PSL Quarterly Review, vol. 62 nn. 248-251 (2009), 87-95

The developing recession in the United States

WYNNE GODLEY*

It is still insufficiently realised, even now, that the US and therefore the rest of the world may be on the brink of a severe and intractable recession. As recently as September 2000, it was commonly held that the US business cycle had been abolished for ever, while the "consensus" forecast was that US GDP would rise 3.7% between 2000 and 2001. The forecasts have proved wildly wrong but no-one has explained, other than in purely descriptive terms, how 3.7% has shrunk to a mere 1%. And undeterred by the errors, the consensus forecast, at the time of writing, is that there will be a quite smart recovery in the second half of 2002.

I think the undertow of optimism, insofar as it has an intellectual basis, derives from the view, which has progressively submerged the Keynesian model which was dominant in the early post-war period, that modern economies are giant market places which spontaneously deliver growth and full employment if the price mechanism is allowed to work properly. In the space available, I can only express my very strong disagreement with this "market" view and reassert my unreconstructed Keynesian belief that a necessary condition for economic growth is that there is an adequate expansion of demand; but that, for growth to be sustained, aggregate demand must be balanced in such a way that stocks of debt (foreign and domestic) do not get out of hand.

Recent developments in the US

The growth of aggregate demand in the US during the eight year period 1992-2000 was – a matter of fact – structured in a highly unusual way. To

---

* Levy Economics Institute of Baard College, Annandale-on-Hudson (USA); e-mail: godley@levy.org.
I am heavily indebted to Alex Izurieta for critical comments and for extensive help at every stage in the preparation of this article.

© Associazione Paolo Sylos Labini
BNL Quarterly Review, vol. 54 n. 219, December 2001, pp. 417-425

illustrate the point I have devised a measure called the 'real fiscal stance' or RFS, which has a strong affinity with the concept of a cyclically adjusted budget deficit. The RFS measures deflated outflows (expenditures and transfers) from the general government expressed as a ratio to the average rate of taxation, with numerator and denominator both corrected for the business cycle. More precisely, the RFS is equal to g_c/θ_c, where g_c is government outlays corrected for the business cycle and deflated by the GDP deflator and θ_c is corrected government receipts (t) as a proportion of full employment GDP. Thus, if the budget were balanced at 5% unemployment, government outlays would equal receipts, so

$$g = g_c = t_c = t.$$

As $t = \theta \cdot \text{GDP}$, it follows that under these circumstances

$$GDP = g_c/\theta_c = RFS.$$

In words, the RFS is constructed in such a way that if the budget of the general government were exactly balanced and if unemployment were steady at 5%, the RFS would be exactly equal to real GDP.

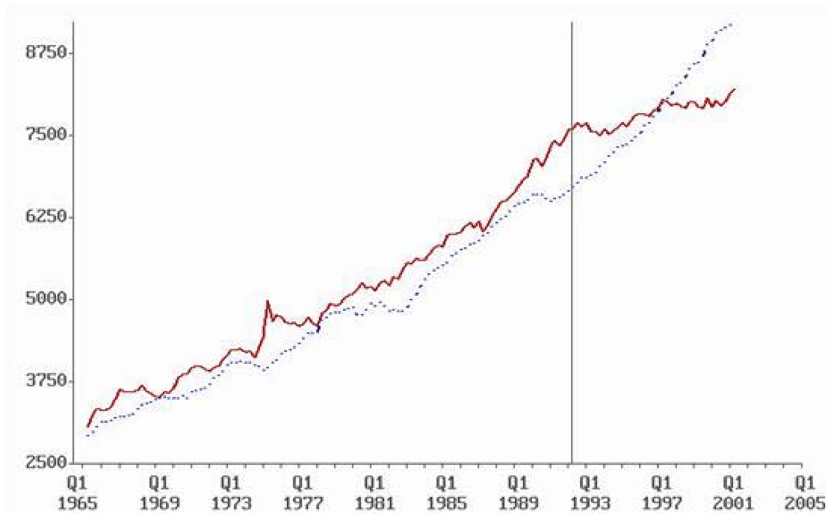
In the charts which follow, US net export demand has been included in the formula, now to be called the 'augmented fiscal stance' (AFS) defined as

$$(g_c + x)/(\theta_c + m_c),$$

where x is exports deflated by the GDP deflator and m_c is the average import propensity corrected for the business cycle. If the budget were balanced and simultaneously the balance of payments were zero, at 5% unemployment the AFS would be exactly equal to real GDP.

Chart 1 shows the AFS and the real GDP over the whole period from 1960 to the third quarter of 2001. Until 1992 the AFS rose at roughly the same rate as the GDP and provided, according to my Keynesian way of thinking, the main driving force behind the expansion of aggregate demand. The AFS, throughout this 32 year period, was invariably in excess of GDP, implying that the private sector as a whole was in financial surplus. This is in accordance with the expectation of Keynesian monetary economists (for instance Hyman Minsky) that in a growth context the government budget will normally be in deficit, supplying financial assets, net, to the private sector.

Figure 1 – *Augmented fiscal stance and real GDP*

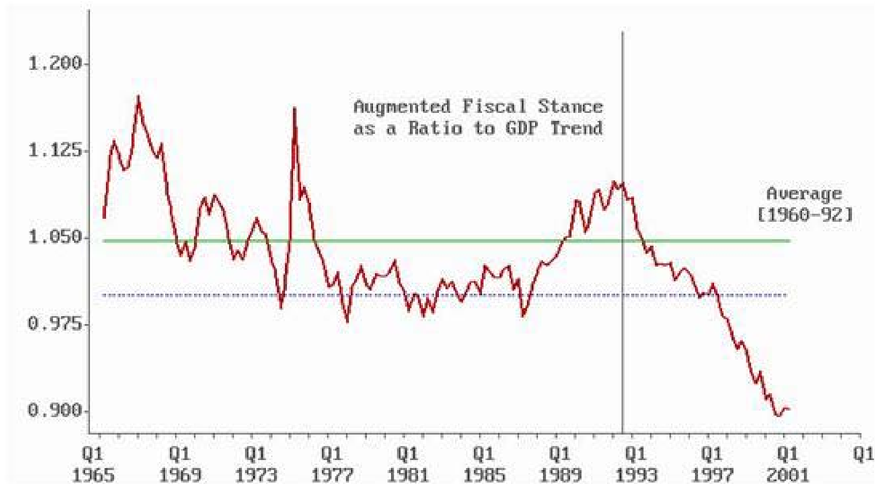


Source: National Income & Production Accounts (NIPA), author's calculations.

As the chart shows, the path of the AFS, and its relationship to real GDP, changed dramatically after 1991. The AFS more or less ceased to expand and after 1997 it fell progressively below GDP; in other words the exogenous forces which had driven aggregate demand upwards for the previous 32 years (at least) ground to a halt in 1992 and contributed nothing significant in subsequent years.

Figure 2 shows the ratio of the AFS to full employment GDP. Until 1992, the AFS almost invariably exceeded full employment GDP; on average the excess was 4.5%. Thereafter it fell like a stone for nine years. In the second quarter of 2001, the AFS was nearly 15% below what had been normal prior to 1992. Translated into dollars, government outlays plus exports would have had to be some $600 billion per annum (6% of GDP) higher than they actually were in mid-2001 in order to restore the AFS to its normal relationship to GDP.

Figure 2 – *Cyclically–corrected, augmented fiscal stance as a ratio to full employment GDP*



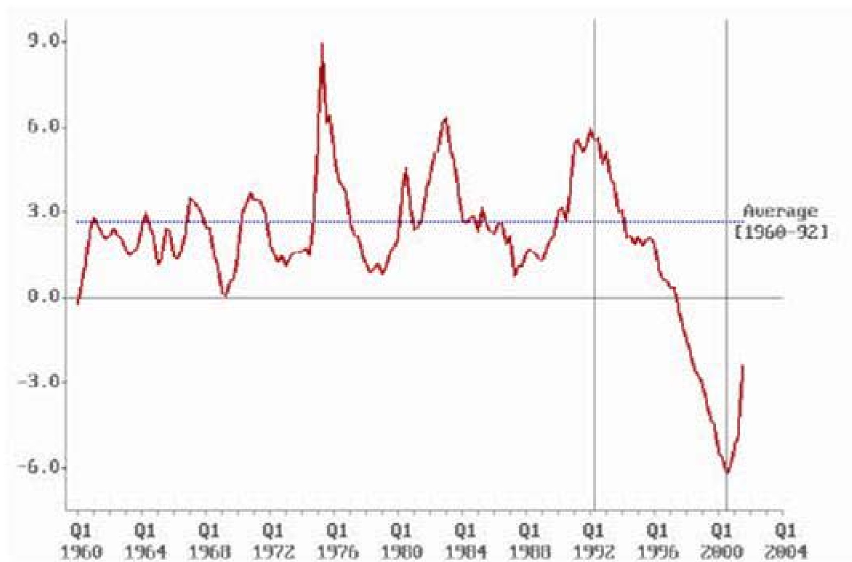
So what has driven the US economy since 1991?

There is a very clear answer to this question. It is that the uniquely restrictive effect of fiscal policy and net export demand was more than offset by a wholly exceptional rise in private expenditure *relative to* disposable income. Chart 3 shows the private sector's financial balance (the gap between total disposable income and total expenditure) since 1960. For 32 years there was a surplus which fluctuated around 3% of GDP. Between 1992Q1 and 2000Q3 there was an astonishing fall in the private balance equal to 12% of GDP; this was the amount by which the rise in private expenditure exceeded that of private disposable income. In 1997 the private balance became negative for (effectively) the first time and it continued to plummet until the third quarter of 2000, by when there was deficit equal to 6.2% of GDP.

Private expenditure could not have exceeded income by growing amounts in this way unless the private sector was borrowing or realizing financial assets on a growing scale. And indeed, in the second quarter of

2001 the indebtedness on the (non-financial) private sector as a whole had reached 172% of disposable income – far higher than at the peak of the previous boom. Debt of the personal sector reached a record 120% of disposable income, while that of the corporate sector was 8 times as large as cash flow (undistributed profits gross of capital consumption) – yet another record.

Figure 3 – *Private sector financial balance as percentage GDP*



But, as I have for many years been arguing, while debt to income ratios can rise for a long time they cannot rise for ever. The high (and rising) gearing of corporations makes them increasingly vulnerable to a fall in profits and sets a limit to the extent to which they can sustain asset prices by buying in their own equity. And even though households' net worth may have been boosted by the rise in asset prices, debts have to be serviced in cash which can only come from income or from net realisation of assets and this sets a limit to the extent to which households can incur debt. Moreover, very high debt/income ratios render households vulnerable to a fall in asset prices or incomes. But while it is easy to see that debt/income ratios cannot

expand beyond a certain point, the inference is not so obvious that debt only has to stabilise as a proportion of income for the net flow of credit to the private sector, and therefore private expenditure as a whole (relative to income) to *actually fall* compared with recent levels.

Until fairly recently I have been unwilling to hazard a guess as to when the turning point would come. But it has become increasingly clear during the course of 2001 that the process of implosion has indeed started. As Chart 3 shows, the private deficit started to fall in the last quarter of 2000; and it has been falling quite rapidly ever since.[1] The turning point was set off by a fall in investment and this was reinforced by a large fall in asset prices, a slowdown in consumption, a rise in unemployment and the cumulative effect of all these things interacting with one another.

The prompt and aggressive reduction in short term interest rates by the Federal Reserve, which has sustained asset prices and significantly reduced the cost of mortgage borrowing, will moderate the pace of the implosion, while sundry measures of fiscal relaxation will add to the growth of aggregate demand. Yet it seems probable that the rise in the private sector's financial balance will indeed continue until a normal relationship between disposable income and expenditure is restored. The main reason for taking this view is that with falling investment, employment and profits, corporations and households will seek to stabilise or even reduce their debt burdens, thereby putting the whole process of credit expansion (the sole driver of the expansion up to now) into reverse. It is worth recalling that, while the emergence of a private deficit in excess of 6% of GDP (or anything approaching that amount) has never before happened in the US, similar deficits did occur in some other countries, notably the UK and Sweden, about eleven years ago. In each of these two cases, having reached 6%, the private deficit did indeed revert and the process did rapidly generate, in each country, a very severe recession.

There are three major points to be made in connection with the medium term prospect adumbrated above.

First, the eventual scale of the fall in private expenditure relative to

[1] The fall was particularly large in the third quarter of 2001 but that is probably misleading; it was almost certainly a one-off consequence of the tax rebate which caused a blip in personal disposable income

income, and its implications for activity and employment, are both extremely large. If the private financial balance were to reach the level which, prior to 1992, was normal relative to income, this would have the effect of removing $ 5-700 billion from aggregate demand. If the reversion were to take place quickly and if it were to overshoot, as happened in the UK and Sweden eleven years ago, there could be a recession, notwithstanding the fiscal relaxations already in the pipeline, as severe as occurred in 1982; that is, there could be a 2% fall in output between this year and the next with unemployment rising (over a longer period) towards 8 or 9%. If the reversion were to proceed at a moderate pace, lasting two or three years, there would probably be a prolonged period of sub-normal growth which would yet be perceived as a long recession, since unemployment would be rising steadily. In either case the fiscal stimulus which has already been put in hand, together with any further stimulus currently under consideration, looks wholly inadequate.

Second, a recession, or prolonged stagnation, generated in the way suggested above would not have much, if any, tendency to recover spontaneously as would be the case if it were being caused in one of the usual ways – for instance by a fall in investment in fixed or working capital. The reason for this is that we are envisaging a reversion from a wholly abnormal state of affairs, in which private expenditure greatly exceeds income, to a normal one, in which income moderately exceeds expenditure. It is an implication of this view that the whole stance of US fiscal policy since 1992, which generated a much praised move of the budget from deficit into surplus, was totally misconceived. It is unfortunate that the effects of the increasingly tight fiscal stance were compounded by a large increase in the balance of payments deficit, which has had the effect of changing the US from being the world's largest creditor into being the world's largest debtor.

Third, it is hardly conceivable that the US will be able to reverse a recession (or prolonged stagnation) by unilateral measures which stimulate domestic demand. This is because the deficit in the US current balance of payments, even after three quarters of stagnant output and rising unemployment, is still about 3.5% of GDP. The immediate prospect for US exports (which have been falling sharply) looks very bleak because

demand and output in the rest of the world is weakening, while the dollar remains strong. It therefore seems unlikely that, if US domestic demand were increased enough to restore the growth of GDP so that it matched the growth of productive potential (not less than 2.5-3% per annum), a balance of payments deficit of truly alarming proportions would open up. As a rough indication, using my simple model of the US economy,[2] I estimate that the balance of payments deficit could rise to 7% of GDP – or more – during the next five years if domestic demand and output were raised unilaterally in this way. At the same time the net overseas indebtedness would roughly double, reaching at least 40% of GDP in 5 years time.

A world problem

It is generally recognized, for instance in the most recent analysis published by the IMF, that the rest of the world, more or less in its entirety, is in an unusually stagnant or depressed condition. Thus, a prolonged period of recession or sub-normal growth in the US could not come at a worse time. The US cannot look to the rest of the world to contribute much if anything to aggregate demand at home, even should there be a devaluation of the dollar. And the rest of the world, which has benefited enormously from the US expansion, will have one of its main motors disabled.

Whether or not we are at the inception of a period of intractable stagnation worldwide, we should recall that, just as market forces have failed to maintain the momentum of the expansion, they may also, if left to themselves, fail to generate a spontaneous recovery at any stage. As it has been shown above, the US already has such a large balance of payments deficit that it may be unable to generate a recovery simply by expanding domestic demand. One implication is obvious: worldwide recovery may only be possible if there is worldwide reflationary action. However, there is no guarantee that, even if the world were to reflate together, chronic imbalances would not continue, particularly as exchange rates, now that

[2] W. Godley (1999), "Seven unsustainable processes: medium-term prospects and policies for the United States and the world," *Special Report*, Levy Economics Institute, July.

international capital transactions are uncontrolled, have ceased to be instruments of policy.

These ideas may run counter to the prevailing orthodoxy, and there exist neither appropriate institutions nor agreed principles of action which could put them into effect. However, should an intractable recession or stagnation develop worldwide (implying that market forces have in some measure failed us) a whole range of policies, including the use and co-ordination of fiscal policy, the regulation of international capital transactions, as well as trade in goods and services, should be seriously considered.