The Levy Economics Institute of Bard College

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Drowning In Debt

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The U.S. expansion has been driven to an unusual extent by falling personal saving and rising borrowing by the private sector. If this process goes into reverse, as has happened under comparable circumstances in other countries, there will be a severe recession unless there is a big relaxation in fiscal policy.

The United States is widely believed to have acquired a New Economy, having achieved the longest economic expansion in its history and the lowest unemployment rate in 30 years. Untold wealth has been created, productivity growth has accelerated, and inflation has been dormant.

It is generally agreed that the growth of the U.S. economy must soon slow down--or be slowed down by Chairman Alan Greenspan--because unemployment cannot fall much further without awakening inflation. The question of the moment is whether growth will slow to a rate that just accords with the rate of productive capacity, in which case there could be a "soft landing." Most people seem to think that if this happens, the good times can continue forever. I, however, doubt that the expansion can continue at all during the next few years unless there are major changes in the stance and structure of policy.

How Private Spending Has Been Able to Increase So Fast

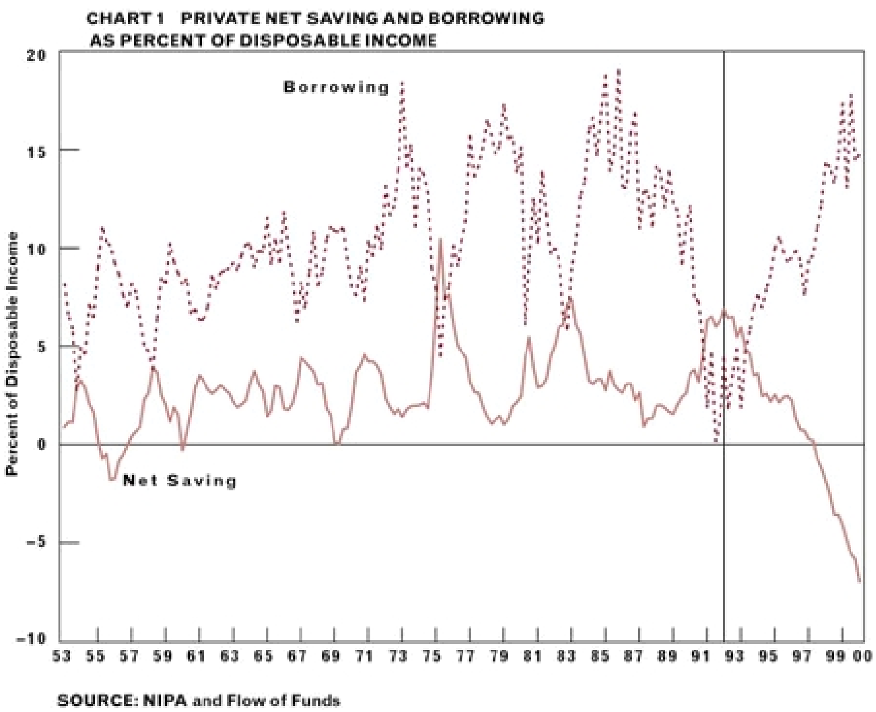
Although the U.S. expansion has been unusually long, it has not been unusually fast. Growth since 1991 has averaged 3.7 percent per annum, only 0.2 percent faster than the average during the whole postwar period. There have been many nine-year periods during which growth was much faster. It is the growth of private expenditure, taking consumption and investment together, that has been unusually high, averaging 4.6 percent per annum.

How could private expenditure have risen so much faster than total output, seeing that it accounts, by itself, for 85 percent of all the expenditure that makes up the GDP? How was a quart extracted from a pint pot? In an arithmetical sense the answer is simple. Private expenditure grew faster than total domestic output mainly because there was a large deterioration in the balance of payments. The pint pot was supplemented by imports of goods and services, which rose at an average rate of 10.4 percent per annum. Imports have risen, that is, nearly two-and-a-half-fold since 1991.

However, the deterioration in the balance of payments and a big improvement in the budget were both factors tending to drive private disposable income downward. So, again, how was the private sector able to increase its spending so fast? An answer is suggested in Chart 1, in which the solid line shows net private saving--the gap between private disposable income and private expenditure. For a great many years income consistently exceeded expenditure, as one would expect; net saving fluctuated quite narrowly, averaging nearly 3 percent of income. Since 1992 expenditure has risen continuously relative to income. Net saving fell through the zero line in 1997 and has been falling more and more deeply into negative territory ever since. In the first quarter of this year net saving reached minus 7.0 percent of income and was 9 to 10 percent below what used to be normal. Whatever this private deficit may portend for the future, it is certainly entirely different from anything that has ever happened before--at least in the United States.

The general view seems to be that private expenditure has risen because capital gains are being spent; so everything should be all right as long as the stock market holds up. But it is impossible literally to "spend" capital gains. Either liquid balances must be run down or securities must be realized (that is, sold to another sector since selling within a sector only shifts money from one pocket to another)--or additional funds must be borrowed.

Figures published by the Federal Reserve reveal that it was borrowing that was the main source of the funds needed to finance excess spending. Borrowing makes it possible to enjoy capital gains without selling shares and thereby incurring a liability for capital gains tax; also, the interest payable on loans is often tax deductible. The private sector as a whole has not been realizing equities on a substantial scale. Households have been selling equities, but these have been largely mopped up by corporate purchases. And corporations could only buy equities and simultaneously pay for investment in capital equipment by borrowing more themselves. According to the Fed's figures, the net flow of credit (advances less repayments) to the nonfinancial private sector taken as whole rose from a negligible quantity in 1991 to over $1 trillion in 1999, by which time (as the dotted line in Chart 1 shows) borrowing was augmenting disposable income by about 15 percent.



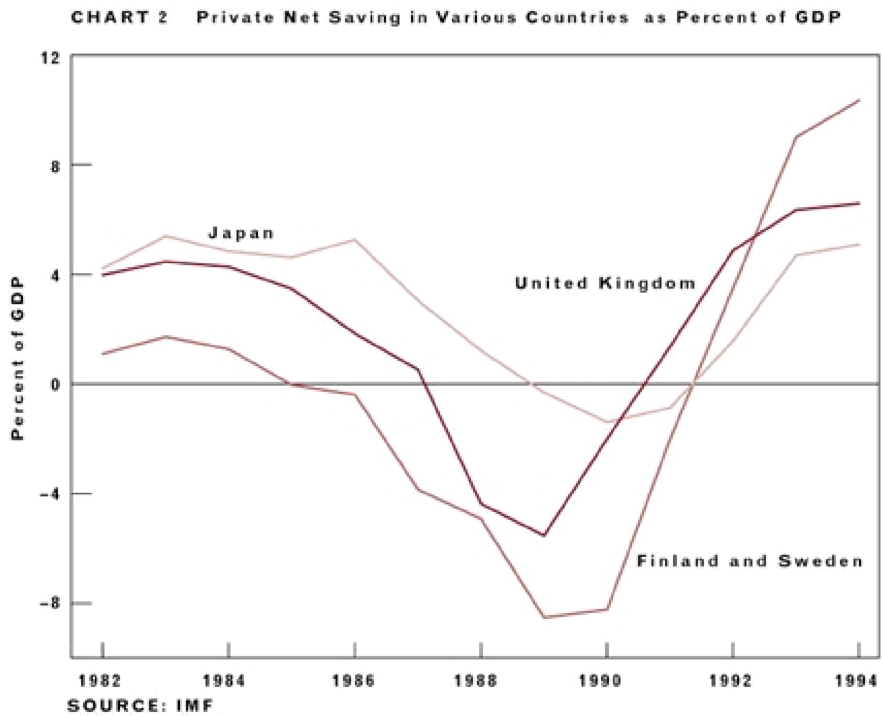
As the flow of lending to the private sector has been so large, the level of debt has risen in a spectacular way, reaching a record 165 percent of disposable income in the first quarter of 2000. Household debt (even if "margin debt" used to finance speculation on the stock exchange is excluded) reached nearly 100 percent of personal disposable income--an all-time high. And corporate debt reached 74 percent of corporate GDP--another record, slightly above the previous peak at the turn of 1989-1990, just before the last credit crunch.

Why Private Debt Cannot Increase Indefinitely

It seems fair to conclude, at a minimum, that the high level of debt now poses a risk; if there were a big fall in asset prices or a significant further rise in interest rates, weak positions might be exposed, which could generate a downward spiral of forced selling. More important, as I shall argue, the combination of the private deficit and the administration's fiscal plans makes it highly doubtful that the future can be anything at all like the past. The danger of severe and prolonged recession is being seriously underestimated.

In its April report, the Congressional Budget Office (CBO) published projections of the federal budget through the next 10 years, all based on the assumption that growth is maintained at about 2.7 percent per annum, a rate slightly below that of productive capacity, implying that unemployment rises to just over 5 percent. All these official projections show the budget surplus continuing to rise throughout the next decade, and recent reports suggest that the rise in the surplus may be substantially larger than what was projected in the April report.

BOX: SOME BASIC FORMULAS DEFINING NATIONAL INCOME IDENTITIES Total private income from production of goods and services plus net property income from abroad (Y) is equal, by definition, to private expenditure (PX) plus government expenditure (G) plus the current balance of payments (BP). Deduct taxes and transfers (T) from both sides and rearrange to yield the identity [Y - T - PX] = [G - T] + BP. This formula states that private net saving, the expression on the left-hand side, is logically equivalent to the government deficit plus the balance of payments surplus.

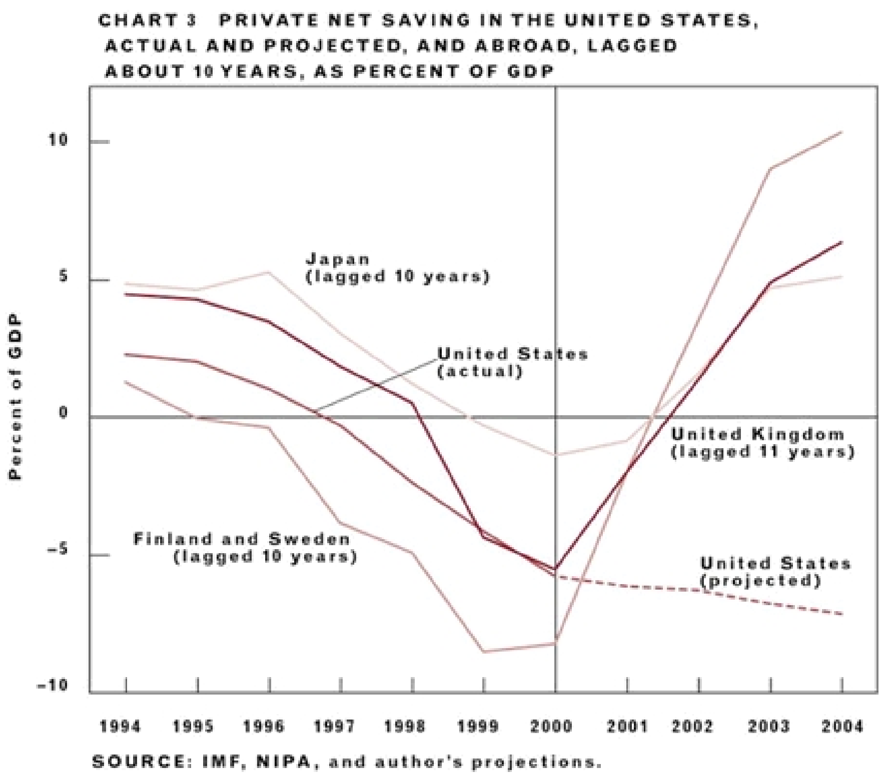


At the same time the U.S. balance of payments deficit looks set to worsen if the economy continues to expand while the dollar remains strong. There has for many years been a trend deterioration in the U.S. balance of trade, which has been exacerbated, perhaps temporarily, by slow growth in the rest of the world. However, even if the balance of trade were now to stabilize as the rest of the world recovers, the foreign debt the United States is now incurring is likely to generate a growing outflow of interest income large enough to make the balance of payments as a whole go on deteriorating.

If the balance of payments does continue to deteriorate, a rise in the budget surplus can occur, as a matter of accounting logic, only if private expenditure continues to rise relative to income (see Box). It is impossible to overemphasize that the entire fiscal plan the authorities have set forth, since it combines a rising budget surplus with continued economic growth, can form part of a coherent macroeconomic strategy only on the assumption that private net saving continues to fall into increasingly negative territory. If saving does not continue to fall--if private expenditure rises less than income in the years to come--this must (by the laws of accounting) be accompanied by some combination of a deteriorating budget (that is, a move away from surplus) and an improving balance of payments. And this could happen (given fiscal stance and trade propensities) only if demand and output in total were to stagnate or collapse. Without a continued stimulus from private expenditure in excess of income growth, there would be nothing to keep the expansion going. It is theoretically possible, if hardly credible, that a fall in the dollar could result in a rise in net exports large enough to keep the U.S. expansion going, as happened in Britain after 1992--after two years of recession.

Yes, but why shouldn't private net saving go on falling, thereby validating the official scenario? Why shouldn't the future, for an indefinite period, be a "calmed down" continuation of the past? While the United States has never before (at least not in modern times) had a large private financial deficit, there have occasionally been such deficits in other countries. The IMF's most recent World Economic Outlook points to three instances of private deficits--in Japan, the United Kingdom, and Finland and Sweden (Chart 2). In each of these cases, having reached a negative position not very different from that in which the United States now finds itself, the deficit recovered over a period of years and regained its habitual state of surplus. In each case, the rise in net saving overshot, so that for a time the private surplus was unusually high. The period during which the private deficit was growing was always accompanied by an economic boom--acclaimed, at least in the United Kingdom, as an economic miracle! But each boom was followed by a severe recession as the credit expansion unraveled.

In Chart 3 the path of the United States's private deficit is superimposed on the deficit paths shown in Chart 2. The solid line shows the actual path of the U.S. private deficit up to the first quarter of 2000; the dash line shows what must be held to happen in the future to validate the CBO's projections. It seems doubtful, to put it mildly, that things can actually turn out this way. As I argued above, the private deficit can go on rising only as long as net lending remains at least at its present level, so that private debt continues to rise rapidly relative to income. I reckon that to validate the story illustrated in the chart, private debt would have to rise to 230 percent of disposable income in five years' time and continue to rise further thereafter.



An increase in private debt relative to income can go on for a long time, but it cannot go on forever. It is true that the net worth of households rose from about 500 percent to more than 600 percent of disposable income in 1999 alone, and some people have argued that this rise completely outweighs any adverse effect from household debt, which has been inching up to a mere 100 percent of income. However, this argument suffers from two flaws. First, apart from the fact that asset prices may well fall substantially, the decisive constraint on borrowing may come not from the extent to which net worth is being mortgaged, but from the extent to which payments of interest and repayments of principal (which must be settled in cash) can be met out of conventional income. It is income rather than net worth that is ultimately the criterion of creditworthiness, since in a crisis it may be impossible for everyone to realize assets simultaneously. Second, the argument that households' net worth has risen a lot does not touch the fact that half of the nonfinancial private debt is owed by businesses. Corporate debt has been rising rapidly relative to corporate GDP for the last two and a half years and now exceeds levels last seen in the 1980s, when the last debt crisis unraveled.

If private net saving were to recover over the next few years to the level that is normal in other countries and that was normal in the United States until fairly recently, the results would be horrendous. With private expenditure falling by 5 to 10 percent relative to income, there could be hardly any growth at all for some years. If the unraveling took place as quickly as it did in the United Kingdom, there could be a severe recession, with grave consequences for the rest of the world. The budget surplus would disappear. And it is easy to imagine that with a recession, or even a prolonged stagnation, there would be a large fall in the stock market, which would make matters infinitely worse.

A Policy Reorientation to Change the Scenario

It would be possible for the authorities to reorient policy so as to avoid the whole scenario I have just outlined. Any fall in private spending could, at least in theory, be offset by a relaxation of fiscal policy, which might have to take place even though the budget was already moving back into deficit. It is difficult to see how the growing external deficit can be stemmed, as it eventually must, without there being, at some stage, a substantial fall in the dollar. It is to be hoped that contingency planning along these lines is in hand, even though it runs slap contrary to conventional thinking at the moment.

While I believe continued prosperity in the United States to be at grave risk without a major change in fiscal and exchange rate policy at some stage, I would be a fool to try to put a date on the turning point. I simply do not know when it will come.

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