Economics focus

In the balance
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America's slowdown has done little to remove the country's serious economic imbalances

MANY economists believe that America's economy has escaped recession and may rebound in the second half of this year. But a new paper* by Wynne Godley and Alex Izurieta at the Jerome Levy Economics Institute argues to the contrary that large, unsustainable imbalances may make a recession inevitable.

Mr Godley was among the first to argue that America's boom of the late 1990s was unsustainable, for two reasons. First, private-sector spending was growing faster than income, causing a huge increase in corporate and household debt. Second, America's current-account deficit had widened to a record 4.3% of GDP. The current-account deficit has been much discussed by other economists, but few Americans pay any attention to the private-sector financial deficit.

The chart shows the financial balances of the three sectors of the economy over the past 40 years: the external current-account balance, the government's budget balance, and the private sector's financial balance. This last (calculated as the disposable income of firms and households, minus their spending) is also known as private-sector net saving, since it is equivalent to saving less investment. By accounting definition, private net saving and the budget balance combined must be equal to the current-account balance.

The government's shift from budget deficit to surplus has been much trumpeted. But far more dramatic has been the private sector's swing from a surplus of 5.4% of GDP in 1992 to a deficit of almost 7% late last year. Between 1960 and 1997, the private sector was always in surplus.

The unprecedented switch during the 1990s reflects the behaviour of households more than of firms. As a result of it, household debt climbed from 95% of disposable income in the early 1990s to 124% in the fourth quarter of last year.

Mr Godley argues that private-sector net saving will eventually rise sharply, as households repair their balance sheets, so driving the economy into recession. Plenty of economists disagree. A flurry of recent papers has concluded that the household saving rate, properly measured, is a lot higher than official figures suggest. If so, fears of a rebound in saving may be overdone (see article). But the problem is that these studies look at gross saving rather than net saving (ie, minus investment).
Consider some of the supposed reasons why household saving is higher than it seems. First, the saving rate as officially measured includes employers’ contributions to pension schemes, but pensioners’ benefits from those schemes are not counted in income. In recent years, large capital gains have allowed many firms to take a holiday, paying out pensions without making contributions. That means that household saving has been understated. Yet if the figure was increased to allow for this, it would also change firms’ financial balance in the opposite direction (as the increased pension benefits of households show up as an increased cost for firms). Total private net saving would thus be unchanged.

Second, some have argued that household spending on cars and other consumer durables should be treated as investment, not consumption, which would lift gross household saving. Yet since this would boost both saving and investment, private net saving would again be unaffected.

Third, it is argued that capital gains should be counted as saving. These do indeed boost wealth, but can be drawn on only if households either sell assets or borrow against those assets—and there are limits to both. Debts have to be serviced out of income; if everybody tried to realise their capital gains by selling shares, prices would crash.

The private-sector financial deficit is therefore a better measure of sustainability than gross saving. Indeed, this measure is favoured by the International Monetary Fund and the Bank for International Settlements. In its latest annual report the BIS points out that, in the past, when a country’s private-sector net saving has fallen sharply below its long-run average, this has always been followed eventually by a sharp economic slowdown, as the private sector swung back into surplus and spending slumped. Examples are Britain and Sweden in the late 1980s, and Japan after 1990. In the first quarter of 2001, America’s private-sector financial deficit shrank for the first time. Could this be the turning point?

What goes up...

The authors consider the likely future path of America’s financial imbalances. Using the latest projections by the Congressional Budget Office for the budget balance and GDP growth implies that the private-sector deficit would rise to 8% of GDP by 2006, with debt continuing to explode. That is clearly unsustainable. Yet, at the other extreme, a turnaround of the financial deficit is unlikely to be as severe as it was in Britain after 1989, because high inflation then reduced Britain’s scope to cut interest rates.

America is likely to follow a middle path. If the private sector’s balance reverts to its historical average within three years, Messrs Godley and Izurieta reckon that this would cause a recession this year, with annual GDP growth in the five years to 2006 of only 1.1%. Even if the private-sector deficit fell by only half, to 3% of GDP, annual growth would average only 2% over the next five years.

To keep the three sectors in overall balance, higher net private saving must be matched by either a fall in America’s current-account deficit or a swing in the budget from surplus to deficit. Forget about all those hopes of repaying public debt.
