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TEMPORARY STIMULUS PACKAGE WON'T ADDRESS UNDERLYING STRUCTURAL PROBLEMS IN U.S. ECONOMY, NEW LEVY REPORT SAYS

Sharp Drops in Stocks, Exports, and Private Spending in 2001 Mark Need for Substantial Changes in U.S. Fiscal Policy

ANNANDALE-ON-HUDSON, N.Y.--As most economists predicted, the U.S. economy contracted in the third quarter, and policymakers, while expecting a rebound in 2002, are now working to implement a modest, short-term stimulus package. Scholars at the Levy Economics Institute of Bard College warn, however, that the forces generating the current slowdown--mainly a sharp drop in private sector spending relative to income--were in place before September 11 attacks and, with exports falling, a substantial and longer-term fiscal response will be needed to restore growth and contain unemployment.

In a new Strategic Analysis from the Levy Institute, *The Developing U.S. Recession and Guidelines for Policy*, distinguished scholar Wynne Godley and research scholar Alex Izurieta argue that a spontaneous recovery is unlikely given the unprecedented structural imbalances that have been allowed to develop over the past decade. "The fall in private expenditure relative to income, which has generated the slowdown, is not temporary at all. It is only the beginning of a reversion toward a normal situation that still has a long way to go," the authors write, stressing the central role that record private spending relative to income played in the economic boom of the 1990s. "The fiscal measures so far announced are not nearly large enough to replace this engine. The scale of the permanent shortfall in aggregate demand in the medium term is very large--probably much larger than most estimates currently under consideration."

Godley and Izurieta contend that, combined with a declining balance of payments, the government's maintenance of budget surpluses has been choking the U.S. economy, bleeding the circular flow of income, and destroying financial assets. Should private expenditure revert fully to its normal relationship to income, they say, government outlays plus exports might have to be $600 billion per year higher than they were in mid 2001 in order to achieve balanced and sustainable growth and full employment.

"As the private sector's financial balance, or net saving, reverts to its normal positive state, the government's budget also will have to revert to its normal state of deficit," write Godley and Izurieta, who note, however, that because of the unacceptable implications for the balance of

payments, the remedy cannot reside in fiscal stimulus alone, and measures to boost exports will be necessary. "It is only by a combination of internal and external policies that it will be possible to achieve adequate growth that can be sustained in the medium-to-long term," they contend.

The authors find that the consensus outlook for a spontaneous recovery is unrealistic because it assumes that the private sector's deficit will begin to grow rapidly again, at a time when businesses and households are already at record levels of debt. Godley and Izurieta maintain that the Congressional Budget Office's most recent assumptions for the economy over the next five years --a 3.1 percent growth rate, 5.2 percent unemployment, and a slowly rising fiscal surplus--would cause a significant deterioration in the balance of payments and require a rise in the private deficit to as much as 8 percent of gross domestic product by 2006, with an accompanying increase in net lending.

"This cannot be expected to happen at a time when many firms are already overindebted and many households, already heavily indebted and threatened with unemployment and reduced earnings, have had their financial wealth depleted as a result of the fall in asset prices," the authors write, pointing to the current downturn as evidence of the dangers of relying too heavily on private spending to fuel the economy. "The growth of private expenditure relative to income required growing injections of net credit, which implied a growing ratio of debt to income--an intrinsically unsustainable process that has made the private sector increasingly vulnerable to negative shocks such as a downturn in income, employment, asset prices, profits, or investment."

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