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## Can Goldilocks Survive?

Wynne Godley and L. Randall Wray

***Growing government budget surpluses combined with growing trade deficits have generated record private sector deficits. Unless households continue to reduce their saving—creating an increasingly unsustainable debt burden—the impetus that has driven the expansion will evaporate.***

Recent economic statistics confirm that our Goldilocks economy continues to grow at a relatively swift pace, in spite of financial turmoil in Asia, Latin America, and Russia and economic recession in a third of the world. The longevity of the expansion is record-setting; it is already the longest peacetime expansion in U.S. history and is about to break the record set by the 1960s Vietnam-era expansion. The expansion's longevity and its strength have tightened labor markets, allowing unemployment rates to remain below 4.5 percent for the past year and raising real wages at a good clip for the first time in a generation. Perhaps the most potent symbol of the strength of the expansion has been the remarkable turnaround of the federal government's budget, from a chronically large deficit to a substantial surplus. One has to go all the way back to the demilitarization of the economy after World War II to find a comparable shift in the fiscal stance. By most accounts, the surplus will continue indefinitely. The Congressional Budget Office (CBO) is projecting a rise in the federal budget surplus through the next 10 years from 1.2 percent of GDP for 1999 to 2.8 percent for 2009. Such projections are, of course, contingent on continued economic growth and unchanged budget policies.

What we wish to do here is to take the CBO's projections (which are not substantially different from those used by the administration) at face value and determine what they mean for the private sector. As we will explain, government budget surpluses imply that the private sector must have an offsetting deficit. The financial situation of the domestic private sector is made worse because of the United States's international payments imbalance. Indeed, it is becoming widely recognized that there are two black spots that blemish the appearance of our Goldilocks economy: low household saving (which actually has fallen to zero) and the burgeoning trade deficit. However, commentators have not yet discovered the links between public sector surpluses, domestic private sector deficits, and international current account deficits. Once these are understood, it will become clear that Goldilocks is doomed.

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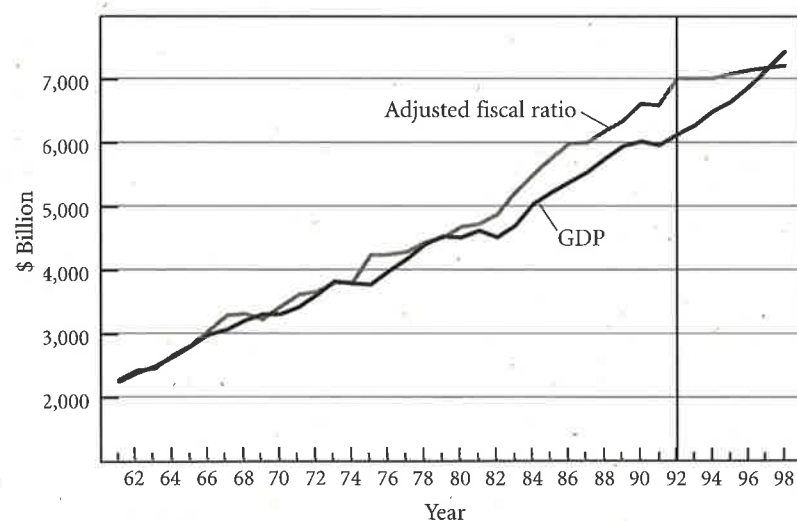
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## The Fiscal Stance

Let us begin with an analysis of the fiscal stance. While most discussion focuses solely on the federal government budget, we prefer to include the state and local government budgets, which show substantial surpluses. This consolidated government balance provides a more accurate assessment of the impact that the overall government budget has on the economy. We also consolidate households and firms for the purposes of our analysis. When the consolidated government balance is negative (i.e., in deficit), the public sector's expenditures exceed its revenues. Ignoring for a moment the foreign sector, this must mean that the private sector's income exceeds its spending, with the difference equal to its net acquisition of government debt. On the other hand, when the consolidated government balance is positive (i.e., in surplus), the public sector's revenues exceed its expenditures, leading to the retirement of public debt. In this case, the private sector must be in deficit, with income less than spending. The private sector deficit will equal the public sector surplus, and this shows up on balance sheets as a reduction of private sector wealth by an amount equal to the retirement of outstanding public sector debt. Thus no one should be surprised that as the federal budget moved to surplus last year, American saving rates fell to zero. While it is possible for household saving to be positive when the public sector runs a surplus, this can happen only when firms run large enough deficits to offset the combined government and household surpluses. As it happens, the business sector as a whole is not in deficit, so the private sector's deficit is entirely due to household expenditures that greatly exceed incomes.

Figure 1 Adjusted Fiscal Ratio and GDP



Note: The line at 1992 indicates the beginning of the most restrictive fiscal stance since 1961.  
Source: NIPA and authors' calculations.

Adjusting for inflation and the business cycle, we obtain the "adjusted fiscal ratio" (Figure 1).<sup>2</sup> Between 1960 and 1992 the adjusted fiscal ratio grew at an average rate of 3.8 percent per year while GDP grew at an average rate of 3.2 percent. This means that over the entire 32-year period, the fiscal stance was stimulative. Of course, there was some variation, with fiscal drag in the mid 1970s

<sup>1</sup> The fiscal ratio is  $G/t$ , where  $G$  is government spending and  $t$  is the average tax rate; since  $t = T/Y$ , where  $T$  is total tax revenue and  $Y$  is national income, the fiscal ratio is  $G/(T/Y)$ . When the consolidated budget is in balance,  $G = T$ , so the fiscal ratio is equal to  $Y$ , or GDP.

<sup>2</sup> The inflation adjustment only corrects flow variables. If correction were made for the erosion to asset values because of inflation, the fiscal ratio would be lower than shown but its growth rate would not be significantly changed.

and substantial stimulus during the Reagan and Bush years. Figure 1 shows the remarkable shift in the fiscal stance after 1992, falling from plus 14.5 percent of GDP in 1992 to minus 3 percent of GDP in 1998. The fiscal stance during this most recent six-year period has been far more restrictive than during any previous six-year period in the postwar era.

## The Trade Ratio and the Combined Fiscal and Trade Stance

We can also construct a trade ratio that corresponds to the fiscal ratio. The trade ratio is the ratio of total U.S. exports and international transfers to the average import propensity (which is the ratio of imports to GDP). When the trade balance is positive, the trade ratio is above GDP; this is a stimulative trade stance, analogous to the stimulative fiscal stance created by a government budget deficit. On the other hand, when the trade balance is negative, the trade ratio is below GDP and a restrictive trade stance results.

We can adjust the trade ratio for price changes and the business cycle to obtain the "adjusted trade ratio," analogous to the adjusted fiscal ratio. Because each of these is a ratio to GDP, we can combine them into one measure, the "combined fiscal and trade ratio." This combined measure then reflects the extent to which the public sector and trade sector stances contribute to growth of GDP and affect the financial situation of the domestic private sector. The consolidated government budget balance, the current balance of payments, and the private financial balance (between income and expenditure) must, by accounting identity, sum to zero. Thus, a private sector surplus must be offset by a deficit—in the public sector or the trade account or both. A public sector surplus, if more than offset by a trade account surplus, could still be associated with a private sector surplus. However, if the public sector runs a surplus and the trade account is negative, the private sector, by definition, must be in deficit.

In recent years, the U.S. trade balance has become increasingly negative. When combined with fiscal restriction, this must be associated with a private sector deficit. Figure 2 plots the combined fiscal and trade ratio and GDP since 1961. Between 1961 and 1992 GDP grew by 3.2 percent on average and the combined ratio grew by 3.5 percent on average. Since mid 1992 GDP has grown at a rate of 3.2 percent per year, while the combined fiscal and trade ratio has increased by only 0.6 percent. Figure 2 clearly shows the shift after 1992 to the most restrictive fiscal plus trade stance we have seen since 1961.

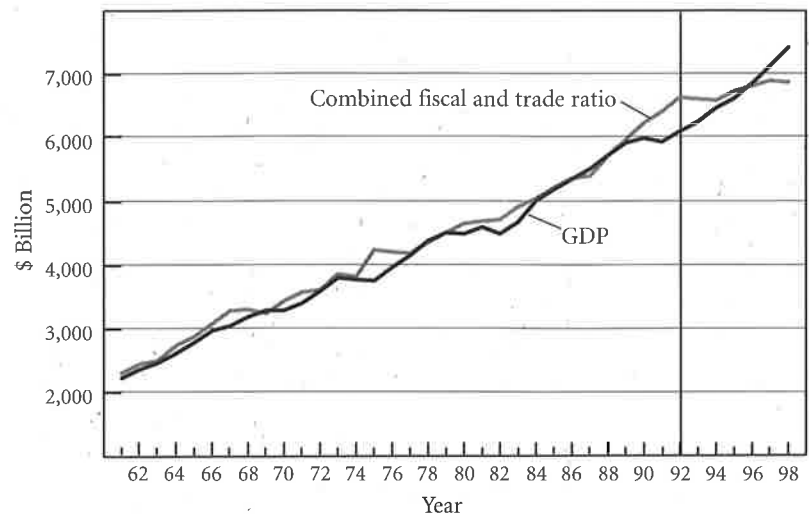
One might then ask, if the fiscal and trade stances are so restrictive, how can Goldilocks appear so robust? The answer is suggested by our accounting identity: the private sector is running a record deficit. Since the end of 1991 private expenditure has persistently risen more than income; indeed, the private sector deficit of the past three years is entirely unlike any that has occurred before. Today, the private sector deficit is 4.5 percent of GDP, with the consolidated government surplus equal to 2 percent of GDP and the balance of payments deficit equal to 2.5 percent of GDP. (The sum of the government and trade balances, of course, equals the private sector deficit.) Before 1992 a private sector deficit was rare, never persisted for more than 18 months, and never exceeded much more than 1 percent of GDP. We are thus in uncharted territory, with a private sector deficit that is (relative to GDP) nearly five times greater than ever before and has already persisted twice as long as any deficit in the past.

If we take the CBO forecasts of a GDP growth rate of 2.0 to 2.4 percent per year indefinitely and an increasing government budget surplus over the next decade and then make reasonable assumptions about the continued deterioration of the U.S. trade account, this implies that the private sector deficit must continue to worsen. In order to validate the CBO's projections, the private sector deficit would have to rise, by our reckoning, to about 8 percent of GDP. Continued economic expansion in the presence of unprecedented fiscal restriction is possible only if the private sector increases spending faster than its income grows. The balance sheet implication is that private sector borrowing must also grow to the point that the ratio of private debt to disposable

income increases to 2.5 from the current ratio of 1.6, which is already a record.

We dismiss this projection based on CBO forecasts as implausible in view of the absurd increase in the private deficit and indebtedness that the forecasts require. The economy will not continue to grow indefinitely, the budget surpluses will not materialize, private sector spending will not continue to outstrip income, and private sector indebtedness will not accelerate forever. We present the projection only to show what *must* happen to the financial situation of the private sector in order for the CBO forecasts to come to pass. As soon as private sector spending stops growing faster than private sector income, GDP will stop growing. When the recession hits, the public sector budget will move from surplus to deficit and our trade account will improve (primarily because imports will fall). Together, these will move the combined fiscal and trade ratio up, generating private sector surpluses.

**Figure 2** Combined Fiscal and Trade Ratio and GDP



Note: The line at 1992 indicates the beginning of the most restrictive fiscal stance since 1961.  
Source: NIPA and authors' calculations.

### Medium-Term Prospects and Policies

Goldilocks is not immortal. Of course, it is impossible to say just when she will succumb. On the basis of past experience with private sector deficits, the turnabout may be expected to begin within a year or two. Goldilocks could be sustained if the private sector increases its already unprecedented deficit and debt, but that appears to be increasingly unlikely. On the other hand, if the public budget were soon shifted to a stimulative stance or if the U.S. trade account were to turn around, expansion could continue without further deterioration of the financial position of the private sector. However, neither of these events appears to be even slightly probable.

Given recent trends in the U.S. trade account, U.S. economic growth must rely on a further increase in the deficit of the private sector or of the public sector. However, public sector budgets are heavily biased toward a restrictive stance. State and local governments always run surpluses (at the aggregate level), and budget cuts and "revenue enhancements" at the federal level have biased the federal government's budget toward surplus anytime the economy grows at a reasonable pace. This implies that economic growth is made possible only by increasing private sector deficits. Firms rarely run large deficits and only for short periods for obvious reasons: they are operated for profit and will cut spending when it exceeds income. Thus, it is up to the household sector to spend more than its income and to accumulate record debt-to-income burdens.

To some extent, this household debt has been offset by the record windfall created by Wall Street and capital gains have fueled some of the household sector's deficit spending. But this provides little comfort. If it really is Wall Street that is fueling the boom, simply maintaining equity values will not be sufficient because continued economic growth requires an *increased* deficit, which requires the stock market to climb even further to induce even more borrowing. And even if such "irrational exuberance" were possible, it is not at all clear that this is a desirable growth path.

There is not much to be done in the medium-term about the U.S. trade account. With a third of the world already in recession and with the expected fallout in other countries from the financial crises that began in Asia, it is not likely that the United States can rely on world demand to increase its exports. In fact, much of the world is looking to the United States as the importer of last resort so it can export its way to recovery. Thus, we suggest that well-targeted tax cuts and federal spending increases may be needed over the next few years so that the expansion can continue while private sector balance sheets improve. This is not "fine-tuning" in response to short-term disturbances; what we are recommending is that the federal budget move toward a stimulative fiscal stance, that is toward deficits, for the medium term. Rather than attempting to run surpluses for the next 15 to 25 years as suggested by the president, we would instead look for persistent deficits. For the longer term, fiscal policy must take into account changes in our trade account. If the trade stance improves, then a less stimulative fiscal stance would be appropriate. However, the notion that a federal budget surplus is sustainable come hell or high water and that it promotes economic growth must be abandoned. Given the realities of the U.S. trade imbalance, public sector surpluses are consistent with economic growth only so long as the private sector's financial situation deteriorates at an accelerating pace.

### Bibliography

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- Martin, Bill, and Wynne Godley. "America and the World Economy." Research Group Occasional Paper no. 3, Phillips & Drew, December 1998.

### Related Publications

For additional Levy Institute research on this subject, see:

- David Alan Aschauer, *How Should the Surpluses Be Spent?* Policy Note 1998/2
- Wynne Godley, "Money and Credit in a Keynesian Model of Income Determination," Working Paper no. 242, July 1998
- Wynne Godley and Bill Martin, *How Negative Can U.S. Saving Get?* Policy Note 1999/1
- Jamee K. Moudud, "Government Spending and Growth Cycles: Fiscal Policy in a Dynamic Context," Working Paper no. 260, December 1998
- , "Finance and the Macroeconomic Process in a Classical Growth and Cycles Model," Working Paper no. 253, October 1998
- Dimitri B. Papadimitriou and L. Randall Wray, *What to Do with the Surplus: Fiscal Policy and the Coming Recession*, Policy Note 1998/6
- Marc-André Pigeon and L. Randall Wray, *Did the Clinton Rising Tide Raise All Boats?* Public Policy Brief no. 45, 1998
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