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ENCOURAGING BUSINESS INVESTMENT COULD STABILIZE U.S. ECONOMY, SAYS NEW REPORT FROM LEVY ECONOMICS INSTITUTE

Trade and Budget Deficits and Household Indebtedness Make U.S. Economy Vulnerable, according to Analysis from Levy Macro Modeling Team

ANNANDALE-ON-HUDSON, N.Y.—While the U.S. economy maintained growth rates higher than 4 percent in 2004, a new study from The Levy Economics Institute of Bard College suggests that surging trade and budget deficits and unsustainable levels of personal debt threaten to undermine prospects for growth. With President Bush calling for budget reductions and interest hikes likely to squeeze households, the Levy Institute's Macro Modeling Team contends that encouraging business investment would stabilize the trade and budget deficits and allow households to trim spending while sustaining growth rates and employment levels.

In their new strategic analysis, *How Fragile is the U.S. Economy?*, Levy Institute President Dimitri B. Papadimitriou, Senior Scholar Anwar M. Shaikh, and Research Scholars Claudio H. Dos Santos and Gennaro Zezza analyze scenarios for the U.S. economy and discuss the implications for growth and the financial balances of the private, government, and foreign sectors of the economy. One of the chief threats to the U.S. economy, the authors maintain, is the impact that rising interest rates and heavy debt burdens will likely have on the household portion of the private sector spending, a driving force in the expansion of the economy. "On the side of households, heavy indebtedness is putting negative pressure on growth," the authors write. "Households face stark choices. If they continue piling up new debt, the combination of their rising debt burdens and rising interest rates will produce rapidly increasing and unsustainable ratios of debt service to

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income. A jump in personal bankruptcies and a sharp drop in consumer spending will be inevitable." The Levy Institute scholars stress, however, that it is more likely that households will respond by cutting back on borrowing and spending.

With household spending likely to decline and both the budget and trade deficits at or near record highs, the authors paint a fairly bleak picture as to where the economy can turn for stimulus. In their baseline scenario, assuming no further devaluation in the dollar and that interest rates will increase by 25 basis points each quarter in 2005 and remain stable thereafter, the authors find that growth rates would remain at or above 3 percent, but the trade deficit would surge to 6.2 percent of GDP in 2005 and debt burdens in the private sector would continue to rise to unsustainable levels. Should households stabilize their debt, the budget deficit would climb to above 5.5 percent of GDP, while growth would drop substantially. In another scenario the authors find some favorable results when evaluating sustained drop in the dollar, but argue that there are too many exchange rate risks and that foreign capital flight could push interest rates higher and exacerbate problems across the U.S. economy.

Papadimitriou, Shaikh, Dos Santos, and Zezza conclude by suggesting that a surge in U.S. business investment could sustain growth without further indebting households or pushing the trade and federal budget deficits higher. In this scenario, which would require only a modest increase in the level of business debt, GDP growth would remain at 3 percent or above, the budget deficit would stabilize, and the trade deficit would rise slightly at first before falling to around 5 percent in 2006 and toward 4 percent thereafter. Though imports would increase, the impact on the trade deficit would be ameliorated by a shift in the composition of domestic demand away from personal consumption toward business investment. In order to bolster business investment, the authors say policy initiatives, such as reenacting the 50 percent tax allowance for purchases of new capital goods and allowing U.S. companies to repatriate foreign profits on favorable terms, would be necessary.

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<u>Strategic Analysis, *How Fragile is the U.S. Economy?*</u>

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