Ajit Zacharias is an emeritus professor of applied economics at Cambridge University. Ajit Zacharias has not entered the public discussion properly. People have.

Gennaro Zezza is a CRI DE COEUR.
Policy Note, 2006 / 4

Gennaro Zezza

The major assumption underlying the projections in Figure 2 is that the GDP grows at an average rate of 3.3 percent during the next five years. The constant account balance, which reached 7 percent of nominal GDP in the fourth quarter of 2005, was not projected to reach 8 percent of GDP in 2010, conditional on the 3.3 percent growth rate. This projection also assumes the assertion that there is no change in the exchange rate, no change in the price of oil, and a moderate continued rise in both stock prices and house prices. It has also been assumed that fiscal policy keeps the combined budget deficit of all levels of government constant as a proportion of GDP. 10 It follows by identity that the private sector balance would have to go on falling, leading minus-surplus by the end of the period.

The average growth rates for 2005–10 come out at 3.3 percent, 2.6 percent, 1.8 percent, and 1.6 percent. The last three projections imply sustained growth recessions—very severe ones in the case of the last two. Figure 6 shows the projected implications of Scenario 4, the gloomiest variant, for the future of the three financial balances. It shows the private sector balance clearly moving toward historical mean, which seems, in any case, to be quite likely to happen. The current account balance improves a lot as a result of the projections, but the government deficit would rise to perhaps 5 percent of GDP for cyclical reasons. It is plausible to suppose that the growth of GDP would slow down so much because of a fall in lending of this size? Figure 7 shows past (and projected Scenario 4) figures for the current account balance, which is expected to fall from 15 percent of income in 2005 to 5 percent in 2010. The results are a bit surprising, since the apparently quite small differences in the flows of debt have extremely strong and unpleasant implications for the path of lending and also for the path of the economy.

Conclusion

The central purpose of this paper is to make a single point, one that we believe is important but largely absent from the public discussion: the path of lending, rather than debt, may turn out to be of decisive importance for the medium-term future of the U.S. economy. And furthermore, quite moderate and in our view highly plausible assumptions about a slowdown of the path of debt have extremely strong and unpleasant implications for the path of lending and also for the future of the U.S. economy. And furthermore, quite moderate and in our view highly plausible assumptions about a slowdown of the path of debt have extremely strong and unpleasant implications for the path of lending and also for the future of the U.S. economy.

Note

1. If, as many think, the current account deficit were to rise to more than 8 percent on these assumptions, the conclusions of this note would be strengthened.

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balance has continued to deteriorate, the expansion has been kept on track by a renewed fall in private net saving. The major assumption underlying the projections in Figure 1—and it is no more than an assumption—that the GDP growth rate of 3.3 percent during the next five years holds constant as a proportion of GDP, which peaked at 7 percent of GDP in the fourth quarter of 2005, next projected to reach 8 percent of GDP in 2010, conditions on the 3.3 percent growth rate. This projection also assumes the assumption that there is no change in the exchange rate, no change in the price of oil, and a moderate contained trend in both stock prices and house prices. It has also been assumed that fiscal policy keeps the combined budget deficit of all levels of government constant as a proportion of GDP. GDP follows by identity that the private sector balance would have to go on track by a renewed fall in private net saving.

Figure 2 shows possible projections of private debt as a percent of disposable income. Scenario 1, the top line, shows what the debt percentage rising to 225 in 2010, what is implied logically by the growth in lending shown in Figure 2. The other three lines show alternative scenarios, all of which, in our view, are more plausible than Scenario 1. The United States would have to change its debt—relative to income. All we have done is enter changes in debt—relative to income. The results are a surprise, since the apparently quite small differences in the lending flows. In particular, Scenario 4, the low-growth scenario, implies sustained growth recessions—very severe ones at the case of the last two. Figure 3 shows the projected implications of Scenario 4, the last three projections of debt levels. In the case of the last two. Figure 3 shows the projected implications of Scenario 4, the last three projections of debt levels. In the case of the last two.

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1. If, as many think, the current account deficit were to rise to more than 8 percent on these assumptions, the conclusions of this note would be strengthened.

2. It is possible to suppose that the growth of GDP would slow down so much just because of a fall in lending of this size? Figure 7, which shows past and projected Scenario 4 figure for net lending combined with recessions, we may need to suppose that it could. Major slowdowns in past periods have often been accompanied by falls in net lending. Indeed, the two have moved together to one extent that is somewhat surprising, in view of the fact that other major factors (e.g., fiscal policy and foreign trade) have also been at work.

Conclusion

The central purpose of this paper is to make a single point, one that we believe is important but largely absent from the public discussion: the path of lending, rather than debt, may turn out to be of decisive importance for the medium-term fortunes of the U.S. economy. And furthermore, quite moderate (and in our view highly plausible) assumptions about a slowdown of the debt of debt have extremely strong and unpalatable implications for the path of lending and also for the growth of the economy.

Note

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kept on track by a renewed fall in private net saving.

The major assumption underlying the projection in
Figure 2—and it is no more than an assumption—that the
GDP growth rate was 3.3 percent during the next five
years, is the current account balance, which reached 7 per-
cent of nominal GDP in the fourth quarter of 2005, was next
projected to reach 8 percent of GDP in 2010, conditional on
the 3.3 percent growth rate. This projection also assumes
the assumptions that there is no change in the exchange rate,
no change in the price of oil, and no a moderate continued rise in
both stock prices and house prices. It has also been assumed
that the government debt, the combined budget deficit of all levels
of government contrast as a proportion of GDP. 1 By definition
the private sector balance would have to go up at least a little
from negative 6 percent in 2005 to less negative 4 percent by the end of the period.

What would have to happen to net lending to bring the
3.3 percent growth rate about? Figure 3 reproduces private net
saving from Figure 2 and also shows our model projection of the
net lending that would be required to bring about the desired 3.3 percent growth rate. This projection also assumes the assumptions that there is no change in the exchange rate, no change in the price of oil, and a moderate continued rise in both stock prices and house prices. It has also been assumed that the government debt, the combined budget deficit of all levels of government contrast as a proportion of GDP. 1 By definition the private sector balance would have to go up at least a little from negative 6 percent in 2005 to less negative 4 percent by the end of the period.

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Economic Analysis. For the future, the figures are projections derived from a simple econometric model, based on assumptions we shall call Scenario 1.

Figure 1 shows the financial balances of the government, the private sector, and the foreign sector, all expressed as proportions of GDP. For the period 1972–2005, the balances are historical data derived from National Income and Product Accounts tables, produced by the Bureau of Economic Analysis. For the future, the figures are projections derived from a simple econometric model, based on assumptions we shall call Scenario 1.

The history of the past can be usefully analysed in terms of change in these balances. The negative impact from the growing current account deficit and increasing fiscal restriction during the "Goldilocks" period of the late 1990s was offset by a long and spectacular fall in private net saving. Then, when private net saving started to recover, around 2000, an incipient recession was headed off by a huge fiscal relaxation. More recently, although the current account deficit remains high, the balance on historical data derived from National Income and Product Accounts tables, produced by the Bureau of Economic Analysis. For the future, the figures are projections derived from a simple econometric model, based on assumptions we shall call Scenario 1.

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Many papers published by the Levy Institute during the last few years have emphasized that the U.S. economy has relied too much on the growth of lending to the private sector, most particularly to the personal sector, to offset the negative effect on aggregate demand of the growing current account deficit. Moreover, this growth in lending cannot continue indefinitely.

**This centrally important point** has not entered the public discussion properly. People have generally been concerned with whether the essentially different threats, for example, the possibility of falling house prices, a potentially excessive burden of interest and debt repayments on personal income, or a disorderly collapse in the dollar exchange rate.

**Figure 1** shows the financial balances of the government, the private sector, and the foreign sector. All are expressed as proportions of GDP. For the period 1972–2005, the balances are historical data derived from National Income and Product Accounts tables, produced by the Bureau of Economic Analysis. For the future, the figures are projections derived from a simple econometric model, based on assumptions we shall call Scenario 1.

**The history of the period can be usefully analyzed in terms of changes in these balances.** The negative impact from the growing current account deficit and increasing fiscal restriction during the “Goldilocks” period of the late 1990s was offset by a long and spectacular fall in private net saving. Then, when private net saving started to recover, around 2000, an incipient recession was headed off by a huge fiscal relaxation. More recently, although the current account deficit is growing, the public sector deficit has been significantly reduced.

**The key central point to understand is that the public sector was essential in getting us through the Goldilocks period, and we cannot rely on the same approach to solve the new problems we face.**

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