

The US economy: weaknesses of the ‘strong’ recovery

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1. A conceptual framework

Macroeconomic analysis is facilitated if the main income and expenditure variables which make up the GDP are arranged in a double entry format so that they can all be seen as transactions involving at least two parties. Such a framework shows how the gap between each sector’s receipts and outlays implies an equivalent rise or fall in its net acquisition of financial assets. One conclusion will be that financial balances (relative to income flows) must stay within certain limits if debts are not to grow excessively, implying that the monitoring of these balances may yield a warning that unsustainable processes are at work. Furthermore, the fact that the net acquisition of financial assets by any one sector necessarily implies an equivalent change in the opposite direction in the

Figure 1 - *A Simplified Transactions Matrix*

	Income / Expenditure	Production	Govt	Foreign sector	Σ
1. Private exp.	- PX	+ PX			0
2. Exports		+ X		- X	0
3. Govt. exp.		+ G	- G		0
4. Imports		- IM		+ IM	0
5. GDP	+ Y	- Y			0
6. Tax, fact. paym. etc.	- TP		+ T	- TF	0
7. Financial balances	+ NAFA	0	- PSNB	- BP	0

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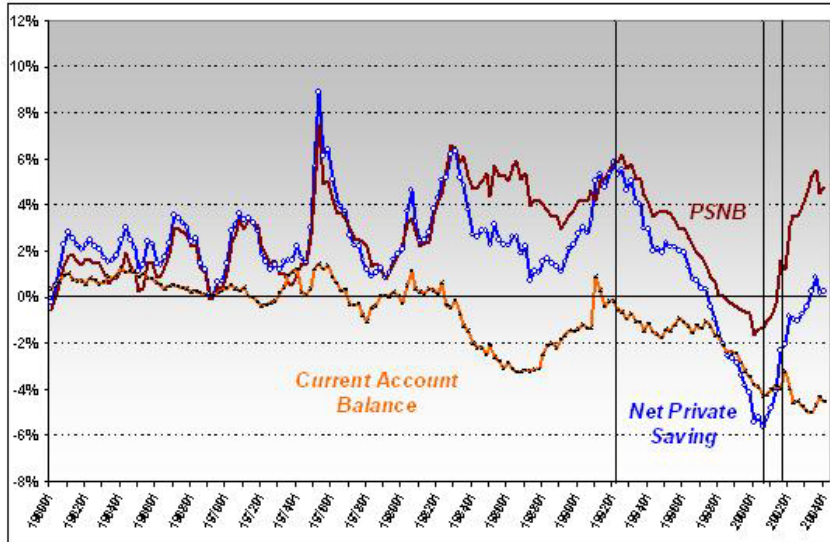
sum of net acquisition by other sectors, has strong implications for the way in which targets for public borrowing should be assessed.

In this matrix the national income identity is shown, reading vertically down column 2, as the appropriation account of a postulated production sector. It says that gross domestic product, Y , is equal to private expenditure, PX , plus government expenditure, G , plus exports, X , less imports, IM . Every item in the GDP identity has a counterpart with the opposite sign of some other column. Taxes less transfers, T , are received or paid by the government while net property income, taxes and transfers, TF and TP , are paid by respectively the external and private sectors. There is a total in line 7 which makes public borrowing, $PSNB$, equal to the private net acquisition of financial assets, $NAFA$, (that is, private saving less investment) minus the balance of payments surplus, BP minus or plus the deficit.

2. Some history

Figure 2 shows the history of the three financial balances in the U.S. between 1960 and 2004 Q1, all expressed as percentages of GDP. The private balance and the balance of payments are both drawn as surpluses while the government balance is drawn as a deficit; these signs are chosen so that the private balance is clearly seen as the sum of the other two. The government budget has almost always been in deficit, generally cycling around 2-3% of GDP. The private balance has generally been positive, averaging nearly 2%. The current balance of payments was close to zero until the early eighties but has been trending downwards since then.

Particular interest attaches, in the first instance, to the period 1992-2000 marked by the first pair of vertical lines. Towards the end of that time there was a veritable tidal wave of self-congratulation in the U.S. public discussion. There had just been the longest period ever of uninterrupted growth: there was a “New Economy” christened “Goldilocks” (not too hot and not too cold): the good times were here to stay; Alan Blinder compared the U.S. economy to “Old Man River” who

Figure 2 - *Balances of the Main Sectors of the US Economy*

just kept rolling along, while Edmund Phelps declared that growth had become structural; and so on. There had been a steady improvement in the general government's budget which had, exceptionally, achieved a surplus. Some people attributed the successful performance of the economy, at least in part, to this surplus because it had allowed interest rates to fall, thereby stimulating investment. See, for instance, Greenspan (2000, p. 2)

“[...] by substantially augmenting national saving, these budget surpluses have kept real interest rates at levels lower than would have been otherwise. This development has helped foster the investment boom that in recent years has contributed greatly to the strengthening of U.S. productivity and economic growth.”

At the same time the Congressional Budget Office (CBO) was predicting, on the assumption that rapid growth would continue, that the budget surplus would go on increasing over the subsequent ten years. It

seemed that the use of fiscal policy to stimulate the economy had been finally and forever foresworn.¹

3. Some analysis

Yet it should only have needed a glance at the configuration of financial balances to infer that a situation had been developing which was totally unsustainable. Throughout the Goldilocks period the change in the government's balance had steadily, and on an increasing scale, been withdrawing purchasing power from the economy; there had been a record 'improvement' in the budget balance equal to nearly 8% of GDP, so that by the end of the period it was in substantial surplus. And net export demand had also been subtracting from aggregate demand. The current account balance had deteriorated by about 4% during this eight year period and a record deficit had opened up, causing a negative net foreign asset position equal to some 16% of GDP. It could therefore be inferred, using nothing more than the system of identities displayed in the matrix table, that the motor driving the economy had resided entirely in a spectacular rise in private expenditure relative to disposable income causing the private balance to fall by an amount equal to 12% of GDP into uncharted negative territory. Furthermore it was easy to ascertain that this private sector deficit had itself been powered by a prolonged surge of borrowing, resulting in record levels of household and corporate debt relative to income.

It was this pattern of balances which led us, in a series of papers starting in 1999,² to point out that the rise in private expenditure in excess of income could not continue for ever and that the financial balance would eventually revert towards its long term average. When this happened the stance of fiscal policy would have to be transformed if a

¹ See, for instance, CBO (2001, p. 18): "Net indebtedness" of the Federal Government was expected to turn into positive by 2009.

² Godley (1999a, 1999b, 2000, 2001a, 2001b, 2002, 2003), Godley and Izurieta (2001a, 2001b, 2002a, 2002b, 2003), Godley and Martin (1999), Godley and Wray (1999), Godley and MacCarthy (1998), Izurieta (2003a, 2003b).

severe recession was to be avoided; also that net export demand would eventually have to be raised as well. In “Seven Unsustainable Processes” (Godley, 1999b, p. 16) we wrote, in mid 1999,

“The main conclusion of this paper is that if, as seems likely, the United States enters a period of stagnation in the first decade of the new millennium, it will become necessary both to relax fiscal policy and to increase exports relative to imports....[This] paper does not argue in favour of fiscal fine tuning; its central contention is rather that the whole stance of fiscal policy is wrong and that it is much too restrictive to be consistent with full employment in the long run...[O]ver the next five to ten years, it will be not only necessary to bring about a substantial relaxation of fiscal policy, but also to ensure by one means or another, that there is a structural improvement in the United States’s balance of payments.”

This is all beginning to seem obvious but, strange to say, it needed courage to write those words because they ran so strongly counter to the conventional view at that time.

During 2001 it gradually became clear that the party was coming to an end because the private deficit had at last turned round – expenditure had fallen relative to income. In a paper “The Developing Recession in the United States,” published by the BNLQR at the end of that year we drew a chart (p. 421) which described the private deficit up to 2001 Q3 as indicated by the third vertical line in the chart shown above. In the text additional evidence was presented that the fiscal stance was still unsustainably tight and it was argued (pp. 422-23) that without a huge further change in fiscal policy the US was in for a severe recession. On the other hand (we wrote)

“It seems [likely]³ that if US domestic demand were increased enough to restore the growth of GDP enough so that it matched the growth of productive potential..., a balance of payments of truly alarming proportions would open up ...[T]he balance of payments deficit could rise to 7 per cent of GDP – or more – during the next five years ... At the same time the net overseas indebtedness would roughly double, reaching at least 40 per cent of GDP in five years time.”

³ Unfortunately the word “unlikely” appeared here in the original text but the sense of the passage makes it quite clear that this was a typo.

This was a conditional prediction which we didn't really believe could be fulfilled because it seemed impossible at that time that the budget could go so far into deficit or that the current account balance could be allowed to deteriorate so much. We reached the conclusion prematurely that for the US to achieve adequate growth there would have to be some kind of co-ordinated reflation in the rest of the world combined with measures which would increase the net export demand for US goods and services; and that if this did not happen the recession would get worse.

But the conditional prediction turned out to be the right one! As the chart shows, a gigantic fiscal expansion, the largest of the post war period, did occur, causing the budget to deteriorate (compared with 2000) by about 6% of GDP. At the same time, the balance of payments deficit looks as though it may indeed keep rising towards 7% in 2006 while the US's net foreign asset position is probably already around 35% of GDP negative.⁴

Yet this change in fiscal policy stance took place with hardly anyone admitting that an earthquake had taken place in the system of ideas supposedly underpinning the formation of economic policy. It has not been uncommon to read articles putting the recent performance of the U.S. economy (with its recovery following an unusually short and shallow recession) entirely down to its inherent vitality and flexibility and failing altogether to mention the fiscal expansion. Chairman Greenspan seems not to have noticed that the growing deficit has been accompanied by interest rates that are even lower than during the surplus era.

But while it seems to be generally held that a solid and durable expansion is now taking place in the US which the rest of the world can

⁴ This statement is warranted by the NIPA which show a deficit of about 5% in the first quarter of 2004. But there is reason to suppose that the official figures flatter the true underlying picture. If net undistributed profits from foreign direct investment (which do not enter the domestic income flow and are in no sense available to finance the deficit in transactions) are excluded, the deficit comes to about 6%. The bizarre story told by the NIPA, that notwithstanding negative net foreign assets worth about 35% of GDP, net property income from abroad is significantly positive, is probably an artefact of the measurement conventions.

reliably count on, the analysis using financial balances must call this conclusion seriously into question.

A major uncertainty concerns the future path of private expenditure relative to income. As the chart shows, the private balance as a whole has now regained positive territory but is still below its long term average. More detailed analysis of private sector behaviour reveals that more than all the increase in the private balance was generated by the corporate sector, which is in substantial surplus following a very rapid rise in profits. By contrast, spending by the personal sector (consumption and investment combined accounting for 74% of GDP) is still far in excess of income. It seems impossible, at this stage of the game, that personal spending could again act as the motor driving a sustained expansion because borrowing, the burden of household debt relative to income, and also household debt relative to net worth, are all close to record highs. On balance, taking the personal and corporate sectors together, it seems improbable that private expenditure will rise much, if at all, relative to income; if anything it seems more likely that the net acquisition of financial assets will continue to rise – and the rise could be substantial if there were to be a significant increase in interest rates.

If we make the assumption that the private balance remains close to zero over the next few years (still more if it rises to its habitual level), an important conclusion follows by logical inference – namely the government deficit in the future must be at least as large as the balance of payments deficit. The Bush administration is promising to cut the deficit in half without, seemingly, realising that this may be a logical impossibility unless there is a large improvement in the balance of payments.

But it is far from clear that the US balance of payments will improve at all – always supposing that growth continues fast enough to keep unemployment constant or falling. The current account deficit increased through the period of recession and may well continue to increase if the economic expansion is kept going by yet more fiscal stimulus. For a time it looked as though a weakening dollar might come to the rescue. But the dollar has recently been recovering because traders have started to expect an increase in US interest rates while the Pacific Rim countries, who feel

the need to export even more to the US, have continued to buy dollars precisely in order to keep the dollar strong; at the end of April the “broad real” dollar index was 10% lower than in the first quarter of 2003 which is probably not enough to generate export led growth for long. The current account balance would be adversely affected if interest rates were now to rise, because the net financial indebtedness of the US (that is, the net foreign asset position excluding direct investment) is now equal to about 35% of GDP; rough calculations suggest that each percentage point on interest rates adds an amount equal to about 0.4% (of GDP) to the balance of payments deficit.

So the medium term alternatives for the US economy look pretty stark. Either an uncovenanted and sustained rise in net export demand provides a motor for expansion in a quite new way: or the fiscal policy continues to generate twin (budget and balance of payments) deficits, possibly growing, as far as the eye can see with surely unacceptable implications for indebtedness at home and abroad; or the US economy relapses into stagnation. Of these possibilities only the first gives promise of sustained growth in the medium term. But it is unlikely that it will come about without a new policy initiative worldwide. The rest of the world must stop relying on the US to provide the motor for growth. It will have to generate a motor of its own and, probably, accept that the dollar must depreciate quite a lot more.

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