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**Imbalances in the U.S. Economy Threaten to Undermine Stock Market Rally, According to New Levy Institute Study**

**High Levels of Debt May Hinder Long-Term Recovery and Could Trigger a Collapse of the Real Estate Market**

ANNANDALE-ON-HUDSON, N.Y.—While the U.S. economy has shown signs of resurgence and the stock market has rallied in the wake of the war in Iraq, a new policy paper from The Levy Economics Institute of Bard College warns that a sustained bull market is unlikely. The study suggests that imbalances in the private sector—chiefly soaring levels of personal debt—will limit the extent of any rally and put the U.S. economy at risk of a property market crash and double-dip recession.

In a public policy brief, *Asset and Debt Deflation in the United States: How Far Can Equity Prices Fall?*, Levy Institute Professor of Economics Philip Arestis and independent financial analyst Elias Karakitsos contend that the 2001 recession, though relatively mild, is part of a lengthier process of asset and debt deflation associated with the bursting of the telecommunications and Internet bubble of the 1990s. The imbalances created by that bubble, the authors argue, will continue to undermine any long-term economic recovery. Arestis and Karakitsos maintain that lower interest rates have boosted the economy in the wake of the equities bubble, but they have also fueled a property market bubble. The authors suggest that weak corporate profits could force an overly indebted personal sector to curtail spending, sparking another, potentially more severe, recession and, perhaps, a crash in the property market.

"The U.S. economy could fall into a double-dip recession as the poor prospects of the corporate component of the private sector affect the real disposable income of the personal

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component of the private sector," the authors write, stressing that personal debt has soared to 106 percent of personal disposable income. "In an asset and debt deflation environment, the nonbank private sector retrenches when the huge debt acquired during the rosy years of rising asset prices is inconsistent with falling asset prices….The inevitable adjustment of debt to a sustainable level that is consistent with current asset prices and of saving to a level that represents a higher proportion of disposable income, will be a long and painful retrenchment process."

Arestis and Karakitsos say the economy could return to a path of asset and debt deflation and a secular bear market in two ways: first, and more immediately, if the economy continues to teeter on the edge of recession and the lack of a recovery triggers a collapse in equity prices and a retrenchment in the private sector, or after a cyclical upturn that could last as little as a few months or until after the November 2004 presidential election. In the latter case, the authors maintain that the longer the cyclical upturn, the more likely long-term interest rates will climb, triggering a collapse of the property market and recession.

Should the economy slide into recession again and the property market crash, Arestis and Karakitsos—using a macro and financial model of the U.S. economy—suggest that the value of the S&P 500 Index could fall by 33 percent, real estate could fall by 25 percentage points of disposable income (similar to the drop in the wake of the early-1990s recession), and corporate profits could slip by 23 percent as the personal savings ratio rises and consumers attempt to pay back their debts.

"In spite of the presence of lower interest rates, which cushioned consumers who were servicing their debts, a substantial fall in real personal disposable income will ultimately trigger the collapse in property prices that will characterize the next recession," write Arestis and Karakitsos, noting that there has been a property market decline with every recession. "The U.S. economy and, by implication, the world economy may not have seen the worst yet, in terms of recession. Under certain conditions, a double-dip recession is highly probable."

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Public Policy Brief No. 73, *Asset and Debt Deflation in the United States: How Far Can Equity Prices Fall?*

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