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Editorial

Is Goldilocks Doomed?

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Recent economic statistics confirm that our Goldilocks[1] economy continues to grow at a relatively swift pace, in spite of financial turmoil in Asia, Latin America, and Russia, as well as economic recession in about one-third of the world. The length of the expansion is record-setting, it is already the longest expansion in U.S. history, and the expansion may continue for some time to come. For many, the most potent symbol of the strength of the expansion has been the remarkable turn around of the federal government's budget, from chronically large deficits 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 of the fiscal stance. By most accounts, the surplus will continue indefinitely. Indeed, 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 of GDP for 2009. Such projections are, of course, contingent on continued economic growth and present 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 to determine what these mean for the private sector of the economy. Government budget surpluses imply that the private sector will have an offsetting deficit. As the United States is importing more than it exports, the implication is that U.S. households and firms, taken as a whole, must continue to borrow on an increasing scale. Indeed, it

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has been widely recognized that there are two black spots that blemish the appearance of our Goldilocks economy: low household saving (which has actually fallen below zero) and the burgeoning trade deficit. However, commentators have not noted so clearly that public sector surpluses and international current account deficits require domestic private sector deficits. Once this is understood, it will become clear that Goldilocks is doomed.

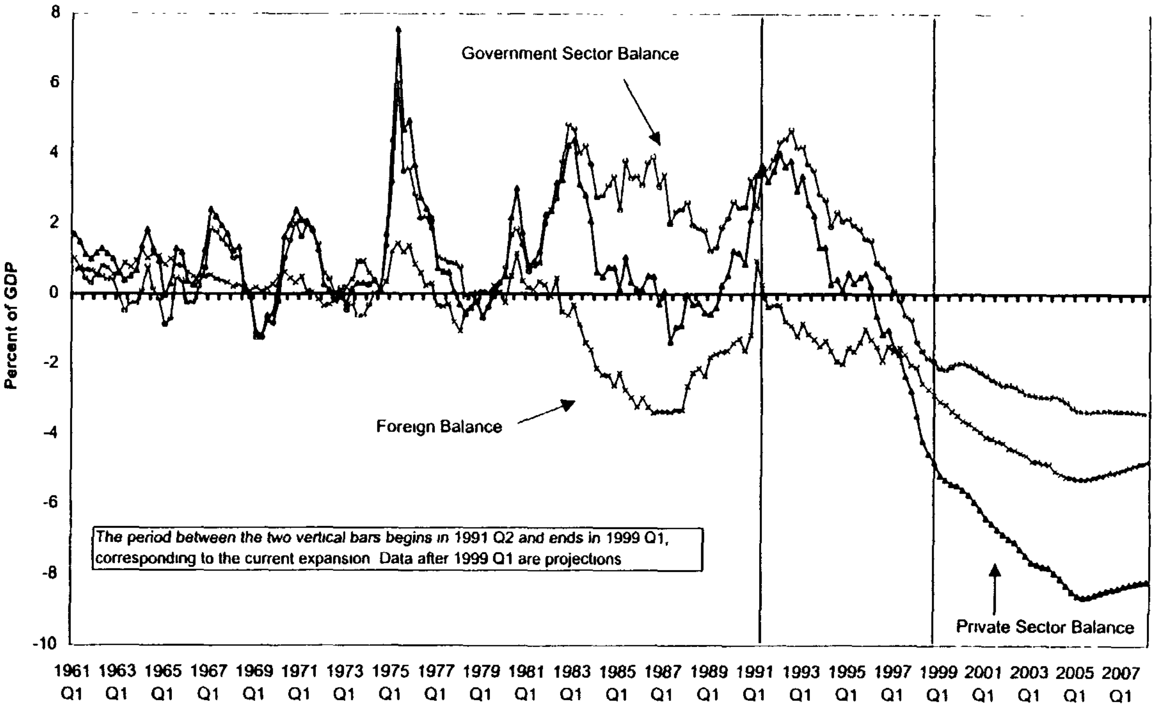
The Financial Balances

Let us begin with an analysis of the government sector. While most discussion focuses solely on the federal government's budget, we prefer to use the consolidated public balance, which includes the substantial surpluses of state and local government budgets. This provides a more accurate assessment of the impact that the overall government budget has on private sector finances. We will also consolidate households and businesses for the purposes of our analysis (although we will briefly disaggregate them below). Ignoring for a moment the foreign sector, when the consolidated government balance is negative (in deficit), this must mean that the private sector's income exceeds its spending, with the difference being equal to its net acquisition of government debt. On the other hand, when the consolidated government balance is in surplus, the private sector must be in deficit, with income less than spending. This will reduce private sector net wealth by an amount equal to the retirement of outstanding public sector debt. While it is possible for household balances to be positive when the public sector runs a surplus, this could happen only if businesses ran large enough deficits to offset the combined surpluses of governments and households. As it happens, businesses are running only small deficits, so the private sector's deficit is primarily due to household expenditures that greatly exceed incomes.

Once we add the foreign sector to our analysis, a positive U.S. trade balance is consistent with a *domestic* private sector surplus and shows up on balance sheets as net purchases of foreign assets. On the other hand, when the trade balance is negative, this yields a domestic private sector deficit[2]—and the balance sheet counterpart is an increase of net U.S. indebtedness to foreigners. By definition, the private sector surplus must equal the public sector deficit plus the trade account surplus. Thus, the public sector could run a surplus, which if more than offset by a trade account surplus, could still be associated with a private sector surplus. On the other hand, 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 imbalance has become increasingly negative. When combined with recent fiscal restriction, this must be associated with a rising private sector deficit. Figure 1 plots the public sector balance, current account balance of payments, and resulting private sector balance for the period since 1961.

Figure 1. The Three Financial Balances (as a Percent of GDP)



Source: National Income and Product Accounts (NIPA). Projections implied by Congressional Budget Office (CBO) analysis.

Since the end of 1991, private expenditure has persistently risen more than income; indeed, the private sector deficits of the past three years are entirely unlike anything that has ever happened before. Today, the private sector deficit is 5.3 percent of GDP, with the general government surplus being equal to 2.2 percent of GDP and the balance of payments deficit being equal to 3.1 percent of GDP (the sum of these, of course, equals the private sector deficit, which is 5.3 percent of GDP). Before 1992, private sector deficits were 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 five times greater than anything achieved in the past (relative to GDP) and that has already persisted for twice as long as any past deficits.

If we take the CBO's projections regarding GDP growth rates and continued (indeed, growing) government budget surpluses, and then make reasonable assumptions about continued deterioration of the U.S. trade account, this implies that the private sector deficit must continue to worsen. Indeed, as shown in Figure 1, according to our projection the private sector deficit will be equal to 8 percent of GDP within five years. What all this means is that continued economic expansion in the presence of unprecedented fiscal restriction is possible only if the private sector continues to increase spending much 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 2.4—from a ratio of 1.6 reached at the end of 1998 (which was already a record).

We hasten to add that we do not believe this projection. The economy will not continue to grow; the projected budget surpluses will not be achieved; private sector spending will not continue to outstrip income; and growth of private sector indebtedness will not accelerate. We present these projections only to show what would have to happen to the financial situation of the private sector in order for the CBO's projections to unfold. 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 (because imports will fall). Together, these will generate private sector surpluses.

Medium-Term Prospects and Policies

The Goldilocks economy cannot be sustained. Of course, it is impossible to say just when she will start to run out of steam. Goldilocks could be sustained if the private sector increased its already unprecedented deficits and debts, but that appears to be increasingly unlikely. On the other hand, if the public budget were soon shifted to a stimulative stance, expansion could continue without continued deterioration of the financial position of the private sector. Similarly, if the U.S. trade account were to turn around, that could continue the expansion. However, neither of

these events appears to be even remotely probable, given current policy. This implies that economic growth must rely on rising private sector deficits. In the modern world, private businesses only very rarely run current account deficits—and then only for short periods—for rather obvious reasons: they are operated for profit and will cut spending when it exceeds income. Thus, it has been up to the household sector to spend more than its income and to accumulate record debt-to-income burdens.

One can argue that to some extent, this household debt is offset by the record windfall created by Wall Street—and, indeed, it is possible that such capital gains have fueled some of the household sector's deficit spending. But this provides little comfort. Since a capital gain only makes a once-for-all addition to the stock of wealth, without adding anything to the income flow, its effect on consumption is essentially transitory. Capital gains can only permanently fuel U.S. growth if the rise in stock prices relative to GDP (and profits) were to continue indefinitely and if the capital gains were realized. This is not a realistic prospect, particularly given that price-earnings ratios are already at record levels.

A much preferred strategic scenario would be to adjust the fiscal stance. Over the intermediate run, the U.S. trade account is not likely to reverse course—with one-third of the world already in recession, and with expected fall-out of 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 they might export their way to recovery. Thus, we recommend that the budget stance revert to a deficit position to counteract recessionary influences as they arise. This is not simply temporary "fine-tuning"—we are suggesting that the federal budget will need to be biased toward deficits for the medium-term. For the longer-term, fiscal policy must take into account the evolution of 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, 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.

Notes

1. "Goldilocks" refers, of course to the children's tale. The US economy is said to be neither "too hot" (to induce inflation) nor "too cold" (to cause unemployment).
2. We are holding the government budget position constant for this exercise.

References

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