



The Levy Economics Institute of Bard College

---

# ***Strategic Analysis***

---

April 2004

## **IS DEFICIT-FINANCED GROWTH LIMITED?**

### **Policies and Prospects in an Election Year**

DIMITRI B. PAPADIMITRIOU, ANWAR M. SHAIKH,  
CLAUDIO H. DOS SANTOS, AND GENNARO ZEZZA

#### **Introduction**

Wynne Godley, our Levy Institute colleague, has warned since 1999 that the falling personal saving and rising borrowing trends that had powered the U.S. economic expansion were not sustainable. He also warned that when these trends were reversed, as has happened in other countries, the expansion would come to a halt unless there were major changes in fiscal policy.

Not long ago, official circles insisted that monetary policy was the most effective tool, and that fiscal deficits were not only unnecessary but also harmful (*Economic Report of the President* 2000, pp. 31–34; Greenspan 2000). Some economists, notably Edmund Phelps of Columbia University, went so far as to suggest that the economic expansion was not caused by rising demand, but rather because growth had become “structural” (Phelps 2000).

Yet fiscal policy has made a swift and major comeback, not simply as tax cuts and military expenditures, but also as huge budget deficits. Three years ago, at the beginning of 2001, there was a government surplus of \$113 billion.<sup>1</sup> One year later this had become a deficit of \$292 billion. According to the latest available figures, by the third quarter of 2003 the deficit had grown to \$604 billion. The historical events that gave rise to this change in practice are well known. But they may also signal a growing recognition of the limited effect of monetary policy. Many colleagues at The Levy Economics Institute have long argued that government deficits, albeit of a different composition, would be necessary to sustain economic growth when private sector borrowing reached its limits (Godley 1999; Papadimitriou and Wray 2001; Godley and Izurieta

---

The Levy Institute's Macro-Modeling Team consists of Levy Institute President DIMITRI B. PAPADIMITRIOU, Senior Scholar ANWAR M. SHAIKH, and Research Scholars CLAUDIO H. DOS SANTOS and GENNARO ZEZZA. All questions and correspondence should be directed to Professor Papadimitriou at 845-758-7700.

2001). At the same time, we have emphasized the limits of this recourse, for deficits are always linked to debts. This is the theme we explore in this Strategic Analysis.

As we expected, real GDP growth responded dramatically to the rise in government deficits: in 2001, growth stood at 0.5 percent; in 2002, it was 2.2 percent; and by the fourth quarter of 2003, it was 4.1 percent, having previously reached a peak of 8.2 percent in the third quarter of 2003. In this process, profits and productivity have soared.

Until very recently, however, employment and wage incomes have lagged far behind. Job growth was weak throughout 2003, despite high rates of output growth. Official statistics based on payroll surveys indicate that 1.89 million jobs have been lost since President Bush took office three years ago. Those statistics also show that only 8,000 jobs were created in December 2003, 97,000 in January 2004, and 46,000 in February 2004. Official views have acknowledged this discrepancy between output growth and employment growth, which they have attributed to an extraordinary surge in productivity. The rate of growth of real GDP per employee stood at 7.7 percent in the third quarter of 2003. While this rate of growth was high, such quarterly productivity growth rates are by no means unusual, and are typically followed by sharply lower ones (see Figure 7). Indeed, by the fourth quarter of 2003, productivity growth had fallen to 1.9 percent. What is relevant to employment prospects is the average rate of growth over longer periods, which we analyze in the next section.

In any case, the latest figures appear to tell a dramatically different story: according to the payroll survey, nonfarm jobs grew by 308,000 in March. This recovery of employment is in line with our analysis of the effects of the greatly expanded budget deficits, which we discuss below. But it is important to place this in context. Some 134,000 new jobs must be created every month just to absorb the growth in the workforce.<sup>2</sup> From this point of view, total job creation from December 2003 to March 2004 *was still 77,000 short of the number needed just to absorb new entrants.*

Moreover, there is continuing dispute over the actual numbers of jobs created, because the two different methods employed by the Bureau of Labor Statistics (BLS)<sup>3</sup> give different results. The payroll survey indicates that jobs rose from 46,000 in February to 308,000 in March. At the same time, the household survey indicates a virtually constant level of job creation, 146,471 in February and 146,650 in March. Nor have

employment measures and unemployment rates moved together. For instance, the March surge in payroll job estimates has actually been accompanied by a slight rise in the unemployment rate, from 5.6 percent in February to 5.7 percent.

Despite the murkiness of the job picture, it is widely agreed that new jobs increasingly encompass low-quality, low-wage employment. According to the lead author of a recent study on employment measures, at “no other point in the nation’s last five recovery periods have so many people been employed as independent contractors, as temporarily self-employed, or paid under the table” (Andrew M. Sum, as cited in Uchitelle 2004, p. 2). Furthermore, as shown by the “Employment Situation” report recently released by the BLS, more than 4.9 million persons currently want jobs, in addition to the 8.3 million unemployed (BLS 2004). The weakness in the labor market also shows up in the virtual stagnation of hourly earnings, which have recently grown “at the slowest pace ever recorded” (Goldman Sachs 2003, p. 2). Real hourly earnings, i.e., the dollar amount of earnings adjusted for the cost of living, have actually begun to fall (BLS 2004). Similarly, total employee compensation has also begun to fall, in both dollar and inflation-adjusted terms. Thus, while the present recovery has been very good for profits, it has yet to have a positive impact on employment and wages.

In any case, the administration and Federal Reserve Chairman Alan Greenspan remain optimistic about growth and employment over the near term, and do not seem alarmed by the sharp rise in government and current account deficits over this same time horizon. Over the longer run, however, even they express concerns about a series of potential problems. These include an inevitable rise in the real federal funds rate to a “more neutral level,” a growing pressure to bring fiscal budgets back into line by cutting government spending or by raising taxes, and a growing pressure to curtail the current account deficit. Others, such as the International Monetary Fund (IMF), are openly pessimistic, and have recently warned that the large current account and government budget deficits may drive up both global and U.S. interest rates, crowd out private investment, and erode productivity growth (see discussion below). The markets are already signaling this concern: one day after the March job growth surge, the yield on the Treasury’s 10-year note jumped from 3.88 percent to 4.15 percent. This was the largest one-day run-up since March 1996 (Fuerbringer 2004).

Our focus in this and previous Strategic Analyses has been on the medium term. In previous policy reports, we suggested that because the private sector was moving toward financial balance, it would take large fiscal deficits to provide the fuel needed to jump-start and maintain economic growth. But we warned that leaving matters alone would lead to large fiscal deficits paired with equally large current account deficits. In October 2002 we considered a depreciation of the currency to be an essential element of the overall policy prescription, and traced out the impact of a 25-percent decline in the broad index of the dollar. In our subsequent report of October 2003, we noted that the exchange rate had already depreciated by 6 percent.

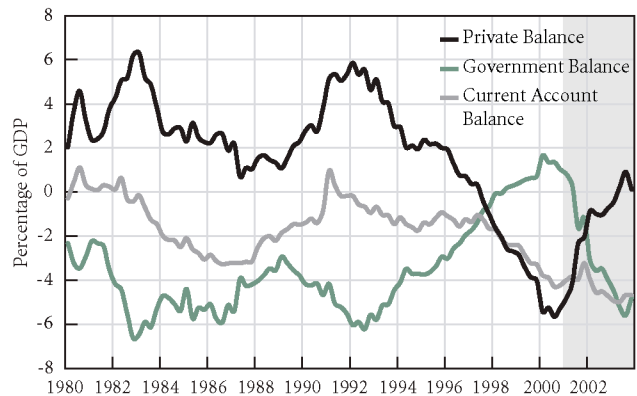
Large budget deficits have come to pass, as have concomitant increases in the current account deficit. At the same time, the currency has continued to depreciate. Its broad index has declined a further 2.7 percent since our previous Strategic Analysis, and in the words of the European Central Bank president Jean-Claude Trichet, its decline against the euro has been “brutal.”

In the next section we examine the current state of the economy in some detail. Then, in the final section, we assess the implications of recent economic events for the future path of the economy. We find that while present monetary and fiscal policy stances are likely to lead to robust growth and improved employment, this would come only at the expense of high government deficits, record foreign deficits, and rising ratios of government and foreign debt relative to GDP. Even under the best of circumstances, with constant interest rates, this scenario is unsustainable. It would be even more so if interest rates rose, as projected by the Congressional Budget Office (CBO) and now anticipated by many observers. We therefore consider two alternative strategies for halving the government deficit in five years: curtailing government spending, which is the path favored by the present administration; and rolling back recent tax cuts. Our model shows that the latter yields substantially higher growth and substantially lower unemployment.

### The Current State of the Economy

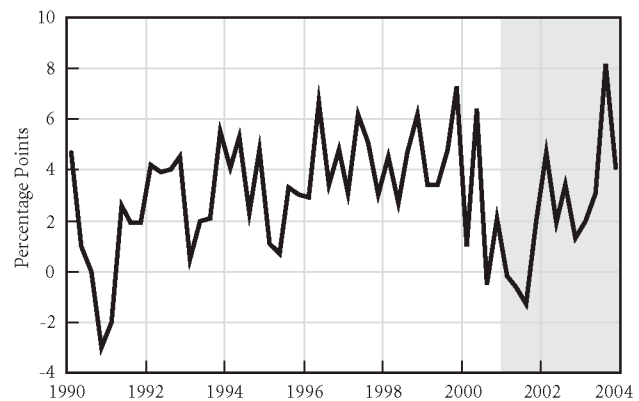
The return of large and growing fiscal deficits is the first striking element of recent times. As a matter of accounting, the “internal” financial balances (receipts minus nonfinancial

**Figure 1 Three Financial Balances in Historical Perspective**



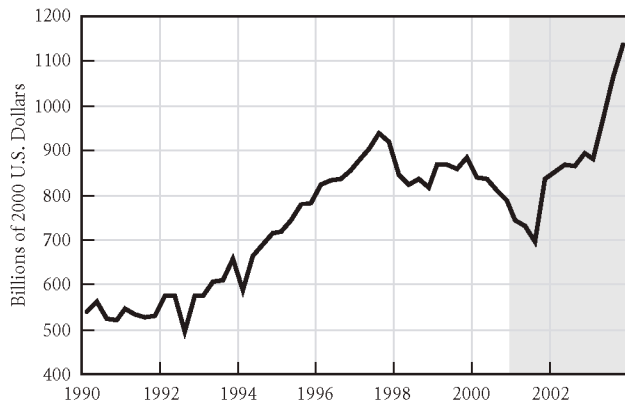
Sources: BEA and authors' calculations (last observation 2003:4)

**Figure 2 Growth in Real GDP (Quarter by Quarter, at Annualized Rates)**



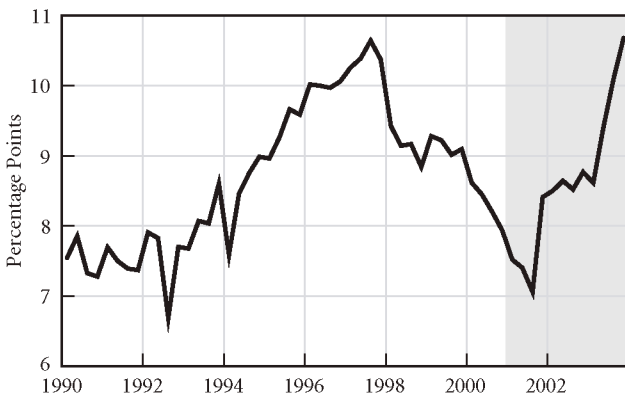
Source: BEA (last observation 2003:4)

**Figure 3 Real Corporate Profits**



Sources: BEA and authors' calculations (last observation 2003:4)

**Figure 4 Corporate Profit Share in GNP**



Source: BEA (last observation 2003:4)

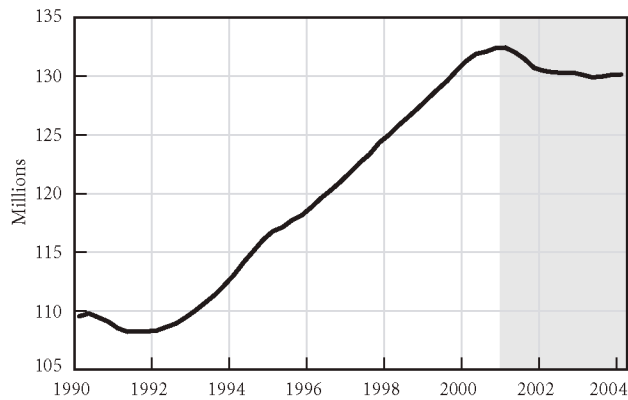
expenditures) of the private sector plus the government sector must equal the “external” financial balance—that is, the current account balance. The private sector encompasses households and businesses; just a few years ago, it was running large deficits, but as we have been projecting in previous reports (Papadimitriou et al. 2002; Shaikh et al. 2003), it has been rapidly reversing itself. At present the overall balance has even moved to a small surplus, because the financial surplus of the business sector has more than offset the deficit of the household sector. Consequently, the current account deficit now mirrors the government deficit. Nearly twin deficits are back, as Figure 1 displays. In Figures 1 through 9, the shaded area represents the time in office of the current administration.

As the unprecedented private sector deficits have receded, their place has been taken by large and growing budget deficits. These have succeeded in pulling the economy out of the 2001 downturn and sustaining current growth. As shown in Figure 2, the growth rate of the economy has risen rapidly in response to the burgeoning fiscal deficits. With this higher growth has come greatly enhanced profitability, for not only do deficits increase personal-sector disposable income (since the income created by the government exceeds taxes collected whenever there is a deficit), but they directly add to corporate profits (Papadimitriou and Wray 1998).

Figure 3 depicts total real corporate profits,<sup>4</sup> which in a short space of time have already surpassed the peak they had previously achieved at the height of the stock market bubble. Alternatively, Figure 4 shows that the share of profits in total GDP behaved in a similar manner, although it is still just short of its previous peak.

Similar benefits have not yet been conferred on labor. Figure 5 displays total nonfarm employment, which began to fall in 2001 and has only just begun to rebound. As we noted earlier, official statistics based on payroll surveys indicate that even the most recent surge in job growth has not managed to erase the job deficits of the past three months. Figure 6 depicts the civilian unemployment rate and the labor-force participation rate. We observe that the unemployment rate rose sharply beginning in the first quarter of 2001, peaked in the third quarter of 2003, and declined slightly in the last quarter. The most recent monthly surge in job growth, which is not displayed on this quarterly chart, has nonetheless been attended by a small rise in the unemployment rate.

**Figure 5 Quarterly Total Nonfarm Employment (Seasonally Adjusted)**

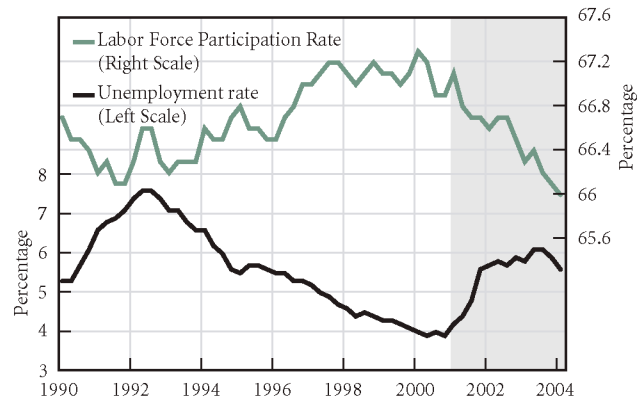


Source: BLS (last observation 2004:1)

On the surface, one would expect the unemployment rate to fall when job growth was positive. This is not necessarily the case, however, because population growth and immigration tend to swell the pool of those looking for work each month. In addition, previously employed people move in and out of the pool of job seekers. When times are bad, people who become discouraged and give up looking for work are not counted as being unemployed. This reduces the apparent pool of those seeking work. Conversely, when the economic climate seems to be improving, as it was in March, people move back into this same pool. This process is reflected in the labor-force participation rate, which measures the sum of those who have jobs (the officially employed) and those who are counted as looking for work (the officially unemployed), in relation to the civilian noninstitutional population. Figure 6 shows that this quarterly figure has dropped consistently since the first quarter of 2001.

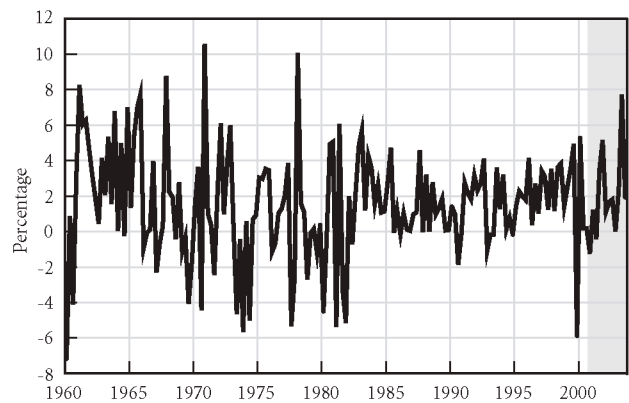
The weakness in the labor market is widely attributed to a “stunning” growth in productivity (Greenspan 2004b). Figure 7 depicts the annualized growth rate of quarterly real GDP per employee,<sup>5</sup> from 1960 through 2003 (such quarterly data will not embody new monthly results until three months are in hand). We observe that recent productivity growth (in the shaded area) has indeed been very high, soaring to 7.7 percent in the third quarter of 2003, and falling thereafter to a mere 1.9 percent. Such fluctuations are by no means unusual in historical perspective, since similar volatility has been recorded at various points in the 1960s and 1970s. For this reason we

**Figure 6 Quarterly Unemployment and Labor Force Participation Rates**



Source: BLS (last observation 2004:1)

**Figure 7 Quarterly Productivity Growth in Historical Perspective**



Sources: BLS, NIPA, and authors' calculations (last observation 2003:4)

continue to expect productivity growth to remain moderate in the near future. Hence, if output growth persists, employment and total wage income should improve markedly. This is more or less the consensus view (Bernanke 2004; Goldman Sachs 2003; Greenspan 2004b). Indeed, the current average rate of growth of productivity is not substantially different from the historical average of about 1.6 percent,<sup>6</sup> which in turn defines the medium-term growth rate needed just to maintain the present level of unemployment. Because the pool of available labor also rises continually, growth rates higher than 1.6 percent would evidently be required to maintain the rate of unemployment, and still higher ones to bring it down.

To summarize, large fiscal deficits have pumped up growth and profits but have left employment and wage income moribund. Because the private (household and business) sector has moved into a small financial surplus, the large government deficits mirror the large current account deficits. And these in turn imply rising government and foreign debts, respectively.

What are the implications of this state of affairs? Official views seem optimistic about the near-term prospects for growth and employment, and are not overly concerned about the near-term consequences of the sharp rise in government and current account deficits.

According to Federal Reserve Board member Ben S. Bernanke, “2003 seems to have marked the turning point for the U.S. economy, and we have reason to be optimistic that 2004 will see even more growth and continued progress in reducing unemployment.

“The Federal Reserve enters 2004 with monetary policy that is unusually accommodative in historical terms, relative to the stage of the business cycle. That accommodation is justified, I believe, by the current very low level of inflation, and by the productivity gains and the weakness in the labor market, both of which suggest that inflation is likely to remain subdued” (Bernanke 2004, p. 7).

Alan Greenspan is similarly optimistic: “Overall, the economy has made impressive gains in output and real incomes . . . [even though] progress in creating jobs has been limited. . . . Looking forward, the prospects are good for sustained expansion of the U.S. economy. . . . In all likelihood, employment will begin to grow more quickly before long as output continues to expand . . . [and] the currency depreciation we have experienced of late should eventually help to contain our current account deficit” (Greenspan 2004b, pp. 1, 3, 4).

These same spokesmen are notably more cautious on long-run prospects, expressing concerns about the consequences of an inevitable rise in the real federal funds rate, and about the adjustments that might have to be made to contain excessively high government and current account deficits (Greenspan 2004b). Others move beyond mere worry to outright pessimism. For instance, the IMF warned recently that the current deficit-driven “economic recovery may come at the eventual cost of upward pressure on interest rates, a crowding out of private investment, and an erosion of longer-term productivity growth” (Mühleisen and Towe 2004, p. 5).<sup>7</sup>

Our concerns are somewhat different. Having argued for some time that consumer spending cannot keep its pace, we are gratified to find that this view has become virtually unanimous (Krugman 2003; Bies 2004). For a long time now, sharply falling interest rates have enabled households to borrow heavily without incurring an explosive growth in their debt service burdens. Figure 8 profiles the household debt service (principal and interest payment) burden based on the Federal Reserve’s latest revisions. At the end of the third quarter of 2003, the debt service payments accounted for 13.1 percent of disposable income, which is very close to the record high of 13.3 percent in 2001, and considerably higher than the mid-1993 level of almost 11 percent.

The Federal Reserve also provides a broader measure (the financial obligations ratio) that includes lease payments for automobiles, rent, homeowner’s insurance payments, and property taxes in the overall debt service burden. This ratio peaked at an all-time high of 18.73 percent of disposable income in the last quarter of 2002, and still remained above 18.3 percent in the third quarter of 2003. These levels are significantly higher than the 16.25 percent ratio reached a decade earlier. Interest rates are still near all-time lows, while debt and debt service burdens are near all-time highs.

The increasing household debt burden has given rise to an unprecedented record of consumer bankruptcies, as shown in Figure 9. These translate into 1.66 million bankruptcy filings for the year ending September 30, 2003—an increase of 7.4 percent from the previous year as reported by the federal judiciary (Kanell 2004). With interest rates having bottomed out, further increases in debt burdens could sharply increase debt service burdens and accelerate bankruptcies. We believe that this represents a significant danger. The official view seems to miss this point when it argues that “the household

sector seems to be in good shape, and much of the apparent increase in the household sector's debt ratios over the past decade reflects factors that do not suggest increasing household financial stress" (Greenspan 2004a, p. 5).

Financial and business constituencies have focused instead on the possibility that large government deficits might renew inflationary pressures and lead to rising interest rates. While we remain vigilant about the prospect of inflation, we are more concerned about a possible drop in demand for U.S. assets by foreign creditors such as China and Japan. In this respect, we agree with Federal Reserve Chairman Greenspan and others who also express similar concerns.

In any case, our focus is on a different set of questions. What is the likely growth path induced by anticipated levels of government deficits, and what implications does this have for current account deficits and for foreign debt? Will growth fade if government deficits are reduced once the election cycle is over? What will this do to employment growth, given that productivity growth seems to have settled at a much higher level than in the past? Will the current account deficit also be reduced, or will the private sector deficit reappear, leaving the current account deficit intractably large? We turn to these issues next.

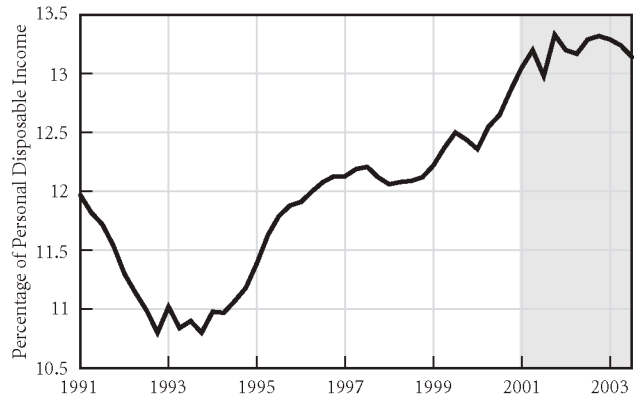
### Postelection Scenarios

In our Strategic Analysis of October 2003, we contrasted the CBO's budget projections with what we considered to be "a more realistic path" for the general government balance. Subsequent events have broadly confirmed our projections.

In examining the likely outcomes of our projected budget paths, we incorporated the CBO's own assumption that households would use some portion of their tax cuts to reduce their debt. But it appears that rising equity markets and the prospect of an increase in disposable income arising from planned tax cuts overcame any concerns households might have had about their high debt levels. Thus households continued to increase their expenditure—mainly on durables and housing—without significantly reducing their rate of borrowing. For this reason, economic growth was somewhat higher than our previous projections. So, too, have been the levels of personal sector debt relative to private income.

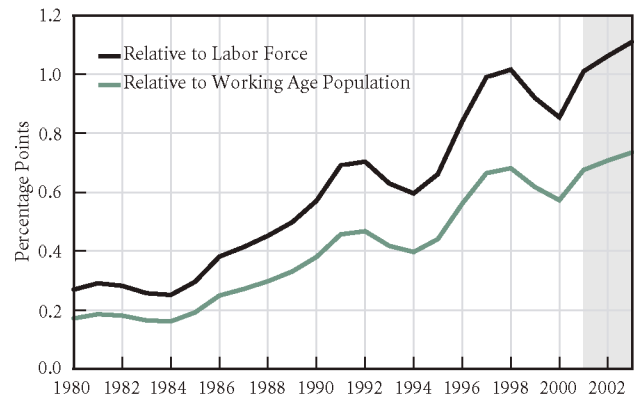
In what follows, we examine the medium-term consequences of three alternative policy scenarios. The first of these, which we call the "baseline" scenario, examines the likely

**Figure 8 Quarterly Household Debt Service Burden**



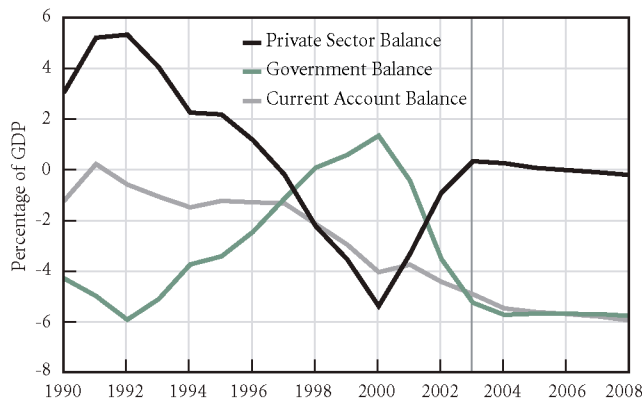
Source: Federal Reserve (last observation 2003:3)

**Figure 9 Relative Households' Bankruptcy Filings (Annual)**



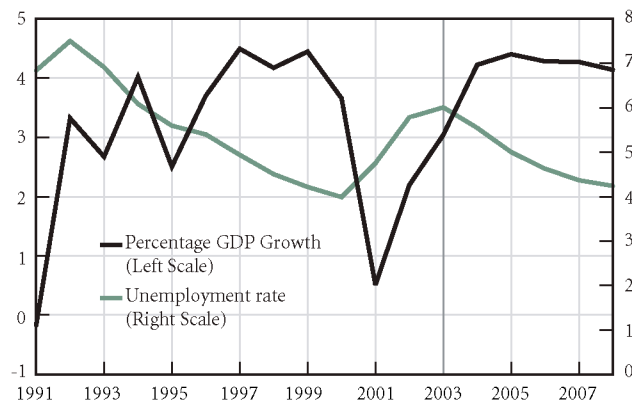
Sources: BLS and ABI World (last observation 2003)

**Figure 10 Main Sector Balances**  
Deficit-Financed Growth



Sources: BEA and authors' calculations

**Figure 11 GDP Growth and Unemployment**  
Deficit-Financed Growth



Sources: BEA and authors' calculations

economic outcomes of present fiscal and monetary policy. Unsustainably high budget deficits and record current account deficits are characteristic of this path. Therefore, the next two scenarios contrast two alternative methods of halving budget deficits over the next five years: reducing government expenditures (Scenario 1) versus rolling back tax cuts (Scenario 2). As we shall see, the output and employment paths are strikingly different in these two scenarios.

Since the focus of our analysis is on alternative fiscal policies, we keep interest rates constant in all simulations.<sup>8</sup> We also assume that the private sector will keep borrowing, albeit at a slower pace than in the past, so that the private sector balance tends to stabilize. On other fronts, we retain the assumptions of our previous Strategic Analysis: world growth at 3.7 percent in 2004, and 3.35 percent thereafter; world inflation around 2 percent throughout the simulation period; and the exchange rate falling at an annual rate of 3 percent in 2004, but stabilizing thereafter. Following recent predictions (*The Economist* 2004), we assume domestic inflation to be 1.5 percent throughout.

**The Baseline Policy Scenario:  
Extending Present Policy**

Our baseline scenario essentially projects the consequences of present economic policy. As detailed in our previous report, we utilize the CBO's projections of government spending. We also assume that present tax cuts will be extended and recent budget proposals enacted. Coupled with the assumed constancy of interest rates, this set of assumptions gives us a direct extension of present policy. It should be noted that we display our simulation results only until 2008, and they are always presented as annual values, not quarterly ones.

The two baseline figures (10 and 11) tell the main story. The assumed deceleration in private borrowing would bring the private sector into balance. But it would also reduce the growth of demand coming from the private sector. This decline would, however, be more than offset by rising government deficits and by sustained export growth due to the depreciation of the dollar. The government deficit would worsen from its annual level of 5.2 percent of GDP in 2003 to 5.8 percent in 2004, and stabilize thereafter. The current account deficit would also deteriorate before it stabilized at a record 5.8 percent of GDP. The stabilization would occur because accelerated export growth would be counterbalanced



by accelerated import growth, owing to the fact that the United States would be growing faster than its trading partners. Real GDP growth would jump from 3.1 percent in 2003 to 4.1 percent in 2004, and would stay between 4.1 percent and 4.4 percent thereafter. On the assumption that productivity growth would return to its average post–World War II level, unemployment would fall steadily, arriving at about 4.4 percent by 2008. This would be the best of all possible worlds for present policy. Should productivity growth continue to be higher than in the past, then unemployment would be correspondingly higher.

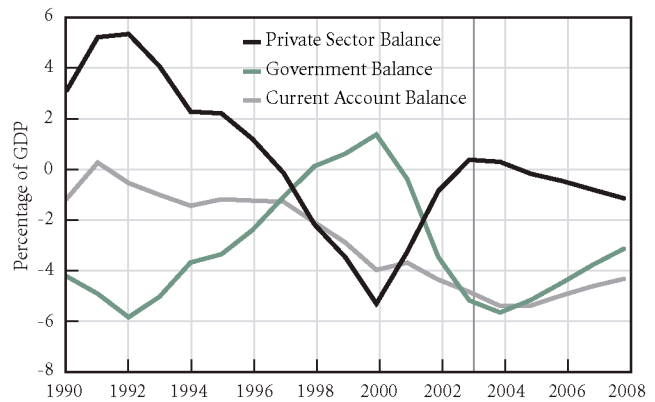
Unfortunately, this apparently rosy scenario would not be stable. Because relative government and foreign deficits would both be higher than the growth rate of GDP, government and foreign debt would rise steadily, relative to GDP. By the end of 2008, the former would rise from its 2003 level of 44 percent to 58 percent, and the latter from 28 percent to 47 percent. Even with interest rates assumed to be constant, this would imply a growing interest burden for general government and for the nation. Were interest rates actually to rise over time, as the CBO now assumes, then matters would be much worse.

### Scenario I: Halving the Deficit by Cutting Government Spending

The preceding prospects lead us to consider two alternate ways of reducing the budget deficit. The present administration clearly favors a reduction in the growth of government spending as the means of achieving this goal (Andrews 2004). Accordingly, in Scenario I we examine the potential consequences of a reduction in the growth in government spending sufficient to halve the deficit in five years, as President Bush suggested in his 2004 State of the Union address. As of 2003, the budget deficit stood at 5.2 percent of GDP, which would make the target level 2.6 percent in 2009. All other assumptions, including tax rates and interest rates, are the same as those in the baseline scenario, and all policy changes are assumed to come into play in 2005 (i.e., after the next election).

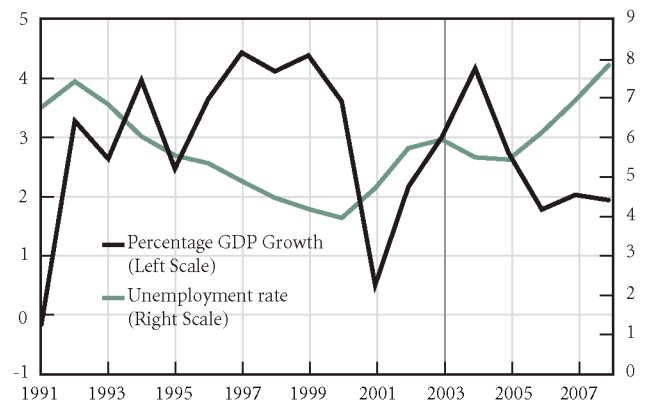
The chart depicting the main sectoral balances for Scenario I (Figure 12) shows that when the government deficit is reduced from its projected level in 2005 toward its target level of 2.6 percent in 2009 (we display results only until 2008), the foreign deficit also falls, albeit much less, from 5 percent to 4.2 percent.

**Figure 12 Main Sector Balances Cutting Government Expenditures**



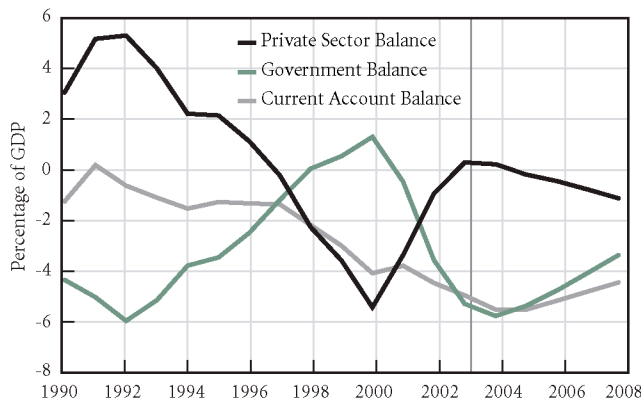
Sources: BEA and authors' calculations

**Figure 13 Real GDP Growth and Unemployment Cutting Government Expenditures**



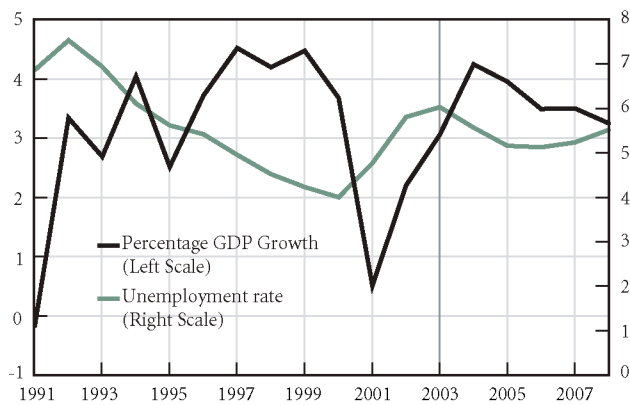
Sources: BEA and authors' calculations

**Figure 14 Main Sector Balances  
Rescinding Tax Cuts**



Sources: BEA and authors' calculations

**Figure 15 Real GDP Growth and Unemployment  
Rescinding Tax Cuts**



Sources: BEA and authors' calculations

The trouble with this particular method of deficit reduction is that our model indicates that this path requires an actual fall in the level of real government spending, not merely a reduction in its growth rate. This would lead to significant negative effects, as indicated in Figure 13. Real GDP growth would slow to 2.6 percent in 2005, and hover around 2.0 percent thereafter. With this, unemployment would rise from its 6-percent level in 2003 to about 8 percent in 2008. Moreover, the private sector would fall back into increasing deficits, which would imply a concomitant rise in private sector debt. Finally, although the foreign deficit would fall to 4.5 percent by 2008, that figure is considerably higher than the corresponding GDP growth rate of 2.6 percent, which means that foreign debt would continue to rise, relative to GDP. What looks good in terms of structural balances therefore turns out to be quite bad for growth and employment.

### Scenario II: Halving the Deficit by Rescinding Tax Cuts

We now consider what would happen if we were to achieve the same target as in the previous scenario—halving government deficit in five years—by letting the personal tax rate return to its pre-tax-cut level. Government expenditure is assumed to grow at the same rate as in our baseline scenario. Our model then indicates that in order to accomplish the desired budget reduction, the direct tax rate would have to return to the levels in effect at the beginning of the Bush administration. As in the previous scenario, this policy change is assumed to begin in 2005, after the coming election.

The three balances depicted in the first figure of Scenario II (14) look very similar to their counterparts in Scenario I. This should come as no surprise, because both scenarios assume the same deceleration in private sector borrowing, and both embody the goal of halving the budget deficit by 2009. Once again the foreign deficit would be modestly reduced, from 5 percent to 4.2 percent, and once again the private sector would go back into deficit.

*There is a substantial difference between the two scenarios, however, regarding growth and unemployment. Under the tax reversion scenario, real GDP growth falls very little, from the projected high of 4.1 percent in 2004 to 3.8 percent in 2005, and to 3.2 percent in 2008 (see Figure 15). As a result, the unemployment rate is actually reduced, albeit only modestly,*

from its present level of 5.6 percent in 2004 to a low of 5.1 percent in 2006, before rising back up to about 5.5 percent by 2008. Finally, as before, the foreign deficit falls to 4.1 percent by 2008, and once again this implies a rising ratio of foreign debt to GDP. Because the final growth rate is higher than it was in the previous scenario, however, foreign debt ratios rise much more slowly.

### Summary and Conclusions

Our baseline scenario depicts what is likely to happen if present monetary and fiscal policy stances are maintained. We find that the government deficit would rise to about 5.8 percent, as would the foreign deficit. The latter would be a new record. Real GDP growth would rise to about 4.2 percent by 2008, and on the favorable assumption that productivity growth returns to its average postwar level, unemployment would fall to about 4.4 percent.

Unfortunately, this apparently promising scenario is not stable, because both government and foreign debt would rise steadily relative to GDP. Even under our neutral assumption of constant interest rates, this increase would imply steadily rising interest burdens in both sectors. Were interest rates actually to rise over time, as the CBO now assumes, then matters would be much worse.

For this reason, we examined two alternative means of reducing the government deficit by half over five years, to take effect in 2005 (i.e., after the coming election). The first of these, as depicted in the figures representing Scenario I, considers what would happen if this goal were achieved by curtailing government spending. This is the path favored by the present administration. The second, as depicted in the charts of Scenario II, examines what would happen if debt reduction were achieved instead by rolling back recent tax cuts.

Not surprisingly, the two scenarios are quite similar at the levels of the three main balances. Yet they give quite different results when we consider the corresponding growth and unemployment rates. Both begin in 2003 from a growth rate of 4.1 percent and an unemployment rate of 6 percent. But halving the budget deficit by cutting government spending causes the growth rate to fall to 2.6 percent in 2005 and to about 2.0 percent by 2008, while unemployment rises to about 8 percent over the interval. Conversely, halving the budget deficit by rescinding recent tax cuts causes GDP growth to fall

only slightly, to 3.8 percent in 2005 and to 3.1 percent by 2008, while the unemployment rate actually falls to 5.1 percent in 2006 before rising back to 5.5 percent in 2008. The latter scenario also produces less troublesome increases in foreign and government debt burdens, precisely because it gives rise to higher growth rates.

Our model therefore indicates that if one wishes to cut the deficit, it is better to do so by rescinding tax cuts than by curtailing government expenditures. By the same token, it also suggests that the sharp rise in actual GDP growth from 2001 through 2003 had more to do with the jump in government spending than with the reduction in tax rates.

Two further issues should be noted. Our simulations assume that the devaluation of the U.S. dollar ends in 2004. Were we to allow for a continued devaluation, our model shows that it would improve the current account balance and accelerate growth, provided that interest rates did not rise in response to the decline in the dollar. On the other hand, if interest rates were to rise in the future, as projected by the CBO and others, the prospects of the U.S. economy would worsen significantly. Interest burdens for the private sector would rise, which would likely slow down that sector's demand for loans and hence its growth in spending. It would also increase the government's interest payments, which would largely benefit foreign holders of government debt, leading to larger income flows out of the country. These increased interest payments would also tend to worsen the government deficit, thereby requiring larger cutbacks in government spending or increases in the tax rates to keep the budget deficit in line. All of this reminds us that fiscal deficits are inextricably linked to foreign deficits. As our colleague Wynne Godley recently noted, "a chronic balance of payments deficit [external balance] will make it impossible to balance the budget. Either the target for the budget must be changed or effective steps be taken to improve the balance of payments" (Godley and Izurieta 2004, p. 16).

## Notes

1. The figures cited in the text are from the National Income and Product Accounts, and refer to the general government net lending or borrowing, at annualized rates. In our charts, however, our measure of total public sector balance, which covers federal, state, and local balances, differs somewhat from the NIPA figures because we include government investment in government expenditure, but exclude consumption of government fixed capital. Our own measure would give a balance of \$82 billion in 2001, -\$319 billion in 2002, and -\$620 billion in the third quarter of 2003.
2. The working-age population grew by about 2.4 million people in 2002, and because the labor-force participation rate was 67 percent, this implies that about 1.6 million new job seekers enter the pool every year. This translates into 134,000 new job seekers every month.
3. The dispute arises from the fact that the BLS produces two surveys to estimate employment creation: one based on a random sample of employers that asks for the number of workers on payroll, and the other based on a random sample of households asking for the number of members employed.
4. Nominal profits deflated by the GDP deflator.
5. Real GDP per employee is the appropriate link between prospective GDP growth and future employment.
6. Recent average productivity growth is measured over 2001:1–2003:1, in order to encompass a complete set of peaks and troughs (see Figure 7). This comes to 1.43 percent, which is not very different from the 1960–2003 historical average of 1.56 percent.
7. Not very long ago, both Chairman Greenspan of the Federal Reserve and (then) Treasury Secretary Robert Rubin emphasized the importance of budget surpluses in fending off pressure on the U.S. balance of payments, in helping keep interest rates low, and in keeping growth strong (Greenspan 2000, p. 4; *Economic Report of the President* 2000, pp. 31–34).
8. The latest CBO report (January 2004) actually assumes that interest rates will rise over the next few years.

## References

- American Bankruptcy Institute. 2004. *U.S. Bankruptcy Filing Statistics* (see [www.abiworld.org](http://www.abiworld.org)).
- Andrews, Edmund L. 2004. “Managing the Deficit with Plans to Spend.” *New York Times*, March 21.
- Bernanke, B. 2004. “Monetary Policy and the Economic Outlook: 2004.” Speech at the Meetings of the American Economic Association, San Diego, January 4.
- Bies, Susan S. 2004. “The Economic Outlook and the State of Household and Business Finances.” Speech before the New York Forecasters Club, February 26.
- Bureau of Economic Analysis. 2004. *National Income and Product Accounts*, various issues (see [www.bea.gov](http://www.bea.gov)).
- Bureau of Labor Statistics. 2004. *Current Employment Statistics*, various issues (see [www.bls.gov](http://www.bls.gov)).
- Congressional Budget Office. 2003. *The Budget and Economic Outlook: An Update*. August (see [www.cbo.gov](http://www.cbo.gov)).
- . 2004. *The Budget and Economic Outlook: Fiscal Years 2005–2014*. January (see [www.cbo.gov](http://www.cbo.gov)).
- Council of Economic Advisers. 2000. *Economic Report of the President*. Washington, D.C.: U.S. Government Printing Office.
- The Economist*. 2004, January.
- Federal Reserve Board. 2004a. *Flow of Funds Accounts, Z.1* Release. March 4 (see [www.federalreserve.gov](http://www.federalreserve.gov)).
- . 2004b. *Household Debt Service Burden*. February 27 (see [www.federalreserve.gov](http://www.federalreserve.gov)).
- Fuerbringer, Jonathan. 2004. “Report of Strong Job Growth in March Spurs a Sharp Rise in Interest Rates.” *New York Times*, April 3.
- Godley, Wynne. 1999. *Seven Unsustainable Processes: Medium-Term Prospects and Policies for the United States and the World*. Strategic Analysis. Annandale-on-Hudson, N.Y.: The Levy Economics Institute (see [www.levy.org](http://www.levy.org)).
- Godley, Wynne, and Alex Izurieta. 2001. *As the Implosion Begins . . . ? Prospects and Policies for the U.S. Economy: A Strategic View*. Strategic Analysis. Annandale-on-Hudson, N.Y.: The Levy Economics Institute (see [www.levy.org](http://www.levy.org)).
- . 2004. *Balances, Imbalances and Fiscal Targets—A New Cambridge View*. Cambridge Endowment for Research in Finance Strategic Analysis. February (see [www.cerf.cam.ac.uk](http://www.cerf.cam.ac.uk)).

- Goldman Sachs. 2003. "Why the Dollar Must Fall Much Further." *U.S. Economic Analyst*, November 7.
- Greenspan, A. 2000. *The Federal Reserve's Report on Monetary Policy*. Testimony before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate. July 20 (see [www.federalreserve.gov](http://www.federalreserve.gov)).
- . 2004a. *Understanding Household Debt Obligations*. Speech at the Credit Union National Association 2004 Governmental Affairs Conference, Washington, D.C., February 23 (see [www.federalreserve.gov](http://www.federalreserve.gov)).
- . 2004b. *Federal Reserve Board's Semiannual Monetary Policy Report to the Congress*. Testimony before the Committee on Financial Services, U.S. House of Representatives, February 11 (see [www.federalreserve.gov](http://www.federalreserve.gov)).
- Kanell, Michael E. 2004. "Burned by Economy, Consumed by Debt." *Atlanta Journal-Constitution*, January 18.
- Krugman, P. 2003. "A Big Quarter." *New York Times*, October 31.
- Mühleisen, M., and Christopher Towe, eds. 2004. "U.S. Fiscal Policies and Priorities for Long-Run Sustainability." IMF Occasional Paper 227. January.
- Papadimitriou, Dimitri B., and L. Randall Wray. 1998. "What to Do with the Surplus: Fiscal Policy and the Coming Recession." Policy Note 1998/6. Annandale-on-Hudson, N.Y.: The Levy Economics Institute (see [www.levy.org](http://www.levy.org)).
- . 2001. "Fiscal Policy for the Coming Recession: Large Tax Cuts Are Needed to Prevent a Hard Landing." Policy Note 2001/2. Annandale-on-Hudson, N.Y.: The Levy Economics Institute (see [www.levy.org](http://www.levy.org)).
- Papadimitriou, Dimitri B., Anwar M. Shaikh, Claudio H. Dos Santos, and Gennaro Zezza. 2002. *Is Personal Debt Sustainable?* Strategic Analysis. Annandale-on-Hudson, N.Y.: The Levy Economics Institute (see [www.levy.org](http://www.levy.org)).
- Phelps, Edmund. 2000. "Europe's Stony Ground for the Seeds of Growth." *Financial Times*, August 9.
- Shaikh, Anwar M., Dimitri B. Papadimitriou, Claudio H. Dos Santos, and Gennaro Zezza. 2003. *Deficits, Debt, and Growth: A Reprieve But Not a Pardon*. Strategic Analysis. Annandale-on-Hudson, N.Y.: The Levy Economics Institute (see [www.levy.org](http://www.levy.org)).
- Uchitelle, L. 2004. "To Understand U.S. Jobs Picture, Connect the Dots and Find the Dots." *New York Times*, January 12.

## Recent Levy Institute Publications

### *Levy Institute Measure of Economic Well-Being Concept, Measurement, and Findings: United States, 1989 and 2000*

EDWARD N. WOLFF, AJIT ZACHARIAS, and ASENA CANER  
February 2004

### *Levy Institute Measure of Economic Well-Being: United States, 1989 and 2000*

EDWARD N. WOLFF, AJIT ZACHARIAS, and ASENA CANER  
December 2003

## STRATEGIC ANALYSES

### *Is Deficit-Financed Growth Limited? Policies and Prospects in an Election Year*

DIMITRI B. PAPADIMITRIOU, ANWAR M. SHAIKH,  
CLAUDIO H. DOS SANTOS, and GENNARO ZEZZA  
April 2004

### *Deficits, Debts, and Growth: A Reprieve But Not a Pardon*

ANWAR M. SHAIKH, DIMITRI B. PAPADIMITRIOU,  
CLAUDIO H. DOS SANTOS, and GENNARO ZEZZA  
October 2003

### *The U.S. Economy: A Changing Strategic Predicament*

WYNNE GODLEY  
March 2003

## PUBLIC POLICY BRIEFS

### *Asset Poverty in the United States*

*Its Persistence in an Expansionary Economy*  
ASENA CANER and EDWARD N. WOLFF  
No. 76, 2004 (Highlights, No. 76A)

### *Is Financial Globalization Truly Global?*

*New Institutions for an Inclusive Capital Market*  
PHILIP ARESTIS and SANTONU BASU  
No. 75, 2003 (Highlights, No. 75A)

### *Understanding Deflation*

*Treating the Disease, Not the Symptoms*  
L. RANDALL WRAY and DIMITRI B. PAPADIMITRIOU  
No. 74, 2003 (Highlights, No. 74A)

***Asset and Debt Deflation in the United States***

*How Far Can Equity Prices Fall?*

PHILIP ARESTIS and ELIAS KARAKITSOS

No. 73, 2003 (Highlights, No. 73A)

***What Is the American Model Really About?***

*Soft Budgets and the Keynesian Devolution*

JAMES K. GALBRAITH

No. 72, 2003 (Highlights, No. 72A)

***Can Monetary Policy Affect the Real Economy?***

*The Dubious Effectiveness of Interest Rate Policy*

PHILIP ARESTIS and MALCOLM SAWYER

No. 71, 2003 (Highlights, No. 71A)

**POLICY NOTES**

***Inflation Targeting and the Natural Rate of Unemployment***

WILLEM THORBECKE

2004/1

***The Future of the Dollar: Has the Unthinkable Become Thinkable?***

KORKUT A. ERTÜRK

2003/7

***Is International Growth the Way Out of U.S. Current Account Deficits? A Note of Caution***

ANWAR M. SHAIKH, GENNARO ZEZZA,

and CLAUDIO H. DOS SANTOS

2003/6

***Deflation Worries***

L. RANDALL WRAY

2003/5

***Pushing Germany Off the Cliff Edge***

JÖRG BIBOW

2003/4

***Caring for a Large Geriatric Generation: The Coming Crisis in U.S. Health Care***

WALTER M. CADETTE

2003/3

***Reforming the Euro's Institutional Framework***

PHILIP ARESTIS and MALCOLM SAWYER

2003/2

***The Big Fix: The Case for Public Spending***

JAMES K. GALBRAITH

2003/1

**WORKING PAPERS**

***The "War on Poverty" after 40 Years: A Minskyan Assessment***

STEPHANIE A. BELL and L. RANDALL WRAY

No. 404, April 2004

***A Stock-Flow Consistent General Framework for Formal Minskyan Analyses of Closed Economies***

CLAUDIO H. DOS SANTOS

No. 403, February 2004

***A Post-Keynesian Stock-Flow Consistent Macroeconomic Growth Model: Preliminary Results***

CLAUDIO H. DOS SANTOS and GENNARO ZEZZA

No. 402, February 2004

***Borrowing Alone: The Theory and Policy Implications of the Commodification of Finance***

GREG HANNNGEN

No. 401, January 2004

***Fiscal Consolidation: Contrasting Strategies and Lessons from International Experiences***

JÖRG BIBOW

No. 400, January 2004

***Does Financial Structure Matter?***

PHILIP ARESTIS, AMBIKA D. LUINTEL, and

KUL B. LUINTEL

No. 399, January 2004

***Inequality of the Distribution of Personal Wealth in Germany 1973–1998***

RICHARD HAUSER and HOLGER STEIN

No. 398, January 2004

***Financial Globalization and Regulation***

PHILIP ARESTIS and SANTONU BASU

No. 397, December 2003

***The Evolution of Wealth Inequality in Canada, 1984–1999***

RENÉ MORISSETTE, XUELIN ZHANG, and MARIE DROLET

No. 396, November 2003

***On Household Wealth Trends in Sweden over the 1990s***

N. ANDERS KLEVMARKEN

No. 395, November 2003

***Wealth Transfer Taxation: A Survey***

HELMUTH CREMER and PIERRE PESTIEAU

No. 394, November 2003

***A Rolling Tide: Changes in the Distribution of Wealth  
in the U.S., 1989–2001***

ARTHUR B. KENNICKELL

No. 393, November 2003

***Understanding Deflation: Treating the Disease,  
Not the Symptoms***

L. RANDALL WRAY and DIMITRI B. PAPADIMITRIOU

No. 392, October 2003

***Aggregate Demand, Conflict, and Capacity in the  
Inflationary Process***

PHILIP ARESTIS and MALCOLM SAWYER

No. 391, September 2003

The Strategic Analysis and all other Levy Institute publications are available online on the Levy Institute website, [www.levy.org](http://www.levy.org).

To order a Levy Institute publication, call 845-758-7700 or 202-887-8464 (in Washington, D.C.), fax 845-758-1149, e-mail [info@levy.org](mailto:info@levy.org), write The Levy Economics Institute of Bard College, Blithewood, PO Box 5000, Annandale-on-Hudson, NY 12504-5000, or visit our website at [www.levy.org](http://www.levy.org).

**The Levy Economics Institute of Bard College**

Blithewood

PO Box 5000

Annandale-on-Hudson, NY 12504-5000

**NONPROFIT ORGANIZATION**

**U.S. POSTAGE PAID**

**BARD COLLEGE**

*Address Service Requested*