The Levy Economics Institute of Bard College

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Policy Note

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IMBALANCES LOOKING FOR A POLICY

WYNNE GODLEY

The latest batch of numbers from the United States makes for a disturbing read. The growth rate of GDP has been adequate, but the current account deficit was 6.3 percent of GDP in the fourth quarter of 2004, and the terrible trade figures for January and February promise an even bigger deficit in the first quarter of 2005 (BEA 2005). Let no one suppose that this deterioration is a temporary effect that will automatically turn around soon.

The dollar, measured against a basket of foreign currencies and adjusted for inflation, has depreciated by 17 percent during the last three years, but, surprisingly, the terms of trade—the prices of non-oil imports of goods and services, relative to those of exports—have actually improved slightly during this period (Fed 2005a; BLS 2005). This trend stands in sharp contrast to what happened in the mid 1980s, when there was a terms-of-trade deterioration equal to 30 to 40 percent of the dollar depreciation. Non-oil import prices have hardly risen at all relative to the overall domestic price level, so, with strong private expenditure, it isn't surprising that imports have continued to soar, and there is every prospect that they will continue to do so. Imports of goods and services are now more than 50 percent higher than exports, implying that if output continues to grow at 3.5 to 4 percent per annum, there will probably have to be a 12 percent annual

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average increase in the volume of exports sustained over four years (a growth rate rarely achieved in the past) to get any significant improvement in the overall balance. It looks less and less likely that the current account deficit will improve at all as a share of GDP, so long as satisfactory growth continues.

In the fourth quarter of 2004, the federal, state, and local governments' combined budget deficit stood at 4.3 percent of GDP (BEA 2005). The implication of this, taken in conjunction with the growing current account deficit, is that the expansion of total demand has been powered entirely by a renewed increase in private expenditure relative to income, which also happened in the Goldilocks period of the 1990s; once again, private net saving has fallen back decisively into negative territory. The counterpart of increasingly negative net saving, in terms of debt and lending, is revealed by the new Flow of Funds figures (Fed 2005b), which have been heavily revised upwards and show that the growth of debt owed by the nonfinancial private sector has been reaccelerating. Private debt has reached about 175 percent of private disposable income, another record, while net lending to the private sector rose from a trough of 8 percent of income in the third quarter of 2002 to more than 15 percent in the fourth quarter of last year; this is the extent to which private income was being supplemented by borrowing. By all accounts, the growth of lending and debt is financing a raging boom in housing, reminiscent of that in the United Kingdom but without any sign yet that it is slowing down.

The public discussion is fractured. There are vacuous suggestions coming from sections of Wall Street that Goldilocks has been reincarnated and everything is fine. There are right-wing voices calling unconditionally for cuts in the budget deficit. The Bush administration seems complacent and, thank goodness, is not being convinced about cutting the federal budget deficit any time soon. Many are concerned about the current account deficit. Some of them fear a big and "disorderly" devaluation of the dollar while others think the dollar isn't falling enough. No one has a clear idea about what can actually be done, by whom, and when. I have no sense that anyone who pontificates on these matters (outside the Levy Institute!) does so with the benefit of a comprehensive stock-flow model—the indispensable basis for competent strategic thinking.

I agree that the current account deficit will eventually have to be turned around, but doubt whether there can now be a market solution to this problem. The United States's largest creditors, in the Pacific rim countries, obviously want to go on building a mighty industrial machine, and this is more important to them than preserving the value of their dollar assets. So market forces may be subverted for quite a long time, perhaps measured in years. Any lasting solution will probably require a new international order, but at the moment no one has a motive for bringing this about. After all, the United States enjoys consuming nearly 7 percent more than it produces.

What worries me most about the medium-term prospect is that the state of aggregate demand in the United States, apparently robust, is most precariously based. The only sustainable configuration of demand growth is one in which exports rise by a larger amount than "full-employment" imports, but that is no longer a realistic prospect; it is more likely that the current account balance will go on exercising a negative influence on demand for some time. But private debt and borrowing cannot continue to provide the motor for expansion for more than a couple of years, particularly if interest rates go on rising. The growth in private debt must eventually slow down, causing net lending to fall and thus threatening recession, exactly as happened in 2000. But there can be no remedy this time in the shape of a fiscal expansion. A repeat of the 2000–2003 stimulus would take the budget deficit to 9 percent of GDP! On the other hand, the prospect of recession would be dangerously increased if President Bush were to prove a man of his word and really try to cut the deficit in half during the next four years.

Taking everything together, there is plenty to worry about.

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