WYNNE SAW IT COMING

L. Randall Wray, Levy Economics Institute
and University of Missouri—Kansas City

www.levy.org; www.cfeps.org;
wrayr@umkc.edu

No One Saw it Coming

- Two Falsehoods: Unforeseeable and Unpreventable; Black Swans with Fat Tails
- Reality: Financial Crisis Inquiry Report
  - A “Man”-made crisis: Captains of Finance & Public Stewards caused it and ignored warnings
- Reality: Many economists saw it coming
  - Godley; Baker; Minsky
- Reality: Everyone saw it coming
  - YBG-IBG: you’ll be gone, I’ll be gone
  - Goldman&Paulson
  - It was Wall Street’s ***desired*** outcome

My Education

- Minsky/Kalecki/Levy Profits equation
  - P=I+def+NX+Cp-Sw
  - What if Sw<0
- Godley alternative: 3 sectors
  - If private sector runs deficit, govt sector can run surplus, given balanced current acct

Wynne's Approach

- Alternative approach to Money: stock-flow consistent→ no independent Ms and Md functions
- Discipline analysis with stock-flow consistency
  - Minsky: discipline with balance sheets
- Behavioral equations and thus causation underlies analysis
- Repeated Simulations → progressively better understanding of what determines stability and how system responds to change

It all started with Goldilocks

- 1996: US Federal Govt begins to run surpluses; continued for 2.5 years
- Clinton projects surpluses for next 15 years
- All Gov’t debt will be retired

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hat's News—

* * *

World-Wide

BUDGET SURPLUSES MAY WIPE OUT the federal debt by 2015, Clinton boasted.

The president, announcing the latter forecast, said the government has the opportunity to cut taxes, add a prescription plan to Medicare and extend the life of the Social Security trust fund. Some Republicans said they were open to a compromise, but many remained skeptical. The White House said surpluses are now projected at $98.8 billion for this fiscal year and $187.3 billion for fiscal 2000. (Articles on Pages A3 and B1)

Some details emerged on Clinton's Medicare plan, due out today. A big pharmacy benefits firm says prices of top prescription drugs surged recently.

* * *

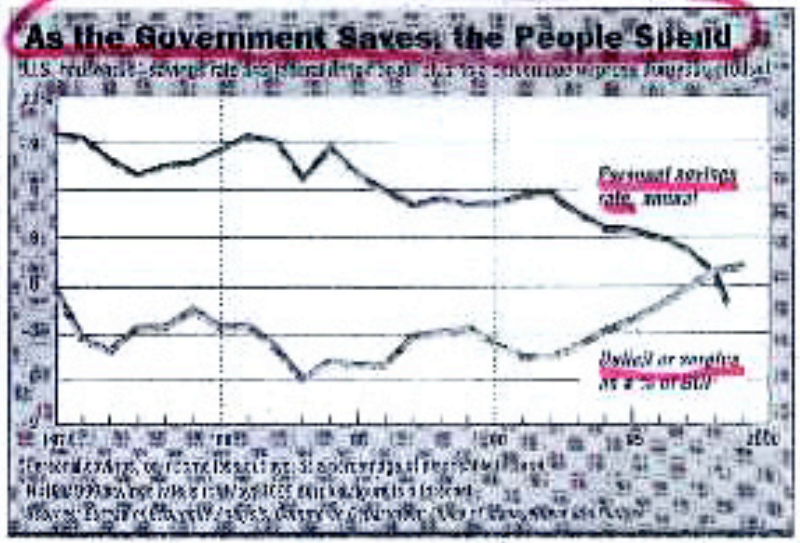
Webster Hubbell agreed to a plea bargain with Whitewater prosecutor Starr that will spare the Clinton friend and ex-aide any additional prison time. Starr associates said it was unlikely Hubbell's cooperation would lead to charges against the Clintons, and the accord could constitute the final chapter of the Whitewater saga. (Article on Page A10)

* * *

Ethnic Albanian refugees returned to their homeland in the first organized U.N. repatriation convoy as Kosovo Liberation Army soldiers turned over guns to NATO. Serbian Orthodox leaders appealed for peacekeepers' protection as they marked the 1389 Serb defeat by the Turks at Kosovo Polje. (Articles on Pages A10 and A11)

Inside Today's Journal

Work Week



Less Than Zero

Few Americans Heed Washington's Urging For Bigger Nest Eggs

Savings Rate Declines Again As Tax Breaks, Caveats Collide With Prosperity

Raiding 401(k) for a Dream

By JACOB M. SCHLESINGER
Staff Reporter of THE WALL STREET JOURNAL

WASHINGTON — For a quarter century, politicians have been tinkering with the tax code and otherwise creating incentives to encourage people to save. Yet Americans have only become more profligate.

In 1974, the year Congress created the Individual Retirement Account, Americans saved 9.9% of their paychecks. These days, Americans are spending everything they make, and then some. Yesterday, the Commerce Department said the official household savings rate in May fell to minus 1.9%, the lowest level since the Great Depression.

The almost universal response from Washington: Keep trying. President Clin-

Big Spenders

The Commerce Department said spend-

Goldilocks was Doomed

- The Perfect Fiscal Storm
- Why? The Three Balances
- The Meaning of Zero:

  0=Private Bal + Govt Bal + Foreign Bal

Sectoral Balances Approach

- Fundamental Principles:

  A. For every surplus there must be an equal deficit

  B. Flows accumulate to stocks

- Two sectors:

  Govt Balance + Private Balance = 0

  -i. Govt Deficit = Private Surplus

  -ii. Govt Surplus = Private Deficit

Sectoral Balances (Con't)

- Three sectors: Govt Balance+Domestic Private Balance+Foreign Balance=0

  -i. Govt Deficit = Private Surplus + Current Acct Def

  -ii. Govt Surplus = Private Def + Current Acct Surplus

  -etc

Stock-Flow Consistency

Flows accumulate to stocks: Deficits→Debt
Surpluses→ Net Financial Wealth

A. Two Sectors: Govt Debt = Private Net Financial Wealth

- Govt Def → Govt Debt = Private Net Financial Wealth

B. Three Sectors: Govt Debt = Domestic Private NFW + Foreign NFW

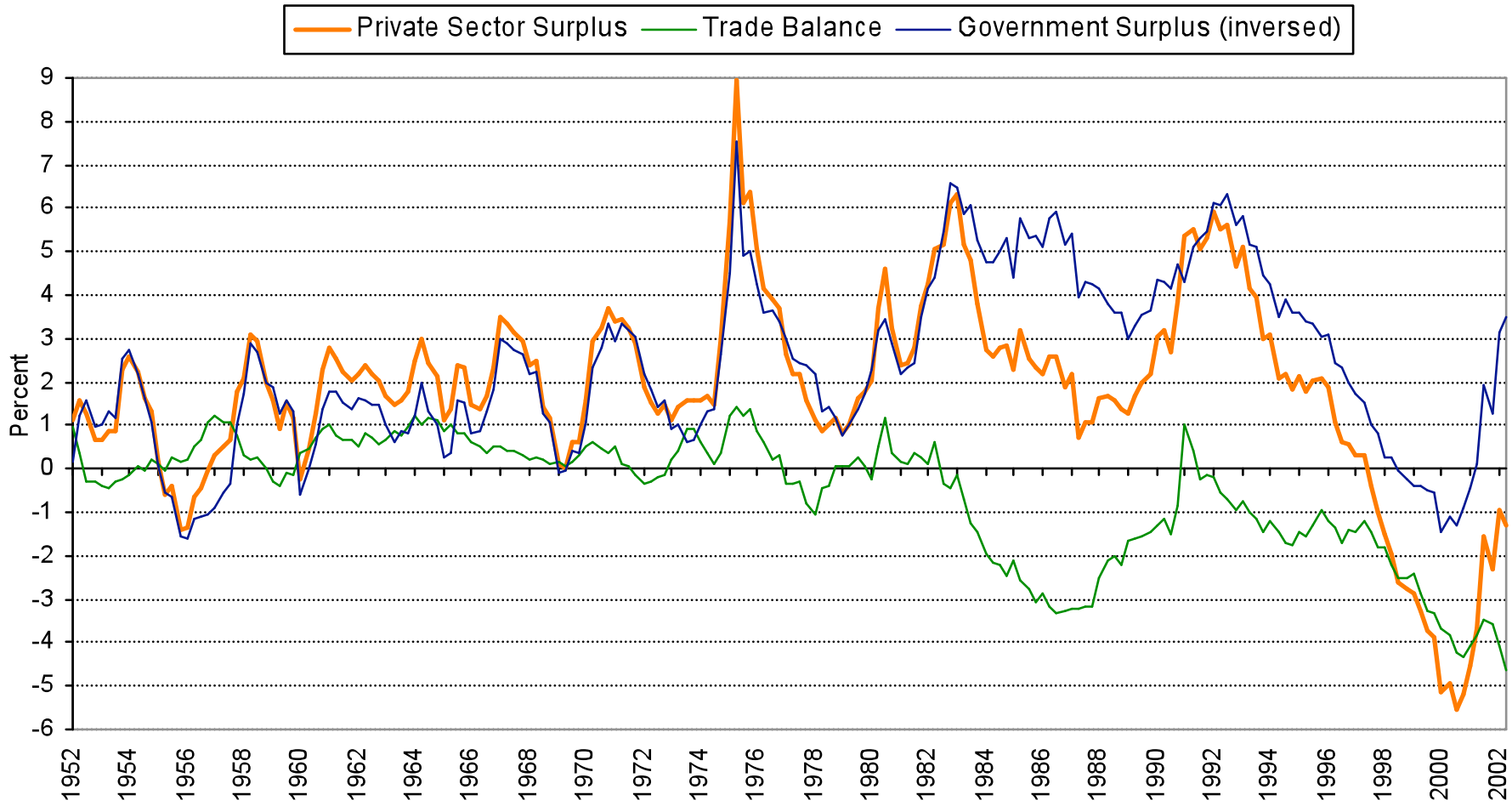
i. Govt Def →Govt Debt = Domestic NFW + Foreign NFW ($)

(NB: domestic private and foreign sectors can accumulate other nongovt assets, depending on balance position; ie foreign can accumulate private domestic debt if current acct is negative)

SUMMARY: Three Sectors

- Nongovt “Inside” net financial wealth created annually = zero
  - Subsequent portfolio adjustments → Prices and returns on stock of financial assets adjust
- Nongovt Net Financial Wealth created annually = Govt Def
  - Subsequent portfolio adjustments → Prices and returns on stock of Treasuries adjust
- ROW Net Financial Wealth created annually = CA Deficit
  - Subsequent portfolio adjustments → prices and returns and exchange rates adjust (floating rate)

Figure 1: Financial balances of the US (% of GDP)



Source: Wynne Godley calculations based on Flow of Funds data. NAFA=private sector net acquisition of financial assets (surplus); BP = balance of payments (surplus); PSBR = public sector borrowing requirement (or, general government deficit).

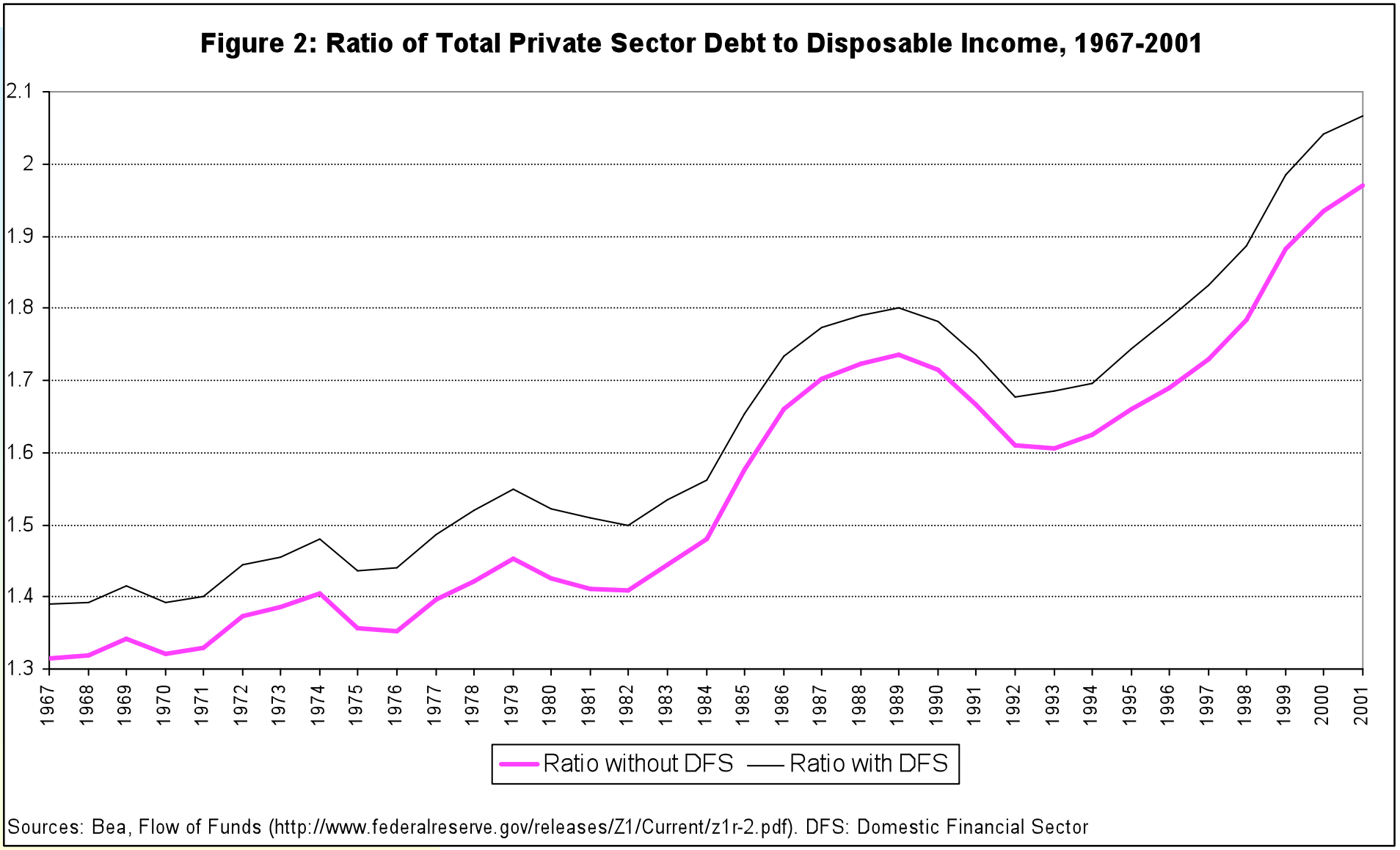


Figure 2: Ratio of Total Private Sector Debt to Disposable Income, 1967-2001
2.1
2
1.9
1.8
1.7
1.6
1.5
1.4
1.3
1967
1968
1969
1970
1971
1972
1973
1974
1975
1976
1977
1978
1979
1980
1981
1982
1983
1984
1985
1986
1987
1988
1989
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1996
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1998
1999
2000
2001
Ratio without DFS
Ratio with DFS
Sources: Bea, Flow of Funds (http://www.federalreserve.gov/releases/Z1/Current/z1r-2.pdf). DFS: Domestic Financial Sector

GOLDILOCKS AND THE THREE BALANCES

- **Easy to show that Goldilocks was driven by unsustainable private sector deficit spending, which resumed in the recovery.**

What drove private deficits?

Democratization of credit

CRA, redlining, deregulation

memories of great depression faded

Stagnant wage income

- **With current acct deficit = 4% of GDP, private sector deficit (5.6%) was sum of the overall budget surplus (1.6%) and the current account deficit: 5.6% = 1.6 + 4**

Clinton Boom Revisited

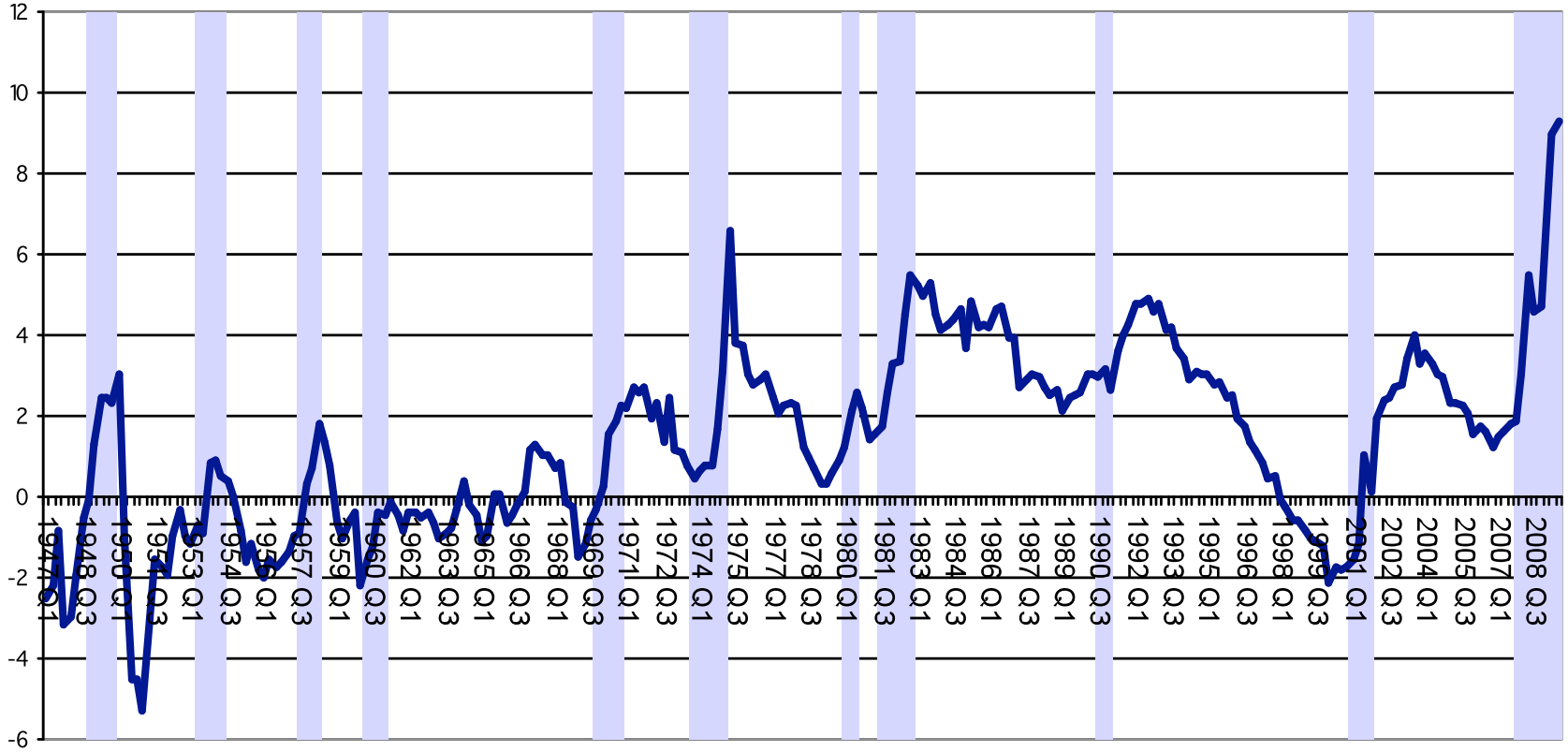
- Most thought the Clinton budget surplus was a great achievement (and projected the surplus to continue for 15 yrs or more--until all debt retired for first time since 1837).
  - Lockboxes endorsed by Summers&Yellin&Rubin
  - Fed govt debt ratio 6% by 2010!!!

- By identity means a private deficit and loss of wealth

- When firms and households retrenched, economy collapsed and budget deficit restored

- (Those who are ignorant of history are doomed to repeat it: 6 previous sustained budget surpluses, were followed by our 6 depressions! 1819, 1837, 1857, 1873, 1893, 1929)

Federal Government Deficit/Surplus (% of GDP) and Recessions



Source: Bureau of Economic Analysis and National Bureau of Economic Research

Note: The Sign of the Deficit/Surplus is Reversed

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Reprise: Implications of Noose Tightening (2005)

- In late 1990s, tax revenues grew 10% per year, much faster than G (3%) or real GDP (4%)
  - By 2000, real GDP growth fell to zero, tax revenue began 4-yr fall (Mar 2002 falling by 15% per year)
- Revenues now increasing at 15%—far outstripping growth of G & nominal GDP (less than 7%), and real GDP (3%)
- In the past, growth of taxes at rate far above GDP was followed by recession; current excessive growth of taxes is unprecedented—and projected to continue!

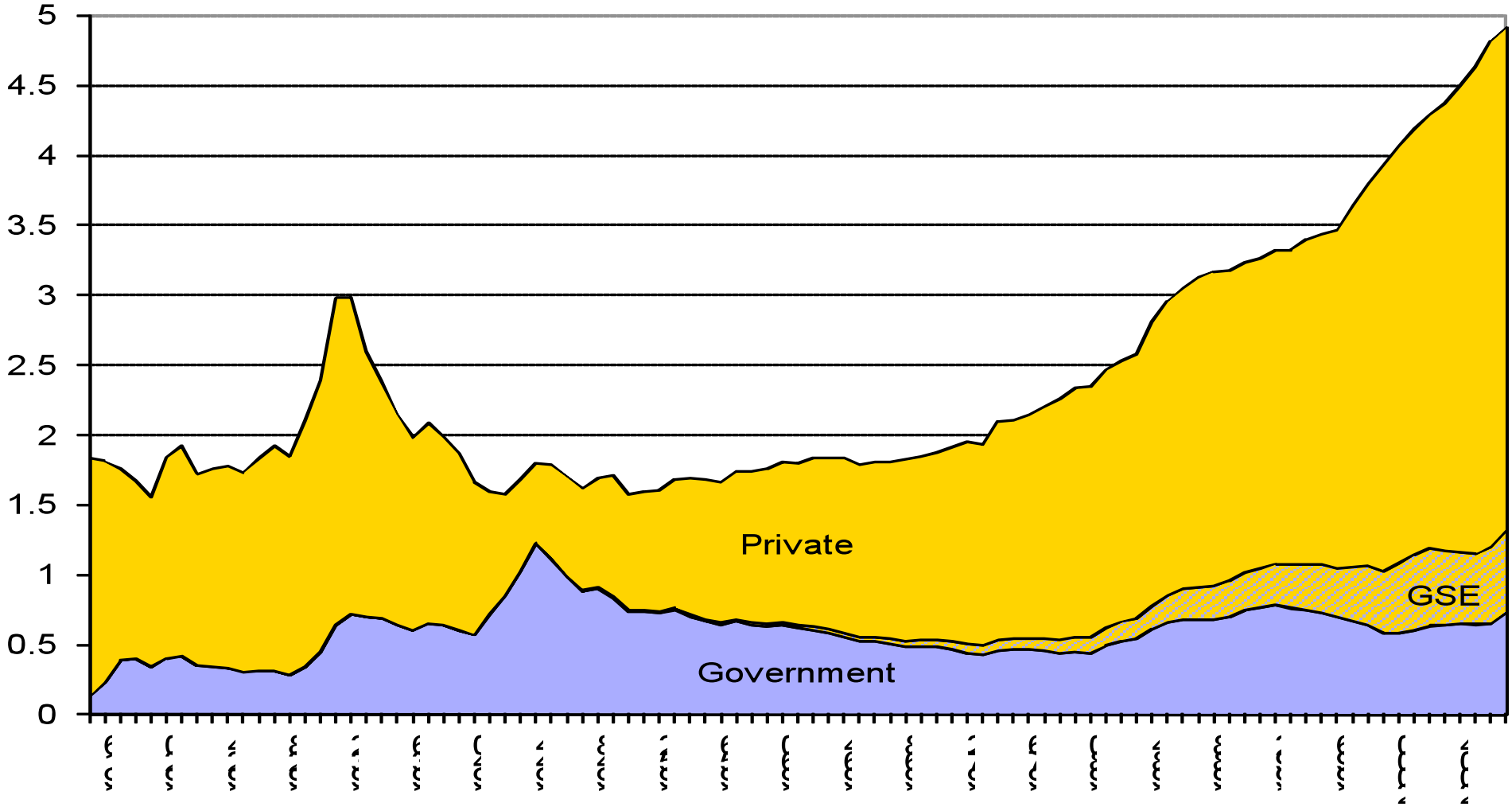
Dangers Facing US Economy (2005—through spring 2008!)

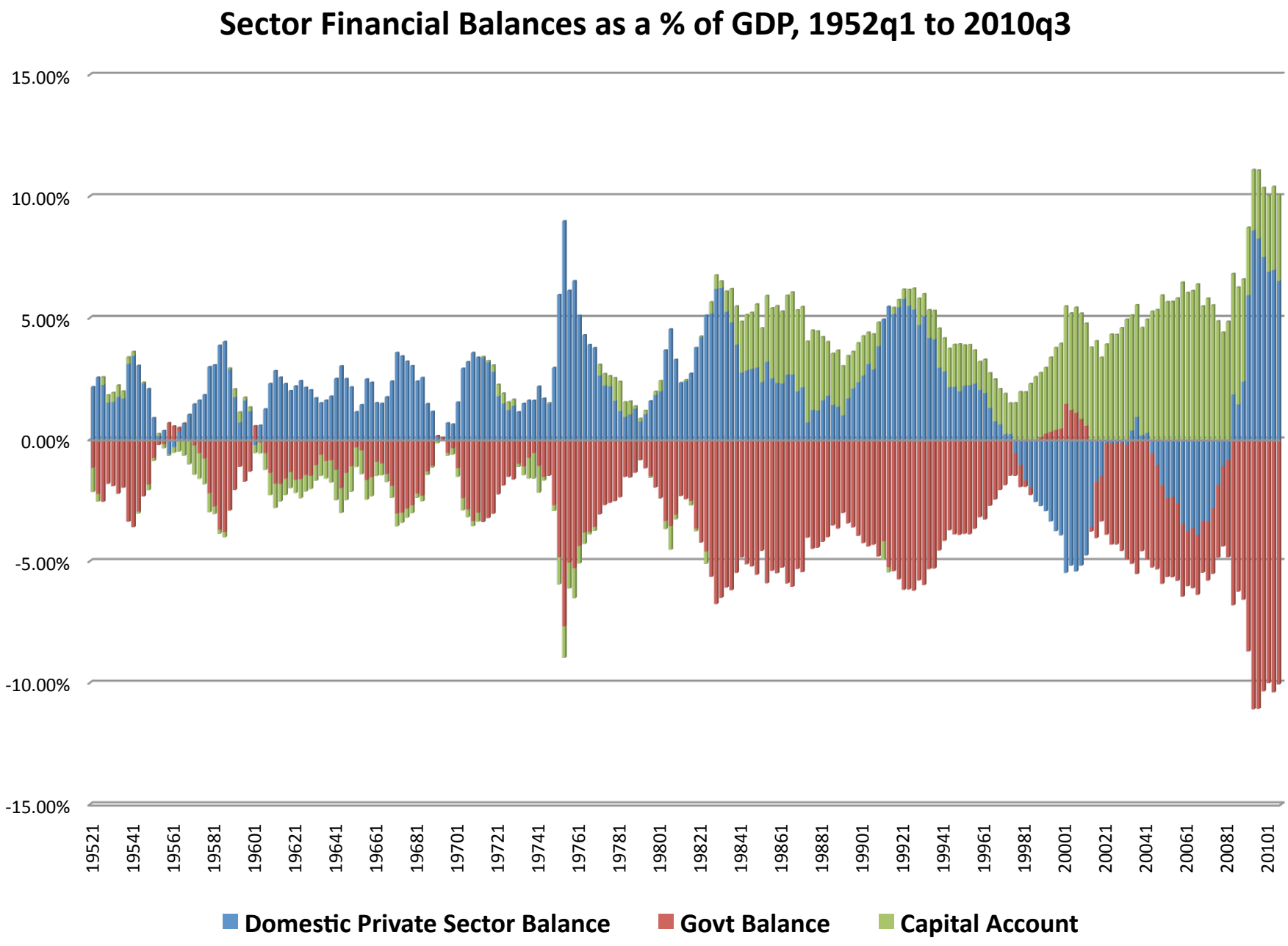
- First dispense with red herrings:
  - Inflation: commodities prices and white noise; anyway, no evidence low inflation is harmful
  - Infinite horizon "unfunded liabilities"; **actually** gov't debt represents private wealth
  - "Unsustainable" US current acct deficits that require foreign lending; **actually** US net imports provide desired saving to ROW; any turn-around is far-off, will be slow, and will raise domestic AggD

Real Dangers 2005

- Federal gov't spending not growing
- Overly restrictive tax policies (regressive S&L; taxes on employment; AMT)
- Rapidly rising private debt (equity & real estate booms, commodites boom, few jobs, stagnant real wages)
  - Orthodox: doesn't matter because wealth is rising, too
  - Godley in 2000: if growth of net lending con't for 8 yrs, "sensational day of reckoning could be at hand"

Financial Liabilities Relative to GDP




Sector Financial Balances as a % of GDP, 1952q1 to 2010q3
15.00%
10.00%
5.00%
0.00%
-5.00%
-10.00%
-15.00%
19521
19541
19561
19581
19601
19621
19641
19661
19681
19701
19721
19741
19761
19781
19801
19821
19841
19861
19881
19901
19921
19941
19961
19981
20001
20021
20041
20061
20081
20101
Domestic Private Sector Balance
Govt Balance
Capital Account

Conclusions

- There really is S&L govt fiscal storm; won't be resolved until economy recovers
- Federal deficit nothing to fear; spends by crediting bank accounts. TINA
- Flex exchange rates and current acct def
- Free of financial constraints, can focus on real problems: unemployment, hunger, poverty, homelessness, S&L govt crises, infrastructure, health care, education
- Fear mongering and looming financial crises: the lesson of Japan