Policy Note 1999/1

How Negative Can U.S. Saving Get?

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In 1998 the volume of U.S. private spending rose by almost twice the increase in disposable income. The impact of this excess private spending financed by increased net borrowing has been profound; without it, the economy would have stagnated. Can this pattern of demand growth continue? The answer is a resounding no.

President Bill Clinton was not alone in late 1997 when he characterized the economic turmoil in Asia as "a few small glitches in the road." Expert opinion was then pretty well united in the belief that the region's problems would not amount to much. Now, faced with Asia's unfolding calamities, the experts know better.

Clinton's gung-ho optimism was not wholly misplaced. Although much of Asia sank, the American economy enjoyed another year of robust expansion; its growth rate in excess of 31/2 percent was substantially faster than expected a year ago. Consumer spending and investment roared ahead, more than making up for the collapse in exports. And thanks to the American locomotive, the world outside Asia and Japan enjoyed a rate of growth-around 3 percent-that compared favorably with the lowly 2 percent or so annual average achieved earlier this decade.

The key question is whether all this can last. Can the United States sustain its strong rate of spending, thereby propping up a troubled world? If the United States slows its spending, the world will need to look to Europe and Japan to take up the slack, a role they would be unable fill given the current state of their economies.

A candid statement about prospects for the American economy in 1999 is "We don't know." History is replete with examples of booms that continue for longer than anyone expects or that reverse into recession just as unpredictably, and short-term forecasters at the moment have produced a wide range of predictions. However, in concentrating so much on the short term, commentators often miss the strategic perspective. Looking ahead to the next few years, it seems to us wholly improbable that the United States can continue to act as the world's spender of last resort. Indeed, if present policies continue, the medium-term outlook for American activity appears exceedingly bleak.

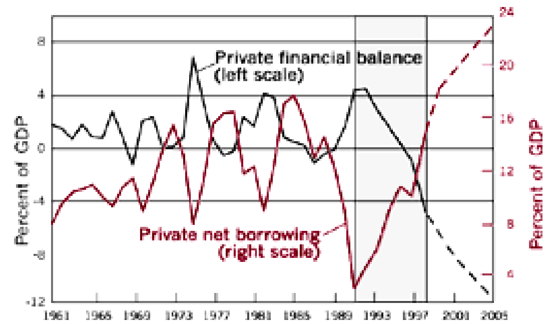
One reason is capacity. The United States's long recovery from its early 1990s recession has not been built on a miracle of technological advance but on a substantial reduction in unemployment. Thus, the current rate of growth can continue only as long as slack remains in the labor market. Even allowing for efficiency improvements, it is unlikely that the United States can sustain a medium-term growth rate much in excess of 2 percent without running into supply constraints that could be inflationary or cause an even more severe balance of payments deficit.

But even more important than capacity is the question of demand. In the face of a bigger budget surplus and a worsening trade performance, American demand has been kept alive by a burst of spending by households and companies well in excess of the advance in after-tax incomes. An unprecedentedly large and growing gap between private spending and income now exists, and that gap has been financed primarily by an increase in borrowing. In 1998 the volume of private spending rose by about 6 percent, almost twice the increase in disposable income. The impact of this excess private spending financed by increased net borrowing has been profound; without it, the economy would have stagnated.

Can this pattern of demand growth continue? The answer is a resounding no. Without a fiscal boost, private spending would need to continue to rise faster than private income to offset the drag on activity arising from long-established adverse trends in U.S. trade performance. The result would be a fabulous increase in indebtedness, both domestic and overseas.

In a report shortly to be published by The Jerome Levy Economics Institute, we shall illustrate the dimensions of the problem. The accompanying chart is a preview showing what we think would have to happen to keep the economy ticking along at about a 2 percent rate of growth. The results are outlandish. According to our calculations, private spending would eventually have to exceed income by an amount double the unprecedented 1998 level and equivalent to over 8 percent of the gross domestic product. The flow of net lending to the private sector would have to rise higher than ever before to over 20 percent of disposable income, and external net debt would rise to over 30 percent of GDP, thanks to a large and widening trade gap. These calculations have to be only very roughly right to be truly worrying.

Private Financial Balance and Private Net Borrowing as Shares of GDP



The shaded area describes what happened from 1991 to 1998 during the period of expansion. Growth depended on the increase in the deficit of private expenditure relative to income (the private financial balance), with spending financed by the increase in borrowing. The dashed lines show what we think has to happen if the expansion is to continue. Both lines look implausible.
Source: NIPA; Flow of Funds Accounts

Because a process that is accelerating is intrinsically unsustainable, the present pattern of American growth cannot continue. At some stage, private sector spending will subside to a rate at best equal to, and more probably below, private sector income. In turn, production and incomes would also subside, as would overseas activity (hit by lower sales to the United States), thus curbing overseas demand for American exports. If it had not already done so, the stock market bubble responsible for much of today's spending buoyancy would burst, amplifying the deflation.

Britain's experience before and after the late 1980s boom offers a parallel. Spurred by explosive housing prices and financial deregulation, Britain's private sector overspent its income by as much as 6 percent of GDP at the peak of the boom. Nemesis came during the next three years as a complete reversal in private saving behavior and a deep and brutal recession. But even if we assume in the case of the United States a much less marked reversion in saving behavior, we find that the shock could potentially wipe out economic growth on average over the next five years. Unemployment would soar.

The collateral damage to the rest of the world would be severe. Worst affected would be those economies heavily reliant on exports to the United States. Prime casualties would be Canada, Asia, and Latin America. According to our calculations, the damage to the medium-term growth outlook in these regions caused by more normal U.S. saving behavior would be on a par with the potential damage experienced by the United States itself. In addition, escalating trade deficits would make Latin America highly vulnerable to the sort of capital flight that devastated Asian economies this year.

Thanks to their much lower exposure, Europe and Japan would suffer least from an American stagnation. However, a further shock to a depressed Japan hardly bears contemplation, and with mass unemployment continuing in much of Europe, the large adjustments in the balance of payments brought about by American retrenchment would risk rekindling trade disputes.

But surely none of this could happen? Would not economic policy respond with vigor to the potential deflation and substantially cushion the blow? Our answer is yes in some ways and possibly no in others. Yes, interest rates would be brought down swiftly, but in the advanced world there is not that much room for maneuver. Nominal interest rates might have to fall to zero (they can go no lower) simply to match falling price expectations, that is, to prevent monetary policy's becoming tighter. If so, there would be no scope to offset the deflation by monetary means.

The spotlight is therefore turned on fiscal policy. Fiscal expansion would be a more promising option, but it cannot be undertaken by the United States alone. If the United States merely replaced deficient private demand with extra public demand, the economy would run ever larger current account deficits and escalate its external indebtedness. The only plausible solution would be coordinated fiscal pump priming in Europe and the United States-and more in the former than in the latter.

And how likely is that? Bill Clinton is savoring the budget surplus while center-to-left European governments face the institutional and intellectual hurdles enshrined in the arbitrary new rules that will determine the fiscal policy of members of the new single currency area. Alas, without a radical rethink by policymakers of their aversion to fiscal policy, the world may face not simply "a few small glitches in the road," but a road disfigured by ruts and potholes, if not an occasional abyss.

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