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Fiscal Policy To The Rescue

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The U.S. expansion of the past eight years has been fueled by a rise in private sector indebtedness. In 1997 U.S. private sector spending exceeded income for the first time since 1952, and since then the gap between the two has risen markedly. The situation closely mirrors that experienced in the United Kingdom during the 1980s, when a two-year slowdown resulted in absolute declines in GDP and a three-percentage-point increase in the unemployment rate.

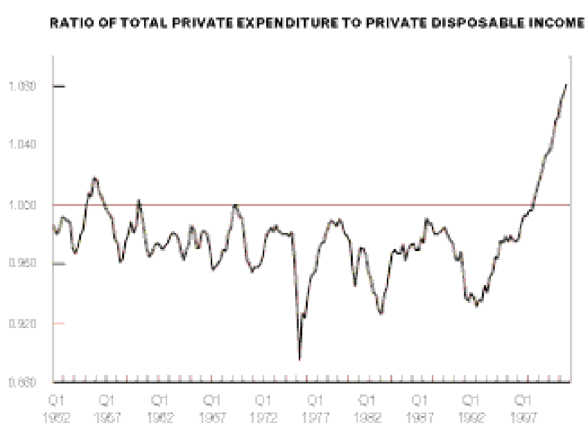
U.S. PRESIDENT GEORGE W. BUSH may eventually have to propose tax cuts or public expenditure increases far larger than those he currently has in mind. The reason is simple: the medium-term outlook for the U.S. economy could be much more depressed than most economists now expect.

For some years it has been fashionable, when discussing macroeconomic policy, to concentrate almost entirely on supply-side factors. The outstanding achievements of the United States with respect to innovation and productivity seem to have led people to suppose that demand can be ignored. Indeed, Columbia University's Edmund Phelps wrote last year that the U.S. experience could not have been caused by demand expansion and concluded that growth had become "structural" (Financial Times, August 9, 2000).

Yet aggregate demand obviously has risen in the United States, and the motor driving it has been both unique and unsustainable. During the 45-year period between 1952 and 1997, total private expenditure was almost always below disposable income (see chart). In the third quarter of 2000, spending exceeded income by 8 percent. This excess was possible only because the private sector has been realizing assets and borrowing on an increasing scale; the indebtedness of the personal sector reached 1.1 times its annual flow of disposable income-a record-while debt of the private sector as a whole reached 1.7 times disposable income-another record.

It is often pointed out that the huge increase in asset prices has put household balance sheets in a strong position despite the increase in debt. But debts have to be serviced with cash, and this sets a ceiling on the extent to which they can prudently be incurred. In addition, businesses have become increasingly indebted: their investment has been growing in excess of internally generated funds, yet they have simultaneously been net purchasers of equity.

Recent levels of private expenditure relative to income cannot be sustained unless the flow of net lending continues on at least its present scale, requiring a further rapid increase in indebtedness. The daunting implication is that aggregate demand will fall if the growth of debt merely slows. If the level of indebtedness were to fall, implying that debts are actually being repaid, the effect on aggregate demand would be even larger. This "hard landing" scenario has nothing to do with the problems that would be created by a traditional end-of-cycle inflation surge which so obsessed many Wall Street economists as recently as last summer.



There are now clear signs that the limits to business sector borrowing are being reached, while the fall in stock prices and the decline in consumer confidence make it unlikely that lending to the household sector will be sustained at recent levels far into the future. The present situation in the United States has close parallels with what happened in Britain 12 years ago. Then, similar claims were made that a new era had dawned as a result of Margaret Thatcher's supply-side reforms. But aggregate demand then was powered by an expansion of net lending, just as the U.S. miracle has been. Moreover, at its peak-the first quarter of 1989-the United Kingdom's private sector deficit expressed as a percent of GDP was almost exactly the same as that reached in the United States during the third quarter of 2000. In the subsequent two years, as the United Kingdom's private deficit fell to zero, its GDP fell absolutely and unemployment rose by about three percentage points.

One does not need an econometric model to conclude that a similar rise in U.S. private net saving could result in a recession of comparable magnitude; it would imply a fall of 8 percent in total private expenditure relative to income as well as a shift of the budget back into deficit. The implications for the rest of the world would be serious.

The Federal Reserve's recent decision to lower interest rates by half a percentage point was possible because inflation is still not a concern, as it was in the United Kingdom 12 years ago. Yet monetary policy alone cannot do the trick. True, the cut in interest rates backed up by subsequent cuts could stem the fall in asset prices and relieve the burden of interest payments. But cutting rates could only reverse a deceleration in aggregate demand by re-establishing the asset price and credit boom. Such measures would do nothing more than postpone the day of reckoning.

The only effective antidote to a shock caused by a reversion of private net saving would be a significant fiscal relaxation. The fact that fiscal policy cannot be used to counteract short-term fluctuations in the economy in the way most policymakers and economists advocated in the 1960s, does not mean that the fiscal stance should not be relaxed if it gets too tight on a medium-term basis.

President Bush is looking for a tax cut worth about 1.5 percent of GDP spread over 10 years. The shortfall in domestic demand could rise to 5 or 6 percent of GDP. So perhaps President Bush should be thinking of numbers about three times bigger than what he is now proposing.

Related Levy Institute Publications

Wynne Godley, *Drowning In Debt,* Policy Note 2000/6.
Wynne Godley, *"Notes on the U.S. Trade and Balance of Payments Deficits," Strategic Analysis,* Interim Report, 2000.
Wynne Godley, *Seven Unsustainable Processes: Medium-Term Prospects and Policies for the United States and the World,* Special Report, 1999.
Wynne Godley and Bill Martin, *How Negative Can U.S. Saving Get?* Policy Note 1999/1.
L. Randall Wray, *Can the Expansion Be Sustained? A Minskian View,* Policy Note 2000/5.

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