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Strategic Analysis

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PROSPECTS FOR THE UNITED STATES AND THE WORLD: A CRISIS THAT CONVENTIONAL REMEDIES CANNOT RESOLVE

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The prospects for the U.S. economy have become uniquely dreadful, if not frightening. In this paper we argue, as starkly as we can, that the United States and the rest of the world's economies will not be able to achieve balanced growth and full employment unless they are able to agree upon and implement an entirely new way of running the global economy. Yet we should admit up front that while we feel able to outline the nature and magnitude of the emerging crisis, and even to set down some of the things that must happen in order to counter it, we have few solid suggestions as to how these changes can be brought about at present.

During the last 10 years, the Levy Institute has published a series of Strategic Analyses, of which the original object was, not to make short-term forecasts, but to set forth a range of scenarios that displayed, over a period of five to 15 years, the likely obstacles to growth with full employment. In the first of these papers,[1] published in 1999, at a time when there was an emphatic consensus that "the good times were here to stay," we took the contrarian view—well ahead of the curve—that unsustainable imbalances were building up that would eventually require both a large fiscal stimulus and a sustained rise in net exports, preferably via a substantial depreciation of the dollar.

The first part of this diagnosis was validated de facto by the huge relaxation in fiscal policy in 2001–03, probably amounting to some $700 billion, which unintentionally (i.e., not as part of any strategic plan) staved off the worst of the recession that took place at that time as a result of the dot-com crash. This stimulus, in our view very properly, put the budget permanently into deficit,

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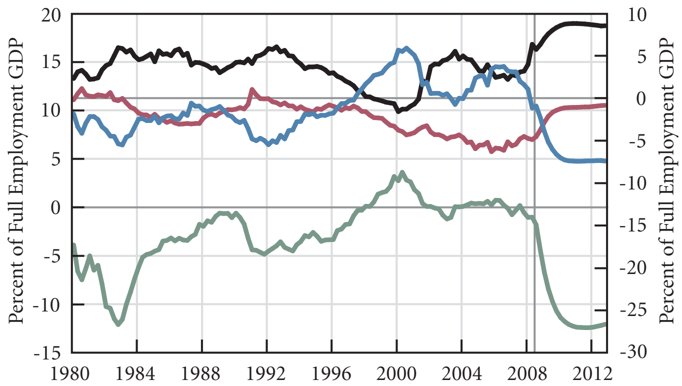
obliterating the surplus of which the Clinton Administration had been so proud.

The balance of payments (which had been zero in 1992) then moved even further into deficit, on a scale never seen before, reaching over 6 percent of GDP in 2006. Despite the growing subtraction from aggregate demand resulting from this adverse trend, the U.S. economy continued to expand at a satisfactory rate because the balance of payments deficit was offset by a large and growing fall in personal net saving—a decline fed by a renewed rise in net lending to the private sector, the counterpart to the disgraceful boom in subprime and other lending.

Once again, it should have been obvious that these trends could not continue for long. As early as 2004, in a Strategic Analysis subtitled *Why Net Exports Must Now Be the Motor for U.S. Growth*,[2] we argued that continued growth in net lending to the private sector was an impossibility, and that at some stage there would have to be a collapse both in lending and in private expenditure relative to income. We also argued that it would not be possible to save the situation by applying another fiscal stimulus (as in 2001) because that would increase the budget deficit to about 8 percent of GDP, implying that the public debt would then be hurtling toward 100 percent of GDP, with more to come. These processes were allowed to continue nonetheless, and we perforce had to bring the short-term prospect into sharper focus. As the turnaround in net lending eventually became manifest, we predicted in our November 2007 analysis[3]—without being too precise about the timing—that there would be a recession in 2008. At the time, we entertained the possibility that, with the dollar so low, net exports might save the day, after an uncomfortable period of recession.

The processes by which U.S. output was sustained through the long period of growing imbalances could not have occurred if China and other Asian countries had not run huge current account surpluses, with an accompanying "saving glut" and a growing accumulation of foreign exchange reserves that prevented their exchange rates from falling enough, flooding U.S. financial markets with dollars and thereby helping to finance the lending boom. Some economists have gone so far as to suggest that the growing imbalance problem was entirely the consequence of the saving glut in Asian and other surplus countries. In our view, this was an interdependent process, one in which all parties played an active role. The United States could not have maintained growth unless it had been happy to sponsor, or at least permit, private sector (particularly personal sector) borrowing on such an unprecedented scale.

Figure 1 **U.S. Main Sector Balances and Output Gap**



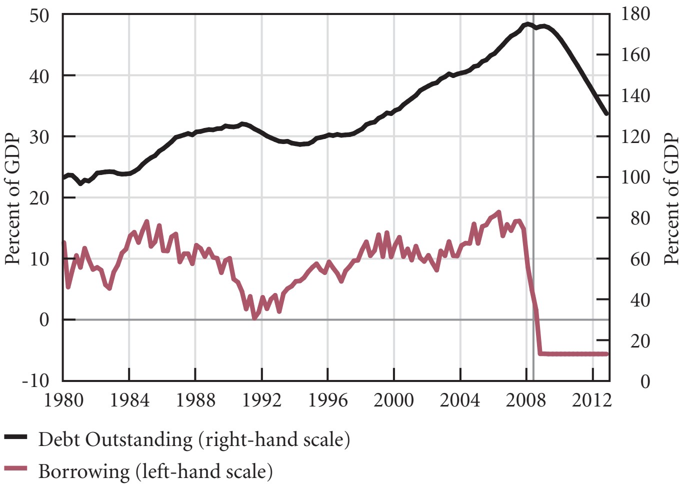
Sources: Federal Reserve and authors' calculations

Changes in the three financial balances—government, foreign, and private—which illustrate the major forces driving the U.S. economy (and the use of which has been central to all our work), are shown in Figure 1.[4] The figure also shows the level of GDP relative to trend, here taken to be actual output in excess of what it would have been with 6 percent unemployment.

Figure 1 illustrates with numbers the story just told. It indicates how the first two output recessions (in the 1980s and 1990s) were driven by falls in private expenditure relative to income. Then, between 1993 and 2000 (the "Goldilocks" period), the appearance of moderately stable growth masked persistent negative impulses from the government and foreign sectors, offset by a persistent upward influence from private expenditure relative to income. The brief "dot-com recession" (2000–03) was partly offset by a fiscal stimulus, sending the budget into deficit. Between 2004 and the first half of 2007 there was a renewed expansion in private expenditure, largely caused by a very steep rise in the financial balance of the private sector (i.e., a fall in private net saving).

For easy comparison, Figure 1 also illustrates the "base run" on which our projections are founded. These are discussed in the following section.

Figure 2 **Private Sector Borrowing and Debt**



Sources: Federal Reserve and authors' calculations

The Recession, 2007– ?

To get a sense of the effect of private indebtedness on private net saving it is useful to look first at the level of private debt expressed as a proportion of GDP since 1980 (Figure 2). The trend was upward throughout the period, but between 2000 and the beginning of 2007 there was a marked acceleration, the proportion rising from about 130 percent to about 174 percent of GDP. The growth suddenly ceased in the first quarter of 2008, though it did not actually reverse course immediately. A vertical line is drawn to indicate the third quarter of 2008, for which figures relating to the flow of funds have just become available.

The lower half of Figure 2 shows how net lending to the private sector (logically equivalent to the change in debt illustrated above) fell between the third quarter of 2007 and the third quarter of 2008, by an amount equal to about 13 percent of GDP—by far the steepest fall over such a short time in the history of the series. This violent change in the flow of net lending is rather surprising at first, for there is nothing in the line just above it to prepare one for the sudden drop. It is perfectly comprehensible (and logically inevitable) nevertheless. Net lending is calculated from two components: repayments plus interest, which will be a relatively stable proportion of the stock of debt; and receipts in the form of new loans, which may be highly volatile and which must have been falling extremely sharply through 2008 as the credit crunch took its toll. It is important to recognize that there is no natural floor to the flow of net lending as it reaches zero; indeed, we are expecting gross lending to continue falling below repayments (causing negative lending) for a considerable time.

As Figure 2 shows, we have assumed (heroically) that over the next five years the level of private debt relative to GDP will fall back to about 130 percent—roughly the level at which it had stabilized before 2000.

The implication of these assumptions is that net lending to the private sector falls by about 14 percent of GDP between the first quarter of 2008 and the first quarter of 2009—a drop that has already largely occurred—and that net lending continues negative for a long time after that.

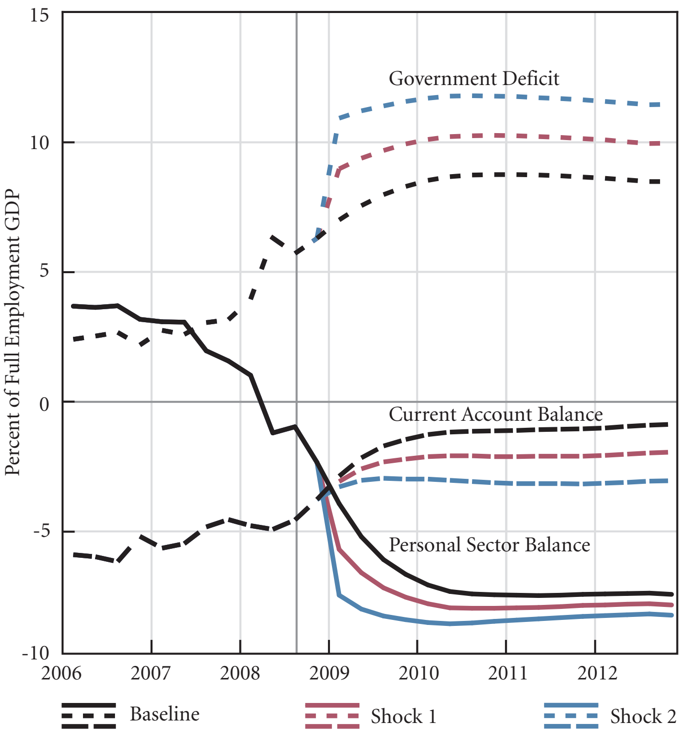
In our view, the unprecedented drop in interest rates recently engineered by the Federal Reserve may not be effective in reactivating standard lending practices, unless confidence in future profits and income growth is restored. However, low interest rates will keep mortgage payments low, sustaining disposable income and helping the economy to recover.

Implications for Future Private Spending, GDP, and the Other Sector Balances

Figure 1 traces our baseline projection for the government deficit through 2012, based on neutral assumptions regarding government expenditure and tax receipts. But it is the dramatic fall in net lending to the private sector on which our projected steep rise in the private sector balance and abrupt fall in GDP over the next few years crucially depends. The balance of trade follows by identity, though there are legitimate grounds for supposing it to be plausible; according to our projection, it improves quite a lot, mainly as a result of the collapse in U.S. GDP. The projection for exports is consistent with that published by the International Monetary Fund, and we allow the model to generate figures for imports. The Appendix below describes the equation in our model that relates private expenditure to disposable income, net lending, and capital gains. This equation—which, with hardly any change, has served us well since 1999—finds the "long term" marginal impact of real expenditure with respect to (real) net lending to be about 0.48.[5]

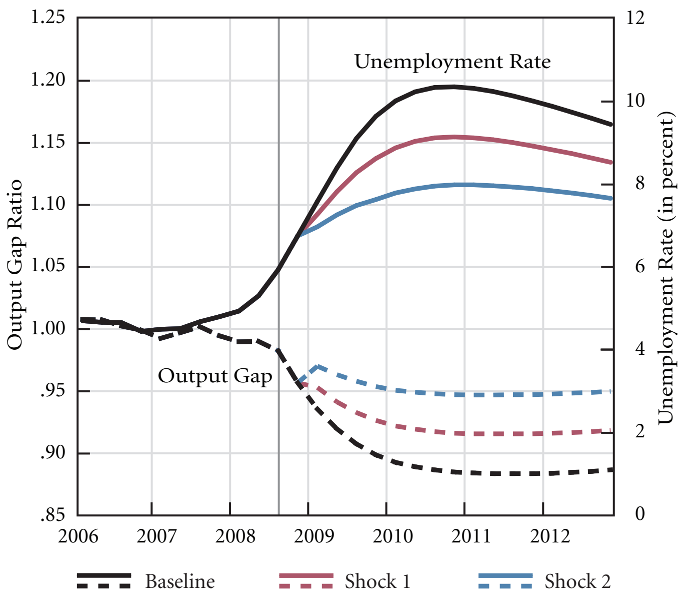
As illustrated in the extreme right-hand section of Figure 1, the implication of these assumptions, taken together, is that GDP will fall about 12 percent below trend between now and 2010, while unemployment will rise to about 10 percent. It is a central contention of this report that the virtual collapse of private spending will make it impossible for U.S. authorities to

Figure 3 **U.S. Main Sector Balances**



Sources: Federal Reserve and authors' calculations

Figure 4 **Output Gap and Unemployment**



Sources: Federal Reserve and authors' calculations

apply fiscal and monetary stimuli large enough to return output and unemployment to tolerable levels within the next two years. In support of this contention, we show in Figures 3 and 4 alternative projections for the main financial balances, output, and unemployment, based on the assumption that fiscal stimuli are immediately applied equal to an increase in government outlays of about $380 billion, or 2.6 percent of GDP (Shock 1), and in the extreme case, $760 billion, or 5.3 percent of GDP (Shock 2).[6]

The implication of these projections is that, even with the application of almost inconceivably large fiscal stimuli, output will not increase enough to prevent unemployment from continuing to rise through the next two years.

U.S. Fiscal Policy Alone Will Not Eliminate the Imbalances

It seems to us unlikely that, purely for political reasons, U.S. budget deficits on the order of 8–10 percent through the next two years could be tolerated, given the widespread belief that the budget should normally be balanced. But looking at the matter more rationally, we are bound to accept that nothing like the configuration of balances and other variables displayed in Figures 3 and 4 could possibly be sustained over any long period of time. The budget deficits imply that the public debt relative to GDP would rise permanently to about 80 percent, while GDP would remain below trend, with unemployment above 6 percent.

Fiscal policy alone cannot, therefore, resolve the current crisis. A large enough stimulus will help counter the drop in private expenditure, reducing unemployment, but it will bring back a large and growing external imbalance, which will keep world growth on an unsustainable path.

Need for Concerted Action

Our baseline scenario may be considered as a rather extreme case, where lending to households and firms is not restored for a considerable length of time. If confidence is restored in financial markets and lending returns to normal, prebubble levels, private expenditure will increase, helping the economy to recover. In this case, the private sector balance will slowly be restored to its prebubble level, with a slower reduction in the debt-to-income ratio, and the government deficit will drop as a result of increased tax revenues. In this case, again, the balance of payments will start to deteriorate, unless countermeasures are taken.

At the moment, the recovery plans under consideration by the United States and many other countries seem to be concentrated on the possibility of using expansionary fiscal and monetary policies.

But, however well coordinated, this approach will not be sufficient.

What must come to pass, perhaps obviously, is a worldwide recovery of output, combined with sustainable balances in international trade.

Since this series of reports began in 1999, we have emphasized that, in the United States, sustained growth with full employment would eventually require both fiscal expansion and a rapid acceleration in net export demand. Part of the needed fiscal stimulus has already occurred, and much more (it seems) is immediately in prospect. But the U.S. balance of payments languishes, and a substantial and spontaneous recovery is now highly unlikely in view of the developing severe downturn in world trade and output. Nine years ago, it seemed possible that a dollar devaluation of 25 percent would do the trick. But a significantly larger adjustment is needed now. By our reckoning (which is put forward with great diffidence), if the United States were to attempt to restore full employment by fiscal and monetary means alone, the balance of payments deficit would rise over the next, say, three to four years, to 6 percent of GDP or more—that is, to a level that could not possibly be sustained for a long period, let alone indefinitely. Yet, for trade to begin expanding sufficiently would require exports to grow faster than we are at present expecting, implying that in three to four years the level of exports would be 25 percent higher than it would have been with no adjustments.

It is inconceivable that such a large rebalancing could occur without a drastic change in the institutions responsible for running the world economy—a change that would involve placing far less than total reliance on market forces.

Appendix

Private sector expenditure (*PX*) is assumed to adjust toward a stable stock-flow norm, with additional impacts arising from borrowing and capital gains. That is to say,

$$PX_t = c_0 + c_1 YD_t + c_2 FA_{t-1} + Z_t$$

where *YD* is real disposable income, *FA* is the real stock of assets of the private sector, and *Z* represents additional variables that affect the propensity to spend out of income and wealth for households and business taken together. More specifically, our preferred equation is the following:

Dependent Variable: PX
Method: Two-stage least squares
Sample (adjusted): 1970:4, 2008:3
Included Observations: 152 (after adjustments)

Variable	Coefficient	Standard Error	T-statistic	Probability
PX(-1)	0.672896	0.041111	16.36761	0.0000
(PX(-1))	0.187152	0.065122	2.873850	0.0047
YD	0.293243	0.037615	7.795832	0.0000
HB	0.158770	0.020951	7.578325	0.0000
BB	0.123124	0.024711	4.982601	0.0000
PFA	0.208714	0.029128	7.165473	0.0000
FA(-1)	0.013021	0.004805	2.710084	0.0075
C	-45.10806	17.08443	-2.640302	0.0092

R-squared	0.999817	Mean dependent variable	5976.533
Adjusted R-squared	0.999808	S.D. dependent variable	2204.724
S.E. of regression	30.51185	Sum squared residual	134060.1
F-statistic	112600.5	Durbin-Watson statistic	2.003535
Probability (F-statistic)	0.000000	Second-stage SSR	186160.9

where *HB* is real household borrowing; *BB*, real business borrowing; and *PFA*, the relative price of equities. The equation is estimated with two-stage least squares and is robust to the standard battery of specification tests.

Notes

1. Godley (1999).
2. Godley, Izurieta, and Zezza (2004).
3. Godley et al. (2007).
4. In the upper part of Figure 1 we plot the balances of the private, government, and foreign sectors, which are derived from the well-known accounting identity $S = I + G - T + BP$, where *I* is private sector investment, *S* is private sector saving, *G* is government expenditure, *T* is government receipts, and *BP* is the current account of the balance of payments.

Defining the government deficit as $GD = G - T$ and the private sector balance as $IS = I - S$ and rearranging, we get $0 = IS + GD + BP$, which are the three lines in Figure 1, scaled by GDP. A positive value for any of these balances implies that the sector net contribution to aggregate demand is positive.

The output gap measure shown in the lower part of Figure 1 is obtained by our estimate of the difference between real GDP and the level of real GDP that implies a stable level of unemployment.

5. The marginal propensity to spend out of household borrowing is 0.48, while the marginal propensity to spend out of business borrowing is 0.37. See Appendix for details.
6. We assume the stimulus to be evenly split between increases in government current and capital expenditure, and increases in government net transfers to the private sector.

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