



# Strategic Analysis

## The U.S. Economy: A Changing Strategic Predicament

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### INTRODUCTION AND SUMMARY

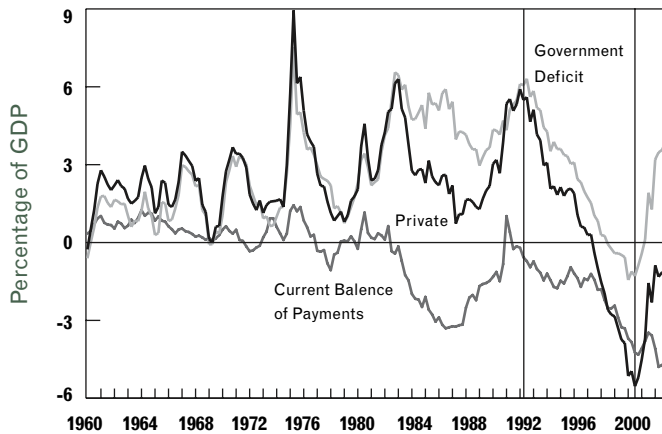
Right through the boom years prior to 2001, the U.S. economy was facing a strategic predicament—to which attention was repeatedly drawn in a series of papers emanating from the Levy Institute—in that the main engine of growth (credit-financed private expenditure) was unsustainable, from which it followed that the whole stance of fiscal policy would have to be radically changed if the New Economy were not to become stagnant. The experience of the last two years has partially vindicated the Levy Institute view. The boom was indeed broken because, as predicted, private expenditure fell relative to income. The potentially dire effects on the level of activity, however, were mitigated by a transformation in the stance of fiscal policy, accompanied by a radical change in attitudes toward budget deficits, which suddenly became respectable. The expansionary fiscal policy initiated by President George W. Bush was reinforced by a further aggressive relaxation of monetary policy so that (real) short-term interest rates have fallen almost to zero, thereby giving the consumer boom a last gasp. Yet, with all this help, the recovery from the recession of 2001 has not been robust. Growth has generally been below that of productive potential, and there is a widespread sense that all is not well.

This analysis argues that a new strategic predicament is on the horizon as a result of the exceptionally large and growing balance of payments deficit, to which the public discussion attaches very little importance. In his testimony to Congress on the state of the economy (February 11, 2003<sup>2</sup>), Fed Chairman Alan Greenspan made no reference whatever to the balance of payments. The models embodying the “New Macroeconomics” that have suddenly become so influential<sup>3</sup> do not even contain a foreign sector or any representation of stocks of foreign debt that the United States is now rapidly accumulating. The *Economic Report of the President* (ERP, 2003, chapter 1, pp.59–62, [w3.access.gpo.gov/eop/index.html](http://w3.access.gpo.gov/eop/index.html)) has a section on the balance of payments but considers that the deficit has no immediate policy implications, on the grounds that the cost of servicing U.S. net foreign liabilities is negligible.

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**Chart 1**  
**The Three Financial Balances**



Sources: National Income and Product Accounts (NIPA) and author's calculations

The central argument of this analysis can be simply stated. The primary balance of payments<sup>4</sup> in the fourth quarter of 2002 was equal to about 5 percent of GDP—easily a postwar record. If, as all official documents assume, the U.S. economy grows fast enough during the next six years to generate some reduction in unemployment, there is a presumption that the primary balance will deteriorate further, to at least 6.4 percent, causing U.S. foreign debt to rise to nearly \$8 trillion or 60 percent of GDP. And if, as the *ERP* assumes, the stance of monetary policy reverts to neutral so that short-term interest rates rise to 4.3 percent, the net flow of interest payments out of the country could well rise to \$200 to \$300 billion per annum, thereby raising the deficit in the overall balance of payments to about 8.5 percent of GDP. As the private sector's financial deficit is likely to revert toward its usual state of surplus, it follows as a matter of accounting logic that the government would have to run a deficit at least as large as the balance of payments deficit—that is, the budget deficit would have to rise from some 3 percent of GDP as now projected for 2003 to perhaps 9 to 10 percent of GDP in 2007–2008. For a number of reasons this is not a credible scenario—if only because such a position would not itself be a stable one; the rate at which foreign debt would be accumulating would be such as to generate a further, accelerating, flow of interest payments out of the country, requiring even larger budget deficits in subsequent years.

The default conclusion is that the U.S. economy will not recover properly in the medium term, but rather will enter a

prolonged period of “growth recession.” The only lasting solution will be to get U.S. exports to rise much faster than imports over a prolonged period. But how is this to be achieved? Whatever the politics of the matter, there was no *technical* obstacle to changing fiscal policy; all that was needed were new tax schedules and public expenditure authorisations. Any policy to generate an adequate expansion of net export demand will likely encounter far more intractable obstacles.

### MORE PRECISELY

It is well known to students of the National Accounts that the surplus of private disposable income over expenditure is equal to the government balance (written as a deficit) plus the current balance of payments (written as a surplus).<sup>5</sup> While these balances are related to one another by a system of accounting identities, each has, to some extent, a life of its own that is reconciled with the other two via the aggregate income flow. The way the balances evolve provides a useful armature around which to organise a narrative account of economic developments, because any one of them is necessarily implied by the other two. Furthermore, the balances may give an early warning that unsustainable processes are taking place, for any high or rising balance implies a change in public, private, or foreign debts, which cannot grow without limit relative to income.

Chart 1 shows how the three financial balances have moved, relative to GDP, since 1960. Vertical lines mark the points at which the '90s boom really started (at the beginning of 1992) and when it came to an end (in the third quarter of 2000). The chart shows how the configuration of balances during the '90s was quite unlike anything that had happened before. It illustrates<sup>6</sup> how the boom took place notwithstanding strong contractionary forces from the government's fiscal stance and also from net export demand; and hence how the expansion of aggregate demand was driven by an unprecedented growth of private expenditure relative to income. By the end of the boom, private expenditure was far in excess of disposable income, an excess made possible by a huge accumulation of debt, by both the personal sector and corporations. The turning point came in the second half of 2000, when (and because) private expenditure started to fall back relative to income. Deprived of what had been its motor during the previous eight years, the economy would have suffered a severe recession had the government not stepped in

with a series of stimulatory fiscal packages. The private sector balance reverted toward its historical mean (a substantial surplus), but the pace at which this happened slowed down during 2002 because a reduction in interest rates—to levels not seen for 40 years—encouraged households to borrow huge sums of money and spend the proceeds. But disturbingly, the balance of payments continued its deterioration apace through 2001–2002, almost impervious to the brief recession and subsequent period of weak growth.

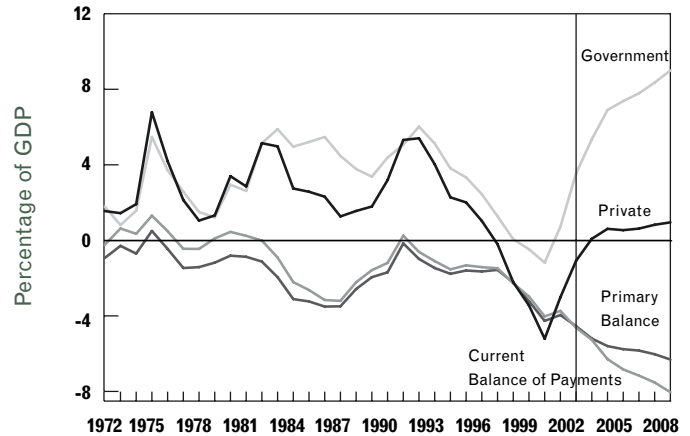
### THE NEW STRATEGIC PROBLEM

Chart 2 does not contain a forecast. It shows what we believe to be the true implications of the growth path for the economy, which is mapped out in the *Economic Report of the President* and is designed to show what can't happen, rather than what will.

The assumptions underlying this chart are as follows. It is assumed, in line with the projections in the *ERP*, that the economy grows at an average rate of 3.3 percent between now and 2008. This is the growth rate considered necessary to bring the unemployment rate down slightly from 5.7 to 5 percent, and we have no reason to disagree with it as a conditional prediction. With such a growth rate, we have taken the view that, provided there is no major devaluation of the dollar, the primary balance of payments will certainly not improve and will likely deteriorate, at least to some extent, over the next five or six years. It has to be emphasised, and this is not just cowardly caution, that our prediction may turn out to be incorrect if there is another major revision to the statistics. In an earlier study,<sup>7</sup> we made a careful projection of the U.S. balance of trade, not entirely dissimilar to the one presented here, which was largely nullified, or at least set back three or four years, by a huge revision to the historical figures, which showed that the balance had deteriorated much less, and that the net foreign asset position was far less negative, than had previously been supposed. In the present study we take the official statistics at face value and assume that recent figures are not freak outliers but correctly describe powerful adverse trends that seem to have become entrenched.

Our conditional projections of the primary balance cannot be justified scientifically. Econometrics tells us (as it has told many other researchers) that the income elasticity of demand for imports in the United States is very high and far in excess of the foreign income elasticity of demand for U.S.

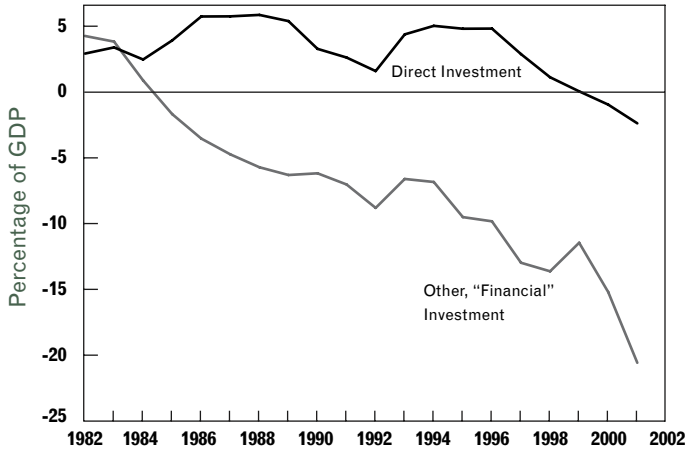
**Chart 2**  
**Financial Balances, Actual and Projected**



Sources: NIPA and author's calculations

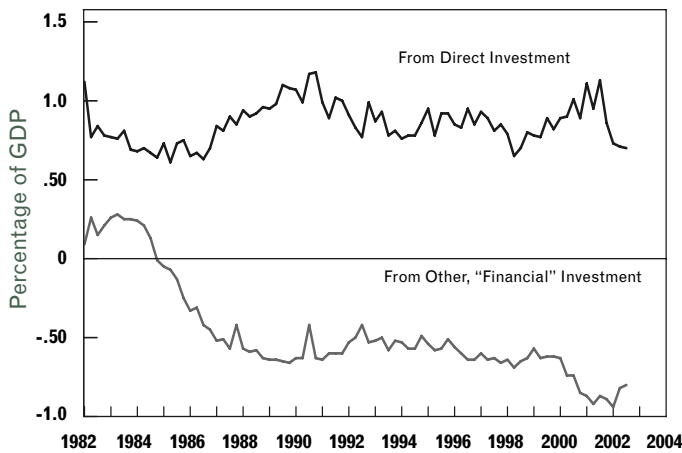
exports.<sup>8</sup> But while it is important to bear this in mind, a point of saturation must eventually be reached, and it would be idle to naively project the results yielded by any estimated equation five or six years into the future. We aim to be conservative, entering figures which, given the growth assumptions in the *ERP*, should commend themselves to most neutral observers. The main considerations to be born in mind are: the assumed annual average growth rate during the next six years (3.3 percent) is somewhat higher than that actually achieved during the past five (2.8 percent); the prospect for (non-U.S.) world growth during the next six years seems if anything less favourable than during the past five, with Japan mired in a seemingly endless stagnation and Europe the victim of perverse rules governing fiscal policy; countries in the rest of the world, not only Japan and China but also nations in Southeast Asia and Latin America, all have an urgent need to expand their exports, and many of them will be prepared to shade their prices in order to raise their shares of the large, open, and well-organised market for manufactures in the United States. To come down to it, we have assumed that the primary deficit in the United States, having risen by 3 percentage points (of GDP) during the last five years, will deteriorate by a further 1.3 percentage points in the next five (notwithstanding the faster growth rate), with a further small decline thereafter taking it from 4.9 percent at the end of 2002 to 6.0 percent at the end of 2007 and 6.4 percent at the end of 2008. Obviously, the deterioration could be much greater than this.

**Chart 3**  
**Net Stocks of Foreign Assets**



Sources: Bureau of Economic Analysis (BEA):  
"U.S. Net Investment Position at Year End, 2001"  
and author's calculations

**Chart 4**  
**Flows of Net Foreign Income**



Sources: BEA: "U.S. International Transactions"  
and author's calculations

### NET FOREIGN ASSETS AND INTEREST PAYMENTS

This conditional prediction of the primary balance of payments carries the implication that the net foreign debt would rise from about 25 percent of GDP at the end of 2001 to nearly \$8 trillion (60 percent of GDP) in 2008. It is true, as the *ERP* points out, that the net outflow of interest, profits, and dividends has recently been close to zero. To understand the underlying trends, however, it is imperative to split the aggregate measures of stocks and flows into two broad components—direct investment and other, "financial," assets and liabilities.

Chart 3 shows these two broad categories of (net) asset stocks expressed as percentages of GDP. The upper line shows how the net stock of direct investment (valued at market prices) has remained relatively close to zero during the last 20 years and became moderately negative in 2001. It follows that virtually all the overall deterioration in the net asset position has taken the form of financial assets—largely short-term instruments like Treasury bills. At the end of 2001 there was a net financial debt equal to about 22 percent of GDP.

Chart 4 shows the net flows of income associated with each broad category of asset. The net flows of income generated by direct investment have been roughly stable at around 3/4 percent of GDP, notwithstanding that the net stock has fallen below zero. And the net outflow generated by financial instruments has drifted down by a roughly equal amount, notwithstanding the large and growing negative asset position.

The *ERP* (pp.61–62) observes that:

"... the rates of return on U.S. investment abroad were higher than the returns enjoyed by foreign investors in the United States"; adding that "Further analysis... indicates that these differences in rates of return are especially pronounced for direct investment, and less so for portfolio investment"; also, "Although debt service became a net transfer from the United States to the rest of the world in 2002, this debt service is unlikely to amount to a significant portion of U.S. output in the foreseeable future."

The first of the quotations above is undoubtedly true. Comparison of disaggregated inflows and outflows relative to the stocks of direct investment that generated them do indeed show that the rate of return to foreign investors is far below that of U.S. investors abroad. But a similar disaggregation of financial investments does not support the second quotation, which suggests that U.S. investors have earned relatively high returns even though the differential is smaller than is the case with direct investment. We will argue here that the inference in the third quotation from the *ERP* is likely to prove definitely incorrect.

Chart 5 shows the quasi-interest rates<sup>9</sup> earned on both financial assets and financial liabilities together with the rate on three-month Treasury bills. What this chart seems to say, *pace* the *ERP*, is that the return to foreign investors on these instruments has been rather higher than the return to U.S. investors. But far more important, it suggests a reason why

the net outflow has failed to rise much in recent times, notwithstanding the huge deterioration in the net stock position.

Both rates of return have tracked the Treasury bill rate quite closely, and nearly simultaneously, through the last 20 years. It seems reasonable to hold the fall in the bill rate responsible for the fall in the quasi-interest rates and hence for the fact that the outflow of income rose so little. As the chart shows, the bill rate in the third quarter was well below the quasi-interest rates on internationally held assets, and it has since fallen further, to 1.2 percent at the end of 2002.

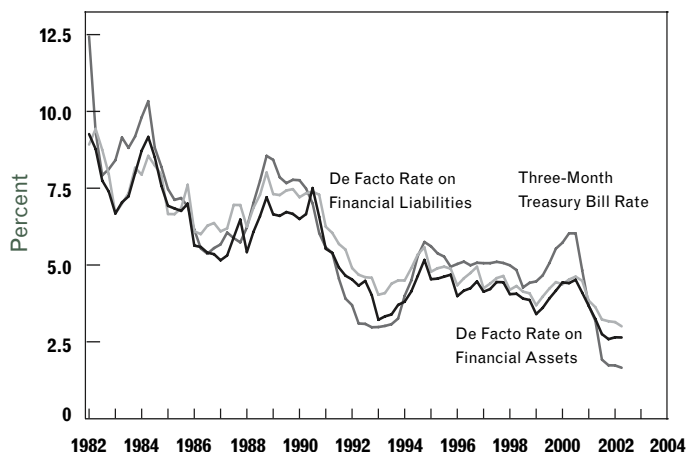
Our projection assumes that the net stock of direct investment and the associated net inflow of profits both remain constant as a share of GDP. We further assume that the change in the net stock of financial liabilities corresponds with the overall deficit in the current balance of payments as a whole and that the rate paid on this stock is exactly equal to the Treasury bill rate projected in the *ERP*, which shows a rise to 4.3 percent in 2007 and 2008. Although we have done no more than mechanically carry across the interest rate assumed in the *ERP*, the number they have used seems to be a reasonable one as, following several years of growth equal to, or slightly above, that of productive potential, the stance of monetary policy would likely shift from its present stimulatory stance to one which is neutral.

These assumptions, all taken together, imply that the net foreign liabilities of the United States would rise to nearly \$8 trillion (60 percent of GDP) in 2008. The net outflow of income would rise from close to zero in the third quarter of 2002 to \$200 to \$300 billion or nearly 2 percent of GDP. And this would generate an overall deficit in the current balance of payments equal to 8 to 9 percent of GDP.

### THE PRIVATE SECTOR

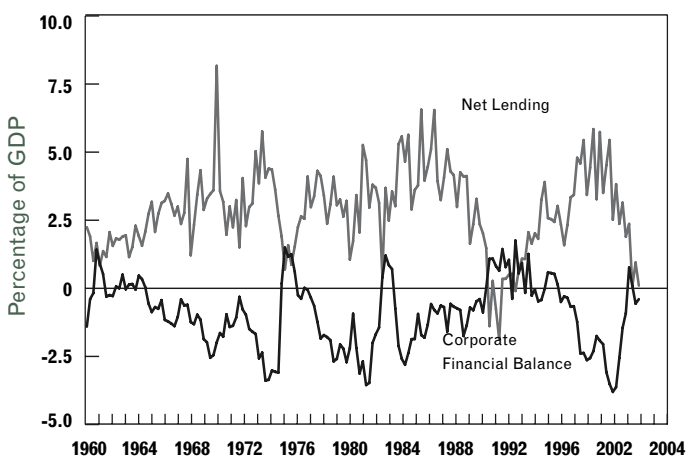
Chart 1 showed how the financial balance of the private sector moved, during the boom, from its historically normal range of about 3 to 4 percent of GDP to a wholly unprecedented minus 5.5 percent of GDP in the third quarter of 2000. Since then there has been a substantial reversion toward the historical norm, although in the fourth quarter of 2002 it was still 1.1 percent negative, implying that private expenditure at that point was still higher than private income. We start with a general presumption that, looking to the medium term, the private balance will continue to recover and eventually move

**Chart 5**  
**Short-Term Interest Rates**



Sources: NIPA, Flow of Funds, Federal Reserve Board, and author's calculations

**Chart 6**  
**Corporate Financial Balance and Net Lending**

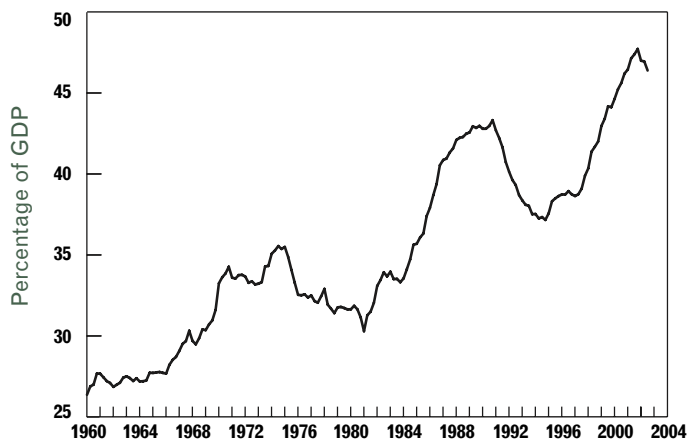


Sources: NIPA, Flow of Funds, and author's calculations

back into surplus. It helps to disaggregate the total private balance into the corporate and personal sectors.

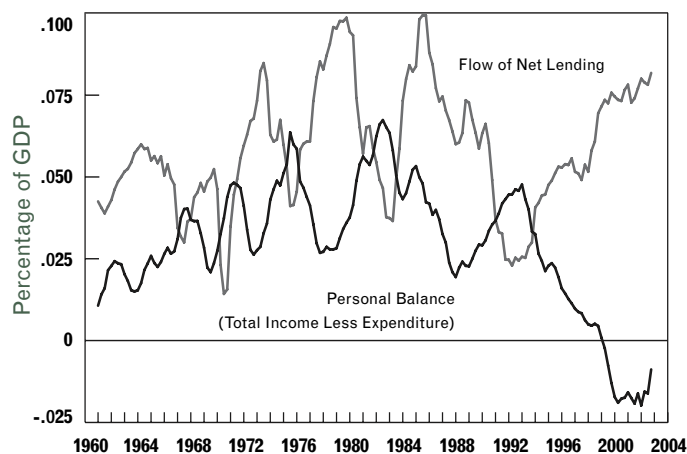
The lower half of Chart 6 shows that the corporate sector has normally been in deficit, with outflows exceeding income (gross of capital consumption), and therefore has normally been dependent for funds on external borrowing. By this criterion, there has been nothing unusual about the corporate experience during the whole period since 1992. Corporations increased their deficit by a large, but not extraordinary, amount during the boom and reduced it (again by a large, but not abnormal, amount) in the subsequent slowdown. The fluctuations in the financial balance were roughly matched by flows of

**Chart 7**  
**Corporate Debt**



Sources: NIPA, Flow of Funds, and author's calculations

**Chart 8**  
**Personal Financial Balance and Net Lending**



Sources: NIPA, Flow of Funds, and author's calculations

net lending, which rose a lot during the boom and have since fallen back. While these corporate flows look quite normal taking the cycle as a whole, it will be as well to remember, when it comes to making projections, that corporate debt *levels* have been raised to record highs. Chart 7 shows how corporate indebtedness rose to a record level relative to GDP. This was at least partly because the corporate sector was borrowing to buy back equity; corporations taken as a whole have been net purchasers of equity, presumably with the aim of maintaining share prices and financing stock options.

It was the behaviour of the personal sector that was truly exceptional. Chart 8 shows how, during the boom, the personal sector's financial balance<sup>10</sup> became negative to an

unusual extent; and how, since the slow recovery in the economy began, the sector has remained in heavy deficit. Spending in recent quarters was below normal (relative to income) by an amount roughly equal to 5 percent of GDP. And, as Chart 8 also shows, personal expenditure has been financed throughout the last 10 years by a rise in the flow of net lending that continued right up to the third quarter of last year.

The Fed has just published a comforting assessment of the present financial position of households<sup>11</sup> that emphasises that, with interest rates so low, the burden of debt service is generally quite tolerable. We have no quarrel with the Fed's assessment of the present position, but personal expenditure cannot be financed forever by a growing flow of net lending—that is, by a continuing rise *in the rise* in debt. The drastic fall in interest rates and the extreme ease with which equity in houses can now be “cashed out” have given a new lease on life to personal expenditure. But a rise of net lending cannot, by its very nature, be an abiding motor for growth of the economy; it can continue for a long time, but it cannot continue forever. Equity can be cashed out only as long as it exists; the process is a once-and-for-all affair. At some stage, perhaps when interest rates increase, the growth of debt will slow down so that it rises no faster than income; as that happens, the flow of net *lending* must fall from 10 percent of disposable income at the last reading to perhaps 4 or 5 percent, bringing a substantial check to the growth of personal expenditure relative to income and a corresponding reversion of the personal sector's financial balance towards its historical norm.

In making the projection of the balances shown in Chart 2, we have assumed that over the next few years, any return by the corporate sector to deficit will be more than offset by a significant recovery in the personal sector balance. Taking the private sector as a whole, we have assumed that the financial balance becomes slightly positive, rising to about 1 percent of GDP between now and 2008, still far below its long-term average.

Is it conceivable (one must ask oneself) that the private sector will provide the motor for expansion by plunging deeply once again into deficit? This seems improbable if only because of the unusually high level of debt that has already been incurred by both corporations and the personal sector.

#### IMPLICATIONS FOR THE BUDGET

There is no escape from the conclusion that if the primary balance of payments reaches 6.5 percent of GDP in 2008, if the

overall balance reaches 8.5 percent, and if the private deficit moves into moderate surplus, then the general government deficit<sup>12</sup> must, by accounting identity, reach 9 to 10 percent of GDP—a story of twin deficits with a vengeance. Yet, while in our exposition we have reached this enormous figure by making a logical inference from various other assumptions used to build the projection, it all fits together well as an economic story. Deficits in the balance of payments are usually feared because they have to be financed by external borrowing that may not be forthcoming on acceptable terms and because foreign debts have to be serviced. The argument put forward here is an entirely different one: that the developing balance of payments deficit is going to act as a formidable drag on demand. The present hemorrhage from aggregate demand, at 5 percent of GDP, is already far in excess of anything that has ever been experienced before (in modern times), though this is still being masked by the highly unusual private deficit (implying private expenditure in excess of income), which is likely to go further into reverse. The rise in the government's deficit is no more than is needed to offset these negative forces.

## IMPLICATIONS

The scenario illustrated in Chart 2 surely cannot come to pass. Insuperable political obstacles would be encountered long before the government deficit reached 9 percent of GDP, with its corollary that the government debt would rise by an amount equal to some 30 percent of GDP compared with present levels. Moreover, should anything like the one represented in our baseline projection really happen, the position then reached would be highly unstable<sup>13</sup>, with foreign debt so high, and rising so rapidly, that the economy could be kept going in later years only by ever larger injections from the public sector.

So, what gives? In our view, the most likely outcome, particularly in the early part of the period under review, is simply that the U.S. economy will not recover properly<sup>14</sup> but rather will enter a long, depressing era of “growth recession” with increasing unemployment and the ever present risk—with corporate and personal debt so high—of financial implosion.

There would appear to be only one antidote to this predicament, that net export demand provides the motor for sustained growth in the future; U.S. exports must rise faster than imports by very large amounts and for a long period of time. Some of the ways in which this might come about are

noted below. Each has its own serious problems, but all of them encounter one substantial disadvantage: U.S. residents would have to stop absorbing 5 percent more goods and services than they produce, with the corollary that fiscal policy would have to become tighter than at present, not looser as in our base projection.

The most congenial solution would be that the rest of the world somehow manages to expand rapidly and spontaneously. Yet this, given present attitudes and institutions, is a hollow suggestion; it would be madness for the United States to base its economic strategy on the assumption that it will be hauled out of stagnation by a discontinuous and autonomous expansion in foreign parts. At present, not only is the rest of the world itself locked into stagnation, it is looking to the U.S. economy to fuel the motor for its own growth.

The classic remedy for chronic external imbalance is, of course, devaluation. It is not inconceivable that devaluation of the dollar will come to the rescue, but there is no obvious policy gesture that the U.S. authorities can now take, with real short-term interest rates close to zero, which would bring this about on the huge scale necessary—even if this is what they wanted to do. Although the dollar has notoriously been weak against the euro in recent months, the more relevant “broad” index of the dollar's value<sup>15</sup> has hardly fallen since the beginning of 2002. It seems that surplus countries (e.g. Japan and China) are accumulating mountainous reserves that they have been using to prevent any natural rebalancing process from taking place. It is unclear what, if any, limits there are to this process. And it is doubtful whether a fall in the dollar, however large, could in practice generate the required (enormous) rise in net exports given that the market is so stagnant.

Before signing off, the use by the United States of nonselective tariffs, conditionally under Article 12 of the World Trade Organization, should be mentioned. It is possible to imagine circumstances under which recourse to protective tariffs might be the only way in which the U.S.'s strategic problem can be solved.

## CONCLUSION

This analysis has identified a major strategic predicament for the U.S. economy.<sup>16</sup> The most likely consequences of the massive and growing leak out of the circular flow of income will be, given present national and international policies, that there will be no proper recovery from the recent recession; and that

this stagnation will eventually have grave consequences for the rest of the world, which has come to look to the United States to give it momentum. A number of solutions have been outlined, but none of them can be relied upon, and some of them carry serious disadvantages. At some stage, it will have to be recognised that a new world solution must be found.

## NOTES

1. I am grateful to Alex Izurieta and Claudio Dos Santos for penetrating comments.
2. Federal Reserve Board's semiannual monetary policy report to the Congress before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate.
3. See, for instance, Bernanke, B. S., and M. Gertler 1999, "Monetary Policy and Asset Price Volatility" in *New Challenges for Monetary Policy*, proceedings of the symposium sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming, 77–128.
4. The primary balance of payments is defined as the overall balance less net payments abroad of interest, dividends, and profits. It is equal to the balance of trade in goods and services plus net unilateral transfers.
5. To spell it out,  $Y = PX + G + X - IM$  where  $Y$  is GNP,  $G$  is government expenditure,  $X$  is exports including net income from abroad, and  $IM$  is imports. Deducting taxes and government transfers,  $T$ , from both sides and rearranging, we have the relevant identity  $Y - T - PX = [G - T] + [X - IM]$ .
6. It illustrates, but obviously does not prove, any of these things; the diagram cannot distinguish between the effect of the budget on the economy and the effect of the economy on the budget, and so on. But a careful analysis of the causal factors at work confirms that the propositions that follow are correct.
7. *A Critical Imbalance in U.S. Trade, the U.S. Balance of Payments, International Indebtedness, and Economic Policy*. Public Policy Brief No. 23, 1995. Annandale-on-Hudson, N.Y.: The Levy Economics Institute.
8. The so-called "Houthakker" effect.
9. Obtained crudely by dividing the recorded stock lagged one period by the recorded flow of payments.
10. This differs from the conventional concept of personal saving in that income is defined as gross of capital consumption, and expenditure includes capital expenditure. If the personal sector's financial balance is negative, this necessarily implies that there is a net acquisition of debt or a net realisation (by the sector as a whole) of assets.
11. "Recent Changes in U.S. Family Finances: Evidence from the 1998 and 2001 Survey of Consumer Finances." *Federal Reserve Bulletin*, January 2003.
12. There are differences (definitions, timing, and coverage) between the deficit of the general government, which we are tracking here, and that of the federal government, but these pale into insignificance, given the huge figure we now tussle with.
13. On the assumptions used, the situation is not formally unstable since real interest rates are below the growth rate. The foreign debt would eventually stabilise at about five times GDP and the balance of payments deficit at about 15 percent—hardly an appetising prospect.
14. Assuming that geopolitical developments do not give rise to military expenditure on a scale far larger than anything so far indicated.
15. The Fed's broad trade-weighted index, corrected for inflation.
16. All the conclusions depend on the assumption that the official figures are broadly correct.



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