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Is Deficit-Financed Growth Limited?

Policies and Prospects in An Election Year

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I. Introduction

Wynne Godley, our Levy Institute colleague, has warned since 1999 that the falling personal saving and rising borrowing trends that had powered the US economic expansion were not sustainable. He also warned that when these trends were reversed, as has happened in other countries, the expansion would come to a halt unless there were major changes in fiscal policy.

Not long ago, official circles insisted that monetary policy was the most desirable tool, and that fiscal deficits were not only unnecessary but also harmful (ERP, 2000, p.31-34; Greenspan, 2000). Some economists, notably Edmund Phelps of Columbia University, went so far as to suggest that the economic expansion was not caused by rising demand, but rather because growth had become 'structural' (Financial Times, August 9, 2000).

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Yet fiscal policy has made a swift and major comeback. Not simply as tax cuts and military expenditures, but rather as huge budget deficits. Three years ago, at the beginning of 2001, there was a government surplus of \$113 billion¹. One year later, this had become a deficit of \$292 billion. According to the latest available figures, by the third quarter of 2003 this had grown into a deficit of \$604 billion. The historical events that gave rise to this change in practice are well known. But they may also signal a growing recognition of the limited effect of monetary policy. Many colleagues at the Levy Economics Institute have long argued that government deficits, albeit of a different internal structure, would be necessary to sustain economic growth when private sector borrowing reached its limits (Godley, 1999; Papadimitriou and Wray 2001, Godley and Izurieta, 2001). But at the same time we have emphasized the limits of this recourse, for deficits are always linked to debts. This is the theme we explore in this Strategic Analysis.

As we expected, real GDP growth responded dramatically to the rise in government deficits: in 2001, growth stood at 0.5%; in 2002, it was 2.2%; and by the fourth quarter of 2003 it was 4.1%, having previously reached a peak of 8.2% in the third quarter of 2003. In this process, profits and productivity have soared.

But until very recently employment and wage incomes have lagged far behind. Job growth was weak throughout 2003, despite high rates of output growth. Official statistics based on payroll surveys indicate that 1.89 million jobs have been lost since President Bush took office three years ago. They also show that only 8,000 jobs were created in December 2003, 97,000 in January 2004, and 46,000 in February 2004. Official views have acknowledged this discrepancy between output growth and employment growth, which they have attributed to an extraordinary surge in productivity. Measured as the rate of growth of real GDP per employee, this stood at 7.7 percent in the third quarter of 2003. While this was high, such quarterly productivity growth rates are by no means unusual, and are typically followed by sharply lower ones (see Chart 7). Indeed, by the fourth quarter of 2003, this rate had fallen to 1.9 percent. What is relevant to employment prospects is the average rate of growth over longer periods, which we analyze in the next section.

In any case, the latest figures appear to tell a dramatically different story: according to the payroll survey, nonfarm jobs grew by 308,000 in March. This recovery of employment is in line with our analysis of the effects of the greatly expanded budget deficits, which we discuss in Section III. But it is important to place this in context. Some 134,000 new jobs that must be created every month to just

absorb the growth in the work force². From this point of view, total job creation from December 2003 to March 2004 *was still 77,000 short of the number needed to just absorb new entrants*.

Moreover, there is continuing dispute over the actual numbers of jobs created, because the two different methods employed by the BLS³ give different results. The payroll survey indicates that jobs rose from 46,000 in February to 308,000 in March. At the same time, the household survey indicates a virtually constant level of job creation, 146,471 in February and 146,650 in March. Nor have employment measures and unemployment rates moved together. For instance, the March surge in payroll job estimates has actually been attended by a slight rise in the unemployment rate, from 5.6% in February to 5.7%.

Despite the murkiness of the job picture, it is widely agreed that new jobs increasingly encompass low quality, low wage employment. According to the lead author of a recent study on employment measures, at "no other point in the nation's last five recovery periods have so many people been employed as independent contractors, as temporarily self-employed, or paid under the table" (Andrew M. Sum, cited in Uchitelle, January 12, 2004, p. 2). Furthermore, as the recently released "Employment Situation" report by the Bureau of Labor Statistics shows more than 4.9 million persons currently want a job in addition to the 8.3 million

unemployed (BLS February 2004). The weakness in the labor market also shows up in the virtual stagnation of hourly earnings, which have recently grown "at the slowest pace ever recorded" (Goldman Sachs 2003, p. 2). Real hourly earnings, i.e. nominal earnings adjusted for the cost of living, have actually begun to fall (BLS February 2004). Similarly, total employee compensation has also begun to fall, in both nominal and real terms. Thus while the present recovery has been very good for profits, it has yet to have a positive impact on employment and wages.

In any case, the administration and Federal Reserve Chairman Greenspan remain optimistic about growth and employment over the near term, and do not seem alarmed by the sharp rise in government and current account deficits over this same time horizon. However, over the longer run even they express concerns about a series of potential problems. These include an inevitable rise in the real federal funds rate to a "more neutral level", a growing pressure to bring fiscal budgets back into line by cutting government spending or by raising taxes, and a growing pressure to curtail the current account deficit. Others, such as the International Monetary Fund (IMF), are openly pessimistic, and have recently warned that the large current account and government budget deficits may drive up both global and US interest rates, crowd out private investment, and erode pro-

ductivity growth (see Section II). The markets are already signaling this concern: one day after the March job growth surge, the yield on the Treasury's 10-year note jumped from 3.88 percent to 4.15 percent. This was the largest one-day runup since March 1996 (Fuerbringer 2004).

Our focus in this and previous Strategic Analyses has been on the medium term. In previous policy reports, we suggested that because the private sector was moving toward financial balance, it would take large fiscal deficits to provide the fuel needed to jump-start and maintain economic growth. But we warned that leaving matters alone would lead to large fiscal deficits being accompanied by equally large current account deficits. In October 2002 we considered a depreciation of the currency to be an essential element of the overall policy prescription, and traced out the impact of a 25% decline in the broad index of the dollar. In our subsequent report of October 2003 we noted that the exchange had already depreciated by 6 percent.

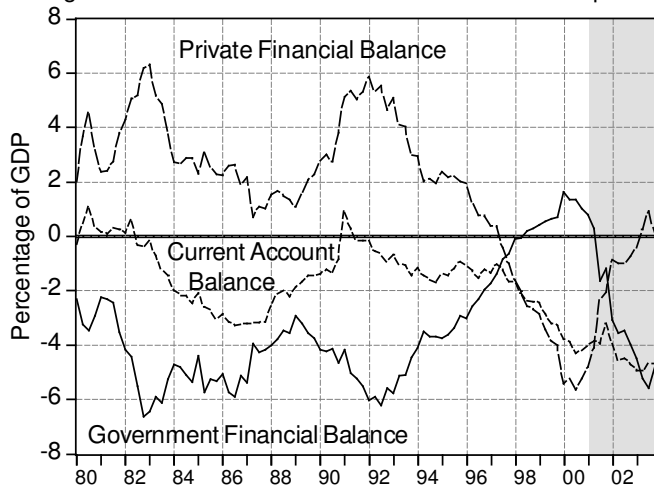
Large budget deficits have come to pass, as have concomitant increases in the current account deficit. At the same time, the currency has continued to depreciate. Its broad index has declined a further 2.7 percent since our previous Strategic Analysis, and in the words of the ECB President Jean-Claude Trichet, its decline against the Euro has been "brutal".

In the next section, we examine the current state of the economy in some detail. Then in the final section we assess the implications of recent economic events for the future path of the economy. We find that while present monetary and fiscal policy stances are likely to lead to robust growth and improved employment, this would come only at the expense of high government deficits, record foreign deficits, and rising ratios of government and foreign debt relative to GDP. Even under the best of circumstances, with constant interest rates, this scenario is unsustainable. It would be even more so under the rising interest rates projected by the CBO and now anticipated by many observers. We therefore consider two alternative strategies for halving the government deficit in 5 years: curtailing government spending, which is the path favored by the present administration; and rolling back recent tax cuts. Our model shows that the latter yields substantially higher growth and substantially lower unemployment.

II. The Current State of the Economy

The return of large and growing fiscal deficits is the first striking element of recent times. As a matter of accounting, the 'internal' financial balances (receipts minus non-financial expenditures) of the private sector and the government sector must equal the 'external' financial balance that is the current account balance. The private sector encompasses households

Figure 1: Three Financial Balances in Historical Perspective

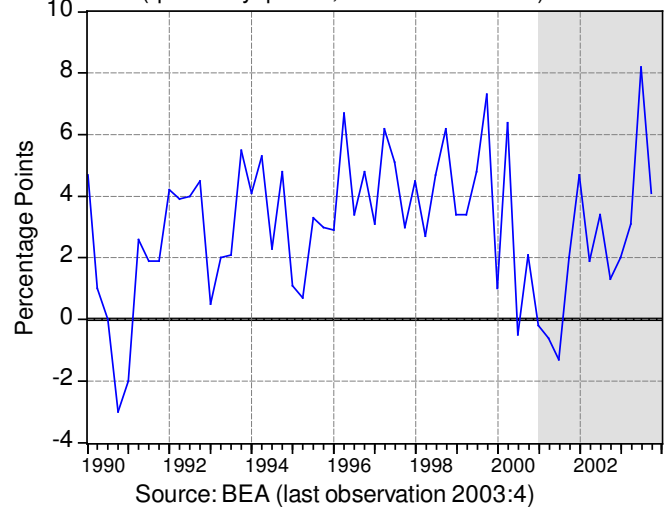


Source: BEA and Authors' Calculations (last observation 2003:4)

and businesses, and just a few years ago it was running large deficits, but as we have been projecting in previous reports (Papadimitriou et al. 2002, Shaikh et al. 2003), it has been rapidly reversing itself. At present the overall balance has even moved to a small surplus, because the financial surplus of the business sector has more than offset the deficit of the household sector. Consequently, the current account deficit now mirrors the government deficit. Nearly-twin deficits are back, as Figure 1 displays. In this, and all subsequent figures, the shaded area represents the time in office of the current administration.

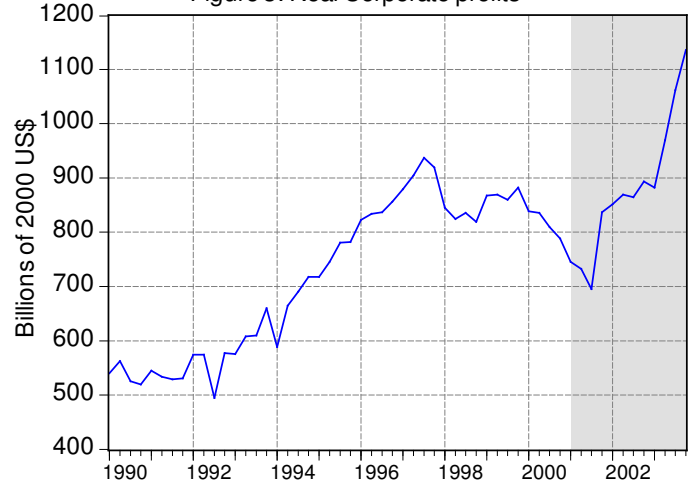
As the unprecedented private sector deficits have receded, their place has been taken by large and growing budget deficits. These have succeeded in pulling the economy out of the 2001 downturn and sustaining current growth. As shown

Figure 2: Growth in Real GDP
(quarter by quarter, at annualized rates)



Source: BEA (last observation 2003:4)

Figure 3: Real Corporate profits



Source: BEA and Authors' Calculations (last observation 2003:4)

in Figure 2, the growth rate of the economy has risen rapidly in response to the burgeoning fiscal deficits. With this has come greatly enhanced profitability, for not only do deficits increase personal sector disposable income (since the income created by the government exceeds taxes collected whenever there

is a deficit), they directly add to corporate profits (Papadimitriou and Wray 1998).

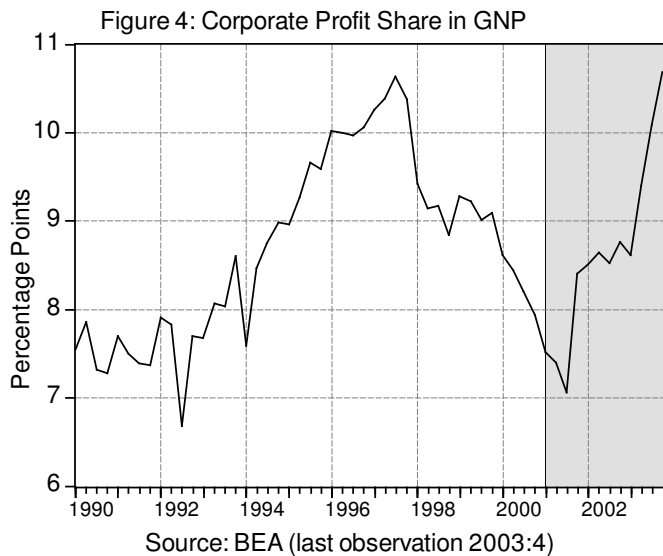


Figure 5: Quarterly Total Non-Farm Employment (Seasonally Adjusted)

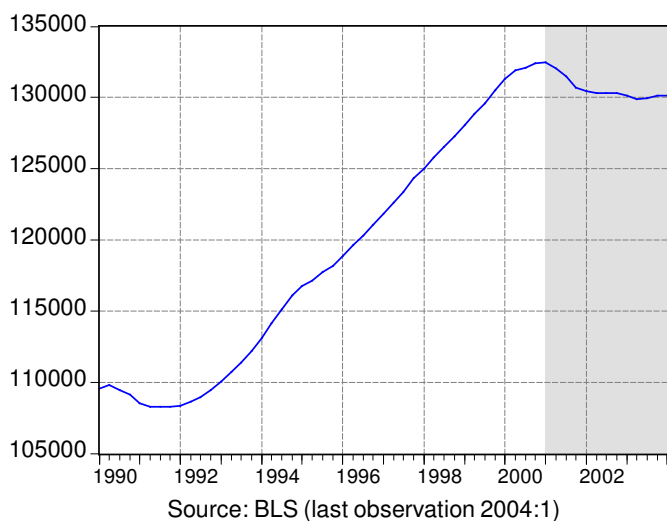


Figure 3 depicts total real corporate profits⁴, which in a short space of time have already surpassed the peak they had previously achieved at the height of the stock market bubble. Alternatively, Figure 4 shows that the share of profits in

total GDP behaved in a similar manner, although it is still just short of its previous peak.

Similar benefits have not yet been conferred on labor. Figure 5 displays total non-farm employment, which began to fall in 2001 and has only just begun to rebound. As we noted earlier, official statistics based on payroll surveys indicate that even the most recent surge in job growth has not managed to erase the job deficits of the past three months. Figure 6 depicts the civilian unemployment rate and the labor force participation rate. We observe that the unemployment rate rose sharply beginning in the first quarter of 2001, peaked in the third quarter of 2003, and declined slightly in the last quarter. The most recent monthly surge in job growth, which is not displayed on this quarterly chart, has nonetheless been attended by a small rise in the unemployment rate.

On the surface, one would expect the unemployment rate to fall when job growth was positive. But this is not necessarily the case, because population growth and emigration tend to swell the pool of those looking for work each month. In addition, previously employed people move in and out of the pool of job seekers. When times are bad, people who become discouraged give up looking for work, and do not get counted as being unemployed. This reduces the apparent pool of those seeking work. Conversely, when the climate seems to be improving,

Figure 6: Quarterly Unemployment and Labor Force Participation Rates

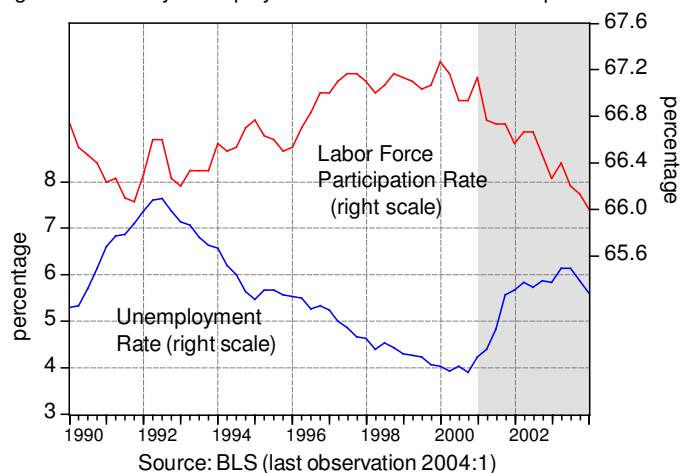
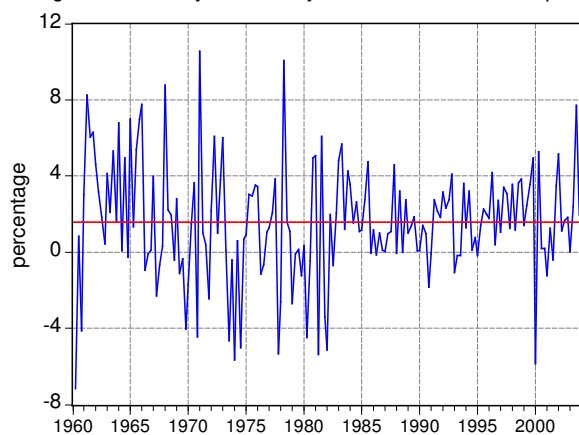


Figure 7: Quarterly Productivity Growth in Historical Perspective



as it was in March, people move back into this same pool. This process is reflected the labor force participation rate, which measures the sum of those who have jobs (the officially employed) and those who are counted as looking for work (the officially unemployed), in relation to the civilian non-institutional population. Figure 6 shows that this quarterly figure has dropped consistently since the first quarter of 2001.

The weakness in the labor market is widely attributed to a 'stunning' growth in productivity (Greenspan, February 11, 2004). Figure 7 depicts the annualized growth rate of quarterly real GDP per employee⁵, from 1960-2003 (such quarterly data will not embody new monthly results until three months are in hand). We observe that recent productivity growth (in the shaded area) has indeed been very high, soaring to 7.7 percent in the third quarter of 2003, and falling thereafter to a mere 1.9 percent. Such fluctuations are by no means unusual in historical perspective, since similar volatility has been recorded at various points in the 1960s and 1970s. For this reason, we continue to expect productivity growth to remain moderate in the near future. Hence if output growth persists, employment and total wage income should improve markedly. This is more or less the consensus view (Bernanke, 2004; Goldman Sachs, 2003; Greenspan, February 11, 2004). Indeed, the current average rate of growth of productivity is not substantially different from the historical average of about 1.6 percent⁶, which in turn defines the medium term growth rate needed to just maintain the present level of unemployment. Because the pool of available labor also rises continually, growth rates higher than 1.6 percent would evidently be required to maintain the rate of unemployment, and still higher ones to bring it down.

In summary, large fiscal deficits have pumped up growth and profits, but have left employment and wage income moribund. Because the private (household and business) sector has moved into a small financial surplus, the large government deficits mirror the large current account deficits. And these in turn imply rising government and foreign debts, respectively.

What are the implications of this state of affairs? Official views seem optimistic about the near term prospects for growth and employment, and are not overly concerned about the near term consequences of the sharp rise in government and current account deficits.

“2003 seems to have marked the turning point for the U. S. economy, and we have reason to be optimistic that 2004 will see even more growth and continued progress in reducing unemployment” (Bernanke Jan 4 2004, p.7).

“The Federal Reserve enters 2004 with monetary policy that is unusually accommodative in historical terms, relative to the stage of the business cycle. That accommodation is justified, I believe, by the current very low level of inflation, and by the productivity gains and the weakness in the labor market, both of which suggest that inflation is likely to remain subdued” (Bernanke Jan 4 2004, p.7).

“Overall, the economy has made impressive gains in output and real

incomes ...[even though] progress in creating jobs has been limited... Looking forward, the prospects are good for sustained expansion of the U.S. economy... In all likelihood, employment will begin to grow more quickly before long as output continues to expand... [and] the currency depreciation we have experienced of late should eventually help to contain our current account deficit” (Greenspan, February 11, 2004, pp. 1, 3, 4).

These same spokesmen are notably more cautious about long run prospects, expressing concerns about the consequences of an inevitable rise in the real federal funds, and about the adjustments that might have to be made to contain excessively high government and current account deficits (Greenspan, February 11, 2004). There are others who move beyond mere worry to outright pessimism. For instance, the International Monetary Fund (IMF) has recently warned that the current deficit-driven “economic recovery may come at the eventual cost of upward pressure on interest rates, a crowding out of private investment, and an erosion of longer-term productivity growth” [IMF Jan 7, 2004, p. 5]⁷.

Our concerns are somewhat different. We have argued for some time that consumer spending cannot keep its pace, and are gratified to find that this view has become virtually consensual (Krugman 10/31/2003, Bies 2004). For a long time now, sharply falling interest rates have

enabled households to borrow heavily without incurring an explosive growth in their debt service burdens. Figure 8 profiles the household debt-service (principal and interest payment) burden based on the Federal Reserve's latest revisions. At the end of the third quarter of 2003 the debt service payments accounted for 13.1 % of disposable income, which is very close to the all time record high of 13.3% in 2001, and considerably higher than the mid-1993 level of almost 11%.

The Federal Reserve also provides a broader measure (the financial obligations ratio) that includes lease payments for automobiles, rent and homeowner's insurance payments and property taxes in the overall debt service burden. This peaked at an all time high of 18.73% of disposable income in the last quarter of 2002, and still remained above 18.3% in the third quarter of 2003. These levels are significantly higher than the 16.25 % ratio achieved a decade earlier. Interest rates are still near all time lows, while debt and debt-service burdens are near all time highs.

The increasing household debt burden has given rise to an unprecedented record of consumer bankruptcies, as it is shown in Figure 9. These translate into 1.66 million bankruptcy filings for the year ending September 30, 2003 –an increase of 7.4% from the previous year as reported by the federal judiciary (Kanell, The Atlanta Journal-Constitution January

Figure 8: Quarterly Household Debt Service Burden (revised 02/27/2004)

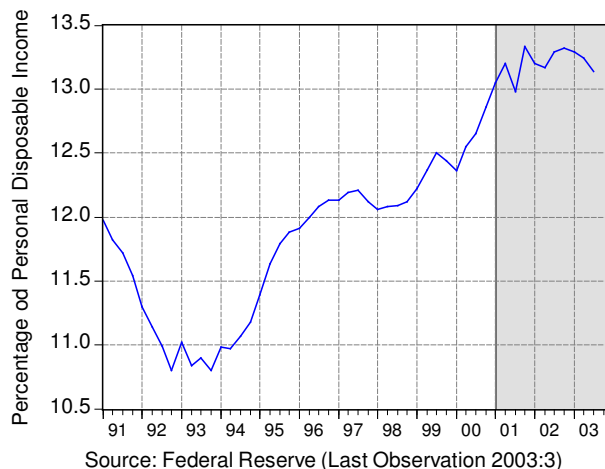
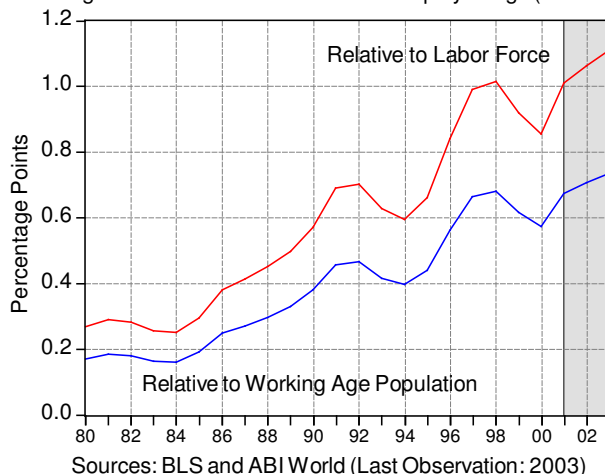


Figure 9: Relative Households' Bankruptcy Filings (Annual)



18, 2004). With interest rates having bottomed out, further increases in debt burdens could sharply increase debt-service burdens and accelerate bankruptcies. We believe that this represents a significant danger. The official view seems to miss this point when it argues that "the household sector seems to be in good shape, and much of the apparent increase in the household sector's debt ratios over the past decade

reflects factors that do not suggest increasing household financial stress" (Greenspan, February 23, 2004, p.5).

Financial and business constituencies have focused instead on the possibility that large government deficits might renew inflationary pressures and lead to rising interest rates. While we remain vigilant about the prospects of inflation, we are more concerned about a possible drop in demand for U.S. assets by foreign creditors such as China and Japan that sparks concern. In this respect, we agree with Federal Reserve Chairman Greenspan and others who also express similar concerns.

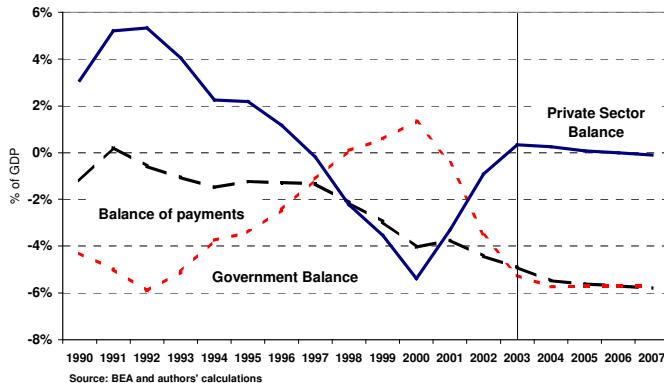
In any case, our focus is on a different set of questions. What is the likely growth path induced by anticipated levels of government deficits, and what implications does this have for current account deficits and for foreign debt? Will growth fade if government deficits are reduced once the election cycle is over? What will this do to employment growth, given that productivity growth seems to have settled at much higher level than in the past? Will the current account deficit also be reduced, or will the private sector deficit reappear, leaving the current account deficit intractably large? We turn to these issues next.

III. Post-election Scenarios

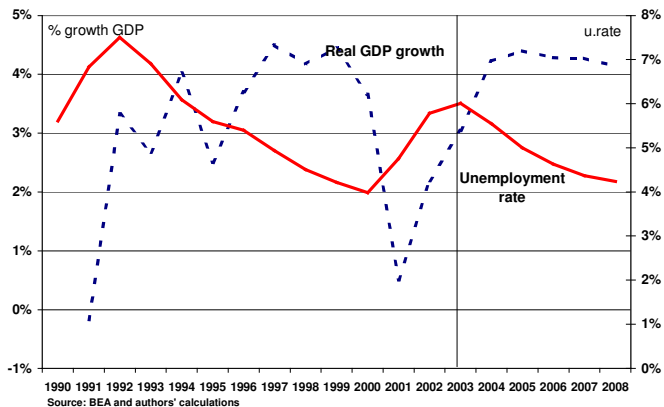
In our Strategic Analysis of October 2003, we contrasted the CBO's budget projections with what we considered to be "a more realistic path" for the general government balance. Subsequent events have broadly confirmed our projections.

In examining the likely outcomes of our projected budget paths, we incorporated the CBO's own assumption that households would use some portion of their tax cuts to reduce their debt. But it appears that rising equity markets and the prospect of an increase in disposable income arising from planned tax cuts overcame any concerns households might have had about their high debt levels. Thus households continued to increase their expenditure – mainly on durables and housing – without significantly reducing their rate of borrowing. For this reason, economic growth was somewhat higher than our previous projections. So too have been the levels of personal sector debt relative to private income.

**Figure 10. Main Sector Balances
Deficit Financed Growth**



**Figure 11. GDP Growth and Unemployment
Deficit Financed Growth**



In what follows we examine the medium term consequences of three alternative policy scenarios. The first of these, which we call the "baseline" scenario, examines the likely economic outcomes of present fiscal and monetary policy. Unsustainably high budget deficits and record current account deficits are characteristic of this path. Therefore, the next two scenarios contrast two alternative methods of halving budget deficits over the next 5 years: reducing government expenditures (Scenario 1) versus

rolling back tax cuts (Scenario 2). As we shall see, the output and employment paths are strikingly different in these two scenarios.

Since the focus of our analysis is on alternative fiscal policies, we keep interest rates constant in all simulations⁸. We also assume that the private sector will keep on borrowing, albeit at a lower pace than in the past, so that the private sector balance tends to stabilize. On other fronts, we retain the assumptions of our previous strategic analysis: world growth at 3.7% in 2004, and 3.35% thereafter; world inflation around 2% throughout the simulation period; and the exchange rate falling at a 3% annual rate in 2004, but stabilizing thereafter. Following recent predictions (The Economist, Jan 31, 2004), we assume domestic inflation to be 1.5% throughout.

III.1. The Baseline Policy Scenario: extending present policy

Our baseline scenario essentially projects the consequences of present economic policy. As detailed in our previous report, we utilize the CBO's projections of government spending. We also assume that present tax cuts will be extended, and recent budget proposals will be enacted. Coupled with the assumed constancy of interest rates, this gives us a direct extension of present policy. It should be noted that we only display our simulation results until 2008,

and they are always presented as annual values, not quarterly ones.

The two baseline charts tell the main story. The assumed deceleration in private borrowing would bring the private sector into balance. But it would also reduce the growth of demand coming from the private sector. However, this would be more than offset by rising government deficits and by sustained export growth due to the depreciation of the dollar. The government deficit would worsen from its annual level of 5.2 percent of GDP in 2003 to 5.8 percent in 2004, and stabilize thereafter. The current account deficit would also deteriorate before it stabilized at a record 5.8 percent of GDP, because accelerated export growth would be counterbalanced by accelerated import growth due to the fact that the US would be growing faster than its trading partners. Real GDP would jump from 3.1 percent in 2003 to 4.1% in 2004, and stay between 4.1% and 4.4% thereafter. On the assumption that productivity growth were to return to its average post-war level, unemployment would fall steadily, arriving at about 4.4 percent by 2008. This would be the best of all possible worlds for present policy. Should productivity growth continue to be higher than in the past, then unemployment would be correspondingly higher.

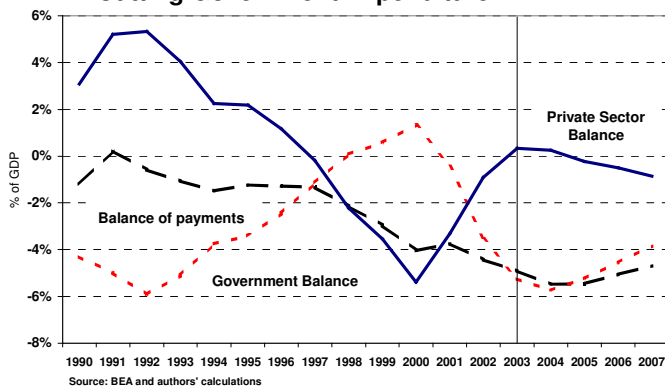
Unfortunately, this apparently rosy scenario would not be stable. Because relative government and foreign deficits

would both be higher than the growth rate of GDP, government and foreign debt would rise steadily relative to GDP. By the end of 2008, the former would rise from its 2003 level of 44% to 58%, and the latter from 28% to 47%. Even with interest rates assumed to be constant, this would imply a growing interest burden for general government and for the nation. Were interest rates to actually rise over time, as the CBO now assumes, then matters would be much worse.

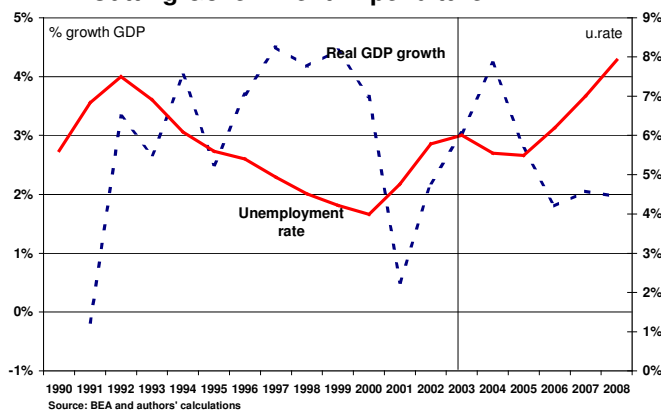
III.2. Scenario I: Halving the deficit by cutting government spending

The preceding prospects lead us to consider two alternate ways of reducing the budget deficit. The present administration clearly favors a reduction in the growth of government spending as the means of achieving this goal (Edmund L. Andrews, March 21, 2004, "Managing The Deficit With Plans To Spend", New York Times, p.BU 4). Accordingly, in Scenario I we examine the potential consequences of a reduction in the growth in government spending sufficient to halve the deficit in 5 years, as President Bush suggested in his recent State of the Union Address. As of 2003, the budget level stood at 5.2%, which would make the target level 2.6% in 2009. All other assumptions, including tax rates and interest rates, are the same as those the baseline scenario, and all policy changes are assumed to come into play in 2005 (i.e. after the next election).

**Figure 12. Main Sector Balances
Cutting Government Expenditure**



**Figure 13. GDP Growth and Unemployment
Cutting Government Expenditure**



The chart depicting the main sectoral balances for Scenario I shows that when the government deficit is reduced from its projected level in 2005 towards its target level of 2.6% in 2009 (we only display results until 2008), the foreign deficit also falls, albeit much less, from 5% to 4.2%.

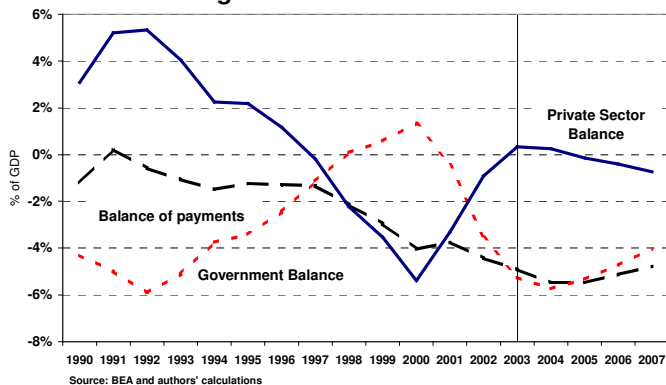
The trouble with this particular deficit reduction method is that our model indicates that this path requires an actual fall in the level of real government spending, not merely a reduction in its growth rate. But then, as indicated in the

growth and unemployment chart for this scenario, there would be significant negative effects. Real GDP would slow to 2.6% in 2005, and hover around 2.0% thereafter. With this, unemployment would rise from its 6% level in 2003 to about 8% in 2008. Moreover, the private sector would fall back into increasing deficits, which would imply a concomitant rise in private sector debt. Finally, although the foreign deficit would fall to 4.5 % by 2008, this is considerably higher than the corresponding GDP growth rate of 2.6%, which means that foreign debt would continue to rise relative to GDP. What looks good in terms of structural balances therefore turns out to be quite bad for growth and employment.

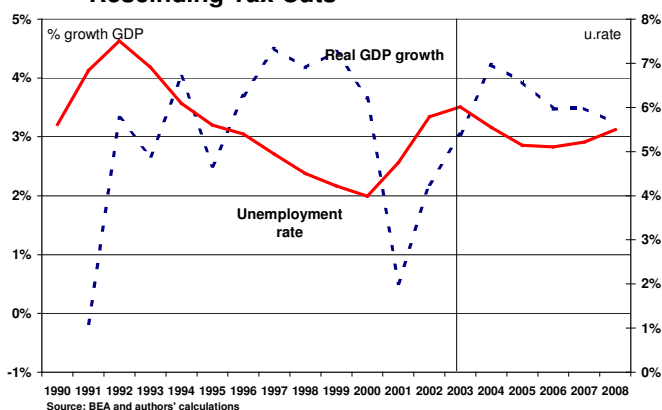
III.3. Scenario II: Halving the deficit by rescinding tax cuts

We now consider what happens if we were to achieve the same target as in the previous scenario— halving government deficit in five years – by letting the personal tax rate go back to its pre-tax-cut level. Government expenditure is assumed to grow at the same rates as in our baseline scenario. Our model then indicates that in order to accomplish the desired budget reduction, the direct tax rate would have to return to the levels in effect at the beginning of the Bush administration. As in the previous scenario, this policy change is assumed to begin in 2005, after the coming election.

**Figure 14. Main Sector Balances
Rescinding Tax Cuts**



**Figure 15. GDP Growth and Unemployment
Rescinding Tax Cuts**



The three balances depicted in the first chart of Scenario II look very similar to their counterparts in Scenario I. This should come as no surprise, because both scenarios assume the same deceleration in private sector borrowing, and both embody the goal of halving the budget deficit by 2009. Once again, the foreign deficit would be modestly reduced, from 5% to 4.2%, and once again, the private sector would go back into deficit.

But there is a substantial difference between the two scenarios when it comes

to growth and unemployment. Under the tax reversion scenario, real GDP growth falls very little, from the projected high of 4.1% in 2004 to 3.8% in 2005, and to 3.2% in 2008. As a result, the unemployment rate is actually reduced, albeit only modestly, from its present level of 5.6% level in 2004 to a low of 5.1% in 2006 before rising back up to about 5.5% by 2008. Finally, as before, the foreign deficit falls to 4.1 % by 2008, and once again this implies a rising ratio of foreign debt to GDP. However, because the final growth rate is higher than it was in the previous scenario, foreign debt ratios rise much more slowly.

IV. Summary and Conclusions

Our Baseline Scenario depicts what is likely to happen if present monetary and fiscal policy stances are maintained. We find that the government deficit would rise to about 5.8%, as would the foreign deficit. The latter would be a new record. Real GDP would rise to about 4.2% by 2008, and on the favorable assumption that productivity growth returns to its average post-war level, unemployment would fall to about 4.4%.

Unfortunately, this apparently rosy scenario is not stable, because both government and foreign debt would rise steadily relative to GDP. Even under our neutral assumption of constant interest rates, this would imply steadily rising interest burdens in both sectors. Were interest rates to actually rise over time, as

the CBO now assumes, then matters would be much worse.

For this reason, we examined two alternative means of reducing the government deficit by half over 5 years, to take effect in 2005 (i.e. after the coming election). The first of these, as depicted in the charts representing Scenario I, considers what would happen this goal was achieved by curtailing government spending. This is the path favored by the present administration. The second, as depicted in the charts of Scenario II, examines what would happen if this goal were achieved instead by rolling back recent tax cuts.

Not surprisingly, the two scenarios are quite similar at the levels of the three main balances. Yet they give quite different results when we consider the corresponding growth and unemployment rates. Both begin in 2003 from growth rate of 4.1% and an unemployment rate of 6%. But halving the budget deficit by cutting government spending causes the growth rate to fall to 2.6% in 2005 and to about 2.0% by 2008, while unemployment rises to about 8% over the interval. Conversely, halving the budget deficit by rescinding recent tax cuts causes GDP growth to fall only slightly, to 3.8% in 2005 and to 3.1% by 2008, while the unemployment rate actually falls to 5.1% in 2006 before rising back to 5.5% in 2008. The latter scenario also produces less troublesome increases in foreign and government debt burdens,

precisely because it gives rise to higher growth rates.

Our model therefore indicates that if one wishes to cut the deficit, it is better to do so by rescinding tax cuts than by curtailing government expenditures. By the same token, it also suggests that the sharp rise in actual GDP growth from 2001-2003 had more to do with the jump in government spending than it did with the reduction in tax rates.

Two further issues should be noted. Our simulations assume that the devaluation of the U.S. dollar ends in 2004. Were we to allow for a continued devaluation, our model shows that this will improve the current account balance and accelerate growth, provided that interest rates do not rise in response to the decline in the dollar. On the other hand, if interest rates were to rise in the future as projected by CBO and others, this would significantly worsen the prospects of the US economy. It would create rising interest burdens for the private sector, which would likely slow down its demand for loans and hence its growth in spending. It would also increase the government's interest payments, which would largely benefit foreign holders of government debt, leading to larger income flows out of the country. These increased interest payments would also tend to worsen the government deficit, thereby requiring larger cutbacks in government spending or increases in the tax rates to keep the budget deficit in line.

All of this reminds us that fiscal deficits are inextricably linked to foreign deficits. As our colleague Wynne Godley has recently noted, “chronic balance of payments deficits (external balance) will make it impossible to achieve internal balance, unless either the target for the budget must be changed or effective steps be taken to improve the balance of payments” (Godley and Izurieta, 2004, p.16).

Notes

¹ The figures cited in the text are from NIPA, and refer to the general government net lending or borrowing, at annualized rates. However, in our charts our measure of total public sector balance, which covers, federal, state and local balances, differs somewhat from the NIPA figures because we include government investment in government expenditure but exclude consumption of government fixed capital. Our own measure would give a balance of \$82 billion in 2001, -\$319 billion in 2002, and -\$620 billion in 2003:3.

² The working age population grew by about 2.4 million people in 2002, and because the labor force participation rate was 67 percent, this implies that about 1.6 million new job seekers enter the pool every year. This translates into 134,000 new job seekers every month.

³ The dispute arises from the fact that the Bureau of Labor Statistics produces two surveys to estimate employment creation: one based on a random sample of employers that asks for the number of workers on payroll, the other based on a random sample of households asking for the number of members employed.

⁴ Nominal profits deflated by the GDP deflator.

⁵ Real GDP per employee is the appropriate link between prospective GDP growth and future employment.

⁶ Recent average productivity growth is measured over 2001:1-2003:1, in order to encompass complete set of peaks and troughs (see Figure 7). This comes to 1.43 percent, which is not very different from the 1960-2003 historical average of 1.56 percent.

⁷ Not very long ago, both Chairman Greenspan of the Federal Reserve and (then) Treasury Secretary Robert Rubin emphasized the importance of budget surpluses in fending off pressure on the U.S. balance of payments, in helping keep interest rates low, and keeping growth strong [Greenspan, July 20, 2000, p.4; *Economic Report of the President*, 2000, p. 31-34.

⁸ The latest CBO report (January 2004) actually assumes that interest rates will rise over the next few years.

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