

PART V

The Aftershocks

21

THE ECONOMIC FALLOUT

CONTENTS

<i>Households : “I’m not eating. I’m not sleeping”</i>	390
<i>Businesses: “Squirrels storing nuts”</i>	394
<i>Commercial real estate: “Nothing’s moving”</i>	397
<i>Government: “States struggled to close shortfalls”</i>	398
<i>The financial sector: “Almost triple the level of three years earlier”</i>	400

Panic and uncertainty in the financial system plunged the nation into the longest and deepest recession in generations. The credit squeeze in financial markets cascaded throughout the economy. In testifying to the Commission, Bank of America CEO Brian Moynihan described the impact of the financial crisis on the economy: “Over the course of the crisis, we, as an industry, caused a lot of damage. Never has it been clearer how poor business judgments we have made have affected Main Street.”¹ Indeed, Main Street felt the tremors as the upheaval in the financial system rumbled through the U.S. economy. Seventeen trillion dollars in household wealth evaporated within 21 months, and reported unemployment hit 10.1% at its peak in October 2009.

As the housing bubble deflated, families that had counted on rising housing values for cash and retirement security became anchored to mortgages that exceeded the declining value of their homes. They ratcheted back on spending, cumulatively putting the brakes on economic growth—the classic “paradox of thrift,” described almost a century ago by John Maynard Keynes.

In the aftermath of the panic, when credit was severely tightened, if not frozen, for financial institutions, companies found that cheap and easy credit was gone for them, too. It was tougher to borrow to meet payrolls and to expand inventories; businesses that had neither credit nor customers trimmed costs and laid off employees. Still today, credit availability is tighter than it was before the crisis.

Without jobs, people could no longer afford their house payments. Yet even if moving could improve their job prospects, they were stuck with houses they could not sell. Millions of families entered foreclosure and millions more fell behind on their mortgage payments. Others simply walked away from their devalued properties, returning the keys to the banks—an action that would destroy families’ credit for

years. The surge in foreclosed and abandoned properties dragged home prices down still more, depressing the value of surrounding real estate in neighborhoods across the country. Even those who stayed current on their mortgages found themselves whirled into the storm.

Towns that over several years had come to expect and rely on the housing boom now saw jobs and tax revenue vanish. As their resources dwindled, these communities found themselves saddled with the municipal costs they had taken on in part to expand services for a growing population. Sinking housing prices upended local budgets that relied on property taxes. Problems associated with abandoned homes required more police and fire protection.

At FCIC hearings around the country, regional experts testified that the local impact of the crisis has been severe. From 2007 to 2009, for example, banks in Sacramento had stopped lending and potential borrowers retreated, said Clarence Williams, president of the California Capital Financial Development Corporation. Bankers still complain to him not only that demand from borrowers has fallen off but also that they may be subject to increased regulatory scrutiny if they do make new loans. In September 2010, when the FCIC held its Sacramento hearing, that region's once-robust construction industry was still languishing. "Unless we begin to turn around demand, unless we begin to turn around the business situation, the employment is not going to increase here in the Sacramento area, and housing is critical to it. It is a vicious circle," Williams testified.²

The effects of the financial crisis have been felt in individual U.S. households and businesses, big and small, and around the world. Policy makers on the state, national, and global levels are still grappling with the aftermath, as are the homeowners and lenders now dealing with the complications that entangle the foreclosure process.

HOUSEHOLDS: "I'M NOT EATING. I'M NOT SLEEPING"

The recession officially began in December 2007. By many measures, its effects on the job market were the worst on record, as reflected in the speed and breadth of the falloff in jobs, the rise of the ranks of underemployed workers, and the long stretches of time that millions of Americans were and still are surviving without work. The economy shed 3.6 million jobs in 2008—the largest annual plunge since record keeping began in 1940. By December 2009, the United States had lost another 4.7 million jobs. Through November 2010, the economy had regained nearly 1 million jobs, putting only a small dent in the declines.

The underemployment rate—the total of unemployed workers who are actively looking for jobs, those with part-time work who would prefer full-time jobs, and those who need jobs but say they are too discouraged to search—increased from 8.8% in December 2007 to 13.7% in December 2008, reaching 17.4% in October 2009. This was the highest level since calculations for that labor category were first made in 1994. As of November 2010, the underemployment rate stood at 17%. The average length of time individuals spent unemployed spiked from 9.4 weeks in June 2008 to 18.2 weeks in June 2009, and 25.5 weeks in June 2010. Fifty-nine percent of

all job seekers, according to the most recent government statistics, searched for work for at least 15 weeks.

The labor market is daunting across the board, but it is especially grim among African American workers, whose jobless rate is 16.0%, about 6 percentage points above the national average; workers between the ages of 16 and 19 years old, at 24.6%; and Hispanics, at 13.2%. And the impact has been especially severe in certain professions: unemployment in construction, for instance, climbed to an average of 19.1% in 2009, and averaged 20.6% during the first 11 months of 2010.

Real gross domestic product, the nation's measure of economic output adjusted for inflation, fell at an annual rate of 4% in the third quarter of 2008 and 6.8% in the fourth quarter. After falling again in the first half of 2009 and then modestly growing in the second half, average GDP for the year was 2.6% lower than in 2008, the biggest drop since 1946.

Looking at the labor market, Edward Lazear, chairman of President George W. Bush's Council of Economic Advisers during the crisis, told the Commission that the financial crisis was linked with today's economic problems: "I think most of it had to do with investment. . . . Panic in financial markets and tightness in financial markets that persisted through 2009 prevented firms from investing in the way that they otherwise would, and I think that slows the rehiring of workers and still continues to be a problem in labor markets."³

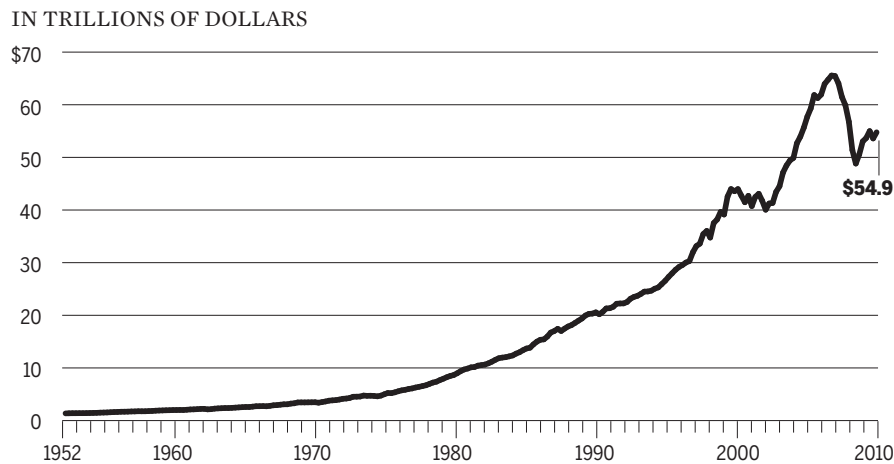
In June 2009, the nation officially emerged out of the recession that had begun 18 months earlier. The good news still had not reached many of the 26.2 million Americans who were out of work, who could not find full-time work, or who had stopped looking for work as of November 2010. Jeannie McDermott of Bakersfield told the FCIC she started a business refilling printer ink cartridges, but in a tight economy, she didn't earn enough to make a living. She said she had been searching for a full-time job since 2008.⁴

Households suffered the impact of the financial crisis not only in the job market but also in their net worth and their access to credit. Of the \$17 trillion lost from 2007 to the first quarter of 2009 in household net wealth—the difference between what households own and what they owe—about \$5.6 trillion was due to declining house prices, with much of the remainder due to the declining value of financial assets. As a point of reference, GDP in 2008 was \$14.4 trillion. And, as a separate point, the amount of wealth lost in the dot-com crash early in the decade was \$6.5 trillion, with far fewer repercussions for the economy as a whole. The painful drop in real estate and financial asset values followed a \$6.8 trillion run-up in household debt from 2000 to 2007. Aided by the gains in home prices and, to a lesser degree, stock prices, households' net wealth had reached a peak of \$66 trillion in the second quarter of 2007. The collapse of the housing and stock markets erased much of the gains from the run-up—while household debt remained near historic highs, exceeding even the levels of 2006. As of the third quarter of 2010, despite firmer stock and housing prices and a decline in household borrowing, household net worth totaled \$54.9 trillion, a 16.5% drop-off from its pinnacle just three years earlier (see figure 21.1).

Nationwide, home prices dropped 32% from their peak in 2006 to their low point

Household Net Worth

The crisis wiped out much more wealth than other recent events such as the bursting of the dot-com bubble in 2000.



NOTE: Net worth is assets minus liabilities for U.S. households.

SOURCE: Federal Reserve Flow of Funds Report

Figure 21.1

early in 2009. The homeownership rate declined from its peak of 69.2% in 2004 to 66.9% as of the fall of 2010. Because so many American households own homes, and because for most homeowners their housing represents their single most important asset, these declines have been especially debilitating. Borrowing via home equity loans or cash-out refinancing has fallen sharply.

At an FCIC hearing in Bakersfield, California, Marie Vasile explained how her family had relocated 40 miles into the mountains to a rental house to help her husband's fragile health.⁵ Their old home was put up for sale and languished on the market, losing value. Eventually, she and her husband found buyers willing to take their house in a "short sale"—that is, a sale at a price less than the balance of the mortgage. But because the lender was acting slowly to approve that deal, they risked losing the sale and then going into foreclosure. "To top this all off," Vasile told commissioners, "my husband is in the position of possibly losing his job. . . . So not only do I have a house that I don't know what's happening to, I don't know if he's going to have a job come December. This is more than I can handle. I'm not eating. I'm not sleeping."

Serious mortgage delinquencies—payments that are late 90 days or more or homes in the foreclosure process—have spread since the crisis. Among regions, the

eastern states in the Midwest (Ohio, Indiana, Illinois, Wisconsin, and Michigan) had the highest delinquency rate, topping 5% in 2007.⁶ By fall 2010, this rate had risen to 9.2%. Other regions also endured high rates—especially the so-called sand states, where the housing crisis was the worst. The third quarter 2010 serious delinquency rate for Florida was 19.5%; Nevada, 17.8%; Arizona, 10.8%; and California, 10.3%.

The data company CoreLogic identified the 25 housing markets with the worst records of “distressed” sales, which include short sales and sales of foreclosed properties. Las Vegas led the list in mid-2010, with distressed sales accounting for more than 60% of all home sales.⁷ “The state was overbuilt and some 100,000 jobs were predicated on a level of growth and consumer spending that seemed to evaporate almost overnight,” Jeremy Aguero, an economic and marketing analyst who follows the Nevada economy, testified to the Commission.⁸

The performance of the stock market in the wake of the crisis also reduced wealth. The Standard and Poor’s 500 Index fell by a third in 2008—the largest single-year decline since 1974—as big institutional investors moved to Treasury securities and other investments that they perceived as safe. Individuals felt these effects not only in their current budgets but also in their prospects for retirement. By one calculation, assets in retirement accounts such as 401(k)s lost \$2.8 trillion, or about a third of their value, between September 2007 and December 2008.⁹ While the stock market has recovered somewhat, the S&P 500 as of December 31, 2010, was still about 13% below where it was at the start of 2008. Similarly, stock prices worldwide plummeted more than 40% in 2008 but rebounded by 24% in 2009, according to the MSCI World Index stock fund (which represents a collection of 1,500 global stocks).

The financial market fallout jeopardized some public pension plans—many of which were already troubled before the crisis. In Colorado, state budget officials warned that losses of \$11 billion, unaddressed, could cause the Public Employees Retirement Association plan—which covers 450,000 public workers and teachers—to go bust in two decades. The state cut retiree benefits to adjust for the losses.¹⁰ Montana’s public pension funds lost \$2 billion, or a fourth of their value, in the six months following the 2008 downturn, in part because of investments in complex Wall Street securities.¹¹

Even before the fall of 2008, consumer confidence had been on a downward slope for months. The Conference Board reported in May 2008 that its measure of consumer confidence fell to the lowest point since late 1992.¹² By early 2009, confidence had plummeted to a new low; it has recovered somewhat since then but has remained stubbornly bleak.¹³

“[We find] nobody willing to make a decision. . . . nobody willing to take a chance, because of the uncertainty in the economic environment, and that goes for both the state and the federal level,” the commercial real estate developer and appraiser Gregory Bynum testified at the FCIC’s Bakersfield hearing.¹⁴

Influenced by the dramatic loss in wealth and by job insecurity, households have cut back on debt. Total credit card debt expanded every year for two decades until it peaked at \$989 billion at the end of 2008. Almost two years later, that total had fallen 19%, to \$802 billion. The actions of banks have also played an important role: since

2008, they have tightened lending standards, reduced lines of credit on credit cards, and increased fees and interest rates. In the third quarter of 2008, 67% of banks imposed standards on credit cards that were tighter than those in place in the previous quarter. In the fourth quarter, 59% did so, meaning that many banks tightened again. In fact, a significant number of banks tightened credit card standards quarter after quarter until the summer of 2009. Only in the latest surveys have even a small numbers of banks begun to loosen them.¹⁵ Faced with financial difficulties, over 1.4 million households declared bankruptcy in 2009, up from approximately 1.1 million in 2008.¹⁶

Together, the decline in households' financial resources, banks' tightening of lending standards, and consumers' lack of confidence have led to large cuts in spending. Consumer spending, which in the United States makes up more than two-thirds of GDP, fell at an annual rate of roughly 3.5% in the second half of 2008 and then fell again in the first half of 2009. Gains since then have been modest. Spending on cars and trucks fell by an extraordinary 40% between the end of 2007 and the spring of 2009, in part because consumer financing was less available as well as because of job and wage losses.

BUSINESSES: "SQUIRRELS STORING NUTS"

When the financial panic hit in September 2008, business financing dried up. Firms that could roll over their commercial paper faced higher interest rates and shorter terms. Those that could not roll over their paper relied on old-fashioned financing—bank loans—or used their own cash reserves. Large firms, one analyst said at the time, turned to their cash balances like "squirrels storing nuts." Jeff Agosta, an executive at Devon Energy Corporation, told the FCIC that had the government not supported the commercial paper market, "We would have been eating grasshoppers and living in tents. Things could have been that bad."¹⁷ While his expression was hyperbolic, the fear was very real. The lack of credit and the sharp drop in demand took its toll on businesses. In 2006, just under 20,000 U.S. companies filed for bankruptcy protection. That figure more than tripled to nearly 61,000 in 2009.¹⁸ Firms' long-term plans suddenly had to be reevaluated—the effects of those decisions persist, even though credit markets have recovered somewhat.

As for the banks, by mid-2007 they had begun to restrict access to credit even for large and medium-size businesses.¹⁹ The Federal Open Market Committee noted this tightening when it announced on September 18, 2007, that it was cutting the federal funds rate. After the Lehman bankruptcy, companies such as Gannett Corporation, FairPoint Communications, and Duke Energy drew down their existing lines of credit because they were worried about getting shut out of credit markets.²⁰

Without access to credit, with cash reserves dwindling, and with uncertainty about the economy high, corporations laid off workers or cut their investments, inhibiting growth and reducing their potential for improving productivity. A survey of chief financial officers found that 57% of U.S. companies were somewhat or very affected by credit constraints, leading to decisions to make cuts in capital investment,

technology, and elsewhere.²¹ News headlines chronicled the problems: scarce capital forced midsize firms to pare back investments and shutter offices, while industrial companies including Caterpillar, Corning, and John Deere; pharmaceutical companies such as Merck and Wyeth; and tech companies alike laid off employees as the recession took hold. Some businesses struggled to cover payrolls and the financing of inventory.

The introduction in October 2008 of the Commercial Paper Funding Facility, under which the Federal Reserve loaned money to nonfinancial entities, enabled the commercial paper market to resume functioning at more normal rates and terms. But even with the central bank's help, nearly 70% of banks tightened credit standards and lending in the fourth quarter of 2008.²² And small businesses particularly felt the squeeze. Because they employ nearly 40% of the country's private-sector workforce, "loans to small businesses are especially vital to our economy," Federal Reserve Board Governor Elizabeth Duke told Congress early in 2010.²³ Unlike the larger firms, which had come to rely on capital markets for borrowing, these companies had generally obtained their credit from traditional banks, other financial institutions, nonfinancial companies, or personal borrowing by owners. The financial crisis disrupted all these sources, making credit more scarce and more expensive.

In a survey of small businesses by the National Federation of Independent Business in 2009, 14% of respondents called credit "harder to get." That figure compares with 9% in 2008 and a previous peak, at around 11%, during the credit crunch of 1991.²⁴

Fed Chairman Ben Bernanke said in a July 2010 speech that getting a small business loan was still "very difficult." He also noted that banks' loans to small businesses had dropped from more than \$710 billion in the second quarter of 2008 to less than \$670 billion in the first quarter of 2010.²⁵

Another factor—hesitancy to take on more debt in an anemic economy—is certainly behind some of the statistics tracking lending to small businesses. Speaking on behalf of the Independent Community Bankers of America, C. R. Cloutier, president and CEO of Midsouth Bank in Lafayette, Louisiana, told the FCIC, "Community banks are willing to lend. That's how banks generate a return and survive. However, quality loan demand is down. . . . I can tell you from my own bank's experience, customers are scared about the economic climate and are not borrowing. . . . Credit is available, but businesses are not demanding it."²⁶

Still, creditworthy borrowers seeking loans face tighter credit from banks than they did before the crisis, surveys and anecdotal evidence suggest. Historically, banks charged a 2 percentage point premium over their funding costs on business loans, but that premium had hit 3 points by year-end 2008 and had continued to rise in 2009, raising the costs of borrowing.²⁷

Small businesses' access to credit also declined when the housing market collapsed. During the boom, many business owners had tapped the rising equity in their homes, taking out low-interest home equity loans. Seventeen percent of small employers with a mortgage refinanced it specifically to capitalize their businesses.²⁸ As housing prices declined, their ability to use this option was reduced or blocked altogether by the lenders. Jerry Jost told the FCIC he borrowed against his home to help

his daughter start a bridal dress business in Bakersfield several years ago. When the economy collapsed, Jost lost his once-profitable construction business, and his daughter's business languished. The Jost family has exhausted its life savings while struggling to find steady work and reliable incomes.²⁹

The standards for credit card loans, another source of financing for small businesses, also became more stringent. In the Fed's April 2010 Senior Loan Officer Survey, a majority of banks indicated that their standards for approving credit card accounts for small businesses were tighter than "the longer-run average level that prevailed before the crisis." Banks had continued to tighten their terms on business credit card loans to small businesses, for both new and existing accounts, since the end of 2009.³⁰ But the July 2010 update of the Fed survey showed the first positive signs since the end of 2006 that banks were easing up on underwriting standards for small businesses.³¹

In an effort to assist small business lenders, the Federal Reserve in March 2009 created the Term Asset-Backed Securities Loan Facility (TALF), a program to aid securitization of loans, including auto loans, student loans, and small business loans. Another federal effort aimed at improving small businesses' access to credit was guidance in February 2010 from the Federal Reserve and other regulators, advising banks to try to meet the credit needs of "creditworthy small business borrowers" with the assurances that government supervisors would not hinder those efforts.

Yet the prevailing headwinds have been difficult to overcome. Without access to credit, many small businesses that had depleted their cash reserves had trouble paying bills, and bankruptcies and loan defaults rose. Defaults on small business loans increased to 12% in 2008, from 8% in 2007.³² Overall, the current state of the small business sector is a critical factor in the struggling labor market: ailing small businesses have laid people off in large numbers, and stronger small businesses are not hiring additional workers.

Independent finance companies, which had often funded themselves by issuing commercial paper, were constrained as well. The business finance company CIT Group Inc. was one such firm. Even \$2.3 billion in additional capital support from the federal Troubled Asset Relief Program (TARP) program did not save CIT from filing for bankruptcy protection in November 2009. Still, some active lenders to smaller businesses, such as GE Capital, a commercial lender with a focus on middle-market customers, were able to continue to offer financing. GE Capital's commercial paper borrowing fared better than others'.³³

Nonetheless, the terms of the company's borrowing did worsen. In 2008, it registered to borrow up to \$98 billion in commercial paper through one government program and issued \$13.4 billion in long-term debt and \$21.8 billion in commercial paper under another program.³⁴ That GE Capital had trimmed commercial paper before the crisis to less than 10% of its total debt, or about \$46 billion, also softened the effects of the crisis on the company. "A decision was made that it would be prudent for us to reduce our reliance on the commercial paper market, and we did," Mark Barber, the deputy treasurer of GE Company and GE Capital, told the Commission.

The firm put more than \$60 billion in cash on its balance sheet, with \$52 billion in back-up bank lines of credit, if needed.³⁵

The decline in global trade also hurt the U.S. economy as well as economies across the world. As the financial crisis peaked in Europe and the United States, exports collapsed in nearly every major trading country.³⁶ The decline in exports shaved more than 3 percentage points off GDP growth in the third and fourth quarters of 2008. Recently, exports have begun to recover, and as of the fall of 2010 they are back near precrisis levels.³⁷

COMMERCIAL REAL ESTATE: “NOTHING’S MOVING”

Commercial real estate—offices, stores, warehouses—also took a pounding, an indicator both of the sector’s reliance on the lending markets, which were impaired by the crisis, and of its role as a barometer of business activity. Companies do not need more space if they go out of business, lay off workers, or decide not to expand. Weak demand, in turn, lowers rents and forces landlords to give their big tenants incentives to stay put. One example: two huge real estate brokerages with headquarters in New York City received nine months’ free rent for signing leases in 2008 and 2009.³⁸

In fall 2010, commercial vacancy rates were still sky-high, with 20% of all office space unoccupied. And the actual rate is probably much higher because layoffs create “shadow vacancies”—a couple of desks here, part of a floor there—that tenants must fill before demand picks back up. In the absence of demand, banks remain unwilling to lend to all but the safest projects involving the most creditworthy developers that have precommitted tenants. “Banks are neither financing, nor are they dumping their bad properties, creating a log jam,” one developer told a National Association of Realtors survey. “Nothing’s moving.”³⁹

In Nevada, where tourism and construction once fed the labor force, commercial property took a huge hit. Office vacancies in Las Vegas are now hovering around 24%, compared with their low of 8% midway through 2005. Vacancies in retail commercial space in Las Vegas top 10%, compared with historical vacancy rates of 3% to 4%. The economic downturn tugged national-brand retailers into bankruptcy, emptying out the anchor retail space in Nevada’s malls and shopping centers. As demand for vacant property fell, land values in and around Las Vegas plummeted.⁴⁰

Because lenders were still reluctant, few developers nationally could afford to build or buy, right into the fall of 2010. Lehman’s bankruptcy meant that Monday Properties came up short in its efforts to build a \$300 million, 35-story glass office tower in Arlington, Virginia, across the river from Washington, D.C. Potential tenants wanted to know if the developer had financing; potential lenders wanted to know if it had tenants. “It’s a bit of a cart-and-horse situation,” said CEO Anthony Westreich, who in October 2010 took the big risk of starting construction on the building without signed tenants or permanent financing.⁴¹ The collapse of teetering financial institutions put commercial real estate developers and commercial landlords in binds when overextended banks suddenly pulled out of commercial construction loans. And when banks

failed and were taken over by the Federal Deposit Insurance Commission, the commercial landlords overnight lost major bank tenants and the long-term leases that went with them.⁴² In California, at least 35 banks have failed since 2003.⁴³

Almost half of commercial real estate loans were underwater as of February 2010, meaning the loans were larger than the market value of the property. Commercial real estate loans are especially concentrated among the holdings of community and regional banks.⁴⁴ Some commercial mortgages were also securitized, and by August 2010, the delinquency rate on these packaged mortgages neared 9%—the highest in the history of the industry and an ominous sign for real estate a full two years after the height of the financial storm.⁴⁵ At the end of 2008, the default rate had been 1.6%.⁴⁶

Near the end of 2010, it was not at all clear when or even if the commercial real estate market had hit bottom. Green Street Advisors of Newport Beach, California, which tracks real estate investment trusts, believed that it reached its nadir in mid-2009. About half of the decline between 2007 and 2009 has been recovered, according to Mike Kirby, Green Street's director of research. "Nevertheless," Kirby added, "values remain roughly 20% shy of their peak."⁴⁷ That's one perspective. On the other side, Moody's Investors Service, whose REAL Commercial Property Price Index tracks sales of commercial buildings, says it is too early to make a call. Moody's detected some signs of a pickup in the spring and fall of 2010, and Managing Director Nick Levidy said, "We expect commercial real estate prices to remain choppy until transaction volumes pick up."⁴⁸ The largest commercial real estate loan losses are projected for 2011 and beyond, according to a report issued by the Congressional Oversight Panel.⁴⁹ And, looking forward, nearly \$700 billion in commercial real estate debt will come due from 2011 through 2013.⁵⁰

GOVERNMENT: "STATES STRUGGLED TO CLOSE SHORTFALLS"

State and local government finances

The recession devastated not only many companies and their workers but also state and local governments that saw their tax revenue fall—just when people who had lost their jobs, or were in bankruptcy or foreclosure proceedings, were demanding more services. Those services included Medicaid, unemployment compensation, and welfare, in addition to local assistance for mental health care, for children, and for the homeless. "At least 46 states struggled to close shortfalls when adopting budgets for the current fiscal year," recently reported the Center on Budget and Policy Priorities, a Washington think tank.⁵¹

"A critical aspect of our situation in Sacramento and . . . throughout the state is that these increased demands for services are occurring at a time that resources . . . are being dramatically reduced," Bruce Wagstaff, the agency administrator with Sacramento's Countywide Services Agency, explained to the Commission.⁵²

Unlike the federal government, almost every state is constitutionally required to produce a balanced budget, so running a deficit is not an option. Sujit CanagaRetna, a senior fiscal analyst with the Council of State Governments, told the FCIC that the

budget shortfalls facing the states “are staggering numbers. It’s not just the big states; it’s almost all states.” He said the “great transformation” occurring in state finances means states are forced to “reorient their whole stance vis a vis the kind of programs and services they offer their citizens.”⁵³ In the 2011 fiscal year alone, which started July 2010, states must come up with \$130 billion in savings or new revenue to balance their budgets, one study estimated.⁵⁴ By the fall of 2010, there was some good news: revenue from some taxes and fees in some states had started to pick up, or at least slowed their rate of decline.⁵⁵

In a September 2010 report, the National Conference of State Legislatures declared that the states “are waiting to see if the economy will sustain this nascent revenue growth. . . . And despite recent revenue improvements, more gaps loom as states confront the phase out of federal stimulus funds, expiring tax increases and growing spending pressures.”⁵⁶

Some states were hit harder than others, either because they were particularly affected by the crisis or because they came into the crisis with structural budget problems. In 2010, New Jersey Governor Chris Christie proposed chopping \$11 billion—or a quarter—of the state budget to eliminate a deficit. California officials struggled through the summer and fall to close a \$19 billion shortfall, an amount larger than the entire budgets of some states. Nonetheless, the state’s independent budget analysis office said in November that the deficit had instead grown to \$25 billion—\$6 billion in the \$87 billion budget for this year and \$19 billion in the fiscal year commencing in June 2011.⁵⁷ As people lost jobs, many also lost their health insurance, helping to drive 3.8 million Americans into the Medicaid program in 2009 alone, an 8% increase—the largest in a single year since the early days of this government health insurance plan, according to the Kaiser Family Foundation, a nonprofit organization focusing on health care research. Every state showed an enrollment increase: in nine states it was greater than 15%; in Nevada and Wisconsin, greater than 20%.⁵⁸

States share the cost of Medicaid with the federal government. Congress included \$87 billion in the stimulus package to help them with this expense, and it has extended the assistance through June 2011 at a reduced level. If the economy has not improved by then, Kaiser predicts, paying for this program will be another huge potential source of trouble for the states.⁵⁹

The National League of Cities recently said that U.S. cities are in their worst fiscal shape in at least a quarter of a century and probably have not yet hit bottom—even after four straight years of falling revenue.⁶⁰ Because property taxes are one of the main source of revenue for most local governments, and because some local assessors are only now recording lower property values, their revenue is likely to continue to decline for at least several more years.⁶¹

“The effects of a depressed real estate market, low levels of consumer confidence, and high levels of unemployment will likely play out in cities through 2010, 2011 and beyond,” the survey of 338 cities reported. The authors of the survey projected that revenue would fall 3% in 2010, and cities’ budgets would shrink another 2%, the largest cutbacks in the 25 years for which the group has published the report.⁶²

Investors now look askance at once-solid state and local bonds, raising borrowing costs for many states and making their task of balancing the budget even harder. Municipalities in Florida, the state with the third-highest rate of home foreclosures, saw borrowing costs rise when they sold \$442 million in bonds in September 2010.

Impact at the federal level

The federal government's response to the financial crisis and the ensuing recession "included some of the most aggressive fiscal and monetary policies in history," said the economists Mark Zandi and Alan Blinder. "Yet almost every one of these policy initiatives remain controversial to this day, with critics calling them misguided, ineffective or both."⁶³

The government's fiscal initiatives began soon after the recession started: the Economic Stimulus Act of 2008, signed into law in February, provided roughly \$170 billion in tax rebates for households and tax incentives for businesses. In October 2008, at the height of the crisis, the \$700 billion TARP was enacted; and in early 2009, the American Recovery and Reinvestment Act of 2009 was enacted to stimulate the weakening economy, costing another \$787 billion in tax cuts and government spending.

Beginning with the rate cuts in mid-2007 through the implementation of the TALF in early 2009, the Federal Reserve provided support to the economy throughout the crisis. Aside from its emergency lending programs put in place during the financial crisis, the Fed put about \$1.7 trillion into the economy from September 2008 to October 2010—primarily by buying financial assets such as mortgages-backed securities and Treasury bonds, a process known as "quantitative easing."⁶⁴ And in November 2010, officials announced another \$600 billion in easing, designed to keep long-term and short-term interest rates down.

In October 2010, the Treasury Department reported that the TARP program would cost far less than the \$700 billion that Congress had appropriated in the fall of 2008, because banks had begun to repay the Treasury in 2009. In fact, Treasury said, TARP would wind up costing about \$29 billion, mostly owing to the bailout of the automakers General Motors and Chrysler and the mortgage modification program.⁶⁵ The latest estimates from the Congressional Budget Office (CBO) put its cost at \$25 billion.⁶⁶ As reported earlier, the CBO projects that the economic cost of the GSEs' downfall, including the financial cost of government support and actual dollar outlays, could reach \$389 billion by 2019.

Overall, as spending increased and revenues declined during the recession, the federal deficit grew from \$459 billion in 2008 to \$1.4 trillion in 2009. And it is estimated to have risen to \$1.6 trillion in 2010.⁶⁷

THE FINANCIAL SECTOR: "ALMOST TRIPLE THE LEVEL OF THREE YEARS EARLIER"

While the overall economy has struggled, the story for the financial sector is somewhat different. Like other sectors of the economy, the financial industry has cut

jobs. After growing steadily for years, employment in the financial sector fell by 128,000 in 2007, 273,000 in 2008, and another 310,000 in 2009. Areas dependent on the financial industry, such as Charlotte, North Carolina, have been hit hard. The unemployment rate in the Charlotte area rose from 4.8% in 2006 to a recent peak of 12.8% in February 2010.

Between January 2009 and December 2010, 297 banks have failed; most were small and medium-size banks.⁶⁸ The number of small banks on the FDIC's list of troubled institutions rose from 829 in the second quarter of 2010 to 860 in the third quarter, the largest number since March 1993.⁶⁹ Though a number of large financial institutions failed or nearly failed during the crisis, on the whole they have done better since the fall of 2008. Total financial sector profits peaked at \$428 billion in 2006 and then fell to \$128 billion in 2008, the lowest level since the early 1990s. They have since rebounded in 2009 and 2010, boosted by low interest rates and access to low-cost government borrowing. Financial sector profits were \$242 billion in 2009 and reached an annual rate of \$369 billion in the fall of 2010.

Within the financial sector, commercial bank profits rose from \$7.6 billion in the first quarter of 2009 to \$18.0 billion in the first quarter of 2010. The gains were concentrated among the larger banks.⁷⁰ For banks with assets greater than \$1 billion, profits more than doubled, from \$6.3 billion to \$14.5 billion, from the first quarter of 2009 to the first quarter of 2010.⁷¹ For commercial banks with less than \$1 billion in assets, profits rose only 26%, from less than \$1 billion to \$1.2 billion.⁷²

The securities industry has reported record profits and is once again distributing large bonuses. Just for those who work in New York City, bonuses at Wall Street securities firms in 2009 were \$20.3 billion, up 17% from the year before, with "average compensation [rising] by 27 percent to more than \$340,000."⁷³ After reporting \$54 billion of losses during 2007 and 2008, the New York State Comptroller reported that in 2009, "industry profits reached a record \$61.4 billion—almost triple the level of three years earlier."⁷⁴