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We can begin our analysis of the impact of government budget surpluses by disaggregating the economy into three sectors.[1] First, we can consolidate all levels of government into a public (or, government) sector, and likewise consolidate households and firms into a domestic, non-government (or, private) sector. For completion, we must add a foreign ("rest-of-the-world") sector. At the aggregate level, the dollar spending of all three sectors combined must equal the income received by the three sectors. It is clear that if the public sector is spending less than its income—that is, is running a surplus—this must imply that at least one other sector is spending more than its income (in other words, is running a deficit). Mathematically, the sum of the balances of the three sectors must equal zero. It is convenient for our purposes to write this as:

{Public Sector Surplus} + {Foreign Sector Surplus} = {Private Sector Deficit},

which merely moves the private sector balance to the right-hand-side and reverses the sign (in other words, writes the balance as a deficit rather than a surplus as a negative surplus is the same thing as a deficit).

Because the US has been running a balance of payments deficit in recent years, this means that the foreign sector is in surplus (the rest-of-the-world spends fewer dollars than it receives). A few years ago, our public sector ran a sufficiently large deficit to more than offset the foreign sector surplus, so that our domestic non-government sector was able to run surpluses. However, in the past two years, the US public sector's balance has turned toward surplus. When combined with our balance of payments deficit (or foreign sector surplus), this means that the domestic private sector's balance has turned sharply negative—that is, toward large and growing deficits. That non-government sector deficit is now approximately equal to 5.5 percent of GDP—far and away the largest private sector deficit the US has seen in the post-war period.

How can our economy boom in the presence of large and growing government and foreign sector surpluses, and how can we explain the willingness of our private sector to spend in excess of its income to the tune of 5.5% of GDP, and rising?

For most analysts, our current situation is not difficult to explain. The government surplus is said to add to our nation's saving, fueling investment in productivity-enhancing technologies. Wall Street is capitalizing future income streams, generating unprecedented private sector wealth. This is a type of saving that is not captured in income and product account figures. Households are devoting a portion of capital gains to consumption, but wealth is growing faster than consumption. Household debt-to-income ratios are high, but this is not the relevant measure because wealth is growing faster than debt. Government saving is keeping interest rates low so that the burden of servicing debt—even out of measured income flows—is not excessive.

The only recognized black spots on our Goldilocks economy are the negative household savings rates (in large part explained away as a measurement problem) and the growing trade deficit. In any case, most analysts are confident that Chairman Greenspan will be able to keep Goldilocks on track in spite of depressionary influences caused by the government's surplus and the trade deficit. Of course, most analysts are still more concerned with the possibility that Goldilocks will grow too fast, than with the likelihood that she will slow excessively.

We believe this view ignores the substantial risks entailed in running large domestic, non-government deficits. How can we explain the processes that brought us to this point, and what are the prospects for continued Goldilocks growth?

First, during the 1990s, US consumers became ready, willing, and able to borrow, probably to a relative degree not seen since the 1920s. Credit cards became much more available; lenders expanded credit to sub-prime borrowers; bad publicity about redlining provided the stick, and the Community Reinvestment Act provided the carrot to expand the supply of loans to lower income homeowners; deregulation of financial institutions enhanced competition. All of these things made it easier for consumers to borrow. Consumers were also more willing to borrow. As memories of the Great Depression fade, people become more willing to commit future income flows to debt service. The last general debt deflation is beyond the experience of almost the whole population. It isn't hard to convince oneself that since we've really

only had one recession in nearly a generation, downside risks are small. Add on top of that the stock market's irrational exuberance and the wealth effect, and one can pretty easily explain consumer willingness to borrow.

Furthermore, until very recently, most Americans had not regained their real 1973 incomes. Even over the course of the Clinton expansion, real wage growth has been very low. Americans are not used to living through a quarter of a century without rising living standards. Of course, the first reaction was to increase the number of earners per family—but even that has allowed only a small increase of real income. Thus, it isn't surprising that consumers increased borrowing as soon as they became reasonably confident that the expansion would last.

The result has been consistently high growth of consumer credit. As already pointed out, the private sector of the economy is now running deficits equal to about 5.5% of GDP. Because the business sector is running only small deficits, this means that most of the deficit is due to household spending in excess of its income. Nothing like this has ever happened before—at least in the post-war period. In the past, private sector deficits never exceeded much more than 1% of GDP, and never lasted for more than 18 months. Our current private sector deficits are thus five times larger than any achieved in the past, and have already persisted longer than any in the past. Furthermore, if the US continues to grow, it can only get much worse.

Looking to the public sector, the consolidated government balance is over 2% of GDP. The federal budget surplus alone was 1.4% of GDP in 1999 and on the Congressional Budget Office's projections, that will double to 2.8% by 2010. By then, federal spending will equal only 16.9% of GDP while tax revenue will equal nearly 20%. It is important to note that this growth of the surplus is projected to occur as economic growth actually slows down—from about a 4% growth rate today to an average of 2.7%. In other words, fiscal policy is supposed to tighten substantially over the next 10 years—so that it will be heavily biased toward running surpluses even when the economy grows far below its long-run average—which is closer to 3.5%. Thus, we've gone from a budget that was biased toward huge deficits at moderate rates of growth to one that is biased toward huge surpluses at even lower growth rates. This means that economic growth in the presence of such fiscal restriction and foreign sector surpluses can occur only as the private sector's deficit continues to climb—to 6%, then 7%, and so on.

What are the implications? We might first look to the case of Japan. The Japanese budget balance similarly became biased toward surplus by the end of the 1980s. The government ran a surplus for 6 years after 1987; even after the economy turned down, the budget remained in surplus. And even with the easiest monetary policy the world has seen since WWII, that is, with zero interest rates for more than 4 years, the economy still has not recovered. The budget deficit returned in 1993, and it is now reaching to 8% of GDP. But the earlier surpluses destroyed the private

sector to such an extent that even with these huge budget surpluses and monetary ease, and with net exports running at 2% of GDP, the private sector just sucks it all up and saves to the tune of 10% of GDP.

In some ways, our position might look even worse than that of Japan in 1989. Our households have never had much savings and are much more indebted. We also can't export our way to growth, and any reduction of household income is going to make it difficult to service debt. There are already several danger signs. Private sector debt ratios are well above any previous record level, although debt service burdens have been moderated by low interest rates so far. But the Fed is already pushing up interest rates, which will eventually increase debt burdens sufficiently that households will begin to default. It is somewhat ironic that bankruptcy law is just now being reformed in a way that will make it harder for debtors to default. While that will make it easier to collect on debts, it also means that indebted consumers will have to cut back spending elsewhere. This will make it harder to get out of recession.

The stock market has probably already started on the way down. Note that if it is true that it is the wealth effect that has been driving consumption, then it is not necessary to have a stock market crash in order to kill the expansion. Stock market capital gains only provide a one-time boost to consumption levels; continued economic growth requires rising stock prices. In addition, since the middle of 1997, profits growth has consistently been below GDP growth and capital spending by firms, opening up a growing financing gap in the corporate sector. Business net interest expense is already rising, and will increase sharply as the Fed raises interest rates. A cut-back of consumer spending combined with rising interest rates will increase the financing gap and cause firms to reduce their own spending.

The expansion might not stall out in the coming months, but continued expansion in the face of a trade deficit and budget surplus requires that the private sector's deficit and thus debt load continue to rise without limit. It is particularly ironic that while many economists would argue that government deficits cannot rise without limit, they do not recognize the dangers in rising private sector deficits. The importance of debt load structures should make us even more concerned about private deficits that are already well above 5% of GDP, and rising, than we were about the Reagan-Bush budget deficits that peaked in that range. Expansion that relies on rising private sector deficits is highly risky and vulnerable to changes of expectations. When the turn-around comes, it could be very sharp and could lead to a long period of slow-to-no growth, such as that experienced by Japan for the last decade.

Note

1. The sectoral approach is based on work done by Wynne Godley. See *"Is Goldilocks Doomed?"*, by Wynne Godley and L. Randall Wray, Journal of Economic Issues, March 2000.

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