



# Kick-Start Strategy Fails to Fire Sputtering U.S. Economic Motor

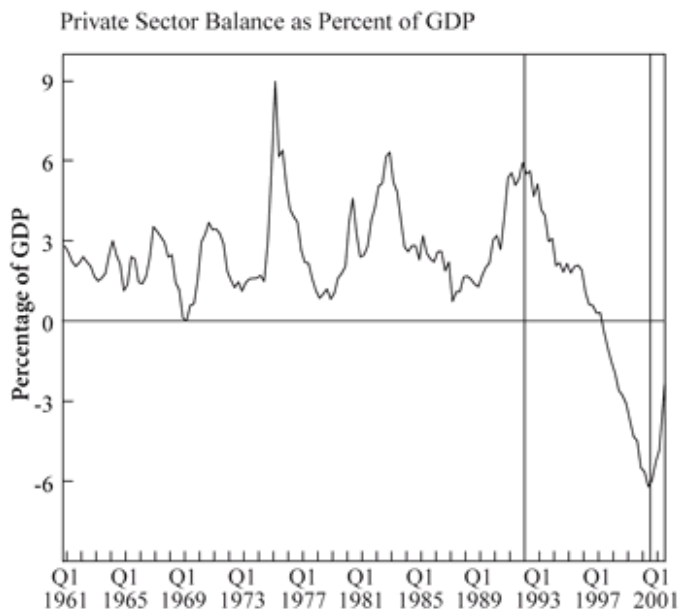
Wynne Godley

**There is a strategic need, if a "growth recession" is to be avoided, for a new motor to drive the economy, particularly if there is a further decline in private expenditure relative to income that could generate a further hole in aggregate demand.**

If share prices on Wall Street are to be believed, recovery by the recession-hit U.S. economy will be under way by the second half of the year. But what exactly does "recovery" mean? "Recession" is defined as two consecutive quarters of negative growth, with the corollary that positive growth, however small, qualifies as a recovery. But there is no significant difference between a decline of 0.1 percent per annum and growth of 0.1 percent; both are so far below productive potential that they would be experienced as an increasingly severe recession if continued for any length of time. No growth rate much below 3 percent should be called "recovery" at all, since unemployment would be rising and profits and capacity utilization falling.

Public discussion is further distorted by Wall Street's obsession with the very short term. People who want to make money on the stock exchange try to predict what will happen during the next few months, but strategic policy formation, particularly with regard to fiscal policy, requires a time horizon several years ahead. "Fine tuning" has been decisively and permanently discredited.

Taking a strategic view, I believe that, in the absence of a substantial and continuously increasing fiscal stimulus, the U.S. recession will continue for several more years. At the least, this will take the form of seriously subnormal growth, although it is easy to imagine circumstances (a world slump or a stock market crash) that would cause the absolute decline to continue.



Source: National Income & Production Accounts, U.S.

The 1990s expansion was powered uniquely and exceptionally by a huge fall in net saving by the private sector, the scale of which is illustrated in the chart above. Vertical lines mark the first quarter of 1992, when the expansion really got going, and the third quarter of 2000, when the slowdown started. During this period the balance between the private sector's income and expenditure fell by 11.5 percent of GDP; in the third quarter of 2000, private expenditure exceeded income by an amount equal to 6.2 percent of GDP, having never exceeded it significantly during the previous 30 or more years. This could not have happened without a huge rise in borrowing, which made the private sector as a whole far more indebted than ever before.

The subsequent recession has clearly been associated with a reversal of this tendency. There has been a sharp fall in private expenditure relative to income since the third quarter of 2000. Yet, in the third quarter of 2001, the private sector deficit was still nearly 2.5 percent of GDP, much higher than in any earlier period and high enough to require so much borrowing that private debt relative to GDP rose to another peak. The private deficit will probably recover to its normal condition of surplus, implying a continued fall in private expenditure relative to income that will withdraw 4.5 to 5 percent-up to \$500 billion-from aggregate demand. But even if the private deficit were not to recover at all, my main conclusion would still stand because the U.S. economy would remain deprived of the motor that drove it in the 1990s.

Total demand and output in the rest of the world is unusually stagnant, so net export demand may not rise at all, while the Congressional Budget Office's 2002 fiscal projections imply no stimulus beyond the injections under consideration.

A number of factors may combine to lift aggregate demand in the very short term. First, a tax rebate put \$40 billion into the hands of U.S. consumers during the third quarter of 2001. (With GDP at about \$10 trillion per annum, this has been written off as too small to count-but while the rebate is indeed less than half of 1 percent of a year's flow of GDP, it was 1.6 percent of GDP in the third quarter, quite enough to have a perceptible effect on spending.) Second, the huge fall in short-term interest rates has reduced mortgage rates to their lowest level in decades, lowering the interest burden on households and resulting in substantial withdrawals of equity from the housing market. Third, there is bound soon to be a recovery in inventory investment, which was heavily negative in the third quarter. And fourth, car buying has surged as a result of

zero-interest credit inducements.

All of these influences will have a positive effect in the immediate future. However, some of them (the rebate, the equity withdrawal) will be "blips" in the sense that they occur only once and will in time cancel themselves out. Others (lower interest payments and the rise in inventory investment), while not self-canceling, are nevertheless one-time-only, while the car splurge is likely not to have an effect, since sales figures have been "stolen" from 2002.

There is a strategic need, if a "growth recession" is to be avoided, for a new motor to drive the economy. Such an engine must, by deduction, be driven by the public sector; my Levy Institute colleagues have made a number of suggestions for the particular forms the the stimulus might take (Galbraith 2001; Papadimitriou and Wray 2001, a, b; Wray 2001). Suffice it to say that fiscal stimulus is necessary, particularly if there is a further decline in private expenditure relative to income that could generate a further hole in aggregate demand, rising toward \$400 to \$500 billion per annum.

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Wynne Godley is distinguished scholar at the Levy Economics Institute and is affiliated with the Cambridge Endowment for Research in Finance at the University of Cambridge, U.K. A similar article appeared in *The Guardian* on January 21, 2002; it is adapted here by permission.

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