Great Recession has also revealed wide variations in the experience of countries within the European Union showing that the Union is far from offering a shared European standard of social security. While the Germans, Dutch, and French weathered the crisis comfortably in spite a serious fall-off in economic growth, those in the economies on the so-called periphery are experiencing double digit unemployment and facing prolonged economic slumps and fiscal crises that will erode living standards for years to come.

The Great Recession has also exposed serious structural weaknesses in the capacity of the European Union to respond to serious economic downturns and to generate ongoing socio-economic progress among all its member countries. Not only does the Europe's Stability and Growth Pact inhibit robust macroeconomic responses to economic downturns, the very structure of euro-zone membership eliminates many of the standard tools of adjustment, such as exchange rate depreciation, to such crises, and places the burden of adjustment on the weaker members. Indeed, the Great Recession has more than ever cemented the reality of a two-tier Europe and puts into question the very model of economic growth that the European Union has

pursued over the past decade. In that sense, the experience of the European Union is very similar to that of the United States, where the Great Recession has also reinforced America's growing two-tier society and put into question its model of economic growth. The question for the future is whether the United States and Europe can find a common agenda to expand their social welfare systems or whether they are forced to become greater competitors in a demand-constrained world dominated by Asian mercantilism and producerism.

## **COMPARING THE AMERICAN AND EUROPEAN SAFETY NETS**

The Great Recession may have revealed the advantages the United States has with its tradition of expansionary macroeconomic policy. But it also clearly exposed the many holes in America's rather porous social safety net. Ironically, it was the much touted modernization of the safety net for the new economy that has caused the greatest gaps in America's economic security. In the late 1990s, reforms in America's social welfare system made many benefits contingent upon work not anticipating that unemployment might climb to double digits. Other so-called modernization measures embraced the notion of the ownership society, ignoring that housing and equity prices can go down as well as up.

Since the Great Recession began, the inadequacies of America's social and economic security system have quickly showed up in the data. To begin with, the ranks of America's poor have swollen by at least an additional 2.5 million; child poverty has climbed to 19 percent from 17.8 percent a few years earlier. One in eight Americans, including one in four children, is now on the food stamps because they are not eligible for unemployment compensation or any other social welfare program. Nearly 50 million Americans lack health insurance, and over 17 percent of households report that they have postponed or delaying seeking healthcare over the past year for financial reason.

As to the ownership society, for a period of time rising home prices and access to credit helped mask the effects of stagnating wages. But now the debt left in the wake of the housing crash, is dragging down millions of American families. As of October 2009, nearly one in four mortgages was underwater, meaning the mortgage holder owes more on the mortgage than the underlying home is worth; that number is expected to increase to 48 percent by 2011. Overall, American households have suffered a \$12.6 trillion loss in household wealth, a significant portion in their homes and retirement accounts, and as a result, one in four Americans over 62 are putting off retirement because they cannot make ends meet.

By contrast to this American picture, there has been little increase in poverty in the core EU countries, no precipitous drop in household wealth or income, little or no evidence of people having to forego health care for financial reasons, and little or no increase in the number of people who are putting off retirement for financial reasons. If one were not rich and one could choose where to experience an economic downturn as serious as the Great Recession, one would clearly choose Germany, the Netherlands, France, Belgium, Italy, or the Nordic members of the European Union, not the United States. The experience of working and middle class in other European

economies of course has been more difficult but these economies do not have the same level of social welfare protections as do the richer core economies.

There are three reasons why the United States has done so much more poorly in cushioning the impact of the Great Recession on its working and middle class than has these core European Union economies. First, the American system of social and economic security revolves much more closely around employment—having a job—than does Europe's. As is well known, health insurance in the United States is still largely employer based; if you lose your job, you most likely lose your health insurance as well. But so are other features of America's social welfare system. As a result of the welfare reforms passed under the Clinton Administration, America's principal welfare program—Temporary Assistance for Needy Families—is now linked to work requirements. Not surprisingly, the number of people accessing the program has scarcely expanded during the recession because employment itself has declined even as the number of poor has increased alarmingly.

Likewise, America's main program for helping the working poor—the earned income tax credit—is dependent on being in work or having earned income. Individuals who can show they have earned income up to a certain level are eligible for a refundable tax credit to supplement their income; those who have not been employed and have no earned income are not. And what is true for America's working poor is as true for America's middle class.

Many of America's most important social welfare state benefits relating to education, child care, home ownership, and retirement are delivered through the tax codes as deductions against income. This has created a social welfare state that heavily favors upper and middle income groups; indeed the majority of benefits now go to the top 20 percent not to those who need them most, creating in effect a two-tier welfare state. But that also means that as unemployment and underemployment rise and the incomes of those in the middle decline, so do their social benefits for education, child care and retirement. As a result, they can quickly find themselves pushed into the bottom tier of America's social welfare system fighting for limited resources.

Yet even as the economic security of Americans has become ever more linked to employment, America's job machine has broken down. Since 2000, the economy has created very few new private sector jobs, and the number of the effectively unemployed (a wider measure of unemployment has steadily increased. As of December 2009, the official rate of unemployment was 10 percent, but that number rises to 17.3 percent when people who have given up looking for work and those working part-time of necessity are included. That means the one in six working Americans are effectively unemployed, and because they are unemployed, many of them have lost their access to health care and other social insurance benefits.

Second, U.S. labor markets are characterized by less unemployment protection than those in Europe where it is more difficult to fire or let workers go. Thus job losses occur more quickly than they do in Europe. It is therefore doubly tragic that the unemployment insurance programs available to workers in the United States are a lot less robust than they are in the core European Union countries. Since the beginning of the recession, the official U.S. unemployment rate increased by 5 percent, while the unemployment rate in the Euro areas during the same period increased by just 2.5 percent. But unlike in Europe, many of those experiencing unemployment

have not been able to have the protection of unemployment insurance. In most European countries, unemployment benefits are available to nearly all workers, cover well over half of an employee's earlier salary, and extend for more than a year.

By contrast, in most states in the United States, unemployment benefits are restricted to a narrow group of workers, often compensate workers for less than half of their previous wages, and generally last less than one year. Less than half of unemployed workers in the United States are eligible for and receive unemployment insurance benefits. That is because many states in the United States have very rigorous eligibility requirements that exclude low-income or part-time workers and that limit any compensation to a very short period of unemployment. As a result, while 15 million workers in the United States are officially unemployed, less than 10 million are receiving unemployment insurance benefits, either because they did not qualify initially or because they have already exhausted their benefits. In sum, America's system of economic security works reasonably well during periods of full employment but quickly collapses during periods of rising unemployment.

Another reason why workers in the core EU economies have faced less hardship than their American counterparts has to do with these economies' successful experience with what are called short-time work programs, which have limited the number of jobs losses. Although the details of the programs vary country to country, the purpose is consistent—to subsidize employers to keep people in their work by reducing the number of hours they work. These programs have enabled European companies to keep much of their work force in tact but at the same time cut costs. They have also helped hold down unemployment and to avoid the loss of human capital associated with long periods of joblessness.

To be sure, there are reports of a few interesting experiments in job sharing among U.S. employers. But for the most part, American companies have resisted these measures and have continued to rely heavily on layoffs to control labor costs. And despite a few advocates on the left, expert opinion continues to oppose the idea of short-time work programs. According to the critics, these programs end up protecting jobs that are not viable even when the economy recovers; they drag down labor productivity and make companies less competitive; and they will only lead to an artificial spike in unemployment later. Moreover, as the critics contend, these programs work best if at all in short downturns, as the name short-time work implies, and are not well suited for a prolonged period of negative or weak job growth such as we are now experiencing.

This American resistance to short-time work programs reflects a major difference in the U.S. and European approach to the Great Recession. In the United States, there is still a prevailing view that economic downturns should lead to market-enforced restructuring and downsizing (banking being an exception), while in Europe there is the view that governments must take care if possible to preserve their industrial capacity. This difference in philosophy was evident in the different approach Washington and European capitals have taken to their ailing auto industries.

In the United States, Chrysler and GM were forced into bankruptcy and were downsized and reorganized. As part of the restructuring plan, nearly two dozen North American plants were shut down and thousands of car dealerships were closed. By contrast, in most of euro-zone Europe,

with the government's blessing and help, automakers have resisted shutting down plants, and have chosen instead to temporarily idle capacity or put workers on partial pay. The contrast between how the United States and core European economies have responded is all the more striking given that the left-of-center Obama administration took a tough-love approach while Mr. Sarkozy's and Ms. Merkel's center-right governments took pains to soften the blow on French and Germany auto workers.

Finally, the United States has embraced much more readily the idea of ownership society than has Europe, and thus the American social contract has come to rely much more heavily on home ownership and private pension plans than has the European counterpart. This embrace obviously has advantages when asset prices are rising but it wreaks havoc in a bubble-prone economy when the bubble bursts. For the past decade, rising home values compensated American workers for stagnant wages, allowing them to maintain and even improve their standard of living by tapping home equity. In addition, easy access to credit allowed families to weather economic downturns or medical emergencies but at the expense of rising household indebtedness. With the bursting of the housing and credit bubble, this essential feature of the Clinton-Bush era imploded, leaving many households with a large debt hangover. As a result, the Great Recession has dealt a double blow to many Americans; not only have they lost their job but they have lost their home and their life savings as well. Worse, there is little in the way of programs available to help them pick up the pieces.

By contrast, most Europeans in the core Eurozone economies have been relatively unaffected from housing price declines and from the tightening of consumer and household credit, because home ownership and credit have never played the same role in core European countries as they have in the United States. Europeans have also been largely protected from the collapse of the value of private retirement programs, which have hit many Americans hard. Over the past two decades, American companies have steadily shrunk their private pension contributions and have put more of the risk onto employees. They have done so in two ways: either by eliminating company retirement plans altogether or by shifting from a defined benefit to a defined contribution pension program. In a defined benefit system, a retired worker knows exactly how much he or she will receive each month; in a defined contribution system, the employee makes a contribution into his or her retirement account—most likely a 401k—that is then invested in the bond and equity markets with attendant risks.

The experience of the past decade shows that this shift in the nature of U.S. retirement system has worked to the disadvantage of American workers while creating more vulnerability and uncertainty. Seniors who retired in the late 1990s before the collapse of the stock market in 2000-01 may be able to enjoy a comfortable retirement but those who were planning to retire this decade face a much bleaker retirement future having seen much of their retirement savings lost during the past two market crashes. That is why for nearly 70 percent of seniors, social security is the main source of retirement income but social security is less generous than most European pension programs. To be sure, Europe's state-supported or state-run pension systems face their own solvency questions but they have not experienced the kinds of shocks America's private retirement accounts have in the decade culminating in the Great Recession.

## **A TWO-TIER AMERICA, AND A TWO-TIER EUROPE**

Unlike other economic downturns, which are largely transitory events that have little lasting impact on American society, the Great Recession is likely to be a multi-year society-shaping force that leaves deep and ugly scars. The most significant effect is likely to be the further collapse of the American middle class, particularly that part of the middle class that has withstood three decades of stagnant wages only by enjoying the benefits of rising home prices and easier credit. The greatest concentration of housing foreclosures to-date has occurred among sub-prime and Alt A mortgages, mortgages that carried greater risk because the owners had more limited means and incomes. This means that the housing bust is having its most concentrated effect on people on the lower and middle rungs of middle-class life, hitting particularly hard those who have bought a home in the last three years. Many of these were first-time home buyers that had achieved a tentative hold on middle-class status but now are being pushed back into poverty with the loss of their home and their job. Others were upwardly mobile middle class families who got caught up in the optimism of the housing bubble and moved from a starter home to a more expensive (and overpriced) house during the same time, and these families now are confronted with a staggering mortgage debt that they will never be able to work off.

The overall effect of the housing bubble bursting, then, has been to make the United States even more of a two-tier society than it was before the crisis, with large number of the middle class falling to a more precarious position in the American economy. The uneven jobless economic recovery from the Great Recession that is beginning to take shape will only further accentuate this move. From all indications, employment and wages will lag behind GDP and profit growth, resulting in a top-heavy recovery in income and consumption. While the top 10 or 20 percent are currently enjoying a recovery in equity prices and benefiting from the trickle-around growth of the return of Wall Street bonuses, much of the rest of the population struggles with high unemployment, stagnant wages, soft housing prices, and a huge debt burden.

Because housing and credit play a much less central role in the European social contract, the core countries of the Euro-zone will largely avoid the harmful societal effects of the Great Recession that the United States is now experiencing. But the Great Recession will affect European Union in other equally profound ways, creating or more accurately reinforcing a two-tier Europe. While the impact of the Great Recession in the United States falls principally along class lines (although some geographic areas have been hit much harder than others), the main effect in Europe is seen between countries, between the core economies of the euro-zone, which have stronger safety nets, most of which avoided the worst of the housing and the credit bubbles, and the so-called periphery economies, which experienced credit and property bubbles even larger than those in the United States and which have weaker economic bases and social safety nets.

Viewed in this way, there are more parallels between the United States and Europe than either Europeans or Americans may care to acknowledge. In the United States, the bursting of the housing and credit bubble has hit disproportionately the subprime and the Alt A mortgage space (although it has not spared the prime mortgages entirely), and with it the lower and middle rungs of the middle class. In Europe, it has struck the European bubble economies—Ireland and the United Kingdom and the peripheral economies of Greece, Portugal and Spain within the Euro-zone

and the Baltic states in the larger European Union. In many respects, the national economies of Britain, Greece, Ireland, Portugal, and Spain and the Baltic states were part of the larger bubble economy with the United States. Like the United States, these economies ran massive current account deficits, and experienced large credit-fuelled property bubbles and private spending surges. And like the U.S. household sector, the private sectors of these countries were spending far more than income, accumulating unsustainable debts that were backed by inflated property values.

And now like parts of the U.S. economy, these European bubble countries are experiencing many of the same wrenching economic and social consequences. Among the euro-zone economies, the bubbles were biggest in Ireland and Spain. Not surprisingly, the bursting of the credit and property bubbles has sunk the Spanish and Irish economies into deep recessions and sent unemployment soaring into the double digits. As of December 2009, the jobless rate in Spain was 18.8 percent, with youth unemployment at more than 40 percent. The bursting of the bubble has also wreaked havoc with these countries' public finances, with budget deficits as a percentage of GDP climbing into the double digits. Greece and Portugal have similar problems, with Greece being the first to experience a full-fledged market-driven debt crisis.

Among the Baltic States, the consequences have been even more severe. The Estonian, Latvian, and Lithuanian economies have all contracted by nearly 20 percent, and their public deficits have ballooned to unsustainable levels as tax revenues have dried up. And what is worse, these economies lack the robust automatic stabilizers that core European economies have to soften the impact of economic downturns on their populations and the economy. A recent study by economists Mathias Dolls, Clemens Fuest, and Andreas Peich found that while in Germany automatic stabilizers absorb approximately 48 percent of an income shock, they absorb just 25 percent in Estonia, 28 percent in Spain, and 29 percent in Greece, even less than in the United States, where automatic stabilizers absorb 32 percent of an income shock.

Moreover, while the core Eurozone economies show at least some signs of a tentative recovery, with France leading the way, the Baltic State economies face even more difficult choices in the months ahead. Indeed, these economies find themselves in something of an economic straight-jacket created by their fixed currency pegs to the euro and by the huge euro-denominated debts they have incurred. If they attempt to correct their budget deficits while maintaining their fixed currency arrangements, then they will most certainly deepen their economic depressions and heighten social tensions. But if they decide to abandon the peg to the euro, they will set off a series of debt defaults that could provoke a larger banking crisis.

The peripheral economies of the euro-zone face similarly tough choices as they cope with what looks like several more years of stagnant economies, high unemployment, and gaping budget deficits. Their task is made more difficult by their membership in the European monetary union. Their initial entry into the union provided a big boost to their economies by lowering interest rates (which in part contributed to their credit and real estate bubbles), but now it threatens to put their economies in a straight-jacket almost as restrictive as that of the Baltic States. As economist Desmond Lachman points out, these economies "have the unenviable task of trying to restore fiscal sustainability in the midst of deep recessions, and at a time when their countries'

international competitive positions have been greatly eroded.” And they must do so within the constraints imposed by their euro-zone membership, which denies these countries the use of an independent exchange rate to restore competitiveness or interest rate policy to mitigate the contractionary effects of their fiscal policy tightening.

That means that we should expect prolonged downward pressure on wages, chronic recessions, and reduced national spending in most of the peripheral economies of Europe, creating a further divergence with the stronger core economies of the European Union. To the extent European Union aspires to be more than a collection of nation-states, to the extent that it seeks to promote a common experience of a being a European citizen, with a common set of standards and roughly a comparable degree of economic and social security, then the Great Recession has struck a huge blow to that ideal.

The only hope these peripheral economies have of avoiding a prolonged Great Recession would for the core Euro-zone economies to mount a major financial rescue or for Germany, France, and the Netherlands to lead a major Keynesian-inspired economic recovery. But the European Union lacks the political institutional arrangements for such a rescue and the political leadership of France, Germany, and the Netherlands are not inclined for full-throated Keynesian spending or ad hoc financial arrangements. Indeed, they may face their own struggles to sustain an economic recovery given their previous reliance on demand from the previously fast-growing peripheral economies.

## **THE CHALLENGE OF FINDING A NEW MODEL OF ECONOMIC GROWTH**

Future socio-economic progress in both Europe and the United States depends upon finding a new economic growth path. Over the past decade, U.S. economic growth was driven by a housing bubble and by a consumer spending surge made possible by an unsustainable increase in household debt. Economists rightly worry that the United States faces a decade of Japan-style stagnation as the private sector is forced to de-lever and consumption is constrained. The problems with the pattern of American economic growth and its overreliance on debt-financed consumption are well known.

But what is less known is that Europe also faces a similar problem. U.S. commentators often mischaracterize the problems Europe must overcome. The main obstacle to European growth is not Europe’s inflexible labor market or its lack of entrepreneurship, as many conservatives argue. It is the structural weaknesses of the European monetary system combined with an antipathy to demand-led growth and a commitment to export-led growth in the core economies of the European Union, above all in Germany. Over the past five years, economic growth in the eurozone has been driven by growing demand in the peripheral economies of the European Union fueled by credit and property bubbles and rising debt. This in turn has provided the demand that has allowed Germany and a few other core European economies to enjoy an export boom.



This pattern of economic growth is reflected in Europe's own internal imbalances, with Germany and the Netherlands running large current account surpluses and the peripheral economies running large current deficits. Germany's current account surplus, for example, rose from 2 percent of GDP in 2002 to 7.5 percent in 2007, while the current account deficits of Greece, Ireland, Portugal, and Spain all increased proportionately—Greece's expanded from 6.5 percent of GDP to 14.2 percent, Ireland from 1 percent to 5.3 percent, Portugal from 8 percent to 9.4 percent, and Spain from 3.3 percent to 10 percent. Germany's trade surplus with other EU economies increased from 94.6 billion euros in 2002 to 174 billion euros in 2007, reflecting the fact that trade within Europe accounted for the growth of most of Germany's current account surplus.

The development of these imbalances was in part the product of the European monetary union of the past decade that brought into being the euro. The entry of Greece, Ireland, Portugal, and Spain into the eurozone had the benefit of dramatically reducing the cost of credit in these economies, as interest rates converged across the eurozone. But these lower interest rates in turn contributed to the property and credit bubbles of the past decade, fueling the rapid expansion of debt-financed demand in those economies. It also led to huge loss of competitiveness because of the rise these economies' relative unit labor costs, relative to the core countries of the European Union. At the same time, core countries like Germany and the Netherlands committed themselves to tight fiscal policy, which slowed wage growth and with it domestic demand, while improving their labor competitiveness. Germany also pursued labor reforms which weakened the power of labor further restraining wage gains and domestic demand. As a result, their trade surpluses with peripheral economies surged, and their economies became even more export-oriented.

Now, as not before, with the bursting of property and credit bubbles, domestic demand in the peripheral economies has collapsed, and they face a long period of slow growth and economic stagnation. But with the peripheral countries in such trouble, the question becomes what will drive demand and economic growth in the future, not just in the peripheral economies but the core countries as well? After all, the core Euro-zone economies have relied on the peripheral economies to supply demand for their excess capacity, and without that demand sustained economic growth is problematic. As FT economics columnist Martin Wolf notes, "there can be only two answers: external demand, with the eurozone moving into external surplus or private demand in core countries, particularly Germany."

From an American perspective, the latter option would clearly be preferred but is not considered very likely given the German political leadership resistance to the kind of changes that would be needed to make Germany a more demand-oriented economy and given the limited mandate of the European Central Bank focused on price stability. But the first option of expanding Europe's external surplus would put Europe into direct competition with the United States, which must replace excess domestic demand with global demand in order to help offset the effects of private deleveraging. That is because it runs smack into the reality of the unmovable object of China and more generally Asian high-savings mercantilism, which both structurally and as a matter of economic development policy is committed to running current account surpluses. As long as China and the other Asian economies are committed to mercantilist oriented development, it will be very difficult for both the United States and the European Union to improve their external balances simultaneously.

If Asia is committed to continuing its decades-long practice of running current account surpluses, then either Europe or the United States will have to give in its effort to restore growth and improve employment conditions by tapping external demand. While the European Union is in a much better position to pursue an expansionary domestic demand oriented recovery given the strong fiscal positions of Germany, France and the Netherlands, the question of who gives is likely to be determined by who ends up having the strongest currency. A stronger currency will make export-led growth more difficult for both the United States and the core European economies as they compete for each other markets and for competitive advantage in Asia. Ironically, it is here that the fiscal crises of the peripheral economies may come to help Europe because these crises could provoke concern about the future of the euro resulting in a weaker euro vis a vis the dollar. But it is a sad day for both Europe and the United States and their long partnership that they are in a race to have the weakest currency. It is hardly the partnership that over the past 50 years helped create the world's largest middle class and the world's most advanced social welfare systems.

There is a third alternative, which unfortunately is not on the political agenda of either the American or European political class. That would be a common front against Asian mercantilism to defend their middle class way of life and a commitment to a major trans-Atlantic Keynesian project to expand public investment and social quality of life spending in both Europe and the United States and to develop the Rim of emerging economies along the European Union and North America. Such a program would clearly benefit the working and middle classes of Europe and the United States. It would also be in the interest of the aspiring middle class in China since China would need to rely more on domestic demand for future economic growth than it does now. But neither the political leadership of Europe nor the Obama administration in the United States is currently thinking along these lines. We must therefore brace for a difficult period in U.S.-European relations and a bleaker future for Western style middle class societies.

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