

Strategic Analysis

Fiscal and Trade Policy to the Rescue

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Recent federal budget deficits, now running to about 3.4 of Gross Domestic Product (GDP), have managed to partially rescue the U.S. economy from the full consequences of its long debt-driven boom. But if we are to avoid a steep recession, much more will be needed.

The long economic expansion, dating from 1992–2000, was fueled by an unprecedented rise in private expenditure relative to income, financed by a growing flow of net credit to the private (household and business) sector.² The ensuing boom was therefore attended by an unprecedented rise in private sector debt relative to its income. On the surface, it seemed as if the growing burden of the household sector's debt was counterbalanced by a spectacular rise in the relative value of its financial assets, but this was never a match among equals. On one side was a debt commitment that had to be met by actual flows of interest and repayments; on the other was a potential valuation compounded out of earnings, expectations, and illusions. It always seemed sensible to us that the two sides of this balance were fundamentally unequal (for example, Godley and Izurieta 2002, p. 8; Godley 1999, p. 6).³ We have consistently maintained, in the face of some skepticism, that such a process was unsustainable, that it would unravel, and that we were headed for a period of stagnation that could only be offset by a sufficiently forceful fiscal stimulus.

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² The private sector is comprised of the household and business sectors. The latter, in turn, is made up of the noncorporate and nonprofit enterprises and the corporate sector.

³ It is remarkable how often analysts tend to forget that debts have to be paid, whereas the capital gains that appear to offset them cannot be realized in any significant amount by the private sector as a whole without causing the markets to crash and gains to disappear.

The great meltdown in the financial markets has proved this imbalance to be true. The private sector has dramatically cut back its acquisition of new credit and reversed the path of its financial balance. The most recently available figures indicate that its financial deficit moved from a high of 6.9 percent of its disposable income in the third quarter of 2000 to 1.6 percent in the second quarter of 2002 (after having dropped to 1 percent in the first quarter). However, this adjustment has been uneven within the private sector. The business sector, as exemplified by the corporate sector, suffered a huge drop in investment; hence, it essentially stopped acquiring new debt even though interest rates have reached their lowest levels since the early 1960s. On the other hand, the household sector has continued to borrow. But even here, the overall trend of rates of net credit flows and financial balances seem to have leveled off since 2000 (Chart 1).

[Chart 1]

With the private sector no longer willing, indeed, no longer able to expand its net credit flows, the very stimulus that fueled the long boom has petered out. No counterweight can be sought in the foreign current account, as it **has long been in deficit and even worsened sharply in 2002 (Chart 2), reaching an unprecedented 4.7 percent of GDP in the 2nd quarter. Preliminary data from the Bureau of Economic Analysis (BEA) for July and August indicate that the trade deficit has deteriorated even further since then (BEA 2002b); we project a third quarter 2002 current account deficit of 4.8 percent of GDP.** We are left with the government sector and, possibly, the net export demand portion of the foreign sector.

[Chart 2]

[Chart 3]

During the long boom, the general government deficit declined steadily, eventually giving way in 1998–2000 to the first set of postwar structural budget surpluses (Chart 2). Indeed, as Chart 3 shows, until recently these surpluses were projected by the Congressional Budget Office (CBO) to rise steadily into the future (CBO 2001a). We

have previously argued that if the government were to maintain its restrictive fiscal stance when the private sector deficit inevitably began to return toward sustainable levels, a severe recession would follow.⁴ Conversely, we argued that in circumstances such as this, it was incumbent on the government to do its part to keep the economy from entering such a recession. With the growth rate of private expenditure declining and a surge in exports unlikely, a sharp rise in government expenditure would be the only means left to sustain adequate growth in aggregate demand.⁵

Indeed, this is just what has happened. Relative to GDP, the public sector balance moved sharply from a surplus of 1.2 percent at the peak of the expansion in the 3rd quarter of 2000, to a deficit of 3.4 percent in the 2nd quarter of 2002, a shift of over 4.5 percent of GDP in less than 2 years. We believe that this is a step in the right direction that has served to stave off a much more severe recession. It is clear that much more is needed. The public sector must move to an even stronger expansionary direction. If net export demand could be improved, say by a devaluation of the U.S. dollar, the size of the government deficit required to do the job would correspondingly decline.⁶ In what follows, we explore the possible size combinations of these two deficits that would serve to maintain the necessary levels of growth and employment.

THE RECENT PATTERNS IN THE U.S. ECONOMY

We begin by examining the recent patterns of the three main sectoral balances that comprise the U.S. economy. As a matter of accounting, the ex post government sector deficit, the current account surplus, and the private sector deficit (the excess of consumption and investment over private sector disposable income), must all add up to zero.

⁴ A “debt crisis” in the sense of Minsky (1982, 1986).

⁵ The consensus in the last decade has been that the U.S. expansion was solid because it was grounded in supply-side factors such as the technological dynamism of the economy and flexibility in the labor market. From this point of view, government intervention is neither necessary nor desirable, because the market is always self righting. Against this consensus, the Levy Institute has long recommended a recourse to fiscal policy when appropriate (Papadimitriou and Wray 1998; Godley 1999; Godley and Izurieta 2001, 2002).

⁶ As a matter of accounting, if the private sector is in balance, the government deficit must equal the foreign deficit.

But ex ante, it is the excess of the sum of all demand injections less the leakages that drives growth (Papadimitriou and Wray 1998). And here, from 1992–2000, the injections from the government deficit declined, turning eventually into leakages as the government balance went to surplus in 1998. During the same period, the current account was in deficit; this particular leakage continued to escalate to unprecedented levels. The result was a rise in private expenditure relative to income—with an attendant rise in the private sector deficit and debt burden—as the major expansionary force. As long as the stock market boom offset personal sector debt, the process seemed endless. But, as we noted earlier, this was an illusion; debt requires actual principal and interest repayments, which cannot be funded out of paper gains to any significant degree without causing the markets to decline and the gains to evaporate. In any case, the bubble burst at the end of 2000. In response the private sector moved swiftly to curtail its expenditures and simultaneously decrease its net borrowing. Chart 2 traces these patterns in the three complementary balances.⁷

Chart 4 breaks down the private sector balance that appears in Chart 2 between personal and corporate components (as percentages of GDP), both in terms of three quarter moving averages. Although the corporate sector has rapidly returned to balance, the personal sector has merely stabilized its balance at a level that represents an ongoing deficit. This negative balance is far below the surplus normally maintained by the personal sector during most of the postwar period.⁸

[Chart 4]

The upshot of the spending boom is that personal sector debt burdens remain extraordinarily high (Chart 5). Nonetheless, the personal sector continues to borrow at a

⁷ In this chart, a negative government balance represents a surplus. The other balances are more intuitive, in the sense that positive numbers imply surpluses.

⁸ Using quarterly data for the period of the recent expansion (second quarter of 1992 through the third quarter of 2000), the personal sector balance declined steadily from an initial surplus of 4.5 percent of GDP to a significant deficit of 1.7 percent. The balance continued to fall somewhat erratically during the first two quarters of 2001, then underwent a swift upturn during the third quarter due to the positive impact of the tax rebate on disposable income. It fell once again in the last quarter of 2001 as households spent previous windfall gains and encouraged by zero-interest rates on the purchases of durable goods.

relatively high rate, although the trend seems to have stabilized (Chart 6). We have argued that such a process is unsustainable. Indeed, the most recent figures for household borrowing show that it dropped sharply in August 2002, posting its smallest gain in eight months. Wall Street analysts, who have generally been bullish in the past, are now concerned that this borrowing slowdown raises “worries about consumer spending ahead.”

[Chart 5]

[Chart 6]

Chart 1 tracks the net wealth of the household sector, which is the balance between the stocks of its debt and its assets, relative to personal disposable income. Note the sharp drop in this measure, starting in 1999, as the stock market began its downward spiral. This drop has been so steep that relative household net wealth has moved a considerable distance back toward its historical average.

It is interesting to note that two major components of the assets of the personal sector have so far moved in quite different ways. Although the value of the sector’s equity holdings has declined sharply relative to its disposable income, the value of its real estate assets has continued to rise (Chart 7). That these two divergent effects are largely due to price effects is made clear in Chart 8, which depicts the relative prices of equities and of housing. Finally, interest rates on household debt have fallen in line with the federal (fed) funds rate, which is itself at a historic low 1.75 percent. All of this suggests that the full force of the personal sector’s fall in net wealth has not yet been felt. Recent commentators have begun to express concern about the overheating housing market and the record levels of real estate prices (*The Economist*, October 12, 2002, pp. 12–13). Should these begin to stagnate, or even fall, it would have a significant negative impact on the borrowing capacity of households. Given the current low level of the fed funds rate, there would not be much room left for monetary policy to counteract such events.

[Chart 7]

[Chart 8]

It has long been our contention that such events were bound to occur at some point, and that they would lead to a sharp slowdown in GDP growth unless sufficiently offset by demand injections elsewhere. Of course, others have also warned that the stock market boom of the 1990s had departed from its fundamentals.⁹ But our particular focus has always been on the need to take the next step in the analysis by linking the potential deflation of financial markets to the ensuing fragility of the economy's debt structure. It was the buildup of this debt that fueled both the growth in real output and the stock market boom of the 1990s. And it was this very same debt buildup which eventually pushed the economy into a state of "financial fragility" as analyzed in the work of Levy Institute Distinguished Scholar Hyman P. Minsky.¹⁰ As our research has warned, over the last several years, the ensuing reaction has unraveled both the stock market boom and real growth (Godley and Kregel 1998, Godley 1999). And we have also consistently argued that in the face of a high and growing current account deficit, growth in aggregate demand could only be sustained by expansionary fiscal policy (Godley 2000).

The annualized trend of GDP growth, depicted here as the percentage change between a given quarter and its counterpart four quarters (one year) ago, began to decline from the third quarter of 2000 to the second quarter of 2001 (Chart 9). This corresponds to the sharp deterioration in the private sector balance during this same period (Chart 2). Yet from the second quarter of 2001 on, growth recovered to some degree, even though it still remained far below its potential.¹¹ But why even this partial recovery? From our point of view, it is largely because fiscal policy came to the rescue as the budget balance

⁹ Many analysts have now come to adopt Robert Shiller's (2000) notion that the stock market boom of the late 1990s was driven by "irrational exuberance."

¹⁰ The classic references are Minsky (1982, 1986). For a concise summary, see Minsky (1991, especially n. 51.).

¹¹ The most recent advance estimates for the third quarter of 2002, which themselves are to be succeeded by the preliminary estimates due November 26, show real GDP growth of 3.1 percent at an annualized seasonally adjusted rate (in comparison to 1.3 percent growth in the preceding). Such estimates are typically subject to considerable revision. More importantly, because the apparent growth surge has been led almost exclusively by the growth in personal consumption expenditures, most commentators now agree with us that such a growth rate is unsustainable in the face of already-record levels of household debt. [quote from Bloomberg service on this, from 10/31/02 report on this release]

reversed itself, moving dramatically from a small surplus in the first quarter of 2000 to a substantial deficit of 3.4 percent of GDP by the second quarter of 2002 (Chart 2).¹²

[Chart 9]

The reappearance of public sector deficits, which we have long predicted, is all the more striking given that the CBO has long projected just the opposite. Chart 10 depicts historical figures up to 2001, as well as CBO projections of the fiscal balance for 2002 onward, made at successive dates from October 2000 to the most recent one in August 2002 (CBO 2000; 2001a,b; 2002a,b). In arriving at these projections, the CBO makes specific assumptions (as opposed to forecasts) about key macroeconomic variables such as real GDP growth, inflation, and unemployment. (This is discussed further in the next section.) In addition, the CBO itself projects only the federal deficit (so that a negative value is a surplus), whereas we depict the general government deficit implied by this.¹³ What is striking is that CBO's projected deficits all display similar paths after 2002, moving steadily toward ever-larger surpluses. But over time the slowdown in actual growth (which was not as severe as it might have been thanks to the massive relaxation of fiscal policy that took place after 2000), has forced them to revise each successive estimate downward. Unless the public sector deficit is increased more sharply, there will be more such revisions in the future. We have consistently argued that CBO's projections were not plausible because they implied an unsustainable increase in the private sector deficit that would be perforce financed by further injections of credit, thereby increasing the private sector's debt burden. The limits of that process have now become evident, and over the last 17 months the CBO has had to revise its projections for the 2002–06 period downward by approximately \$500 billion *per year*.

¹²The BEA (2002a) indicates that “both the previously published and the revised estimates show GDP growth peaking in the fourth quarter of 1999 and slowing substantially during the quarters of 2000. However, the revised estimates show declines in GDP for each of the first three quarters of 2001, whereas the previously published estimates showed positive but decelerating growth in the first half of 2001 and a decline in the third quarter. Both sets of estimates show GDP growth resuming in the fourth quarter of 2001.”

¹³ To arrive at the general government deficit from the federal deficit, we adapted the CBO's projection using a scaling factor derived from the past (fairly stable) relationship between the federal budget and the surplus or deficit in the general government.

[Chart 10]

As noted earlier, no relief can be expected from net export demand, since the current account portion of the balance of payments not only remains stubbornly in deficit, but has deteriorated sharply over the first two quarters of 2002 (to a new record level of 4.7 percent of GDP). Past Levy Institute reports have shown that the decline in the balance of trade in manufactures accounts for the greater part of this pattern. It is evident that this is an unsustainable process, because it implies a growing external debt burden that, too, must ultimately run up against its limits. Chart 3 depicts the recent history of this balance, which is clearly driven by the primary balance. The recent modest reversal in the appreciation of the dollar evidently has little effect, and was not able to prevent net property income from abroad falling considerably—even turning negative. This is to be expected, since a rising foreign debt burden should, *ceteris paribus*, imply a continuous shift in interest and dividend payments in favor of foreigners (Godley and Izurieta 2002, pp. 5–6).

Finally, it is worth noting that in recent times the public and foreign sectors have once again become duals of each other (Chart 2). In effect the economy is once again approaching a period of “twin deficits” comparable to that of the 1980s and 1990s.¹⁴ This, too, is something we have anticipated in a series of reports issued beginning in early 2001 (e.g., Godley and Izurieta 2001, 2002). Indeed, we have argued that the alternative to expanding the public deficit would have been a prolonged recession, and it was our belief that such an outcome would not have been politically feasible. Current events seemed to have borne this out.

AVOIDING A “HARD LANDING”: SOME POLICY SCENARIOS

The Baseline Scenario

As a matter of accounting, the *ex post* government sector deficit, the current account surplus, and the private sector deficit (private sector disposable income less consumption

¹⁴ For details, see Godley (1995, n.138).

and investment), must add to zero. Given the complementary nature of the three main balances, the paths of any two will imply the ex post path of that of the third. We can make use of this property to first draw out what is likely to happen in the economy if the CBO's assumptions underlying its projections of future budget balances are to be realized. This is our baseline scenario, which tracks what the private sector will have to do in order to obtain the CBO's projected growth path. We will then reverse the procedure and try to ascertain what the government deficit is likely to be if the private sector chooses a more plausible adjustment path. Finally, we will turn to various alternative scenarios that could achieve the CBO growth path via a combination of fiscal policy and significant improvement in net export demand.

The first step is to construct what we call the baseline scenario. The aim here is to show what the private sector and foreign sector balances must be within our model if the CBO's projected fiscal balances, growth rates, and inflation rates are to be realized. The latest CBO projections (2002b) for the government deficit are shown previously in Chart 6. In addition to these, the CBO assumes that GDP will grow at 2.3 percent in 2002, 3 percent in 2003, and 3.2 percent on average from 2004 until 2007; and that inflation, as represented by the rate of change of the GDP deflator, will be 1.1 percent in 2002, 1.6 percent in 2003, and 2 percent on average from 2004 until 2007. To this we add the provisional assumption that the nominal dollar exchange rate will remain constant, and that world demand growth will rise moderately from its current low level. Chart 11 depicts this baseline scenario. The dark line represents the *general* government deficit corresponding to the CBO projection of the federal deficits, while the other two represent the relative surpluses of the private and foreign sectors implied by the CBO's assumptions.¹⁵ It is worth noting that in the case of the government sector it is the *deficit* that is depicted (so that a negative number represents a surplus), while for the private and foreign sectors it is their surplus that is shown (so a negative number is a deficit).

[Chart 11]

¹⁵ We scale up the federal budget balance to obtain the implicit general government balance using historical patterns between the two.

The lower line in Chart 11 shows our conditional forecast of the current account balance, as a percentage of GDP, through 2006. This brings us to our central point. If, as in CBO's latest projection, the present government deficit were to be pared back to a surplus by 2006, the private sector would once again have to run increasing deficits to generate the GDP growth projected by the CBO. This in turn would increase private indebtedness to new heights. It is hard to believe that after the collapse of equity prices, the private sector will return to a high and even rising level of indebtedness. Yet if the fiscal stance projected by the CBO were to be achieved, this is what must occur.

It is our contention therefore that a different policy is required. In order to achieve growth sufficient to maintain unemployment at reasonable levels, there must be substantial injections of new demand. This cannot come from the private sector, as it has in the past, because this very same past has left the private sector with dangerously high levels of household and corporate debt. Hence, it is the government sector that must take up the bulk of the burden.

Scenario 1: Private Sector Balance by 2007

In the baseline scenario (Chart 11) we found that private sector would have to run large deficits if the CBO assumptions of growth were to be achieved in the face of its projections about the public sector fiscal stance (that is, about the tax rate and growth of government spending). We now consider what would happen if instead the private sector were to continue on the path it is presently following, and achieve eventual balance by 2007. Given the same fiscal stance as before, we find that such a result would imply a lower rate of real GDP growth over the 2002–06 period, to an average of about 1 percent per year. This lower growth rate in turn would imply lower tax revenues so that the government deficit would rise to almost 5 percent by 2006 (a figure within the range of the postwar average).¹⁶ Secondly, given that the three sectoral balances must add up to zero, the assumption that the private sector moves into balance implies that the public sector and the foreign sector must move in opposite directions. Thus the “twin” deficit in

¹⁶ There is in addition a small increase in government expenditure arises in Scenario 1 due to the projected higher level of unemployment.

the foreign sector would also be around 5 percent, which is essentially its current level (see Chart 3). This is Scenario 1, depicted in Chart 12. But this scenario is in concert with an implied rise in unemployment to around 7 percent by 2005, and 8 percent by 2006, which seems to us to be both undesirable and unsupportable.

[Chart 12]

Scenario 2: Achieving CBO Growth via Budget Deficits

We might now turn the question around and ask: What fiscal stance would be required to achieve the CBO's projected growth rates of real output? We retain the assumption that the private sector will continue to move toward balance. Given the high level of debt in the household sector, it is plausible that this sector will continue to pare its borrowing and perhaps even move toward net saving. On the other hand, the revival of growth on which this scenario is predicated is likely to stimulate further borrowing by the business sector to support its expansion. It is plausible, therefore, that the two effects would cancel each other out so that growth of borrowing in the private sector as a whole remains flat. Under these conditions, as depicted in Chart 13, we find that in order to achieve the CBO's growth targets it would be necessary to have budget deficits rise sharply, to a level of over 8 percent by 2006. Such a level would be higher than the 4–5 percent postwar-years average, higher than the 6.5 percent level of the Reagan-Bush era, and higher still than the previous peak of 7.5 percent in 1975. Moreover, with the private sector moving into balance, the current account deficit would have to be of roughly the same order as the budget deficit. But the current account deficit (about 5 percent) is already at record levels, and its further deterioration to over 8 percent is unsustainable.

[Chart 13]

Scenario 3 (The Dream Scenario): Sustainable Balances

If fiscal policy alone could not sustain growth and employment without unacceptable increases in both budget and current account deficits, where else might we turn? The answer lies in what we have previously called our dream scenario: an improvement in net export demand sufficient to achieve CBO projected growth and, hence, employment without relatively large budget deficits.

In all of our previous simulations we provisionally assumed that the exchange rate remained unchanged and that real exports grew at 1 percent per year. But we believe in concert with others (Bergsten 2002) that net export demand could be raised substantially by means of a devaluation of the effective exchange rate of around 25 percent at the beginning of 2003. This would reverse the present trend of the current account, bringing it close to a sustainable level of 2 percent to 2.5 percent of GDP by 2006. With the private sector assumed to be approaching balance itself, this would in turn imply that the government sector would also move toward balance. Thus all three sectors could return to sustainable balances, while still achieving desired levels of employment and growth. This felicitous combination is Scenario 3, depicted in Chart 14.

[Chart 14]

We are aware that the policy scenario we propose is by no means an easy one. With the advent of flexible exchange rates, devaluations are no longer a standard policy instrument. Growing current account deficits since 1998 have not led to any substantial depreciation of the dollar other than a modest fall in first half of 2002. Indeed, the deficit has not even reacted in the usual manner to the latest decline in U.S. growth (such as in the third quarter of 2002), which should have slowed down the growth of imports and hence reduced the deficit. Instead, the both the trade balance and the current account deteriorated even further. We also recognize that devaluation on the order of 25 percent would raise import prices and hence might stimulate a general price rise. But in this regard our estimates indicate that this effect would be fairly modest, and we are given confidence by the fact that a much larger depreciation in the mid-1980s was not attended by a significant rise in inflation.

However, the consequences for foreigners of a substantial improvement in the U.S. current account balance are much more serious. Other things being equal, such an improvement would imply a decline in relative net export demand by the rest of the world, with a corresponding decline in their levels of output and employment. This in turn would inevitably feed back onto our own export growth, and hence onto our output and employment growth. The only solution, therefore, is for our trading partners to take up part of the burden of fueling worldwide growth by undertaking their own expansionary measures at the same time. The U.S. net trade deficit has long provided a stimulus to its trading partners, but the record levels of its current account deficit signal the approaching end of that process. What seems to be required, therefore, is a coordinated expansionary effort on an international scale, with a greater share being taken up by the rest of the developed world. The alternative is a severe growth recession and a large rise in unemployment in the United States and, most, likely in the rest of the world.

CONCLUSIONS

Economic growth from 1992–2000 was largely fueled by a spectacular rise net lending to the private sector (Chart 6). We have argued in the past that the borrowing frenzy and its concomitant buildup of debt, which had fueled both the growth in real output and the stock market boom of the 1990s, was pushing the economy into an unsustainable Minskian state of financial fragility. Others had also warned about the unsustainability of the boom in the latter part of the 1990s, particularly in regard to the stock market. Our particular concern has always been that the potential deflation of financial markets could also unravel real growth, which is precisely what happened. The equally spectacular rise in value of financial assets that sustained private sector net worth melted away (Charts 1, 7–8), and the private (business and personal) sector responded by cutting back its acquisition of further debt (Charts 2, 4). In the face of these events, the trend of the GDP growth rate declined sharply from the third quarter of 2000 to the second quarter of 2001 (Chart 9).

Yet from the second quarter of 2001 on, real GDP growth made a partial recovery, having still achieved only half the average rate of growth experienced during

the previous expansion. Although this is far too modest to sustain employment, even this partial recovery took place only because the previous small budget surplus in the first quarter of 2000 reversed itself and moved dramatically to a substantial deficit of almost 4 percent of GDP by the second quarter of 2002 (Chart 2). We had consistently advocated just such a reversal in fiscal policy in the face of the approaching end of the 1992 debt-fueled expansion. This reappearance of public sector deficits was evidently a surprise to the CBO, which had steadfastly been projecting substantial surpluses, and then successively revising these projections downward in light of actual events (Chart 10). Over the last 17 months the CBO has had to revise its projections for the 2002–06 period downward by \$500 billion *per year*.

But while the current fiscal policy has moved in the right direction, we believe that it is far from sufficient. To substantiate this, we undertake to examine four alternative policy scenarios.

The first of these is what we call our baseline scenario depicted in Chart 11. In it we show that within our model, in order to realize the CBO's latest projected growth rates and fiscal balances, the private sector would once again have to run increasing deficits and raise its indebtedness to new heights. We have argued in the past (and more urgently now) that even current private sector debt burdens are unsustainable, so that the prospect of their further escalation do not seem as feasible.

Consequently, we turn to Scenario 1 depicted in Chart 12. Here we retain the latest CBO assumptions about the government's fiscal stance (tax rates and spending plans), and we supplement this with the assumption that the private sector will continue on its present path toward decreasing deficits (Chart 2) culminating in eventual balance by 2007. We find that under these circumstances, the growth of real GDP would average about 1 percent over the 2002–07 with associated levels of unemployment in the order of 7 percent to 8 percent. This, in turn, would imply lower tax revenues, thereby raising the government deficit to almost 5 percent of GDP by 2007 (which is within the range of the postwar average), and second, it would keep the current account deficit at roughly its present level of about 5 percent. This tells us that the CBO assumptions about the fiscal stance are incompatible with its assumptions on growth and employment, and would moreover result in undesirable economic outcomes.

In Scenario 2 of Chart 13, we consider what fiscal stance would be necessary in order to achieve the CBO assumptions on growth, retaining the assumption that the private sector will continue to move toward balance. This leads us to conclude the CBO growth targets would necessitate sharply higher budget deficits in the order of 8 percent of GDP by 2007. If we assume the private sector moving into balance, this would require a correspondingly large “twin deficit” in the current account balance. Both of these would be significantly higher than the present and postwar averages, and even higher than past postwar peaks. This leads to conclude that sustaining growth and employment through fiscal policy alone is simply not feasible.

Finally, we turn to Scenario 3 (Chart 14), which we call our dream scenario. In it, we allow for the possibility of substantial improvement in net export demand brought about by a devaluation of the dollar of about 25 percent. This would require a much smaller initial budget deficit in order to realize the levels of real GDP growth assumed by the CBO. Indeed, over time the resulting GDP growth would reverse the directions of both the public sector and current account deficits, so that along with the private sector, they would all approach sustainable levels by 2007. Thus the combined effects of a devaluation and expansionary fiscal policy could achieve desired levels of employment and growth while also restoring each sector to a better balance. In the light of the present high levels of sectoral debt burdens, this latter possibility is of great significance.

We recognize that the fiscal and trade policies we propose are by no means easily implemented, particularly in light of their probable global repercussions. We also realize that fiscal conservatives may react poorly to the reappearance of the “twin deficits” that seem inevitable to us in the short run. But we believe that the alternative is a severe recession with a significant rise in unemployment. And that, surely, is unacceptable to all concerned.

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