Levy Economics Institute of Bard College

Strategic Analysis

March 2010

GETTING OUT OF THE RECESSION?

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In our Strategic Analysis of December 2009 (Papadimitriou, Hannsgen, and Zezza 2009) we argued that, without policy action, the U.S. economy would move from a deep recession to a period of sluggish growth, and that unemployment would remain very high for some years to come.

We now update this exercise, using new evidence, to confirm that strong policy action is required to achieve full employment in the medium term—and that a persistently high government deficit will be required to produce a reduction in the unemployment rate.

Fuel for Growth?

Our approach to the dynamics of real GDP is based on the analysis of the likely paths of the components of demand rather than the evolution of potential output. The largest component of aggregate demand in the United States is consumption (70 percent of GDP), which needs to be financed either by disposable income or by borrowing.

Our last projection, of sluggish growth in the U.S. economy, relied on the principal assumption—based on the available evidence up to the second quarter of 2009—that consumer and business borrowing would remain in negative territory for the rest of 2009.

The latest figures published by the Federal Reserve show that our assumptions were indeed correct. Household borrowing in the third quarter was a negative $351 billion, or 2.5 percent of GDP (Figure 1), with a large drop in both mortgages and consumer credit. Data on consumer credit for the last quarter of 2009 show a drop of $9 billion in the stock of credit outstanding, again implying that net borrowing was negative for the rest of last year, and this probably continued in the first two months of 2010.

The stock of household debt and the flow of net borrowing have thus been falling (Figure 1), suggesting that households are still operating to reduce excessive indebtedness. Mortgages and

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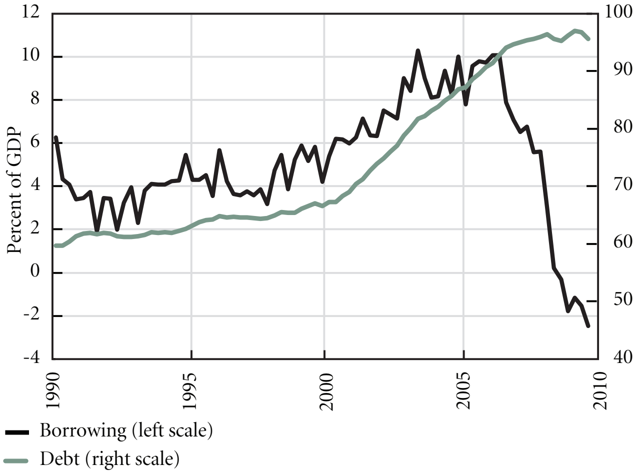
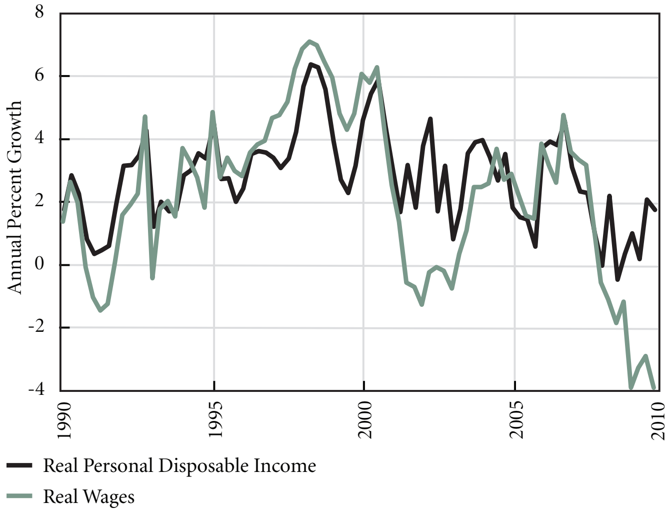
Figure 1 Household Borrowing and Debt, 1990Q1–2009Q3 (in percent of GDP)



Sources: Bureau of Economic Analysis (BEA); Federal Reserve

Figure 2 Real Disposable Income and Wages, 1990–2009 (annual percent growth)



Source: BEA

consumer credit are additional sources of fuel for household spending, together with the purchasing power of disposable income.

Real disposable income has been increasing in the last two quarters (Figure 2), but the purchasing power of the wage bill has been falling.[1] The increase in disposable income is therefore not the result of increases in wages but rather the result of net government transfers to the private sector, and profits. While government transfers are likely to boost consumption, the effects of profits on aggregate demand are more questionable: real investment in the fourth quarter of 2009 was still 14 percent below its level in the previous year.

Another potential support for aggregate demand and employment derives from net exports. In our last report we showed that a further devaluation of the U.S. dollar, particularly against the currencies of countries that have a sizable surplus with the United States, would have been an effective stimulus to demand. As Figure 3 shows,[2] the U.S. dollar lost value throughout most of 2009, mainly against the euro and the Japanese yen, but not against China's currency. While the latest movements[3] in the dollar will be beneficial for U.S. exports to the eurozone (and Japan, to a minor degree), the undervaluation of the yuan is not reducing U.S. imports from China, and is proving detrimental to the stimulus the United States may get from net exports. Besides, the dollar has stopped its descent, so no further improvement on this front can be expected in the short term.

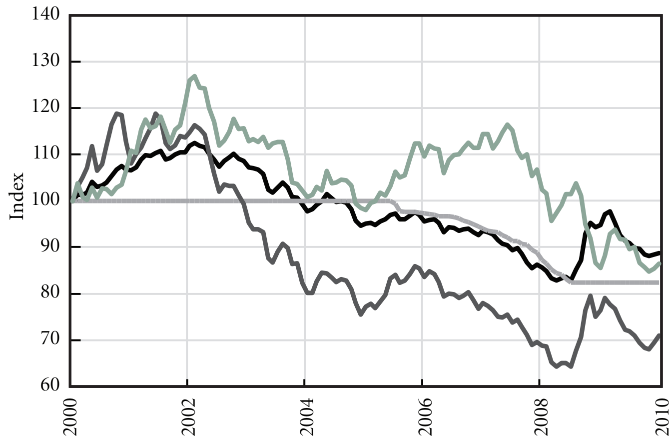
In sum, it seems likely that any increase in private sector aggregate demand in 2009 was obtained as a result of the fiscal stimulus, without which the recession would have been much deeper.

A Baseline Scenario with Persistent Unemployment

We have now updated our December 2009 baseline scenario with the newly available data, using the same projection strategy. We use the latest projections by the International Monetary Fund (IMF 2010) for real GDP growth in major U.S. trade partners, and revise our projections for revenues and outlays of the government under current policies on the basis of the latest report of the Congressional Budget Office (CBO 2010). The CBO is projecting a decrease in the federal deficit from 9.9 percent of GDP in fiscal year 2009 to 2.6 percent in 2015, with a strong upward adjustment to government revenues starting in 2011.

We adopt a similar trajectory for the general government account as the starting point for our baseline. We retain our assumptions that borrowing by the household and nonfinancial business sectors remains negative, so that household debt

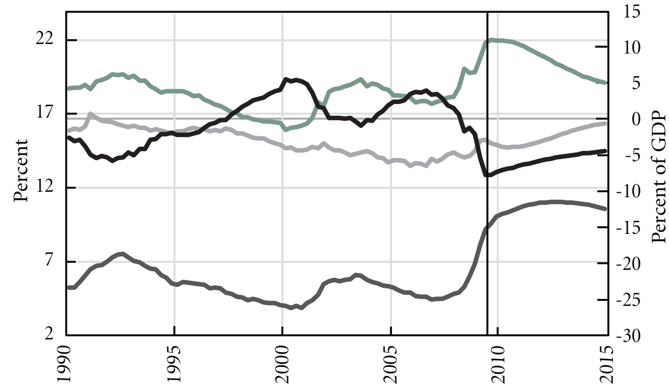
Figure 3 U.S. Dollar Exchange Rates, 2000–10 (2000Q1=100)



Broad Nominal Index
Yen
Euro
Yuan

Source: Federal Reserve

Figure 4 U.S. Main Sector Balances and Unemployment in Baseline Scenario, 1990–2014



Government Deficit (right scale)
Current Account Balance (right scale)
Private Sector Investment Less Saving (right scale)
Unemployment Rate (left scale)

Sources: BEA; authors' calculations

rebounds to 73 percent of GDP by the end of the simulation period, while nonfinancial business debt declines to 65 percent of GDP—which used to be the norm. The assumptions for our baseline scenario are therefore as neutral as possible, and do not consider the possibility of another major crash in either the stock market or the housing sector, nor a more optimistic (or pessimistic) hypothesis about the price of oil, the stability of the euro, and so on.

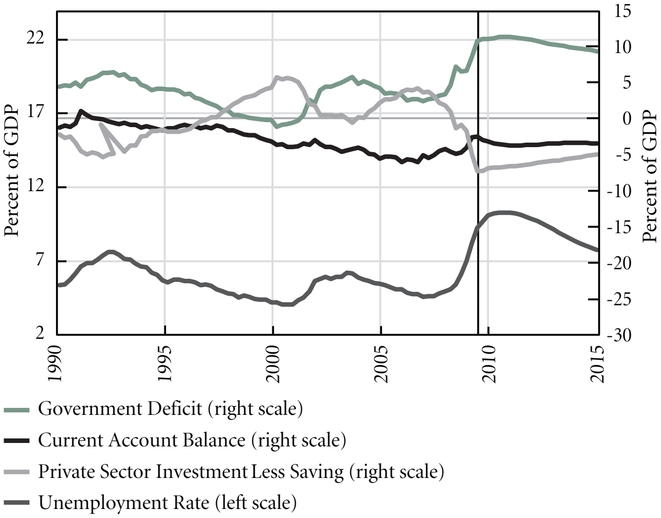
Our baseline results are summarized in Figure 4. Insufficient growth in all components of aggregate demand imply that unemployment will hover around 10 percent, while output slowly recovers to a growth rate of about 2.5 percent only in 2014. It is assumed that the federal deficit will decrease to about 5 percent of GDP by 2015, while the balance of payments on the current account is balanced in the same year. Notwithstanding the increase in government revenues and lower growth in government outlays, government debt will rise by about 30 percent of GDP by the end of the simulation period, since the deficit will remain large relative to the GDP growth rate.[4] The recovery in stock-flow imbalances, which we have been warning about for so long, will therefore come at too high a cost for output and employment, calling for strong policy intervention.

We chose to simulate our baseline scenario under "neutral" assumptions and official references for growth in U.S. trading partners and fiscal policy. However, we do not believe such a scenario to be realistic, since the projected path for fiscal policy under current legislation—as outlined by the CBO—usually underestimates government deficits.

A Growing Public Debt Will Bring Unemployment Down

A first alternative scenario to be considered uses more plausible assumptions about fiscal policy than those of the CBO. The CBO (2010) notes that its "baseline projections understate the budget deficits that would arise under many observers' interpretation of current policy, as opposed to current law. . . . If the tax cuts were made permanent, the AMT was indexed for inflation, and annual appropriations kept pace with GDP, the deficit in 2020 would be nearly the same, historically large, share of GDP that it is today, and debt held by the public would equal nearly 100 percent of GDP" (11–12). Accordingly, in our alternative scenario we assume permanent tax cuts and a larger increase in government outlays related both to expenditure and transfers to the private sector.

Figure 5 **U.S. Main Sector Balances and Unemployment in Prolonged Fiscal Stimulus, 1990–2014**



Sources: BEA; authors' calculations

Our results, shown in Figure 5, show that the unemployment rate would decline to 7 percent by the end of the simulation period, with output growing at 3 percent or above from the end of 2011 onward. The government deficit remains high relative to GDP, with public debt growing at approximately 101 percent of GDP by the end of 2015. We assume that monetary policy is able to keep interest rates at the current, very low level, so that the increase in public debt implies an increase in interest payments to about 2.5 percent of GDP by the end of our projection.

The recovery in output, driven by public expenditure and public transfers, will have an impact on the current account balance, which stabilizes around 4 percent of GDP. We estimate that about half of the external deficit, or 2.1 percent of GDP, will arise from oil imports (we project the price of oil to stabilize in relative terms).

As in our previous reports, we keep claiming that an expansionary fiscal policy will be effective in sustaining output and employment, albeit at a cost of a deterioration in the external balance. In our view, our alternative scenario, where the growth in output is obtained through a growing public debt, is to be preferred to our baseline scenario of persistent unemployment. Any sector that increases its debt relative to its income is by definition becoming more fragile, but as long as the United States maintains its international role as issuer of the major reserve currency, it is difficult to believe that foreign countries will be unwilling to finance its public debt. However, this scenario perpetuates—albeit on a smaller scale—the international imbalances that characterized the previous decade, and a different growth strategy is needed.

Conclusion

The current recession has not been simply the result of a temporary, unexpected shock to the financial sector. Rather, it has been the inevitable consequence of an unbalanced growth path that the United States has followed over the past 20 years (Godley 1999). It will therefore be extremely difficult to deal with its consequences—specifically, unemployment.

In this report we have shown that a large and persistent government deficit is and will be needed in the short run in order to reduce the unemployment rate. This implies a growing public debt, which will be sustainable as long as interest rates are kept at the current low level—and a smaller cost to future generations than that implied by an unemployment rate persistently above 10 percent.

Acknowledgment

I wish to thank Wynne Godley for his penetrating comments. Opinions and remaining errors are my sole responsibility.

Notes

1. Figure 2 reports personal disposable income and wage and salary disbursements using the consumption deflator.
2. Index numbers in Figure 3 are such that a devaluation of the U.S. dollar is reflected in a lower value of the indexes.
3. This report was prepared before the turmoil in Greece and other countries in Europe, which has led to an appreciation of the U.S. dollar. Our argument is thus reinforced: a stronger dollar and slower growth in Europe both imply smaller increases in U.S. net exports.

4. Abstracting from capital gains, inflation, and so on, government debt B grows with deficit D according to

$$B(t) = B(t-1) + D(t)$$

Dividing by GDP, with g as the nominal GDP growth rate, we get

$$b(t) = b(t-1)/(1+g) + d(t)$$

where b and d denote debt- and deficit-to-GDP ratios, respectively. The debt-to-GDP ratio will increase when

$$d^*(1 + g) - b^*g > 0$$

If the debt-to-GDP ratio is 100 percent, any deficit larger than the GDP growth rate will imply an increase in the debt-to-GDP ratio. If the debt-to-GDP ratio is smaller, an even smaller deficit is sufficient for debt to increase.

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