The Levy Economics Institute of Bard College

Policy Note

2006 / 4

DEBT AND LENDING: A *CRI DE COEUR*

WYNNE GODLEY AND GENNARO ZEZZA

Many papers published by the Levy Institute during the last few years have emphasized that the U.S. economy has relied too much on the growth of lending to the private sector, most particularly to the personal sector, to offset the negative effect on aggregate demand of the growing current account deficit. Moreover, this growth in lending cannot continue indefinitely.

This centrally important point has not entered the public discussion properly. People have generally been concerned with related but essentially different threats, for example, the possibility of falling house prices, a potentially excessive burden of interest and debt repayments on personal income, or a disorderly collapse in the dollar exchange rate.

Figure 1 shows the financial balances of the government, the private sector, and the foreign sector, all expressed as proportions of GDP. For the period 1972–2005, the balances are historical data derived from National Income and Product Accounts tables, produced by the Bureau of Economic Analysis. For the future, the figures are projections derived from a simple econometric model, based on assumptions we shall call Scenario 1.

The history of the period can be usefully analyzed in terms of changes in these balances. The negative impetus from the growing current account deficit and increasing fiscal restriction during the "Goldilocks" period of the late 1990s was offset by a long and spectacular fall in private net saving. Then, when private net saving started to recover, around 2000, an incipient recession was headed off by a huge fiscal relaxation. More recently, although the current account

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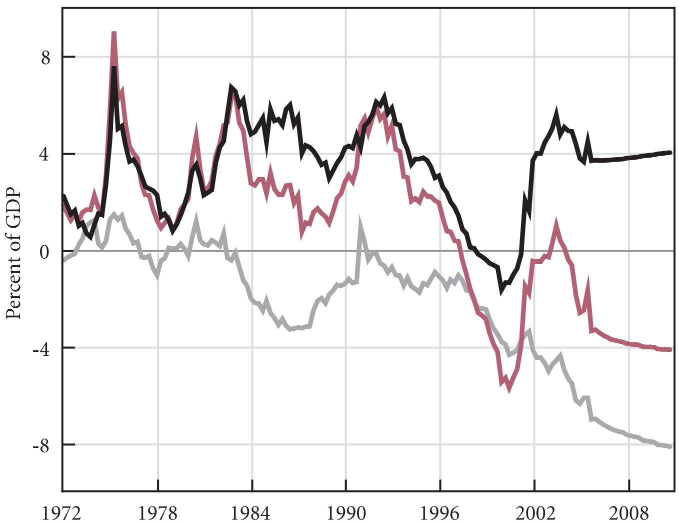
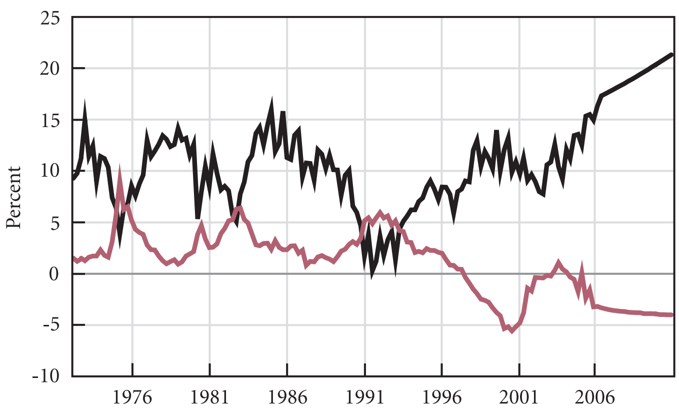
Figure 1 **Financial Balances in Scenario 1**



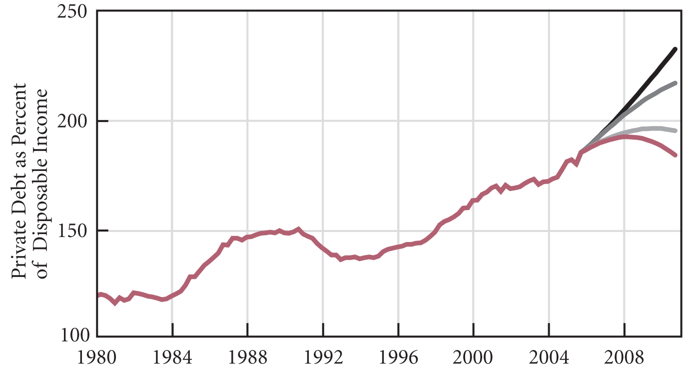
Sources: BEA and authors' calculations

Figure 2 **Private Sector Balance and Net Lending in Scenario 1**



Sources: Flow of Funds, BEA, and authors' calculations

Figure 3 **Debt-Income Ratio**



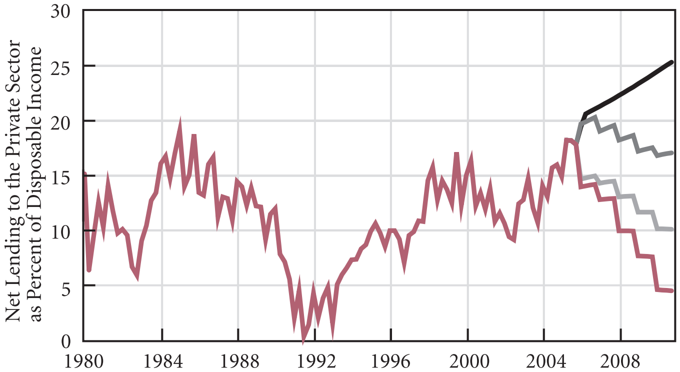
Sources: Flow of Funds, BEA, and authors' calculations

balance has continued to deteriorate, the expansion has been kept on track by a renewed fall in private net saving.

The major assumption underlying the projection in Figure 1—and it is no more than an assumption—is that the GDP grows at an average rate of 3.3 percent during the next five years. The current account balance, which reached 7 percent of nominal GDP in the fourth quarter of 2005, was next projected to reach 8 percent of GDP in 2010, conditional on the 3.3 percent growth rate. This projection also uses the assumptions that there is no change in the exchange rate, no change in the price of oil, and a moderate continued rise in both stock prices and house prices. It has also been assumed that fiscal policy keeps the combined budget deficit of all levels of government constant as a proportion of GDP.[1] It follows by identity that the private sector balance would have to go on falling, reaching minus 4 percent by the end of the period.

What would have to happen to net lending to bring the 3.3 percent growth rate about? Figure 2 reproduces private net saving from Figure 1 and also shows our model's projection of the net lending that would be required to bring this about. According to this projection, the net flow of lending would have to go on growing, from 15 percent of private disposable income at the end of 2005 to 20 percent in 2010. This may or may not be a correct inference, but the history of the relationship between the two series gives it some plausibility, as inspection of Figure 2 suggests.

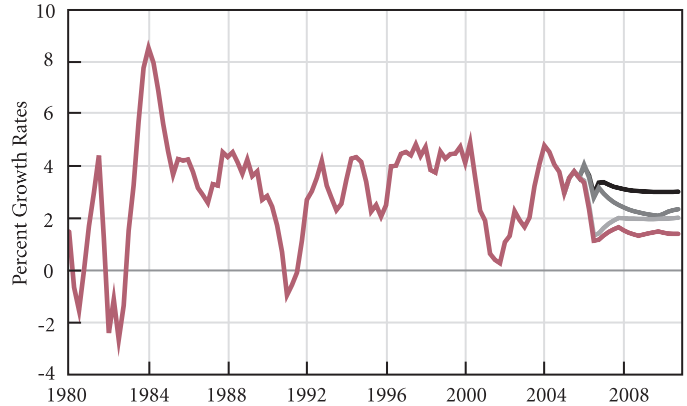
Figure 4 Net Lending–Income Ratio



- Scenario 1
- Scenario 2
- Scenario 3
- Historical and Scenario 4

Sources: Flow of Funds, BEA, and authors' calculations

Figure 5 GDP Growth Rates



- Scenario 1
- Scenario 2
- Scenario 3
- Historical and Scenario 4

Sources: BEA and authors' calculations

Figure 3 shows possible trajectories of private *debt* as a percent of disposable income. Scenario 1, the top line, which shows the debt percentage rising to 225 in 2010, is what is implied logically by the growth in lending shown in Figure 2. The other three lines show alternative scenarios, all of which, in our view, are more plausible than Scenario 1. It could easily happen that, if house prices stop rising or if the financial-obligations ratio published by the Fed continues to rise, the debt-to-income ratio will slow down during the next few years, much as it did in the late 1980s and early 1990s.

Figure 4 illustrates the central point to which this paper is designed to draw attention—the logical implications of the Figure 3 projections of debt *levels* for the flows of net *lending* relative to income. All we have done is enter changes in debt—instead of debt levels—relative to income. The results are a bit surprising, since the apparently quite small differences between debt levels in the four scenarios generate such huge differences in the lending flows. In particular, Scenario 4, the lowest projection, shows that the debt percentage only has to level off slowly and then fall very slightly for the flow of net lending to fall from 15 percent of income in 2005 to 5 percent in 2010.

What effect would this have on activity? Figure 5 shows four possible paths of growth rates of GDP between now and 2010, corresponding to the four scenarios for net lending but retaining the same assumptions about all other given variables. All the scenarios imply seriously deficient growth rates. The average growth rates for 2005–10 come out at 3.3 percent, 2.6 percent, 1.8 percent, and 1.4 percent. The last three projections imply sustained growth recessions—very severe ones in the case of the last two.

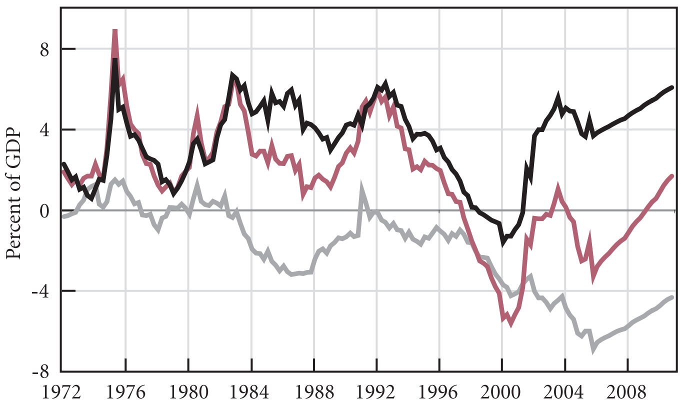
Figure 6 shows the projected implications of Scenario 4, the gloomiest variant, for the future of the three financial balances. It shows the private sector balance slowly rising toward its historical mean, which seems, in any case, to be quite likely to happen. The current account balance improves a lot as a result of the stagnation, but the government deficit would rise to perhaps 5 percent of GDP for cyclical reasons.

Is it plausible to suppose that the growth of GDP would slow down so much just because of a fall in lending of this size? Figure 7, which shows past (and projected Scenario 4) figures for net lending combined with successive, overlapping three-year growth rates, suggests that it could. Major slowdowns in past periods have often been accompanied by falls in net lending. Indeed, the two series have moved together to an extent that is somewhat surprising, in view of the fact that other major forces (e.g., fiscal policy and foreign trade) have also been at work.

Conclusion

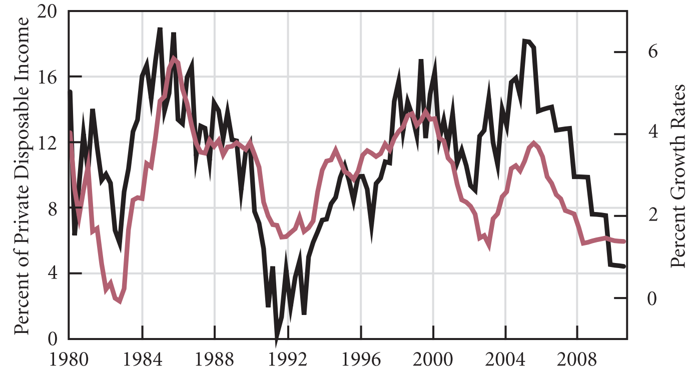
The central purpose of this paper is to make a single point, one that we believe is important but largely absent from the public discussion: the path of lending, rather than debt, may

Figure 6 Financial Balances in Scenario 4



Sources: BEA and authors' calculations

Figure 7 Net Lending and GDP Growth Rates in Scenario 4



Sources: Flow of Funds, BEA, and authors' calculations

turn out to be of decisive importance for the medium-term future of the U.S. economy. And furthermore, quite moderate (and in our view highly plausible) assumptions about a slowdown of the path of debt have extremely strong and unpleasant implications for the path of lending and also for the growth of the economy.

Note

1. If, as many think, the current account deficit were to rise to more than 8 percent on these assumptions, the conclusions of this note would be strengthened.

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