"As the Implosion Begins . . . ?":

A Rejoinder to Goldman Sach's J. Hatzius' "The Un-Godley Private Sector Deficit" in *US Economic Analyst* (27 July).

Wynne Godley and Alex Izurieta

In the July 27 issue of Goldman Sachs's *US Economics Analyst,* Jan Hatzius (2001) pays a generous tribute to some of the work which the Levy Institute has published during the last few years. But he claims that in our most recent paper (Godley and Izurieta 2001) "the predictions are overly alarmist, because each of [our] assumptions is extreme." Mr. Hatzius's main points are as follows.

1) "The assumption [which he attributes to us] that the entire [private] deficit must be eliminated seems too extreme. . . . The sustainable [private] debt growth rate . . . is surely higher than zero."

2) "Mr. Godley argues that a violent adjustment is likely. [His] analysis. . . ignores the response of monetary policy to the downturn."

3) "In principle, a financial deficit could be eliminated through lower spending, higher income or a combination of the two. In practice, however, Mr. Godley believes that the whole adjustment must come from a sharp drop in spending."

4) "The [favorable] outlook for public debt is important in assessing [the] sustainability [of private debt]."

5) "Deficits that merely raise debt in line with income should pose no problems".

Taking these points in turn

1) We do *not* assume that the entire private deficit must be eliminated. We make a range of assumptions and show that any of those that we can accept as remotely plausible imply very sluggish growth rates. Our simulation 1, shown in Chart 13 of our paper, *pace* Mr. Hatzius, assumes that the private sector remains in deficit through the next five years. And in the table that immediately follows, we show (what we believe to be) the realistic consequences of this assumption, namely that in 2006 unemployment could exceed 7 percent, the budget balance could be 0.7 percent of GDP in deficit, and the balance of payments could be 2.5 percent of GDP in deficit. We agree that the sustainable private debt growth rate is greater than zero; but there is nothing in our paper to suggest otherwise.

2) The primary objective of our new paper was to make not a short-term forecast, but a strategic assessment. It is for this reason that, in the table that provides our main results, all comparisons

are between 2000 and 2006, precisely in order to avoid taking any strong position about timing. It is, admittedly, the case that we remark, in a heavily qualified sentence, that we expect a fair part of the adjustment to happen quite soon. It is not true that we ignore any effects from monetary policy; rather we do not believe that these effects will be strong enough to prevent the implosion from continuing in the future--any more than they have during the past nine months.

3) This is not a correct statement of what we have done, or assumed. We started with a "base run" (labeled Simulation "0" in Chart 13) that shows what must be assumed about the private deficit if the CBO's assumptions about GDP and inflation, together with their conditional forecasts of the budget surplus, are to come true. We then modified this outcome by feeding a succession of assumptions about the growth of debt *relative to income*, the stock market and world trade into an interdependent model of the economy as a whole. We made no assumption that it is a drop in private spending (an endogenous variable in our model) that will bring the adjustment about.

4) It is quite true that the rise in the private deficit has in part been the accounting "counterpart" of the government surplus. But the fact that government debt is lower does not make high private debt any easier to finance. The reduction in interest payments by the government as a result of lower public debt has already been taken into account in deriving the estimates of the budget surplus.

5) It is true, as a general rule, that deficits that do not raise the debt-to-income ratio should cause no problem, though if debt is very high there will always be a danger should there be a decline in income or asset prices.

However, this final point raises a fundamental question that has altogether escaped Mr. Hatzius's critique. The central contention of all the work we have done in this area has been that with the government and external sectors both (as we put it) having bled the circular flow of income on an increasing scale through the last 10 years, the entire expansion has been driven, from the demand side, by a continuing growth of private expenditure relative to income; this was a process that by its very nature could not continue forever. If, from now on, debt rises no faster than income, the situation may look "safe" to Mr. Hatzius, but it carries the implication that the entire motor that has driven the economy for the last 10 years has been removed.

While we have previously been very cautious about guessing when the inherently unsustainable processes would unravel, the evidence mounts that an implosion has now started in earnest and that U.S. (and world) stagnation, at best, now stares us in the face--unless policies are changed quite dramatically.

REFERENCES

Godley, Wynne, and Alex Izurieta. 2001. *As the Implosion Begins. . . ? Prospects and Policies* *for the U.S. Economy: A Strategic View.* Strategic Analysis (July). Annandale-on-Hudson, N.Y.: The Levy Institute. www.levy.org

Hatzius, Jan. 2001. "The Un-Godley Private Sector Deficit." *U.S. Economics Analyst* 01/30 (July 27). Goldman, Sachs & Co.