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BUDGET AND TRADE DEFICITS THREATEN U.S. ECONOMY, ACCORDING TO NEW LEVY INSTITUTE STUDY

Dollar Devaluation and Export Growth are Needed to Reign in Trade Deficit and Prevent Structural Imbalances from Undermining Growth

ANNANDALE-ON-HUDSON, N.Y.—With the Federal Reserve raising interest rates and both presidential candidates promising to slash the federal budget deficit, a new study from The Levy Economics Institute of Bard College warns that it will be difficult for the U.S. economy to maintain adequate growth rates without a considerable boost in export-driven growth. The new report contends that the U.S. economy cannot maintain an ever-increasing deficit in its current account with interest rate hikes likely to curtail personal spending and deficit-reduction policies further draining demand.

In their Strategic Analysis, *Prospects and Policies for the U.S. Economy: Why Net Exports Must Now Be a Motor for U.S. Growth*, Levy Institute distinguished scholar Wynne Godley and research scholars Alex Izurieta and Gennaro Zezza argue that "with the government and external deficits both so large and the private sector so heavily indebted, satisfactory growth in the medium term cannot be achieved without a large, sustained, and discontinuous increase in net export demand." Given the world's dependence on U.S. consumption and the large dollar reserves amassed by countries such as China and Japan, the scholars assert that engineering export-driven growth will not be easy.

In their analysis, which sets U.S. growth at 3.2 percent through 2008 and assumes no further devaluation in the dollar, the authors project that the current account deficit will rise to 7.5 percent in four years time and that personal net savings will rise significantly in response to rising interest rates and in consideration of the record levels of debt amassed

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by American households. Under these circumstances, Godley, Izurieta, and Zezza maintain that the general government deficit would have to rise to nearly 9 percent of GDP between now and 2008 and public debt would follow suit, rising to 60 percent of GDP. Such a scenario, the authors argue, would push the internal and external debts toward 100 percent of GDP. “If there is anyone who considers a 9 percent budget deficit tolerable, what about 15 or 30 percent? It has to stop somewhere. The longer the debt and deficit rations go on rising, the larger and more painful the adjustment will be when the tide eventually turns,” the authors write. “There is only one remedy for the rather disastrous situation envisioned in our base run. A sustained rise in net export demand must soon become the motor for U.S. growth.”

The authors project that a decline in the value of the dollar by 5 percent per year, making a total devaluation of 33 percent between the beginning of 2002 and the end of 2008, would result in a very large improvement in the current balance of payments, and fiscal policy could be tightened somewhat. The same “dream” scenario, however, incorporating plans by both parties to cut the deficit in half, would put U.S. output at 1.2 percent in 2008, the slowest in postwar history.

Godley, Izurieta, and Zezza conclude that the United States must address its trade deficit, though they admit there are considerable obstacles for establishing export-driven growth. “The Pacific Rim countries must somehow be persuaded to allow their currencies to appreciate, seemingly against their own perception of what is in their best interest. But there is no obvious way they can be forced to do this. It is always possible that global financial market forces will move in with overwhelming force, but again there is no certainty as to when or whether this will happen,” the scholars write, suggesting that the need for a major realignment of currencies is so pressing that U.S. authorities should consider forcing the issue, possibly by imposing a temporary import surcharge.

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Strategic Analysis, *Prospects and Policies for the U.S. Economy: Why Net Exports Must Now be a Motor for U.S. Growth*

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