Contact: Mark Primoff
(845) 758-7749
primoff@bard.edu

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U.S. TRADE IMBALANCE RAISES THE SPECTER OF UNPRECEDENTED TWIN DEFICITS AND PROLONGED RECESSION, LEVY STUDY SAYS

ANNANDALE-ON-HUDSON, N.Y.—In the fourth quarter of 2002, the U.S. primary balance of payments was equal to about 5 percent of gross domestic product (GDP)—easily a postwar record. With other world economies stagnating and private spending likely to slow on any increase in interest rates, the trade deficit will likely grow further and require equal growth in the U.S. budget deficit, according to a new study from The Levy Economics Institute of Bard College. In *The U.S. Economy: A Changing Strategic Predicament*, Distinguished Scholar Wynne Godley argues that such a return to massive twin deficits will result in a prolonged "growth" recession in the United States with increasing unemployment and will undermine a global economy fueled by American consumption.

The record levels of private spending and debt that fueled the 1990s economic boom were unsustainable, Godley contends, and the reversal of that spending pattern in 2000 marked the beginning of a downturn that has been limited only by the U.S. government's willingness to embrace deficit spending. Countering the record imbalance in trade and the primary account, however, will prove far more difficult, he says.

Godley estimates that if—as the *Economic Report of the President* predicts—the U.S. economy grows at an average rate of 3.3 percent through 2008 and monetary policy returns to a neutral stance, the deficit in the overall balance of payments could rise to about 8.5 percent of GDP over the next six years and U.S. foreign debt could rise to nearly $8 trillion or 60 percent of GDP. If private spending continues to slow and the private balance reverts to its traditional state of surplus, as Godley predicts, such an increase in the external

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balance would have to be countered by equally dramatic increases in the federal deficit, he argues. "The developing balance of payments deficit is going to act as a formidable drag on demand," Godley writes. "The present hemorrhage from aggregate demand, at 5 percent of GDP, is already far in excess of anything that has ever been experienced before (in modern times), though this is still being masked by the highly unusual private deficit . . . which is likely to go further into reverse."

Godley contends further that a sharp devaluation of the U.S. dollar, the classic remedy for chronic external imbalance, is unlikely because interest rates are too low to be effective as a policy tool, other world economies are stagnating, and some surplus countries, such as China and Japan, are buying dollars to prevent any rebalancing in world trade. "There is no obvious policy gesture that the U.S. authorities can now take, with real short-term interest rates close to zero, which would bring this about on the huge scale necessary—even if this is what they wanted to do," writes Godley, stressing that even a large drop in the dollar might be ineffective, given the weakness in other economies. "It is doubtful whether a fall in the dollar, however large, could in practice generate the required (enormous) rise in net exports given that the market is so stagnant."

Godley concludes by stressing that the solutions for reducing the trade deficit, from devaluation to protective tariffs, would be difficult to enact and would carry some serious disadvantages. Given the level to which the world is looking to the U.S. economy as a motor for growth, Godley suggests that a new world solution may be needed to head off the potential consequences of growing twin deficits in the United States. "The most likely consequences of the massive and growing leak out of the circular flow of income will be, given present national and international policies, that there will be no proper recovery from the recent recession; and that this stagnation will eventually have grave consequences for the rest of the world, which has come to look to the United States to give it momentum," he writes.

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Strategic Analysis March 2003, *The U.S. Economy: A Changing Strategic Predicament*

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