

WORKING PAPER No 6

**ECONOMIC SLOWDOWN IN
THE U.S., REHABILITATION OF
FISCAL POLICY AND
THE CASE FOR A CO-ORDINATED
GLOBAL REFLATION**

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ECONOMIC SLOWDOWN IN THE U.S., REHABILITATION OF FISCAL POLICY AND THE CASE FOR A CO-ORDINATED GLOBAL REFLATION

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INTRODUCTION

Prospects for sustained economic growth in the developed world are weak at best. Analysis of the US and UK economies reveals an ongoing implosion, with no signs of a reversion to acceptable growth rates in the absence of stimulus to effective demand. Furthermore, the sluggish performance in the Euro area, exacerbated by the damaging, pro-cyclical implications of the ‘Growth and Stability Pact’, suggests that stagnation is being allowed to persist here too. And there is not prospect of a recovery in growth in Japan.

Unlike other periods when faltering economies were propped up by growth among other northern countries, there is now the risk of an orchestrated decline in the developed world. It may have been hoped that the U.S. would continue to play the role of ‘importer (and perhaps employer) of last resort’. However, a substantial part of this study is devoted to suggest that, given conditions at present, this is no more than wishful thinking. Indeed, in the absence of active policy at a world level, there is an imminent risk of a large-scale recessionary spiral.

? ? This paper rests on work commonly shared with Wynne Godley at the Cambridge Endowment for Research in Finance, CERF, University of Cambridge. The author is indebted to Godley’s pioneering insights and dedicated attention to these issues. The support of the CERF team was invaluable. Discussions with former colleagues at the Levy Economics Institute of Bard College and with Bill Martin of UBS Global Asset Management were very helpful. Usual disclaimer applies.

This new situation reveals the true nature of the globalisation process. The enthusiasm for globalisation grew at a time when some of the northern economies were booming. Then, it was the norm to single out crises elsewhere as the consequence of an individual country's mistakes alone, or – at best – of an incomplete exposure to the beneficial effects of globalisation. But with the world economy now slowing down, globalisation may have adverse consequences¹.

The implications of policy inaction for the developing world could be devastating. Below-capacity growth in the northern hemisphere would translate, first, into lower import demand, perhaps a 10% net-import retrenchment. Second, unemployment would bring lower income remittances to the southern hemisphere and probably more severe immigration restrictions. Finally, capital flows to developing countries would drain away, either because of negative saving gaps in countries such as the US and the UK, or because demand for portfolio investments in the southern hemisphere has deteriorated (FitzGerald, 2002).

It is, however, possible to regard this global impasse as a unique opportunity. Co-ordinated expansionary policies might be advocated and even implemented. This is not a popular idea. Fiscal policy has long been stigmatised as the cause of policy failure and economic downturn. Unfortunately, the fashion for fiscal restraint has ignored serious analytical and empirical arguments to the contrary². It is misleading in two respects. First, it overlooks the recurring evidence that the most severe economic crises of the recent past have not been associated with public-sector excess but with private-sector failures (Vos, 1995; Stiglitz, 1998; Izurieta, 2000). Second, it overlooks the fact that the US is today offsetting a potentially severe recession with fiscal relaxation equivalent to 4.75 percent of GDP in the past eight quarters.

In the following section the structural problems of the U.S. economy will be analysed. The methodology replicates the approach pioneered by Wynne Godley and his former colleagues at

¹ I am not discussing whether the ongoing global liberalisation would yield a more uneven division of global produce (Baker, Epstein and Pollin, 1998, and many other studies), and would lead to increasing volatility and financial risk (Eatwell and Taylor, 2000; Singh, 1999). This paper seeks to explore the strategic prospects of a slowdown in the developed world and its implications for developing economies.

² See, among many others: Nell (1988), Killick (1989), Crotty (1989), Anglade and Fortín (1990), Stern (1991), Taylor (1993), Fazzari (1995), Godley and McCarthy (1998).

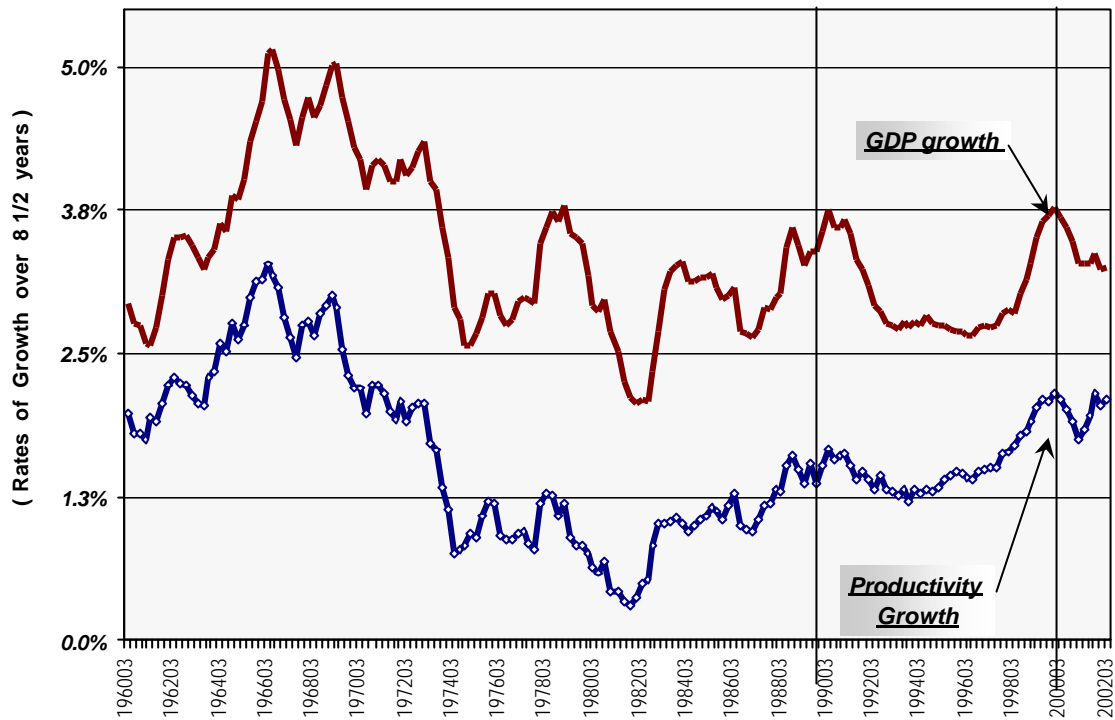
the University of Cambridge and subsequently the Levy Economics Institute of Bard College. Underlying this framework is the notion that the study of an economy requires a proper system of accounts, which fully incorporates both flows and stocks. The following section will discuss some strategic solutions as suggested by a macroeconomic model of the US (a revised update of Godley, 1999c). The final section will underscore the policy option of a co-ordinated global reflation as the means to avoid concurrent, large-scale implosion.

THE U.S. ECONOMY: A STRUCTURAL VIEW

The structure of demand during the expansion

The US economy experienced a relatively long period of expansion between 1992Q2 and 2000Q3. Many observers believed this to be permanent. They argued that economic prosperity would be uninterrupted, since it was based on the correct combination of productivity growth, fiscal discipline and minimal policy intervention.

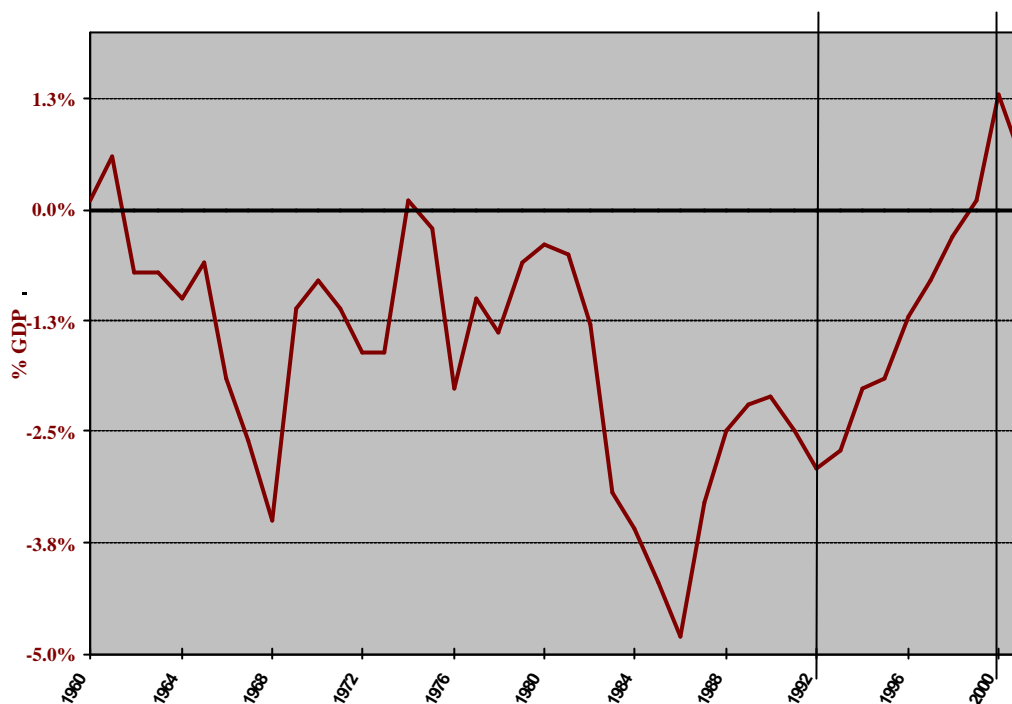
The evidence is summarised in Charts 1–3. GDP growth and productivity growth during the 1992–2000 period, and their apparent correlation, are captured in Chart 1. At the 2000Q2 peak, the average rate of growth over the previous eight-and-a-half years was 3.8 percent, and the rate of productivity growth, estimated over the same period, was 2.1 percent. It is noteworthy that these figures were not unprecedented. Moreover, the growth *peak* of 3.8 per cent is merely half a percentage point higher than the growth *average* of the entire post-war period (3.3 percent). Yet, from the perspective of that peak, it was tempting to believe that the economic expansion caused by faster productivity would maintain its upward trend, perhaps indefinitely.

Chart 1: GDP and Productivity Growth in the U.S.

It was expected that leading industries (like the IT sector) would follow the pace dictated by the so-called Moore's Law for semiconductors³. Needless to say, such exuberant expectations drove the stock market boom and, with it, the avalanche of windfall gains to portfolio holders. Coincidentally, the free, unregulated, private-sector driven IT and internet sectors served to corroborate the notion that the forces of economic growth would gain momentum without active fiscal and monetary policies⁴.

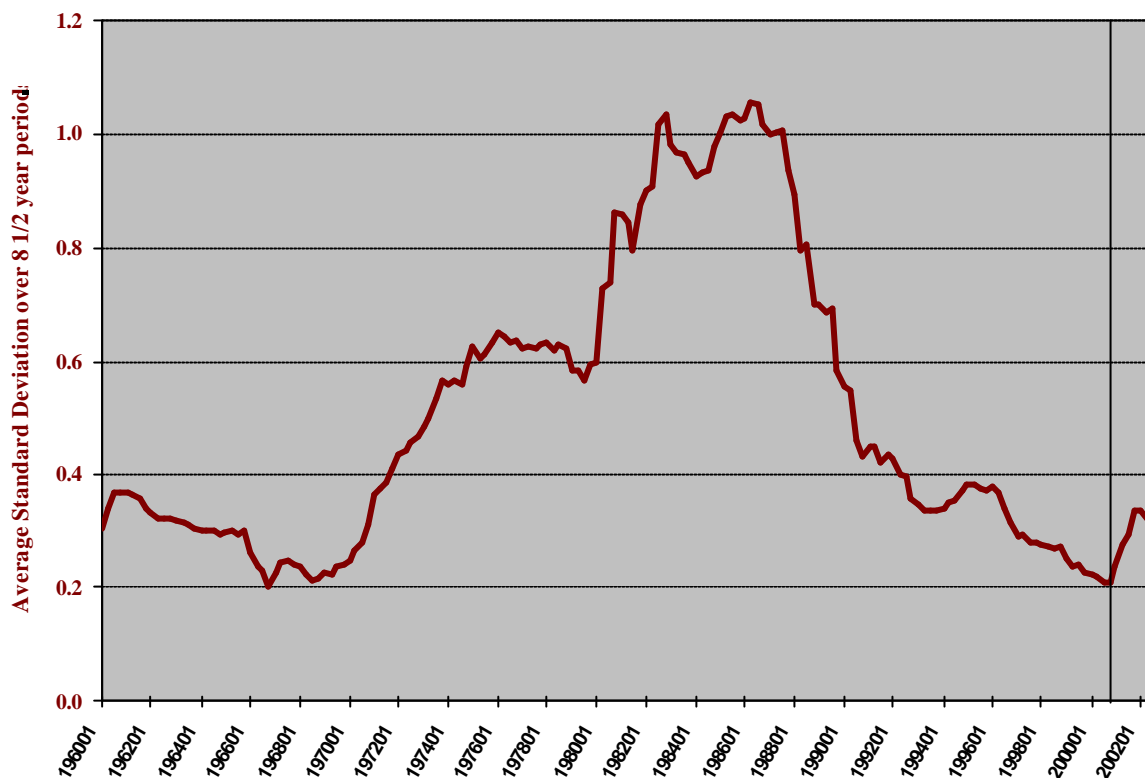
³ Gordon Moore, from Intel Corporation, once claimed that developments in electronic chip manufacturing would be able to double their density and, thus, performance every eighteen months.

⁴ See, for example, Cecchetti (2002). Underlying the orthodox notion of the supremacy of markets over policy, a new theme seems to be recurrent: that by tightly reining fiscal policy, monetary policy would itself become less influential, because of the increasing reduction of public debt and thus the weaker influence of its interest rates on financial markets.

Chart 2: Standardised Budget Surplus as per cent of Potential GDP

The retreat of fiscal policy is apparent in Chart 2, which illustrates the *standardised* budget surplus (as calculated by the Congressional Budget Office, CBO). This measures the extent to which policy-making has tightened the fiscal stance independent of the effect of the cycle on spending and tax revenue. As may be seen the expansion of the 1990s (between vertical lines) occurred alongside the most restrictive fiscal stance in at least four decades.

During the same period, monetary policy intervention was minimal. After a measured adjustment of interest rates in tune with the beginning of the recovery in 1992, policy makers left the markets to regulate themselves. As Chart 3 shows, the average of the absolute deviation of interest rates (on Treasury bills) from the mean over any 32-quarter period was, in the aftermath of the expansion (fourth quarter of 2000, marked by the vertical line) the lowest in the previous three decades. Only during the 1960s was there similar stability, but then fiscal policy was actively expansionary, as also evident in Chart 2.

Chart 3: The Pace of Monetary Policy Intervention

Thus, whereas economic growth and productivity during 1992–2000 were not unprecedented, the particular configuration of expectations, market forces and policy (in-action) were indeed novel.

Most importantly, the composition of demand was unique. The main accounting relationships are revealed by disaggregating the economy into its main sectors (private, public and external). The resultant accounting identity reveals both the financial balances of the main sectors and the contributions of net spending to aggregate demand. Starting from the basic notion that total income is identical, ex-post, to total expenditure; and expressing the latter as the sum of aggregate demand components, we have:

$$Y = PX + G + (X - M + NF)$$

where PX stands for total private expenditure (consumption and investment); G is total government expenditure; and X , M and NF are exports, imports and net factor incomes from abroad. Subtracting taxes on both sides and rearranging:

$$Y - T = PX - (G - T) = (X - M) - NF$$

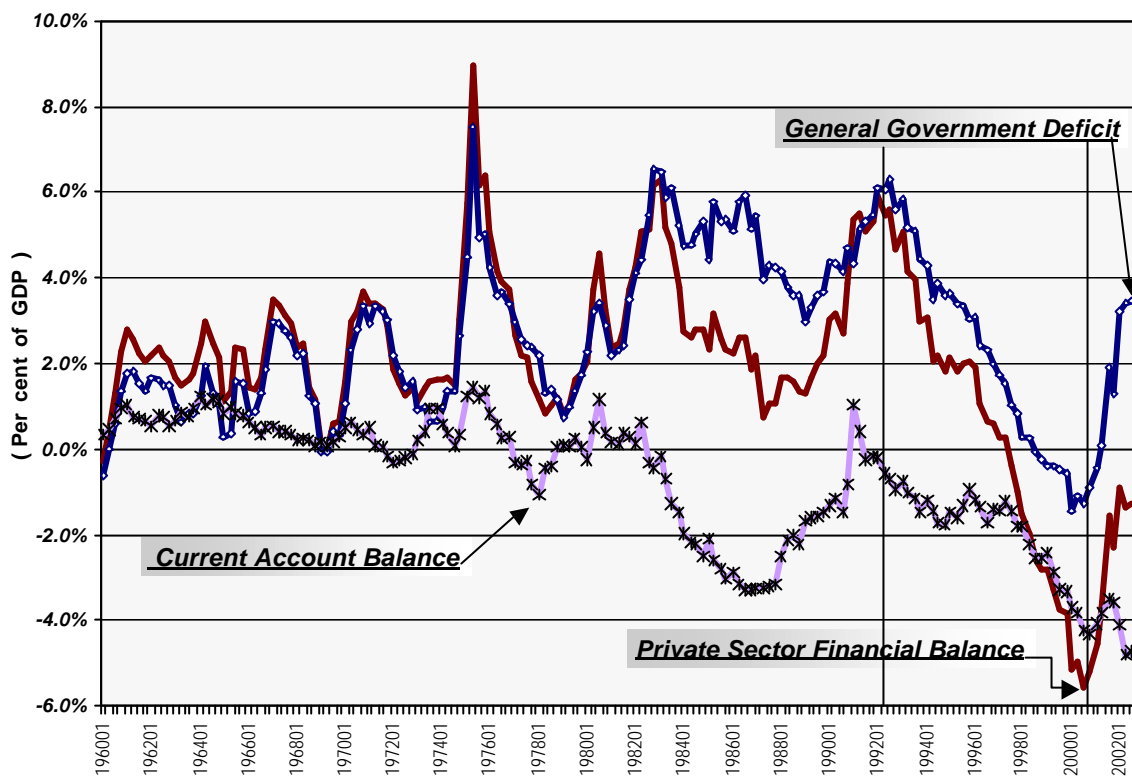
Since $Y - T$ is private disposable income, the LHS defines the private-sector balance; while the right hand side represents the sum of the general government *deficit* and the current account balance, i.e.

Private balance = Public-sector Borrowing Requirements + Balance of Payments

Any two of these balances necessarily implies the third. The identity also denotes that the two net demands on the RHS (public-sector net spending, after tax income, and net export-demand), 'create income and financial assets for the private-sector, whereas budget surpluses and balance of payments deficits withdraw income and destroy financial assets' (Godley, 1999c, pp. 8).

The balances of the main sectors, expressed as percent of GDP, are shown in Chart 4. The boom coincided with unprecedented behaviour in the three sectors. From 1992 (the beginning of the last expansionary cycle) until the third quarter of 2000, the balance of the private-sector moved from a positive (i.e. net- saving) 6% of GDP to a negative (net- borrowing) 6% of GDP. The deterioration of the private balance (12 percentage points of GDP, or \$1.2-trillion at today's prices) is matched by the sum of 8 percentage points' withdrawal of public-sector outlays relative to revenue and 4 percentage points of increased imports relative to exports. At the end of the expansion, the three balances had attained record values.

Chart 4: Financial Balances of the Main Sectors of the U.S. Economy



The downward trend of both the government deficit and the current account balance have (net-) negative impact on demand, while the downward trend of the private-sector balance (total expenditure growing faster than income) is a demand stimulus. Thus, the sole force of economic expansion was the private-sector.

Since spending in excess of income can be sustained only either by selling financial assets or by a growing flow of net- credit, it is legitimate to question whether the expansion, under these conditions, could be sustained (Papadimitriou et al, 2002; Godley & Izurieta, 20002a,b,c; 2001a,b; Papadimitriou & Wray, 2001; Godley & Martin, 1999; Godley & Wray, 1999).

The private-sector *as a whole* cannot liquidate financial assets and, simultaneously, sustain an economic expansion. Concurrent sales of financial assets would result in a stock market collapse with consequent capital losses. A market crash would also affect the state of expectations (forcing agents to adjust their balances rather than encouraging extravagance). And deteriorating net-wealth would adversely affect the ability of private agents to raise credit.

The flow of net-credit to the private-sector cannot continue to grow forever. At some point an economy driven by private spending in excess of current income must slow down.

Private-sector debt: fuelling the expansion... and the decline

In Chart 5 I have assembled the private balance plotted above with the flow of net-lending to the non-financial private-sector, both as percent of GDP.

Chart 5: Private Balance and Credit Flow

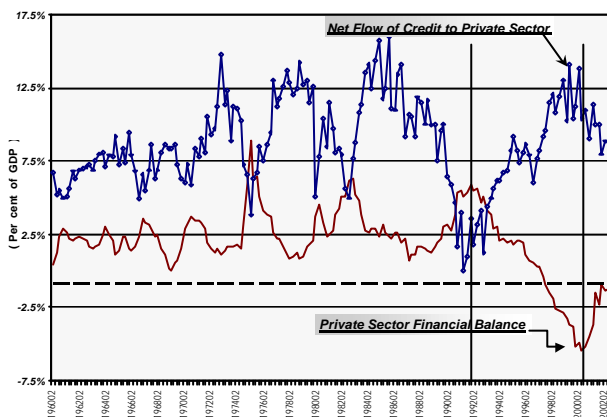
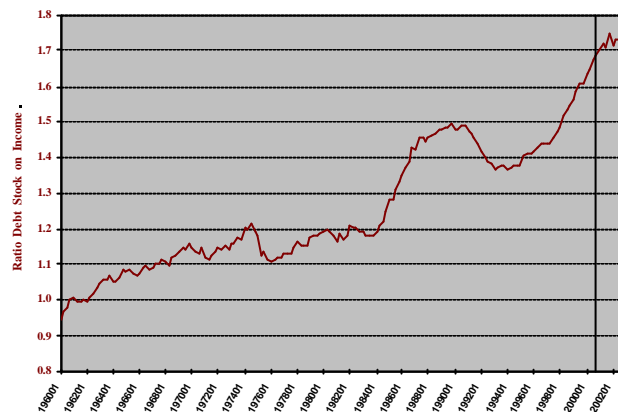


Chart 6: Private Debt Stock



The excess of private spending over current income between 1992 and 2000 was propelled by a rise of net-flows of credit. As expected, the debt stock of the private-sector, relative to disposable income, accelerated during the same period⁵ (Chart 6).

The above analysis of the boom is now the basis of the explanation of the recession. The recession that began at the end of 2000 was the result of a fall of (aggregate) private expenditure relative to income. This was caused by the slowdown of the net-flow of credit. However, despite the slowdown, net-flows remained positive, and consequently the stock of debt, in proportion to income, kept on rising (though at a different pace).

⁵ A growing flow of credit (required to sustain a credit-fuelled expansion) is tantamount to a debt acceleration (the flow being a first derivative of the stock). Meanwhile, a stable, positive credit flow would still generate a growing stock of debt (Godley 2002c, Godley & Izurieta 2002c).

To understand the unique nature of this process more clearly divide the private-sector into corporations and the personal sector. It is noteworthy that the main features of the corporate sector (namely: the financial balance moving to negative territory during the expansion, the net-flows of credit rising (Chart 7) and debt stocks accumulating (Chart 8)) are not intrinsically different than over previous cycles. Generally, corporations tend to finance their working capital by borrowing (a process that is intensified during expansions,) and refrain from doing so when they face adverse conditions. They show a readiness to adjust by reducing costs, employment, and inventories.

Chart 7: Corporate Balance and Credit Flow

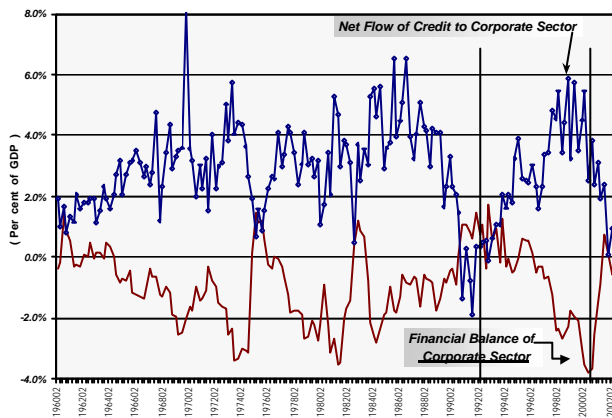
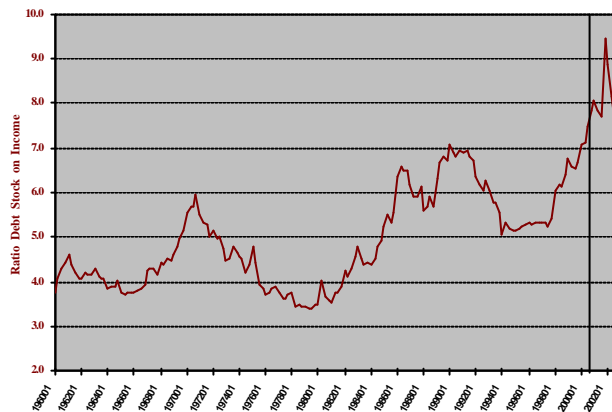


Chart 8: Corporate Debt Stock



Indeed, the rapid restoration of the corporations' financial balance followed a shift in direction of net-borrowing, where the balance and the net-flow of credit both approached zero. Through this process, corporations slashed costs (related to the rise of unemployment), curbed investment, and even used available funds to purchase their own equity. This is a double-edged sword. By adjusting spending and servicing debt in line with the credit restraint, firms hoped to regain financial health. However, they have reduced the spending stream that had contributed to the expansion. From their perspective, the absence of new, exogenous forces of demand to replace their own withdrawal meant that further adjustment was necessary, creating a downward, deflationary spiral...

A blind belief in the 'resilience of corporate America' has overlooked these basic facts, instead focussing on productivity increases to promote a rapid restoration of economic growth

to full potential and, perhaps, beyond⁶. However, a combination of excess capacity, sluggish demand arising from almost all other sectors and high unemployment followed by faster productivity-potential will cause more lay-offs, a lower state of confidence and, eventually, a persistent recession.

Producers need demand to be generated by an *exogenous* force. This role was substantially played by the personal sector. The (net-) stream of credit inflows that nourished both consumers and producers started to dry up for corporations. Thus, following the implosion that started in mid-2000, the personal sector was left acting as a ‘consumer of last resort’. It was doing so by excessive overspending. Chart 9 shows that the financial balance of the personal sector (the net of cash-income flows after total expenditure) was rapidly deteriorating, entering negative territory for first time in at least fifty years. But, this source of demand is also receding. The unprecedented imbalance could only be maintained by an increasing flow of credit, or by selling financial assets (Chart 9). Such a process cannot continue forever.

⁶ See Hale (2002), Jerman and Quadrini (2002) and others.

Chart 9: Personal S. Balance & Credit Flow

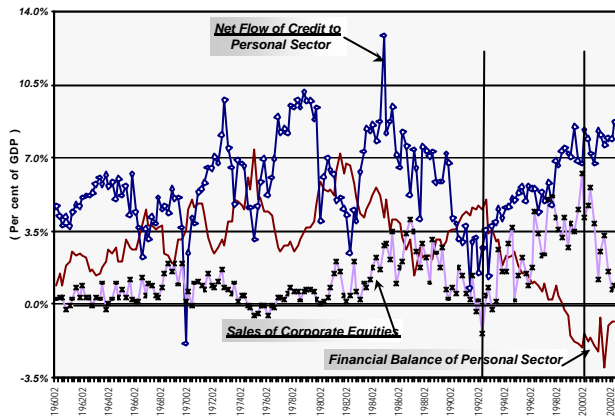
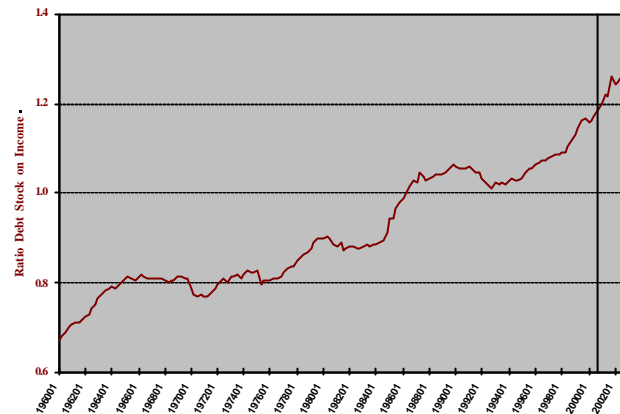


Chart 10: Personal S. Debt Stock



On the one hand, greater efforts to sell assets results both in price falls and in the inability of other sectors, particularly corporations, to absorb the excess supply. There might have been scope for foreigners to keep buying US assets ('thus 'borrowing our way out of recession', as correctly observed by D'Arista, 2001)⁷. Yet, the US has now reached a net *liability* position *vis-à-vis* the rest of the world of c. 25% of GDP. Predicting the cyclical patterns of equity sales observed in Chart 9 and considering that outstanding amounts of equities directly held by the personal sector have halved during the last ten quarters,⁸ one could conclude that such a source of funding is unreliable at best.

On the other hand, households have benefited from an increasing flow of net-credit, readily available to them even beyond the peak of 2000. As is widely known, this comprises mortgage borrowing (and refinancing), consumer credit and recent zero-interest rate payment schemes

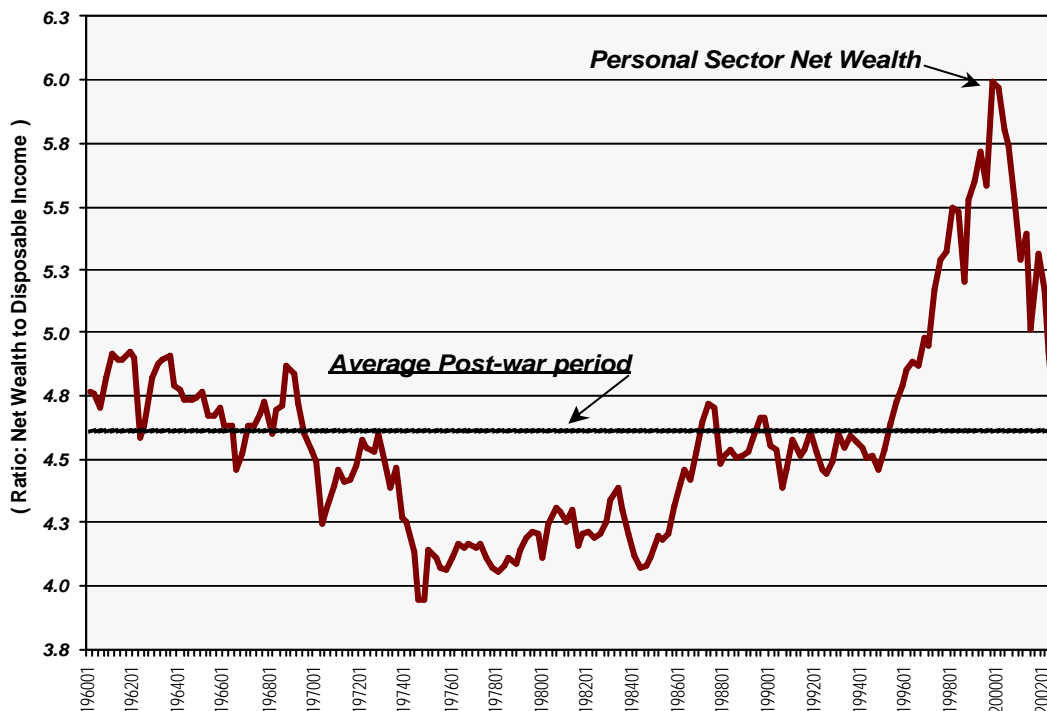
⁷ Further, D'Arista points out that foreigners would not buy directly from households but via market pools. Yet, in the end, it would be these purchases that underpinned mortgage borrowing. One way or another, the demand for assets expressed by foreign investors allowed domestic agents to spend at a faster pace than their current income streams.

⁸ Flow of Funds, Table L.100, line 17.

for durables and cars. Concurrently, the debt stock of the personal sector as ratio to disposable income is still accelerating (Chart 10).

This unprecedented pattern has continued because of the over-valuation of the stock market and of real estate, inflating the net-worth of households during the period of 'irrational exuberance'. Until recently, economic rationalism approved of lending to households at a faster rate than income, since their net-wealth was rising at an even faster pace. And so it was. Market players were fascinated by the virtuous cycle of higher productivity, aggressive consumer demand, credit expansion and a booming stock market. And, over the past six years, households' net-wealth has risen one-and-a-half times their disposable income (Chart 11). It was a spectacular rise, which suspended judgement about the vertiginous accumulation of debt. But, in half the time it took to reach such a record level, the ratio of net-wealth to disposable income slid to the post-war average. Conceding, for the sake of argument, that it was rational to lend recklessly on the way up, one would expect a drastic credit cutback on the way down.

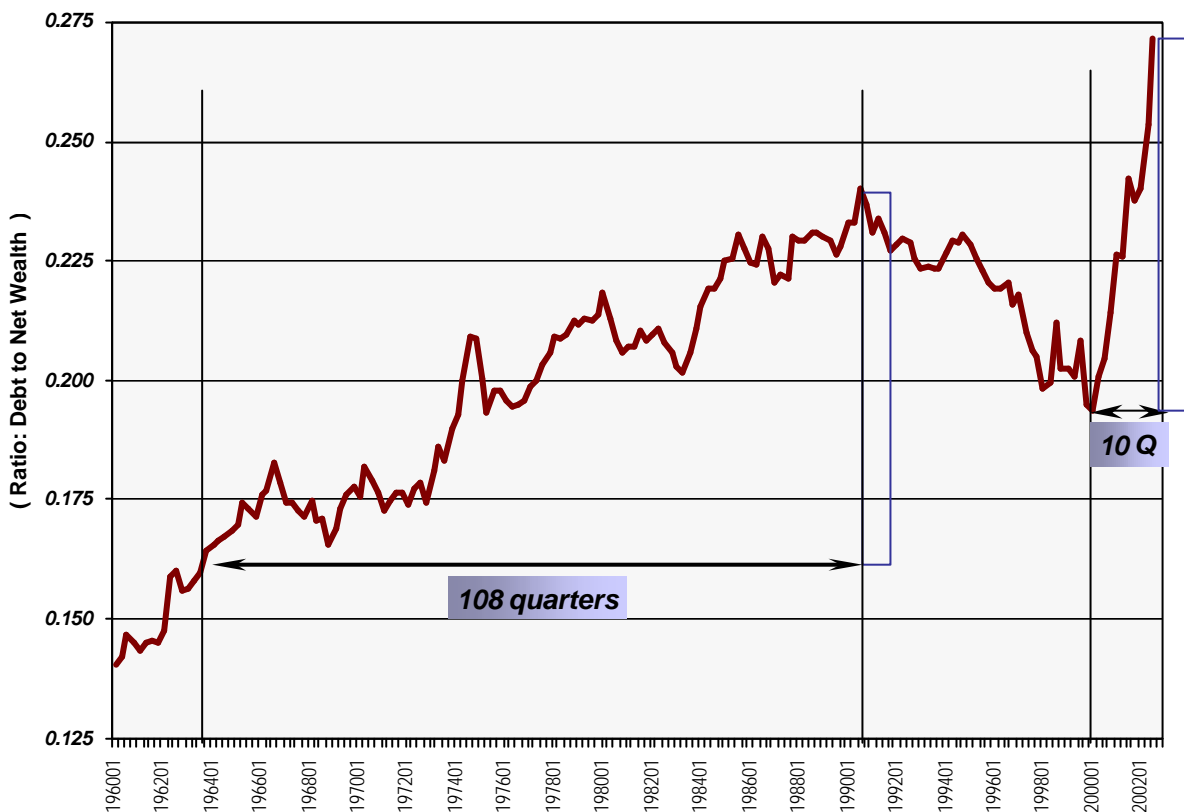
Chart 11: Net-Wealth as a ratio to Personal Disposable Income



There is no doubt that a credit implosion is imminent. This prognosis can be validated by using yet another indicator: the ratio of debt to net-wealth (Chart 12). During the period of economic expansion, both creditors and borrowers found this ratio attractive; it showed a decreasing trend, unparalleled in scale and duration. However, a slide in the debt to net-wealth ratio should

have been a reason for concern rather than excitement. For the denominator of this ratio is constructed on the fragile foundation of speculative valuations, which can change overnight. But debts have to be serviced with cash. In a deflation, fluctuations in portfolio valuations can have devastating implications for net-debtors, as may be seen in Chart 12. The debt to net-wealth ratio has shifted dramatically upwards. It has climbed as quickly in the last *ten quarters* as it had over the *twenty-seven years* before the previous peak.

Chart 12: Ratio Debt to Net-Wealth of the Personal Sector



To sum up, private-sector spending beyond income was the *sole* cause of the US expansion during the 1990s. The boom was entirely due to the ever-growing debt of the private-sector. The scale and duration of the expansion were not extraordinary, but since it was driven by a single sector, the pace of spending needed to be so much in excess of income that it required an unsustainable accumulation of debt. If borrowing were to slow down or even reverse, the US economy would be left with no expansionary impulse from the demand side. In my opinion, this is inevitable, since, even if the cost of servicing the debt is low, the debt burden cannot continue to accelerate indefinitely. The private-sector imbalance must eventually be resolved. This has begun to happen.

Fiscal policy did matter

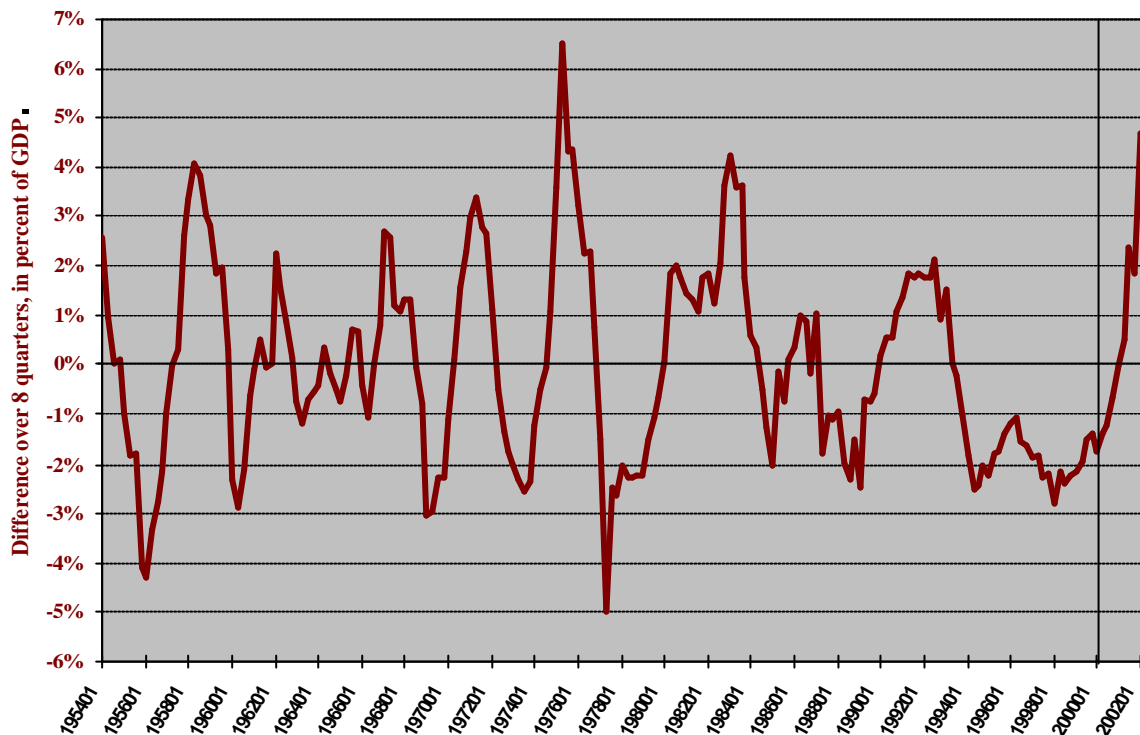
The current slowdown in the US economy would be more dramatic if both monetary and fiscal policy had not come to the rescue⁹. Charts 2 and 3 above reveal that there was a clear change in the direction of policy as soon as the symptoms of decline became alarming (as manifest in stock market losses, rising unemployment figures and signs of deflation). By mid-2001, when revised NIPA figures were released, there was no doubt that the economy was in difficulty and active policy intervention was intensified.

It should be noted that the main effects of monetary relaxation should not be overestimated, indeed they may be ambiguous. In a nutshell: monetary policy would, at best, be working in the same direction characterised above as unsustainable. Lower interest rates and attractive financing packages simply encourage private-sector overspending for a while longer – and are anyhow bounded by zero interest rates (Godley, 2002c).

It was fiscal policy that dramatically changed the entire post-boom landscape. The change of direction, from fiscal restraint to expansion, has been so aggressive that it is a record in its own right. The reversion to the cyclically adjusted budget plotted in Chart 2 (which goes up to 2001 in CBO estimates), is not the end of the story. By 2002Q3 (using the last available official figures), the fiscal balance has changed over only eight quarters by 4.75 percentage points of GDP. The size of the change from surplus to deficit is, at today's prices, almost exactly \$500-billion. As Chart 13 shows, this remarkable shift into deficit was the second most aggressive two-year expansionary move in the last fifty years!¹⁰

⁹ In previous reports (Godley, 1999c, Godley and Izurieta, 2001a,b, 2002a,b,c) a series of simulations have indicated the plausible range of outcomes once the implosion begins, in the absence of policy intervention. In sum, our exercises have shown that, *without policy intervention*, the average growth rate would be around one or one-and-a-half percent over the next five years, with unemployment reaching untenable figures (higher than eight per cent in all cases).

¹⁰ The graph shows the change in public-sector borrowing requirements over any two-year period, *scaled by the GDP*. If instead the constant price deficit were shown (i.e. chained prices, 1995 base) the present expansionary move would be by far the largest of the post-war period, almost twice that of mid-1970s.

Chart 13: Fiscal Expansionary Moves Over Each 8 Quarter Period

Within the \$500-billion switch in the fiscal balance the ex-post effect of output fluctuations on the budget must be distinguished from the ex-ante policy-determined injection. The estimated effect of the economic slowdown on the budget over the last two years is around \$100 billion per annum (Godley and Izurieta 2002c, pp.2¹¹). Thus, the cyclically corrected, effective policy relaxation over the last two -year period would be c. \$300billion (3 percentage points of the GDP). It still remains a mystery why this extraordinary policy shift has attracted so little attention.

The extent of the fiscal relaxation implemented during this period matches that proposed in previous papers (Godley and Izurieta, 2001a,b) as an alternative to implosion. The fiscal stimulus has boosted personal sector disposable income at an estimated average rate of around 3 percent greater than GDP. Such a significant income injection was channelled, at least partially, into the spending stream and has saved the U.S. economy from a severe, lasting recession. We argued, however, that for fiscal relaxation to restore growth to an acceptable,

¹¹ The CBO suggests a very similar figure.

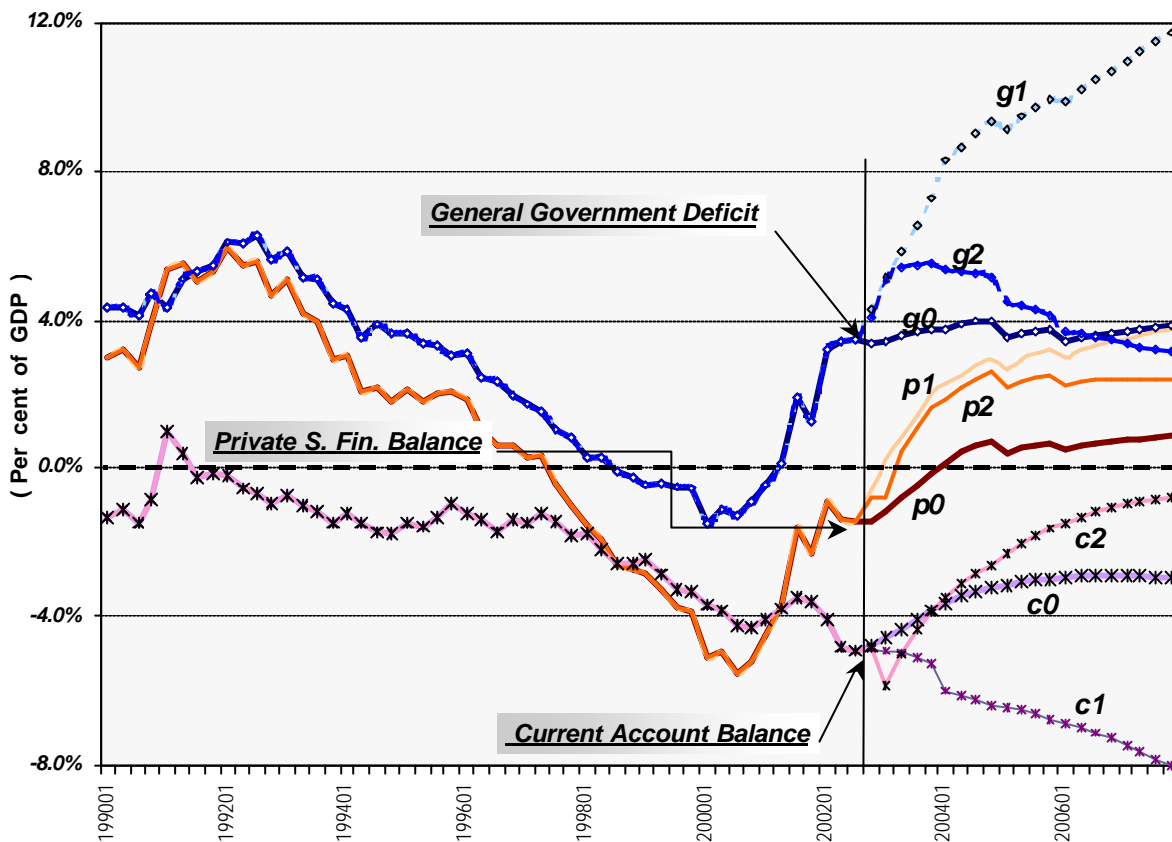
historic standard, it ought to be accompanied by a similar stimulus from the trade balance. Otherwise, in due course the fiscal expansion will need to be impossibly large.

RECOVERY SCENARIOS FOR THE U.S. AND IMPLICATIONS FOR THE REST OF THE WORLD

With the usual disclaimer of how little we can know of future developments, I would like to suggest some possible scenarios for the medium-term horizon. I have made use of a revised and updated stock-flow macro-econometric model of the US, streamlined to the minimum amount of accounting and behavioural relations that would still be capable of capturing the main features and strategic perspectives described above¹². Throughout these experiments, my assumptions have been moderately conservative; such as a stable, positive (though low) net-flow of credit to the private-sector, stationary stock market valuations, low inflation and gradually growing real estate prices. Other exogenous variables would be expected to follow their (average) historic pace.

The main differences between alternative scenarios are determined by the emphasis given to domestic policy and external dynamism. In summary the three alternatives are: first, a non-recovery scenario in the absence of policy changes; second, recovery by means of fiscal policy alone; and finally, recovery by a combination of fiscal policy and external expansion. The underlying structures of demand for each scenario are plotted in Chart 14. The first, absence-of-policy scenario carries the suffix '0', the second, fiscal-policy-alone scenario has the suffix '1' and the final, combined solution of fiscal and external expansion has the suffix '2'.

¹² See Godley (1999c) and successive Levy Economic Institute's and CERF's reports (Godley and Izurieta, 2001a,b, 2002a,b,c).

Chart 14: *Estimated Scenarios for Recovery*

The solutions illustrate the following stylised facts:

- The baseline scenario precludes further monetary and fiscal policy (while keeping interest rates low and allowing moderate tax relaxation). On the basis of the assumptions outlined above, and given a slowdown in private spending, the US economy would not be able to maintain its historical pace of growth. The average rate over the next five years would not be higher than 1½ percent. Unemployment would rise, rapidly approaching untenable figures. This is a ‘growth-recession’ scenario (Godley and Izurieta, 2002a, 2002d) in which growth rates need not be negative.
- With the growth-recession scenario the private-sector would slowly move to a balanced position and the only net addition to demand would come from the fiscal deficit. The external balance would remain negative (since no variations in world-demand or the exchange-rate are assumed) but the income elasticity of import-demand would be a

factor in partially dampening the increasingly negative trend¹³. Under these conditions, U.S. global import-demand would hardly grow. If one considers that economies worldwide are structured on the basis of 3% US growth the knock-on effect worldwide, after accounting for successive feedback, could be substantial¹⁴.

- c) Consider now the scenario labelled '1'. In order for the economy to grow sufficiently so as to prevent any further rise in unemployment by means of fiscal policy alone, the already large government deficit would have to grow further. The private-sector would, in all probability, return to its historical, balanced position (disposable income would rise along with the expansion, but spending will not rise at the same speed due to the heavy debt burden). It follows from accounting and economic logic that the current account balance would become largely negative - economic expansion at the historical average would increase imports at the current pace, with no assumed change in export demand. Various exercises yield an external *imbalance* of between eight and ten per cent of GDP (allowing for moderate outflows of factor payments). In five years the net foreign liabilities of the U.S. would have reached near fifty per cent of GDP.
- d) The growth-by-fiscal-policy-alone scenario (suffix '1') would reproduce, on a *much larger scale*, the twin deficits experienced in the 1980s. But a medium term fiscal deficit of more than ten percent of GDP and a current account imbalance in the range of eight to ten percent of GDP are most unlikely. The political establishment and the American public would resist. Also, an increasingly negative asset position *vis-à-vis* foreign lenders and investors (the counterpart of the accumulation of current account deficits) would make the entire system ever more vulnerable to investor's preference and interest rate changes.
- e) Finally, the scenario delineated with suffix '2' in Chart 14 seems attractive. It was constructed to achieve historic growth rates by means of a combined fiscal relaxation and an injection of demand from net exports. Fiscal policy could consist of a mix of tax relief and social spending (to the extent that these measures are addressed to

¹³ This scenario is based on the very conservative assumption that net-factor payments to the rest of the world would remain very limited, though the net-external liability position of the U.S. is by now c.25% of the U.S. GDP.

¹⁴ Since an updated version of the world models used previously was not available (Godley, 1996; Vos and Izurieta, 1993), it would be bold to offer a reasonable estimate of the shock. In any case, the final impact on global export-demand to developing countries would be larger than the initial 3 percent withdrawal.

expenditure-sensitive sectors). The income and employment effects would be beneficial to all. If the tax scheme was well-calibrated and oriented towards lower income groups and employment-creation incentives, aggregate demand would be reinforced without reproducing the negative savings characteristic of the 1990s¹⁵. The positive synergies generated by net-export demand and private-sector behaviour explain, in part, the declining fiscal deficit noted in Chart 14 after the initial injection.

- f) Under ‘normal conditions’, the net-export expansion could have been achieved by a substantial devaluation of the dollar - model simulations require at least a 30 percent devaluation *vis à vis* trading partners. Unfortunately, the exchange rate is not an ‘exogenous’ policy instrument; and even if it could be ‘influenced’ by investors’ reactions to policy-makers’ statements, this is not a reliable means of conducting policy. Alternatively, since what matters to net-export demand is real exchange rates, current deflationary pressures may help. However, reaching a real exchange depreciation by deflation is not neutral. Deflation would impact negatively on debt-holders, thus forcing them to subsequent withdrawals of spending. Furthermore, the relative improvement of terms of trade via deflation would probably fade away as trading partners in the northern hemisphere were also subject to perverse deflationary pressures. In particular, if there were an orchestrated deflationary process in the US and other developed countries, trading partners from the developing world would be forced to bear the largest part of the U.S. recovery.
- g) Thus, it seems that the ‘normal circumstances’ that can be generated in a model simulation exercise are distant from reality. There remains the possibility of generating a positive stimulus to net-export demand in the U.S. by faster growth on a global scale. But for this alternative to become plausible a drastic change of policy stance in the rest of the world is necessary. However, Euroland is now experiencing deflationary pressures reinforced by the Growth and Stability Pact. The UK is facing structural imbalances similar to those affecting the US. Japan remains mired in a recession that began more than a decade ago. Indeed, many low growth economies are looking to the US to restore growth as ‘importer of last resort’.

¹⁵ At the time of revising this paper (January 2003) a tax plan is being proposed by President Bush as if it were a ‘stimulus package’. But the plan, it is a regressive tax reform rather than a demand stimulus. This makes it more urgent to expand our analysis so as to enable an assessment of the effects on demand expansion of this and alternative stimulus packages. (Working paper forthcoming).

To sum up: the US economic downturn will have unpleasant consequences, domestic and worldwide, if alternative solutions cannot be found. One scenario predicts that the US could move from an unsustainable accumulation of private debt to untenable public-sector and external debt levels. In another scenario, if there is no change of policy stance in the developed world, the emerging and developing economies would be subject to severe adjustments to accommodate the sluggishness elsewhere. Yet a US recovery via devaluation may lead to policy retaliation, endless chains of devaluation, deflationary pressures, etc., eventually making of US recovery an ephemeral experiment.

OPEN-END CONCLUSION: TOWARDS REHABILITATING FISCAL POLICY ON A GLOBAL SCALE

On the basis of the analysis above, it may be possible to restore acceptable rates of economic growth in the U.S., but is certainly not inevitable. Moreover, even if it were only a question of choosing ‘the best growth strategy’, the implications of any of them are not without limitations and worrying consequences, at home and abroad. Recent expansion in the US was driven by imbalances that were allowed to persist much longer, and go much deeper, than the point at which both financial rebalancing and growth could be attained simultaneously and painlessly. As the same time, the world economy is contracting, exacerbated by the defeatist attitude of policy-makers who seem afraid to recognize that ‘policy matters’.

Policy has mattered, as this study has shown, when a relaxation of the fiscal stance helped, initially at least, to resolve an unprecedented and hazardous combination of financial imbalances, debt and deflation. But, this seems only to be the preamble. Future developments will depend on acknowledging and assessing the role of fiscal policy and carefully implementing new strategies.

This exercise could serve to shed light on problems faced by other economies; some of which are stifled by old orthodoxies that halt growth ‘just in case’ the ghost of inflation re-appears. For developing countries, there are major challenges ahead. Developing economies are not only the most in need, but also the most fiercely limited with respect to the exercise of policy discretion. Finally, were such a process of balanced reflation to take off, it would require the active co-ordination of policy makers globally since markets, created for competition, cannot do what they were never meant to deliver and what today is most required: a solution for all.

There is much work to do in order to pursue such an agenda. This paper has highlighted an analytical framework, pioneered by Wynne Godley and the Cambridge Economic Policy Group, further enhanced at the Levy Economics Institute and the Cambridge Endowment for Research in Finance. The analysis has not only proven useful in outlining the main, structural problems of economies such as the US and the UK. It may also be instrumental in devising strategic solutions. But, a more substantive contribution to enhancing demand at a global level is still pending. Forthcoming steps include revising and updating world-modelling tools for the empirical analysis of alternative scenarios under changing world conditions. Yet, it does not require a full world-model to realize that, facing a contracting world economy, a policy-generated, global reflation is urgently required.

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