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RISING INEQUALITY AND DEPENDENCE ON EXCESSIVE PRIVATE BORROWING THREATEN SUSTAINABILITY OF U.S. ECONOMIC RECOVERY, NEW LEVY ECONOMICS INSTITUTE STUDY SAYS

ANNANDALE-ON-HUDSON, N.Y.— While the U.S. economy has been expanding moderately since the end of the Great Recession in 2009, a new study from Levy Economics Institute of Bard College argues—with the federal government’s restrictive fiscal policy stance exerting a negative influence on aggregate demand and growth—current Congressional Budget Office projections for a continued recovery rely on unsustainable excessive private borrowing, precisely the process that led to the 2001 and 2007 recessions. Furthermore, given that the income distribution has worsened since the crisis—continuing a 35-year trend—the burden of indebtedness will again fall disproportionally on the middle class and the poor. The ongoing process of balance sheet deleveraging (primarily by the bottom 90 percent) sharply constrains the group’s spending, however, which helps explain the slow recovery in the aftermath of the 2007–09 recession. According to the Levy Institute’s macro model simulations in their new report the rise in inequality is unsustainable, and if it is allowed to continue, will lead to an era of anemic growth and high unemployment.

“In order for the CBO projections to materialize, households in the bottom 90 percent of the distribution would have to start accumulating debt again in line with the prerecession trend while the stock of debt of the top 10 percent remained at its present level. Clearly, this process is unsustainable,” writes the Levy Institute’s Macro-Modeling Team—President Dimitri B. Papadimitriou and Research Scholars Michalis Nikiforos, Gennaro Zezza, and Greg Hannsgen—in their new Strategic Analysis, Is Rising Inequality a Hindrance to the US Economic Recovery?. “Given the weak foreign demand, high income inequality, and fiscal conservatism, the United States faces the choice between two undesirable outcomes: a prolonged period of low growth—secular stagnation—or a bubble-fueled expansion that will end with a serious financial and economic crisis.”

In their report, the Levy Team analyzes the economic outlook for the United States and find that a sharp deterioration of the external position of the U.S. economy over the next three years (driven by higher U.S. growth rates combined with the anemic growth rates of its trading
partners) puts the burden for growth on domestic deficits. The continuous accumulation of these domestic deficits, they write, especially on behalf of the private sector, becomes an unsustainable process that sooner or later leads to a crisis. Exacerbating the situation, the Levy team argues is another unsustainable process: the extreme rise in income inequality that has taken place in the United States over the past 35 years. “The income of the bottom 90 percent of households has stagnated over the last three and a half decades, and consumption growth had to be financed by excessive borrowing as a result,” they write. “Absent the increase in indebtedness of the bottom 90 percent during the 1990s and 2000s, the macroeconomic performance of the United States would have suffered dramatically.”

Looking at the impact of income inequality on the current CBO projections for economic growth, the Levy Team explores a scenario in which the bottom 90 percent of the population continue to deleverage along its postcrisis trend, while the top 10 percent maintained its debt-to-disposable-income ratio at current levels. They find that the economy does not manage to recover, save for a brief uptick in growth in 2014, and that by 2017, growth slows to 1.7 percent—lower than it has been in the postrecession years— and unemployment begins to rise again, reaching 7.6 percent by 2017. “Looking into the future, if the distribution of income remains as is, the US economy will face the prospect of either secular stagnation, due to the bottom 90 percent’s low levels of debt and stagnating demand; or a repeat of the pre-2007 condition of debt-led growth, based on increased borrowing and debt and a new sort of speculative bubble,” the authors write. “The only way out of this dilemma is a reversal of the trend toward greater income inequality. A change in the income distribution is a necessary condition for sustainable growth in the future.”

The authors conclude that if the United States maintains its restrictive fiscal policy stance, as seems likely, it will take many more years for high growth to resume and unemployment to fall significantly—unless the economy reenters an era of excessive private sector borrowing reminiscent of the late 1990s and mid-2000s, with the known subsequent effects.

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Strategic Analysis: Is Rising Inequality a Hindrance to the US Economic Recovery? To read the full text of this policy paper or to learn more about the Levy Economics Institute of Bard College, please visit http://www.levyinstitute.org/publications/?docid=2066.

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