The American Economy in the 21st Century: The Early 2000s

by Sophia

WHAT'S COVERED

Although the Bush Doctrine and the "War on Terror" marked a significant change in American foreign policy, the administration continued to pursue an economic policy based on supply-side economics. As the economy went into recession following the 9/11 attacks, the Bush administration called for tax cuts and deregulation. By 2008, it was clear that this approach had not produced the desired results, as the United States experienced the worst financial crisis since the Great Depression.

This tutorial examines the U.S. economy during the early 21st century in three parts:

1. Widening the Gap

Shortly after taking office, and before the catastrophe of 9/11, the Bush administration pushed a $1.35 trillion tax cut through Congress. Based on the same **supply-side economic** policies implemented by Ronald Reagan during the 1980s, the largest tax cuts went to the wealthiest Americans.

TERM TO KNOW

Supply-Side Economics

Ronald Reagan's economic policy; suggested that lowering taxes on the upper-income brackets would stimulate investment and economic growth.

When the Bush administration promoted this tax plan, some members of Congress called for a balanced budget. **George W. Bush** responded that the revenue necessary to balance the budget would be provided by wealthy taxpayers who would invest their tax savings and expand their businesses. He referred to them as "job creators."

PEOPLE TO KNOW

George W. Bush

Republican president and son of the former president (George H. W. Bush) who served as president from 2001 to 2009 following the contentious election of 2000; the terrorist attacks of 9/11 defined his term in office as he launched a "War on Terror" that committed American troops and resources to ongoing conflicts in Afghanistan and Iraq.

While President Bush called for tax cuts, the "new economy" of the 1990s seemed to have overexpanded.

During the late 1990s, as the Information Age created economic opportunities, millions of Americans invested in the stock market. Some of them did so through online investment firms, others by placing orders through brokerage offices. Many more invested through their retirement accounts and mutual funds.

DID YOU KNOW

In 2000, the majority of American households owned stocks directly or through investments in mutual funds or pension accounts.

An increasing number of investors were interested in high-tech companies, known as "dot-coms," that conducted business via the internet. Investment in these companies skyrocketed by the end of the millennium. Unfortunately, few of them made a profit and, in April 2000, the "dot-com" bubble burst. The stock market continued to fluctuate and decline throughout the early 2000s.

As a result, the millennium began with significant economic problems for many Americans—problems that President Bush's tax cuts were unable to solve. Many investors saw the value of their accounts decrease substantially as stock prices fell. The decline in the stock market triggered a recession in which a significant number of Americans lost their jobs.

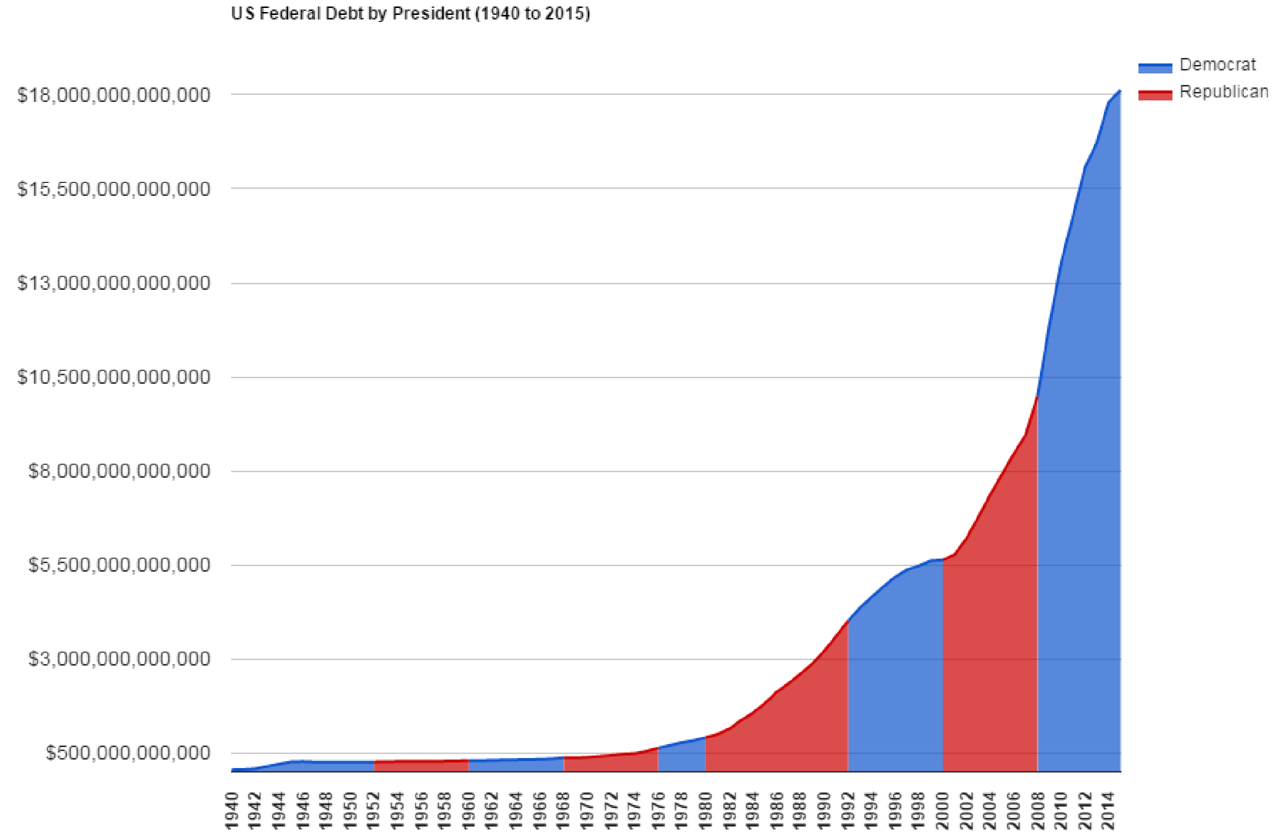
Some of the job losses occurred in the technology industry, which had boomed during the 1990s.

EXAMPLE The computer industry cut 40% of its jobs between 2001 and 2003.

Many manufacturing workers also lost their jobs at this time as globalization continued. Relocation of jobs to China, India, and Mexico, known as "outsourcing," was a problem during the early 2000s. Additionally, companies that continued to manufacture in the United States reduced their employees' wages, as well as their health and retirement benefits, to remain competitive with overseas producers.

EXAMPLE In 2004, a Maytag factory in Galesburg, Illinois, which made refrigerators and other appliances, relocated to northern Mexico. The company paid Mexican workers $1.10 an hour. Maytag had been paying employees in Galesburg an average of $15 an hour.

In response to the economic recession, the Federal Reserve reduced interest rates to historic lows to encourage consumer spending. The Bush administration approved another $320 billion in tax cuts in 2003. At the same time, government spending increased to support Social Security (as the baby boomer generation neared retirement) and to pay for the "War on Terror." These increases in spending, combined with lower tax revenue and lackluster economic growth, caused the federal deficit and the national debt to increase. In 2004, the federal deficit exceeded $400 billion.



This chart shows the increase in the national debt from 1940 to 2014, distinguishing between Democratic (blue) and Republican (red) presidential terms.

A wave of corporate scandals in the early 2000s led to additional setbacks to the economy:

- After years of huge profits in the deregulated energy markets, a Houston-based company called Enron collapsed in 2003 following revelations of accounting fraud. Enron's top executives, Ken Lay and Jeff Skilling, received long prison sentences.
- In 2003, it was revealed that Bernard Ebbers, the CEO of telecommunications giant WorldCom, had inflated his company's assets by $11 billion, making it the largest accounting scandal in the nation's history.

The gigantic amounts of money involved in these scandals indicated that, in the "new economy," the rich appeared to be getting richer while, despite the claims of supply-side proponents, very little "trickled down" to middle- and lower-income earners.

> ↱ EXAMPLE In 2005, the chief executive of Walmart earned $15 million, roughly 950 times what the company's average employee earned. At the time, Walmart was the nation's largest private employer, with over 1.5 million workers.

With a larger share of the wealth, the richest Americans increased their influence in government and public policy. At the same time, average citizens saw their resources dwindle. As a result, their power to influence policy also declined. The growing national debt and increasing budget deficit made it difficult for the federal government to provide services and maintain infrastructure.

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2. The Housing Bubble

The widening income gap during the early 2000s revealed another important factor that contributed to the **Great Recession**.

TERM TO KNOW

Great Recession

The economic recession that began in 2008 following the collapse of the housing boom.

Throughout the prosperity of the “new economy” in the 1990s and the economic uncertainty of the early 2000s, wages and consumer buying power remained flat, relative to inflation. To compensate, many people were buying on credit. Interest rates were low, and lenders were eager to provide mortgages, car and student loans, and credit cards.

EXAMPLE By 2008, credit card debt in the United States had risen to over $1 trillion.

At this time, many banks offered high-risk, high-interest mortgage loans called**subprime mortgages**.

TERM TO KNOW

Subprime Mortgages

A type of mortgage offered to borrowers with lower credit ratings; subprime loans feature interest rates that are higher (often adjustable) than conventional mortgages to compensate the bank for the increased risk of default.

The complex terms of these loans were not understood by many who received them. In addition, subprime mortgages were often marketed directly to low-income home buyers. These buyers were lured by the initially low interest rates. However, the rates rose significantly after a year or two. Many low-income home buyers were unable to make the higher payments.

Although they enabled many people to purchase homes that they could not have afforded otherwise, subprime mortgages had a devastating impact on the economy because they encouraged speculation in the financial industry.

In the past, prospective home buyers went to banks for mortgage loans. Because the banks expected to profit from the interest charged on those loans, they carefully considered buyers’ ability to repay. Changes in financial and banking laws during the late 1990s and early 2000s altered this process.

The Financial Services Modernization Act of 1999 repealed sections of the Glass-Steagall Act, specifically those that prohibited commercial banks from engaging in investment banking. The act allowed for the creation of financial holding companies (FHCs), or “superbanks,” which were corporations that oversaw subsidiaries engaged in various activities, including home mortgages.

Another key change enabled lenders to sell home mortgages to other institutions (often larger banks). This practice separated the lender from the borrower’s ability to repay. As a result, risky loans, like subprime mortgages, became attractive to many lenders. They could afford to make bad loans because they could sell them and not suffer the financial consequences when borrowers failed to repay.

Once they had purchased these subprime mortgages, larger investment banks bundled them into investment vehicles known as collateralized debt obligations (CDOs) and sold them to investors around the world.

DID YOU KNOW

A collateralized debt obligation is a collection of pooled assets, including mortgages, bonds, and loans, that is sold to other investors.

Although CDOs that included subprime mortgages or credit card debt (both of which might not be repaid) were risky investments, credit ratings agencies had a financial incentive to rate them as “safe.” Making matters worse, financial institutions created instruments called credit default swaps, which served as a form of insurance on investments.

A credit default swap is a financial instrument that pays buyers even if a purchased loan defaults. It acts as insurance for risky loans by compensating investors if their investment loses money, such as when a borrower stops making payments on a subprime mortgage.

This system of borrowing and repackaging risky investments swelled the housing loan market. On the surface, things looked fine as financial institutions earned record profits and CEOs received enormous bonuses. However, the widespread speculation created a housing bubble. Home values rose year after year, based on the ease with which people could buy them (due to the availability of mortgages). Many homes were purchased with subprime mortgages. As interest rates on those loans increased and wages remained flat, many borrowers were unable to keep up with their payments.

3. The Great Recession

After peaking in 2007, the real estate market stalled. New home construction in the United States reached a saturation point, and home prices began to fall. Homeowners also began to default on their loans. As a result, the house of cards built by the country’s largest financial institutions came tumbling down. The Great Recession began.

The major financial institutions, which had once been prevented from engaging in risky investment practices by federal regulations, were in significant danger. They were either besieged by demands for payment or found their demands for payment (from their insurers) unmet.

American International Group (AIG), a multinational insurance company that had insured many risky investments, faced collapse. The prestigious investment firm Lehman Brothers reported a loss of $2.3 billion in September 2008. Other endangered companies, including Merrill Lynch, were sold to more stable financial institutions.

The financial panic of 2008 revealed fraudulent schemes that speculators during the roaring 20s would have admired.

> EXAMPLE A “Ponzi scheme” organized by New York financier Bernard Madoff encouraged investors to divert funds into a series of unfounded ventures. Madoff sent fictitious statements to his investors but never made any investments on their behalf. He was convicted in 2009 after defrauding his investors of at least $18 billion.

Worried that many major financial institutions were “too big to fail” (i.e., their collapse would cause an economic depression), Ben Bernanke, the chairman of the Federal Reserve Board, authorized a **bailout** of endangered firms.

TERM TO KNOW

Bailout
The use of federal funds to support a failing industry or private companies within that industry in order to prevent a depression.

In September 2008, Congress agreed with the Federal Reserve and authorized $700 billion to save the struggling financial institutions. The bailout meant that taxpayers were paying for the financial industry's transgressions. Very little of the bailout went to homeowners, who struggled to make mortgage payments.

Congress also passed the Emergency Economic Stabilization Act, which created the Troubled Asset Relief Program (TARP). One important element of this program was the aid it provided to the auto industry, which received a $17.4 billion loan to prevent its collapse.

The actions taken by the Federal Reserve, Congress, and President Bush prevented the collapse of the nation's financial sector and a second Great Depression. However, they did not prevent the Great Recession that followed.

In 2009 and thereafter, stock prices plummeted as investors lost confidence in the economy. Unable to receive credit from wary lenders, small businesses could not pay suppliers or employees. Job insecurity, combined with decreased access to credit, caused a decline in consumer spending. Americans stopped buying new houses and new cars. As home values decreased, owners were unable to borrow against them to pay off other obligations, including credit card debt and car loans. Some homeowners had expected to sell their houses at a profit and pay off their mortgages with the proceeds. Instead, they were stuck with houses that no one would buy, as home values fell below their purchase price. Many owners could no longer afford to make the mortgage payments on these homes (payments based on the purchase price). Millions of college students, who had taken out loans to pay their tuition, were unable to access more credit or find jobs.

During the last 4 months of 2008, 1 million American workers lost their jobs. In 2009, another 3 million became unemployed.

MAKE THE CONNECTION

A significant number of Americans were affected by the Great Recession. Have you been negatively impacted by the Great Recession, or do you know someone who has? In what ways were your experiences similar to—or different from—those described in this tutorial?

As the Great Recession continued, many Americans resented the federal bailout of banks and investment firms. It seemed to them that the wealthiest had been saved from the consequences of their greed and corruption by taxpayers. Dispirited by the economic downturn and tired of the "War on Terror", voters turned to **Barack Obama**, a relative newcomer on the political scene, in the presidential election of 2008.

PEOPLE TO KNOW

Barack Obama

First African American president of the United States who served in office from 2009 to 2017 after running on a campaign of "hope and change" that appealed to American voters looking for an alternative to the ongoing conflict in the Middle East and the economic recession at home.

SUMMARY

When George W. Bush took office in January 2001, he pursued an economic agenda based on supply-side economics. The Bush administration cut taxes on the rich and took action to limit the role of the federal government. This approach widened the income gap between the rich and the poor. The federal deficit also increased at this time. Deregulation of the financial industry encouraged speculation that resulted in the Great Recession. When the economy threatened to collapse, the federal government intervened to bail out failing institutions. As jobs and homes were lost, many Americans resented the federal bailouts.

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