Economic Stagnation in the United States: Domestic Causes and Global Consequences

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Robert A. Blecker, Professor of Economics, American University
Washington, DC, USA, blecker@american.edu

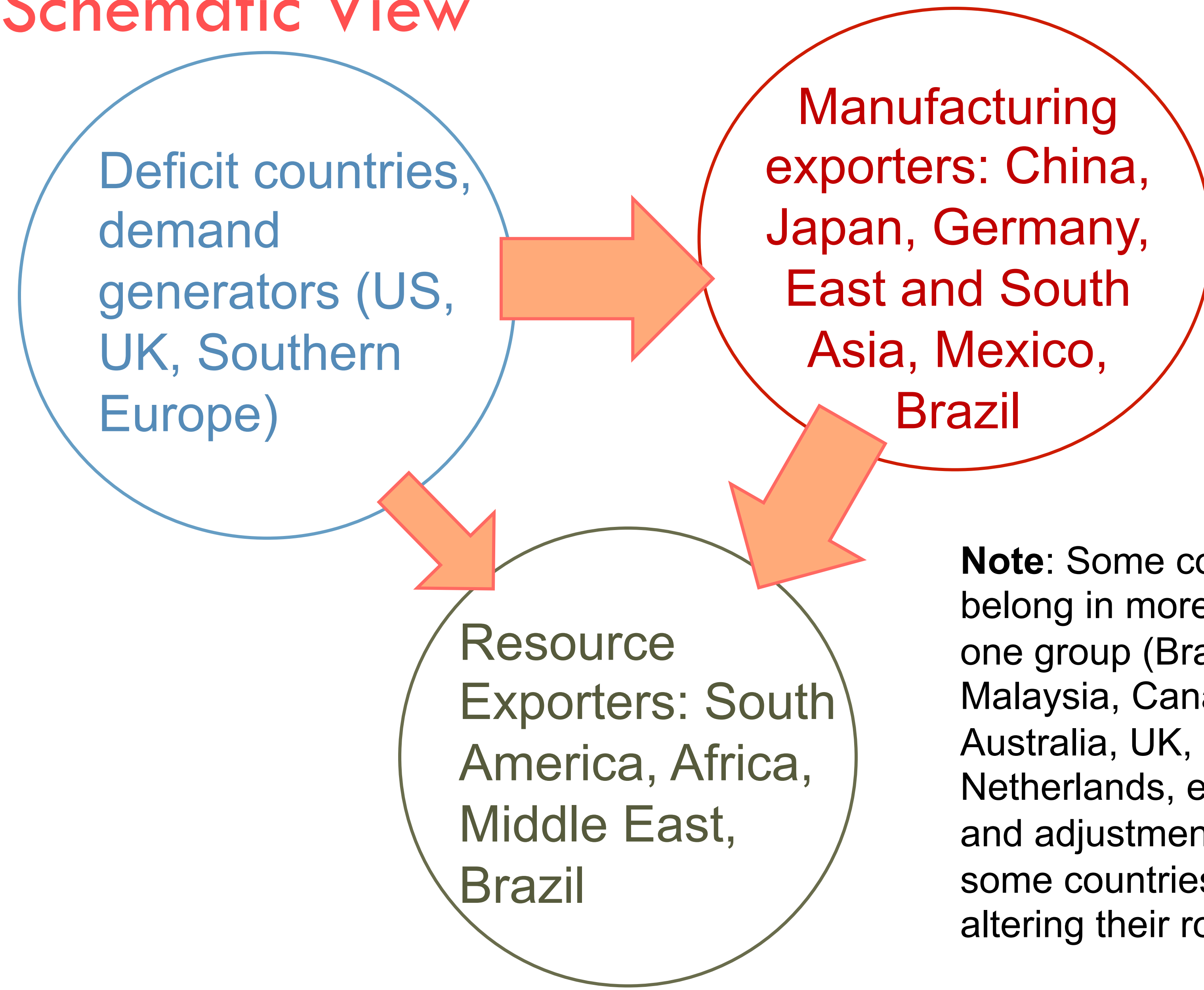
Preface

- The theme of this conference is how to double Brazil's per capita income in 15 years
  - The most important initiatives for achieving objective this will undoubtedly be national or domestic policies
  - I am learning much about this from all of you
- Nevertheless the international economic environment will be an important factor in either facilitating or constraining the achievement of this objective
  - I will mostly address trends in the U.S. economy as well as their impact on global trade imbalances and the world economy generally
  - Unfortunately what I have to say is largely pessimistic

Global imbalances

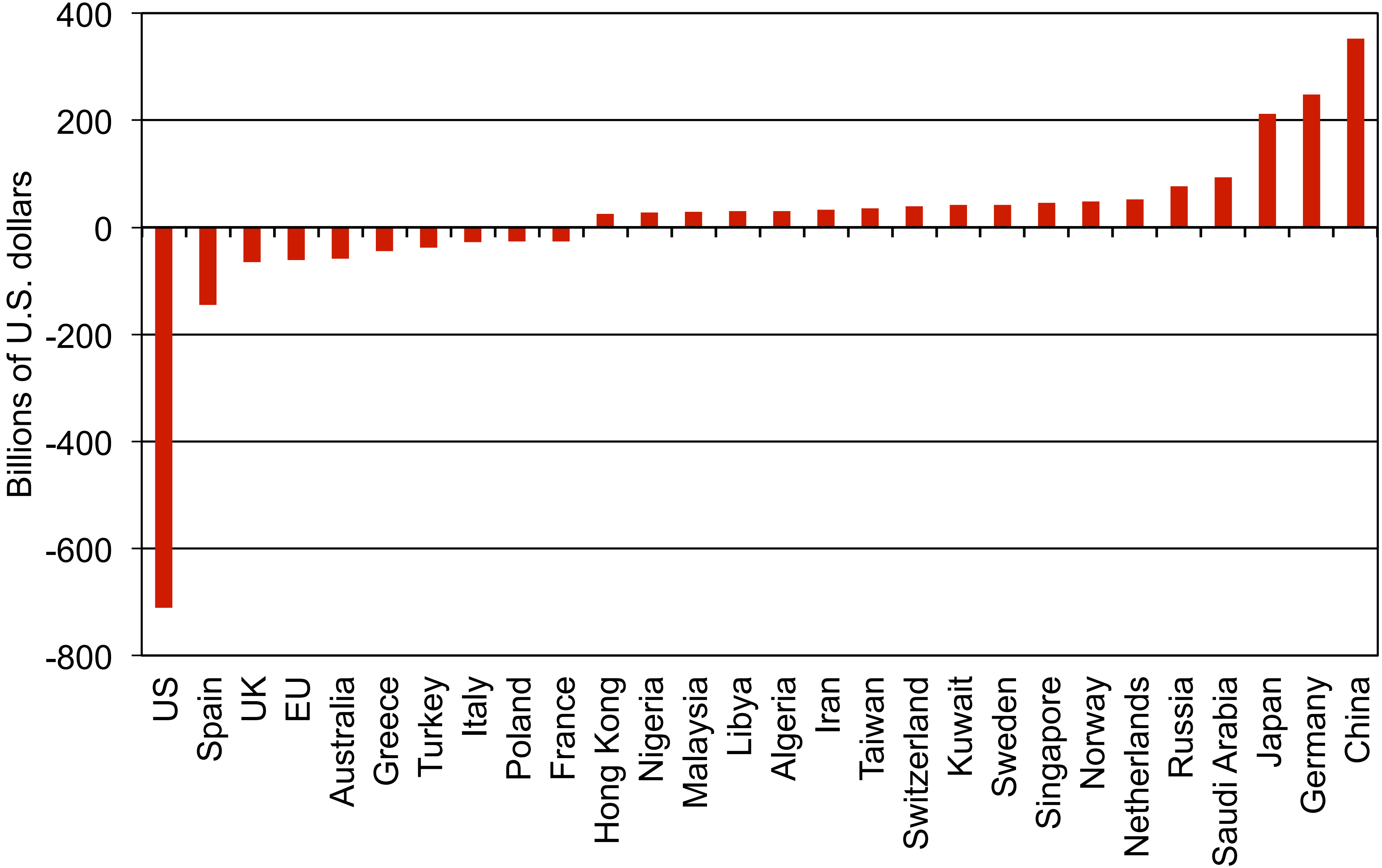
- In the past few decades (up to the crisis), global growth was sustained by a triangular pattern of trade imbalances, financial flows, and demand transmission (Blecker, 2013)
  - This operated mainly via the U.S. current account deficit and corresponding East Asian surpluses, with demand spillovers favoring resource exporters
  - Plus additional intraregional imbalances and flows, especially Germany-Southern Europe (underlying cause of the eurozone crisis)
- This pattern of growth-with-imbalances led to rising commodity prices for resource exporters
  - They form the third vertex of the triangle
  - But is the resource boom a blessing or a curse?
  - Dutch disease is rampant, especially in mixed primary-manufactures economies like Brazil, Canada, Australia, etc.

Principal Net Global Demand Flows: A Schematic View



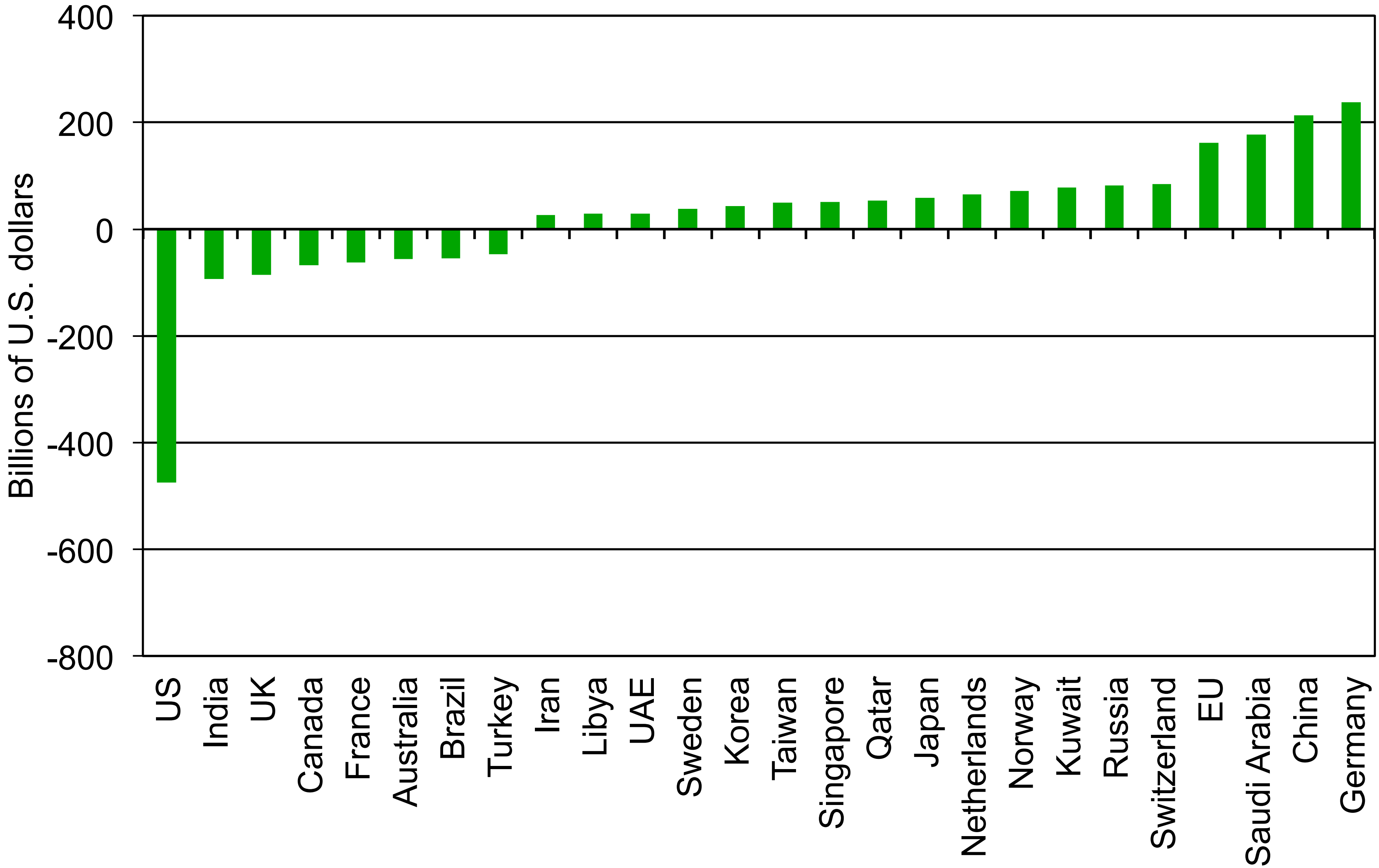
Note: Some countries belong in more than one group (Brazil, Malaysia, Canada, Australia, UK, Netherlands, etc.), and adjustments in some countries are altering their roles.

Current account balances, countries over ± US$25 billion, 2007 (pre-crisis)



Source: IMF, *World Economic Outlook*, April 2013 database, downloaded September 10, 2013.

Current account balances, countries over ± US$25 billion, 2012 (post-crisis)



Source: IMF, *World Economic Outlook*, April 2013 database, downloaded September 10, 2013.

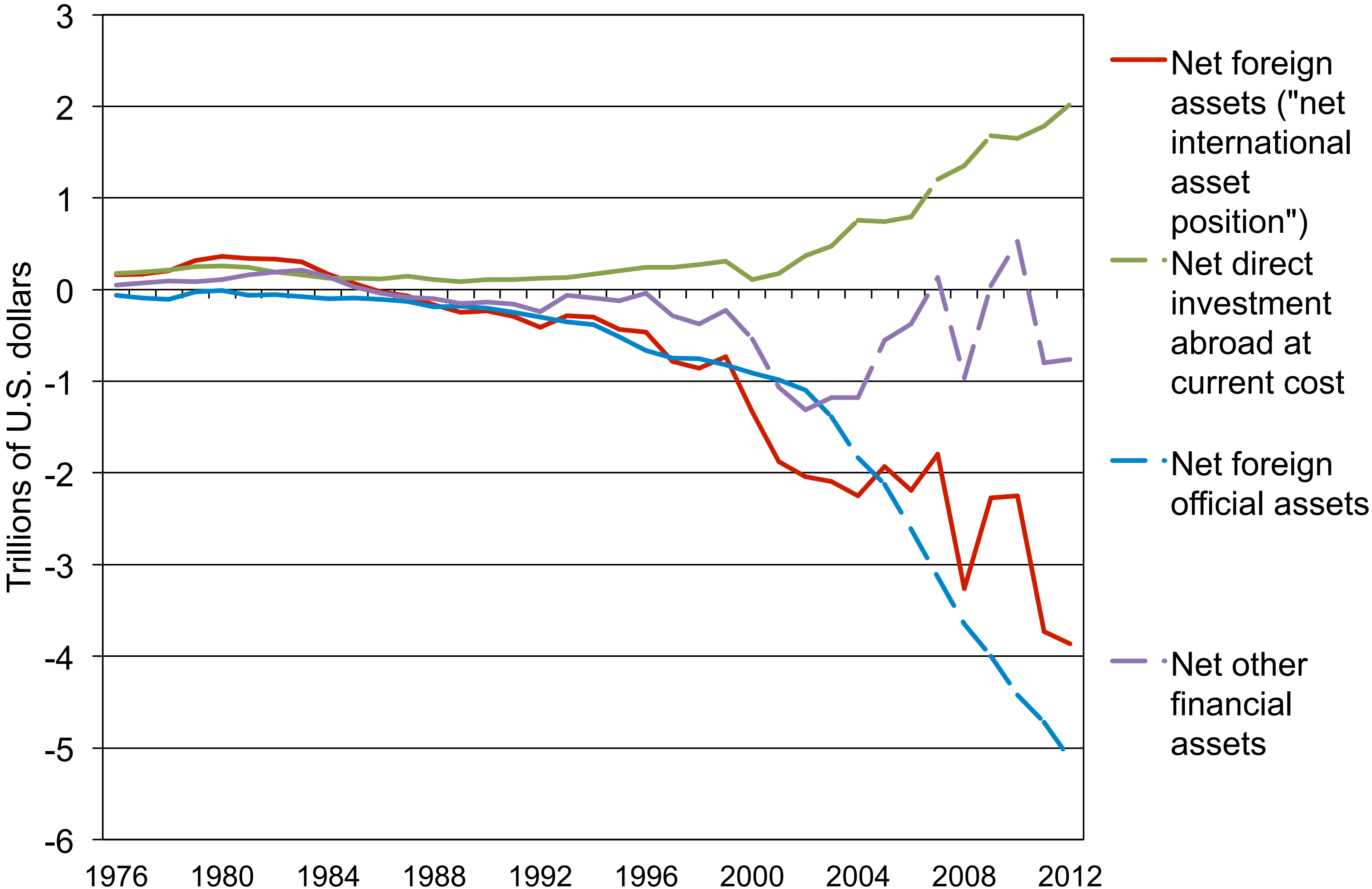
Global current account imbalances

- The biggest CA deficit continues to be that of the United States
  - But it was more than US$200 billion smaller in 2012 than in 2007
- Pre-crisis (2007), the three biggest surpluses were in China, Germany, Japan (manufacturing exporters)
  - Followed by major resource exporters (Saudi Arabia, Russia, Netherlands, Norway, Kuwait) and other East Asia (Singapore, Taiwan)
  - Post-crisis (2012), China and Japan's surpluses have fallen
- The European Union as a whole has swung from a small deficit to a large surplus, due to austerity and slow growth
  - Within the EU the large CA deficits of Spain and Greece have been eliminated by austerity and depressed demand
- Some major countries that were close to balanced trade in 2007 have significant deficits now (including Brazil, India, Canada)

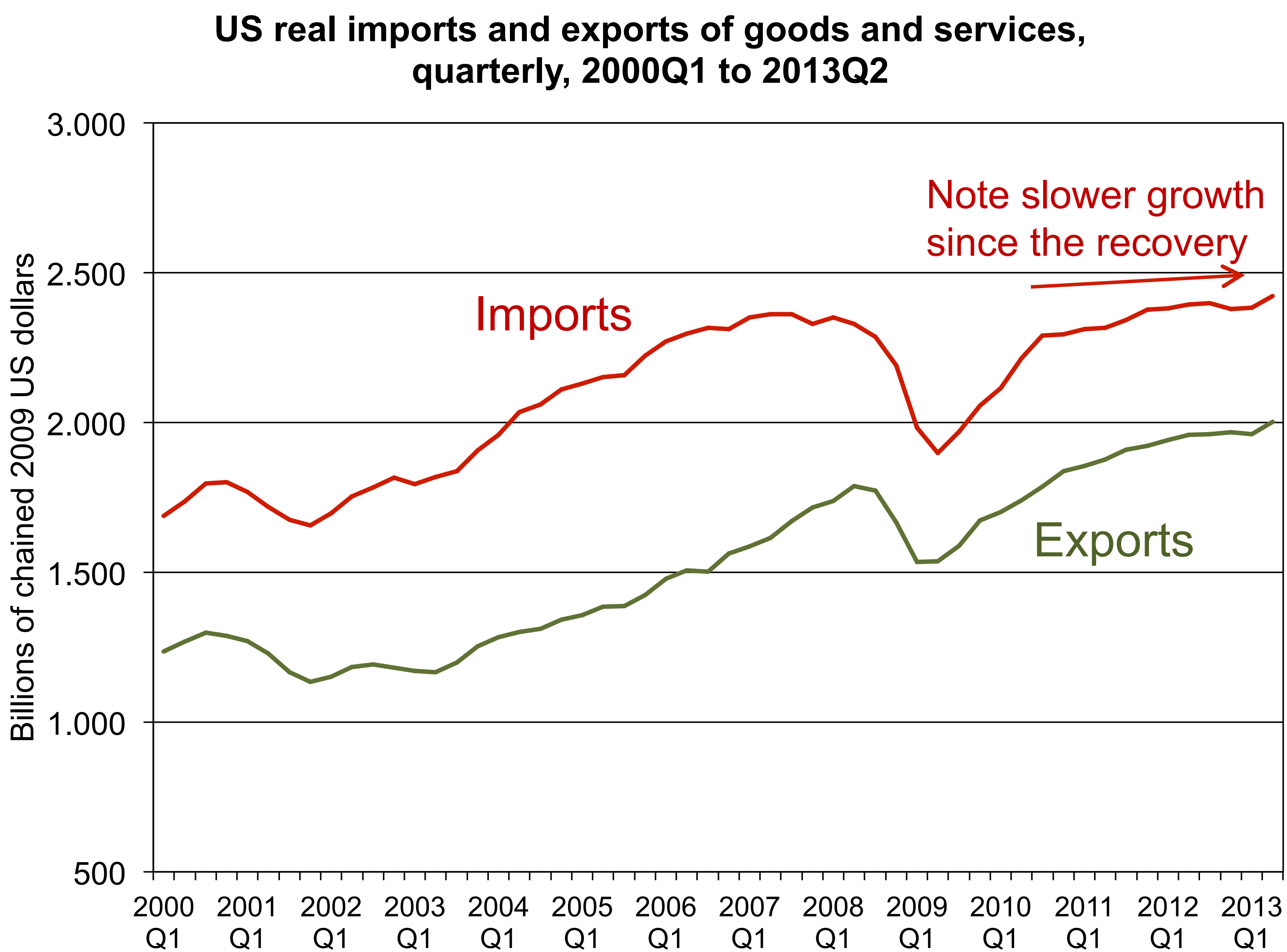
Thesis (I)

- This pattern of imbalanced global growth rested on a foundation of growing debt in the United States and other deficit countries
  - **The financial crises in the US and EU (eurozone) have shown that this pattern of growth was not sustainable**
- In the U.S. case, this is primarily because the debt of the <u>household</u> sector became unsustainable
  - Not corporate, government, or external debt
- In reality, more than 100% of the U.S. net *external* debt consists of foreign central bank reserves ("official assets in the U.S.")
  - The U.S. is a large net creditor in FDI and only a small net debtor in portfolio investment
  - This makes it unlikely that a new crisis will break out in the U.S. external accounts
- *Although the origins of the financial crisis were largely internal to the U.S. economy, the consequences are nevertheless global and are transmitted partly through trade as well as through the financial system*

U.S. Net International Investment (Foreign Asset) Position and Composition, Yearend 1976-2012



Source: BEA, U.S. Net International Investment Position: End of First Quarter 2013, Year 2012, and Annual Revisions (Tables), June 25, 2013.


US real imports and exports of goods and services, quarterly, 2000Q1 to 2013Q2
Billions of chained 2009 US dollars
3.000
2.500
2.000
1.500
1.000
500
Note slower growth since the recovery
Imports
Exports
2000 Q1
2001 Q1
2002 Q1
2003 Q1
2004 Q1
2005 Q1
2006 Q1
2007 Q1
2008 Q1
2009 Q1
2010 Q1
2011 Q1
2012 Q1
2013 Q1

Thesis (II)

- The U.S. is not likely to be able to be the primary generator of global demand in the foreseeable future as it was before 2008
  - The U.S. trade deficit remains so large mainly because U.S. exports have not grown much more than U.S. imports since the recovery from the 2008-9 Great Recession
  - A true rebalancing is not taking place (Carvalho, 2013)
  - *Thus the continued U.S. external deficit represents a smaller amount of demand transmission to the rest of the world*
- Therefore Brazil and other emerging market nations will have to generate more of their own demand (both internally and reciprocally), and not rely on the U.S. or other rich countries to provide the locomotive of growth, in the coming decade

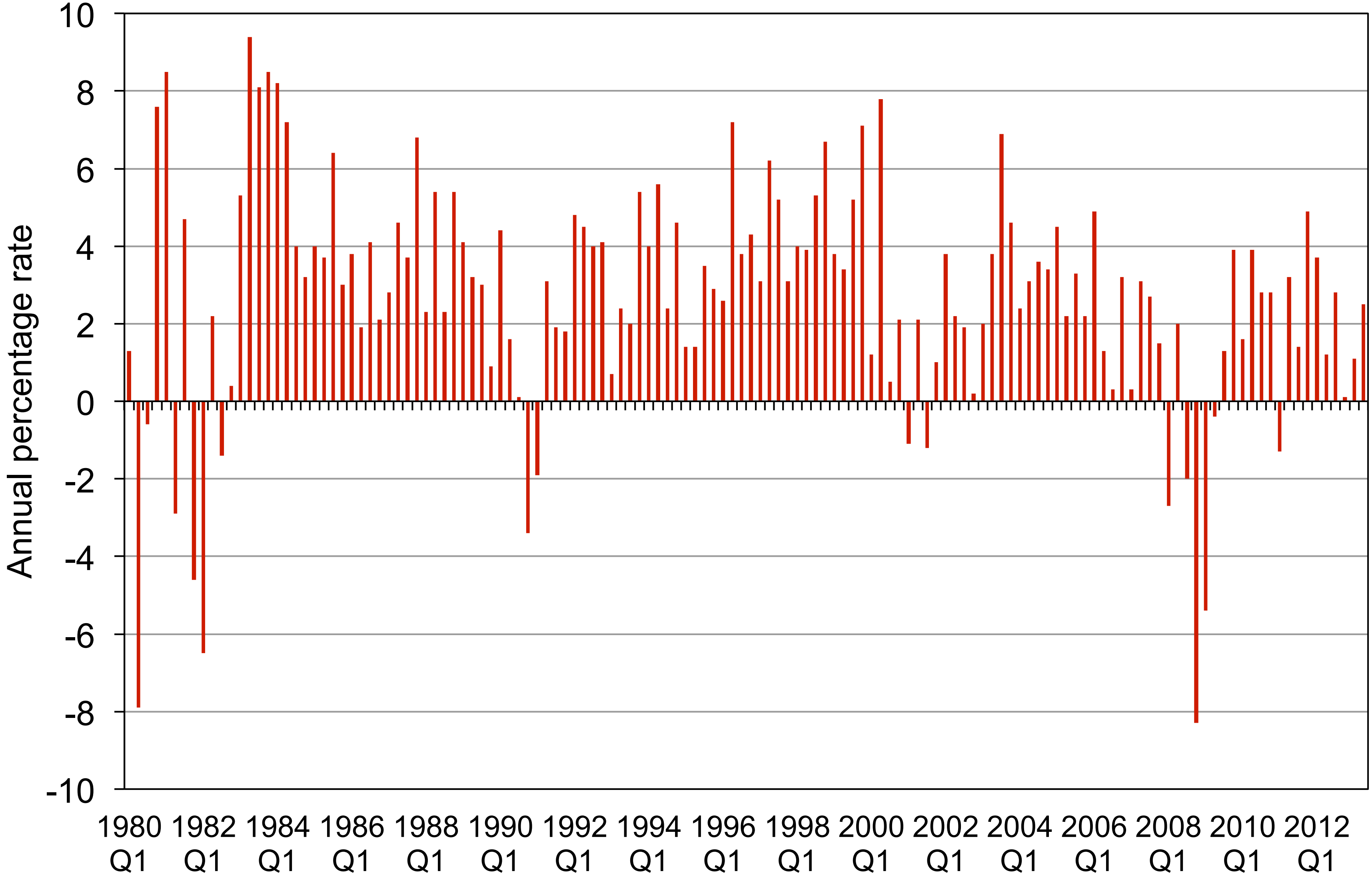
Prospects for the U.S. economy

- A prolonged depression of U.S. demand and employment is resulting from
  - Underlying weakness of demand due to stagnant real wages and increasing inequality
  - Structural changes leading to reduced employment generation in proportion to output growth
  - The severity of the financial crisis and difficulties of restoring healthy balance sheets
  - Republican-led political paralysis and the imposition of austerity in fiscal policy
  - Reverberations from foreign slowdowns especially in the EU/eurozone

The “Lesser Depression” in the United States

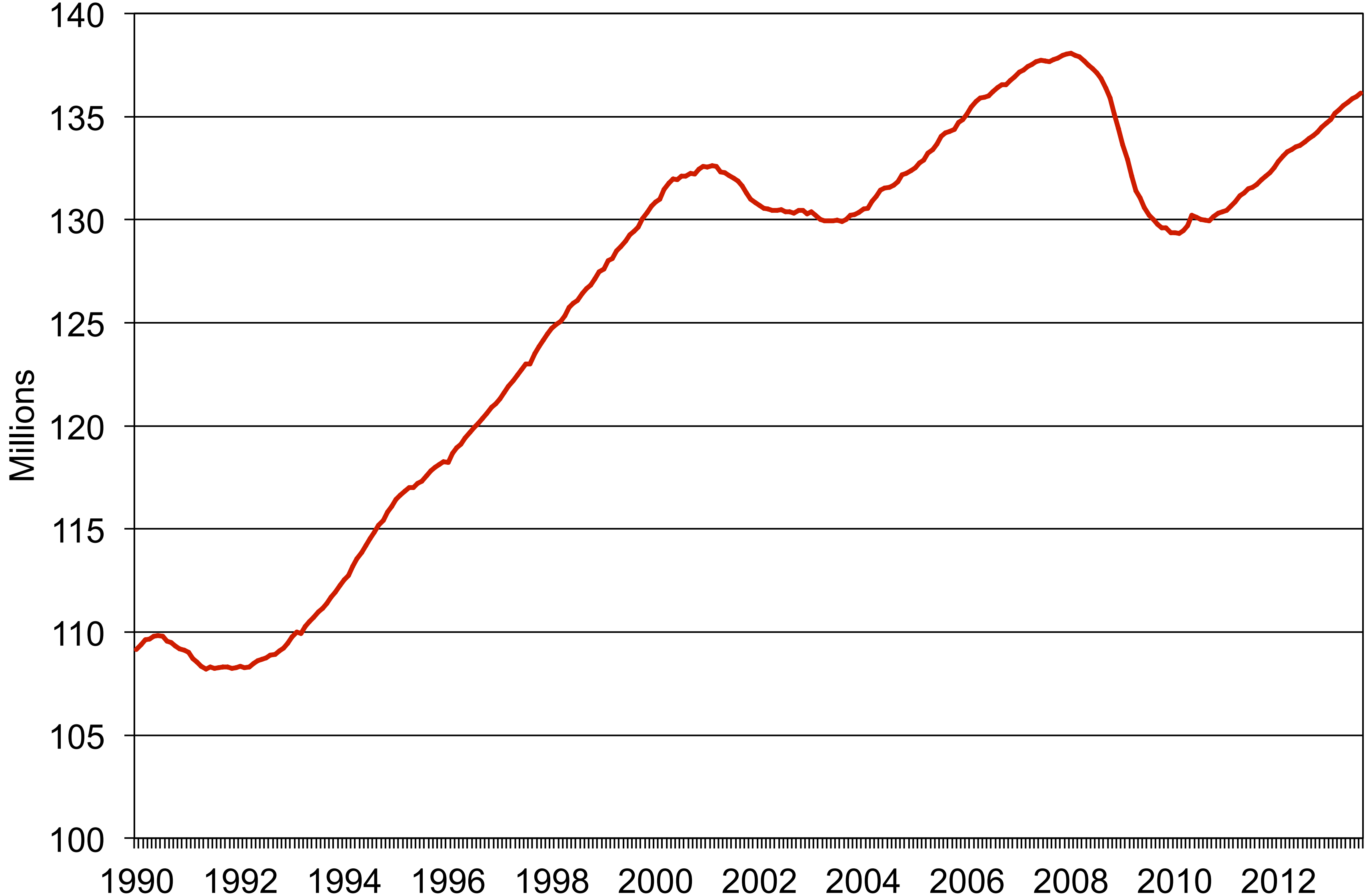
- ...to use Paul Krugman’s (2011) phrase
- Not as bad as the Great Depression of the 1930s
  - But the worst economy since that time
  - The Great Recession of 2008-9 officially ended in June 2009
- Since then the recovery has been historically sluggish
  - Chronically slow growth for four years since the “recovery” began, too slow to create enough jobs
  - The US is in a “jobs crisis”
    - Unemployment and underemployment rates are persistently high
    - Employment is still 2 million below the previous peak of 2007
    - Total employment grew by only 3.5 million jobs from 2001 to 2013, compared with 22.8 million from 1990 to 2001
    - Labor force participation has fallen and the employment-population ratio is at a historic low

Growth rate of US real gross domestic product, quarterly 1980Q1 to 2013Q2



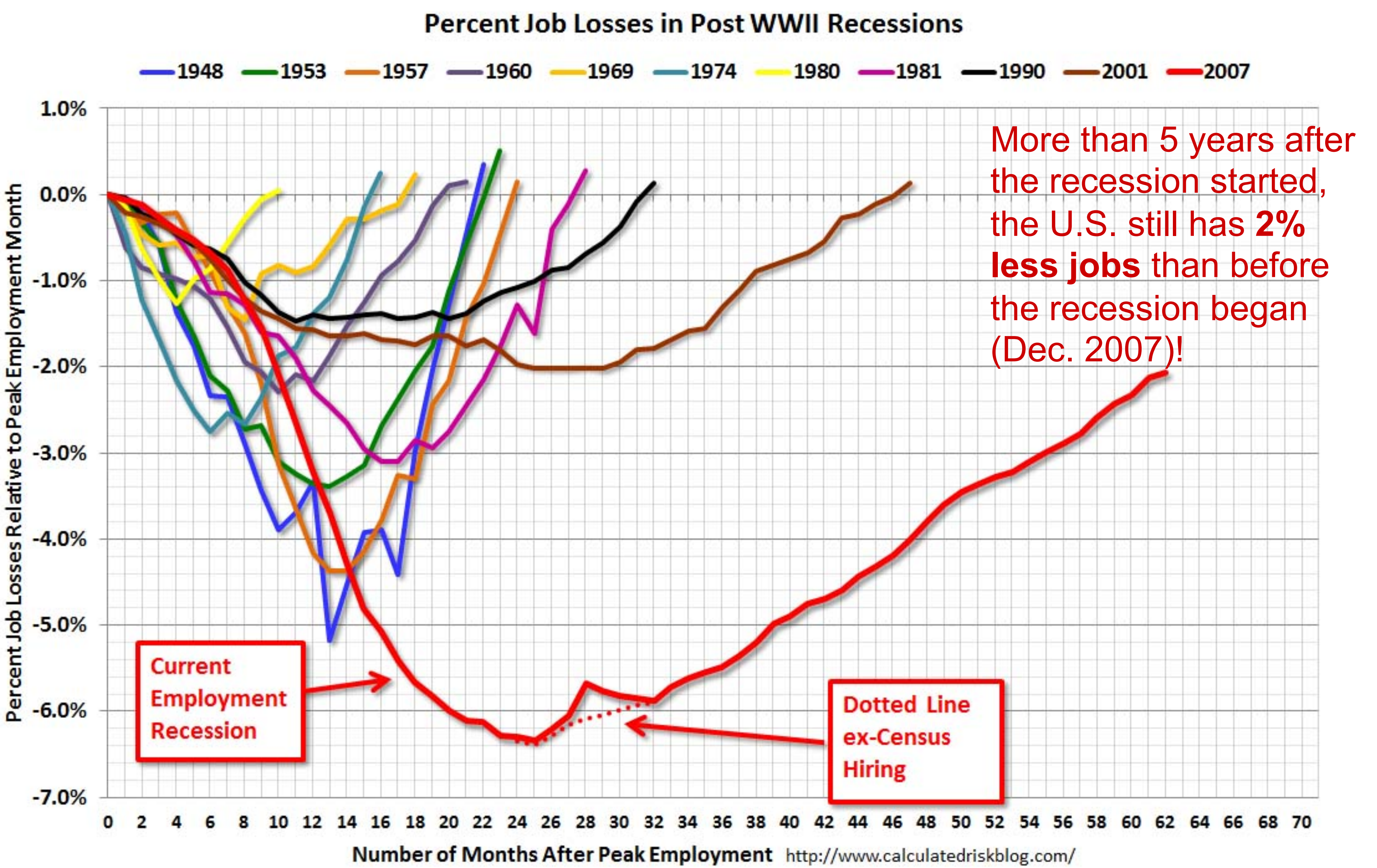
Source: US Bureau of Economic Analysis, www.bea.gov, NIPA Table 1.1.1, data revised 29 August, 2013.

Total US Nonfarm Employment in Millions, January 1990 to August 2013



Source: US Bureau of Labor Statistics, www.bls.gov, Employment, Hours, and Earnings from the Current Employment Statistics survey (National), downloaded 8 September, 2013.

U.S. recent recession and recovery compared with earlier cycles

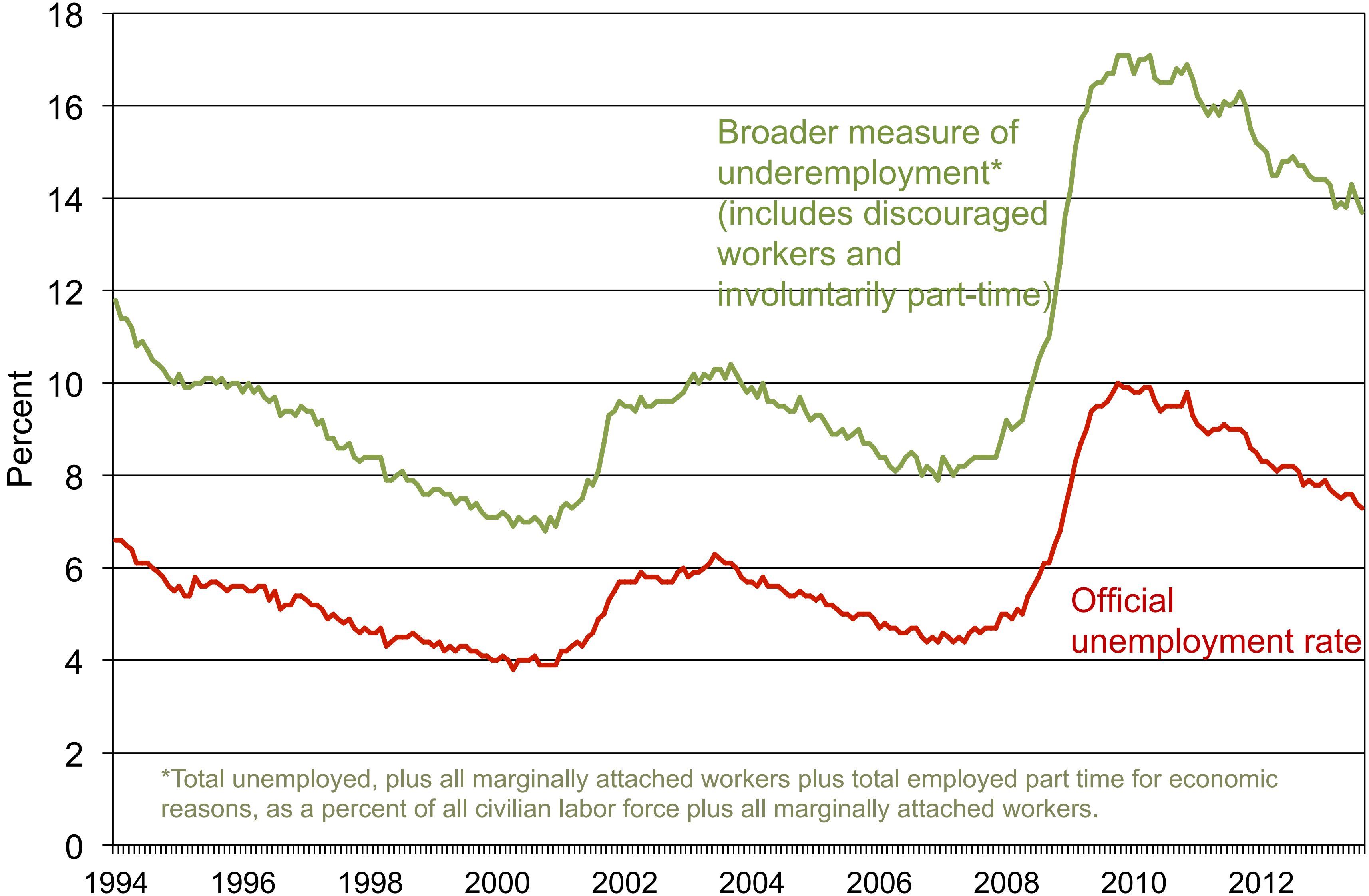


Cited in Olney and Pacitti (2013)

The changing behavior of employment in U.S. business cycles

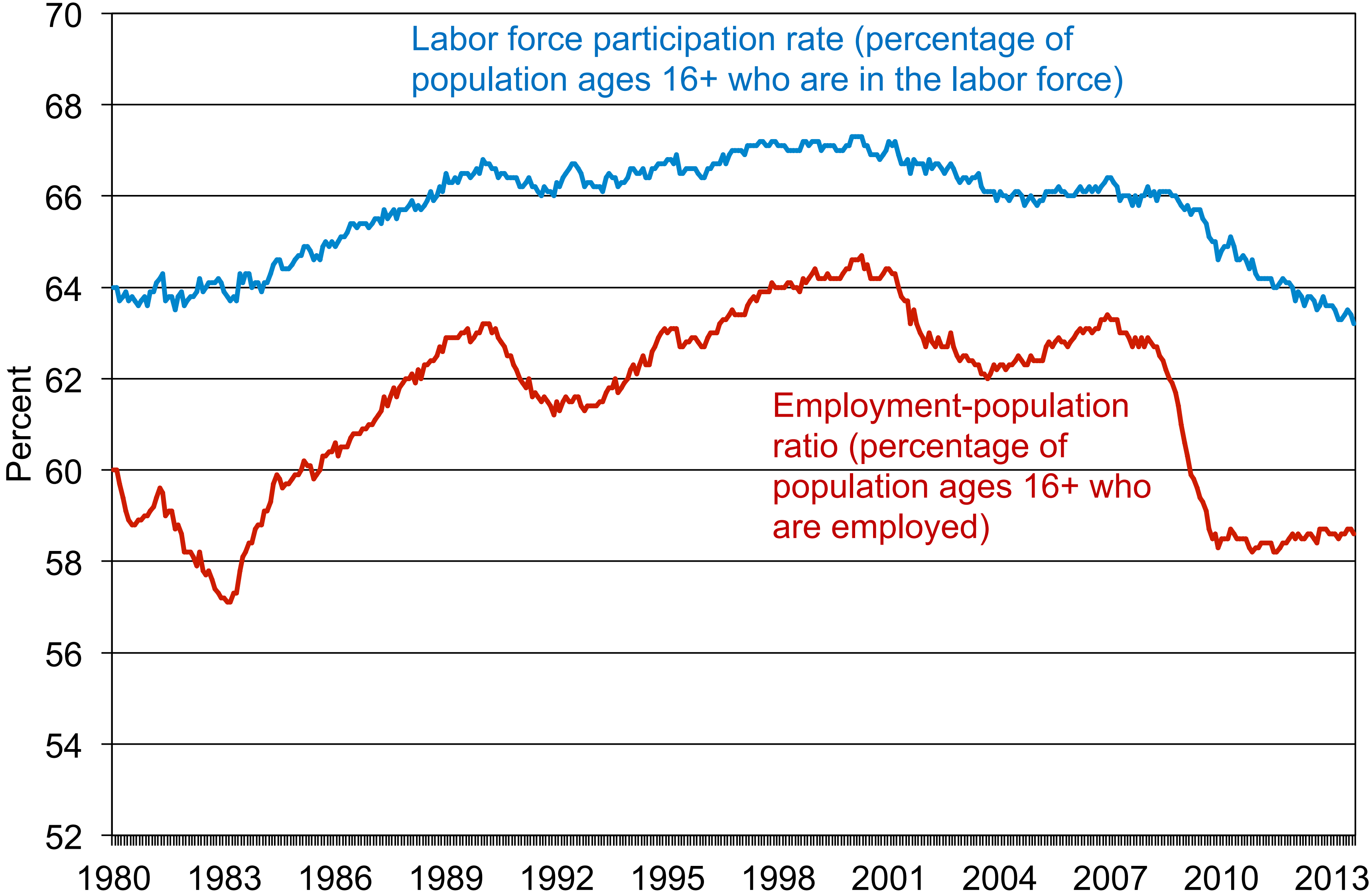
- U.S. employment used to exhibit a sharp V-shape in recessions, with a steep decline followed by an equally sharp recovery
  - Up to the double-dip recessions of 1980 and 1981
  - Driven by rapid layoffs and subsequent rehiring in manufacturing
- Starting in the 1990-92 recession/recovery (also 2001-3), this stretched out into a wide U-shape with a prolonged “jobless recovery”
  - This coincided with the offshoring of manufacturing and the shift to a services economy (Olney and Pacitti, 2013)
  - Later this afternoon I will show you where the “V” went....
- In the 2007-present cycle, **employment still hasn’t fully recovered after almost 6 years**

US Unemployment and Underemployment Rates, Monthly, January 1994 to August 2013



Source: US Bureau of Labor Statistics, www.bls.gov, Labor Force Statistics from the Current Population Survey, downloaded 8 September, 2013.

US Labor Force Participation Rates (Economically Active Population), Monthly, 1980-2013

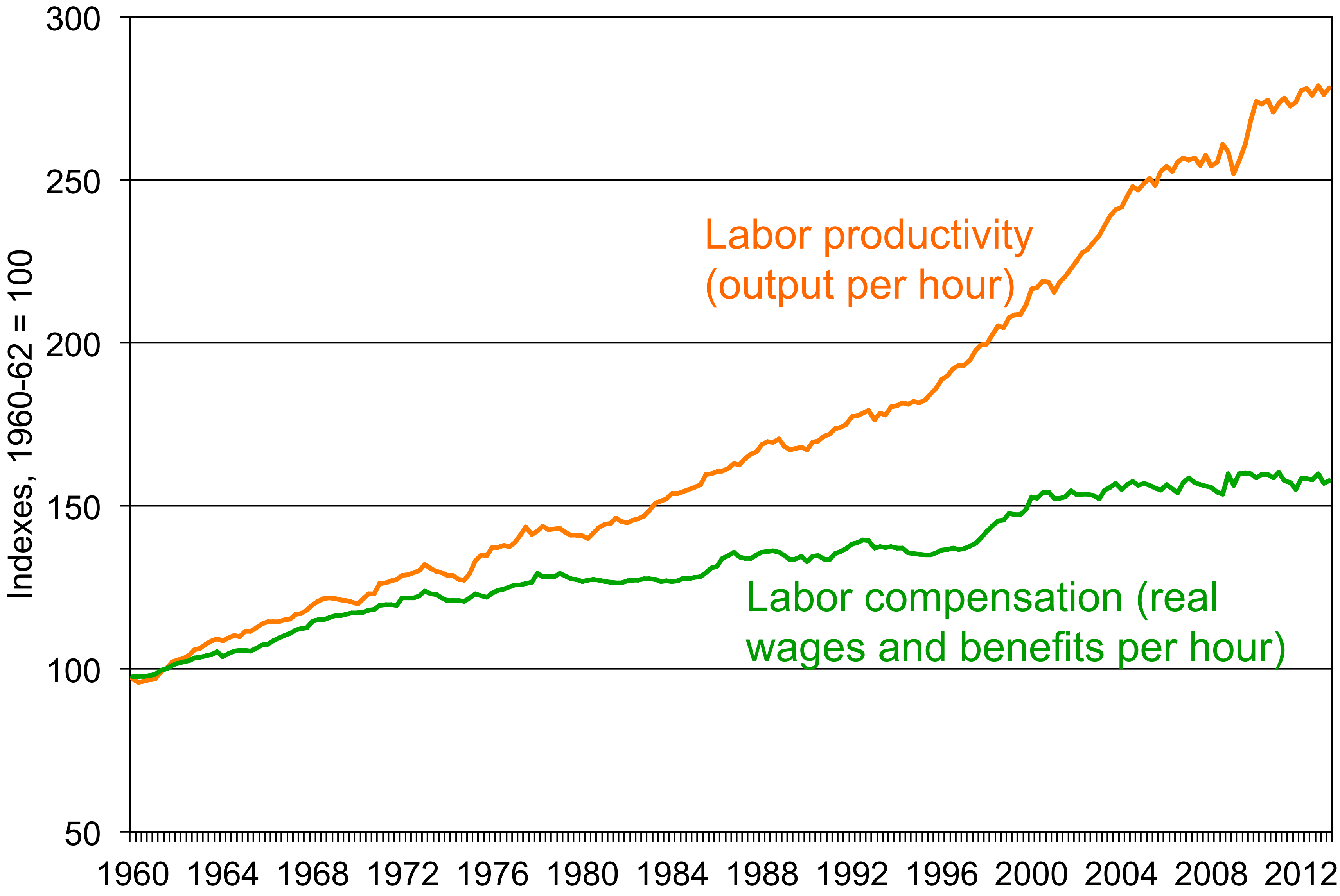


Source: US Bureau of Labor Statistics, www.bls.gov, Labor Force Statistics from the Current Population Survey, downloaded 8 September, 2013.

Underlying causes: Income distribution and the demand side

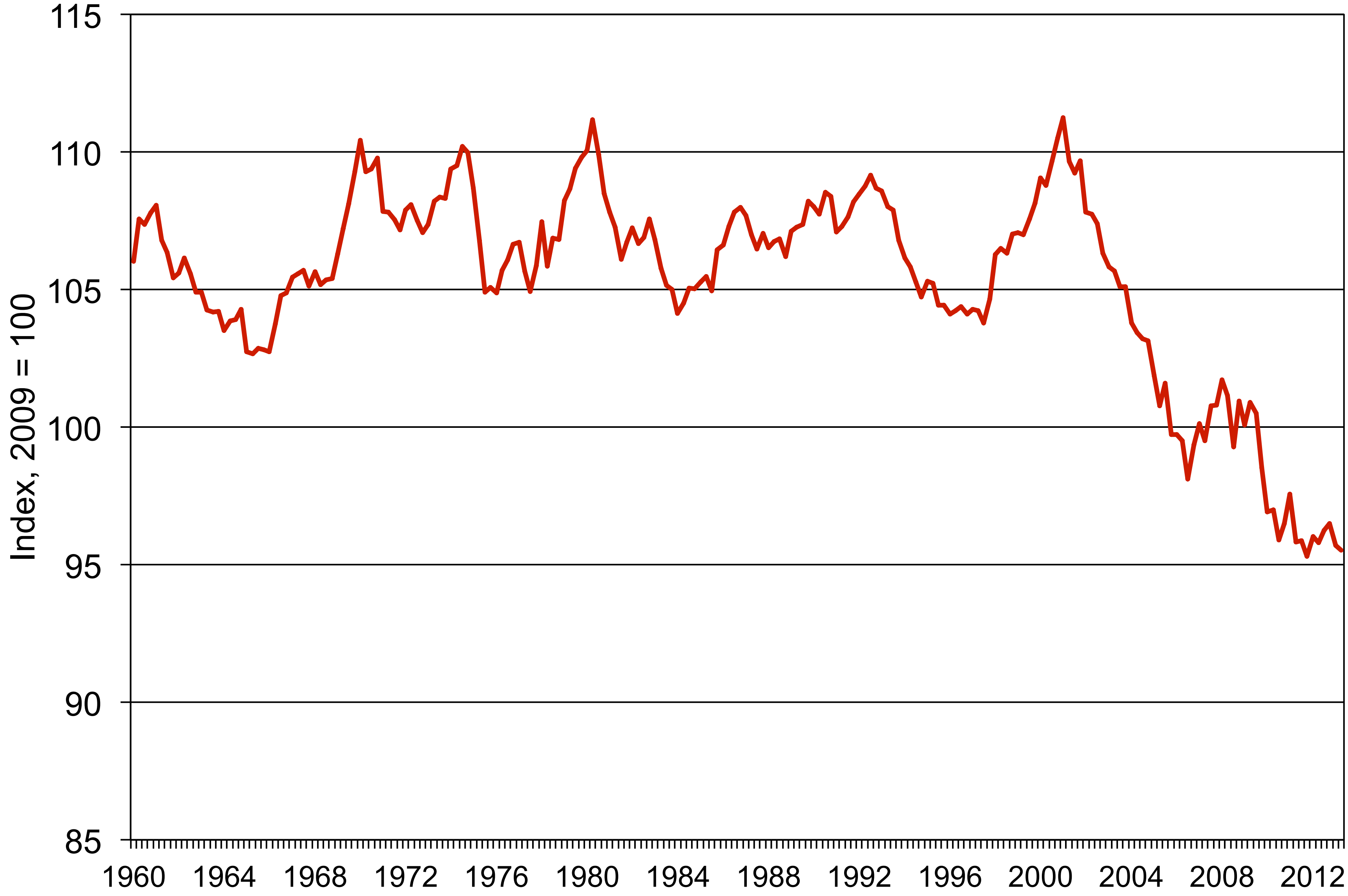
- Increasing inequality and stagnating middle class income
  - Real wages have lagged behind growth of labor productivity since 1980s and especially in the last decade
  - ⇒ Decreasing labor share of national income
- This was counteracted by increasing household debt during the previous expansion
  - But that borrowing was unsustainable
    - See Pollin (2003); Cynamon, Fazzari, and Setterfield, eds. (2013)
- In spite of record profits and low interest rates, the corporate sector is not increasing its investment beyond the level of the previous cycle peak
  - Firms seem to be responding mainly to the lack of demand growth and are sitting on their profits

Labor productivity and real hourly compensation, US nonfinancial corporate business sector, 1960Q1-2013Q2



Source: US Bureau of Labor Statistics, www.bls.gov, Major Sector Productivity and Costs, downloaded September 12, 2013, and author's calculations.

Index of the labor share of value added, US nonfinancial corporate business sector, quarterly 1960Q1 to 2013Q2



Source: US Bureau of Labor Statistics, www.bls.gov, Major Sector Productivity and Costs, downloaded September 12, 2013, and author's calculations.

The gains from the recovery have been captured almost exclusively by the top 1%

During the U.S. recovery of 2009-12, according to Emmanuel Saez (2013):

> "the gains were very uneven. Top 1% incomes grew by 31.4% while bottom 99% incomes grew only by 0.4% from 2009 to 2012. Hence, the top 1% captured 95% of the income gains in the first three years of the recovery. From 2009 to 2010, top 1% grew fast and then stagnated from 2010 to 2011. Bottom 99% stagnated both from 2009 to 2010 and from 2010 to 2011. In 2012, top 1% incomes increased sharply by 19.6% while bottom 99% incomes grew only by 1.0%. In sum, top 1% incomes are close to full recovery while bottom 99% incomes have hardly started to recover."

This continues a long-term trend toward income gains being concentrated at the very top of the income distribution, as shown in Saez's updated charts →

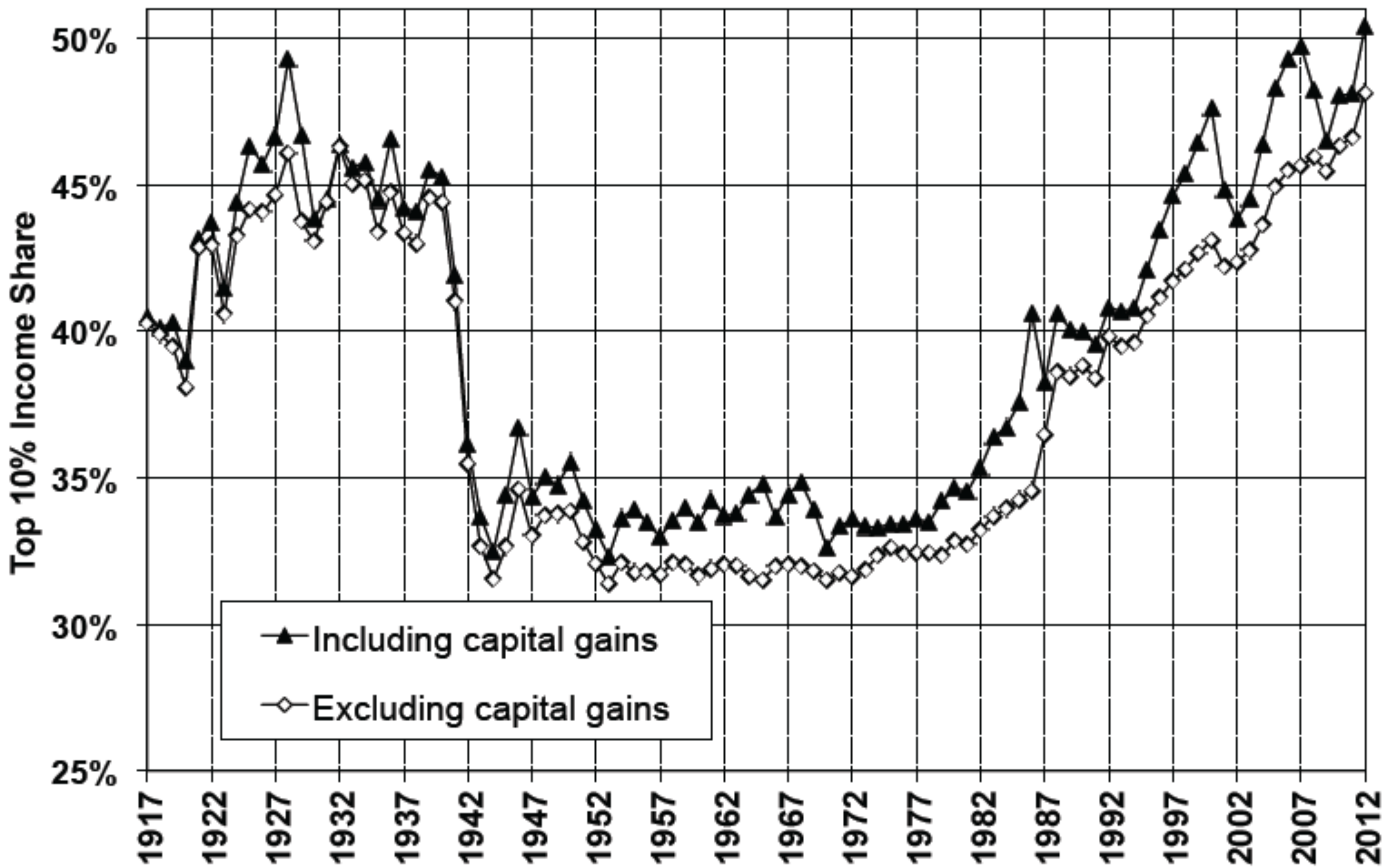


FIGURE 1
The Top Decile Income Share, 1917-2012

Source: Saez (2013), http://elsa.berkeley.edu/~saez/saez-UStopincomes-2012.pdf.

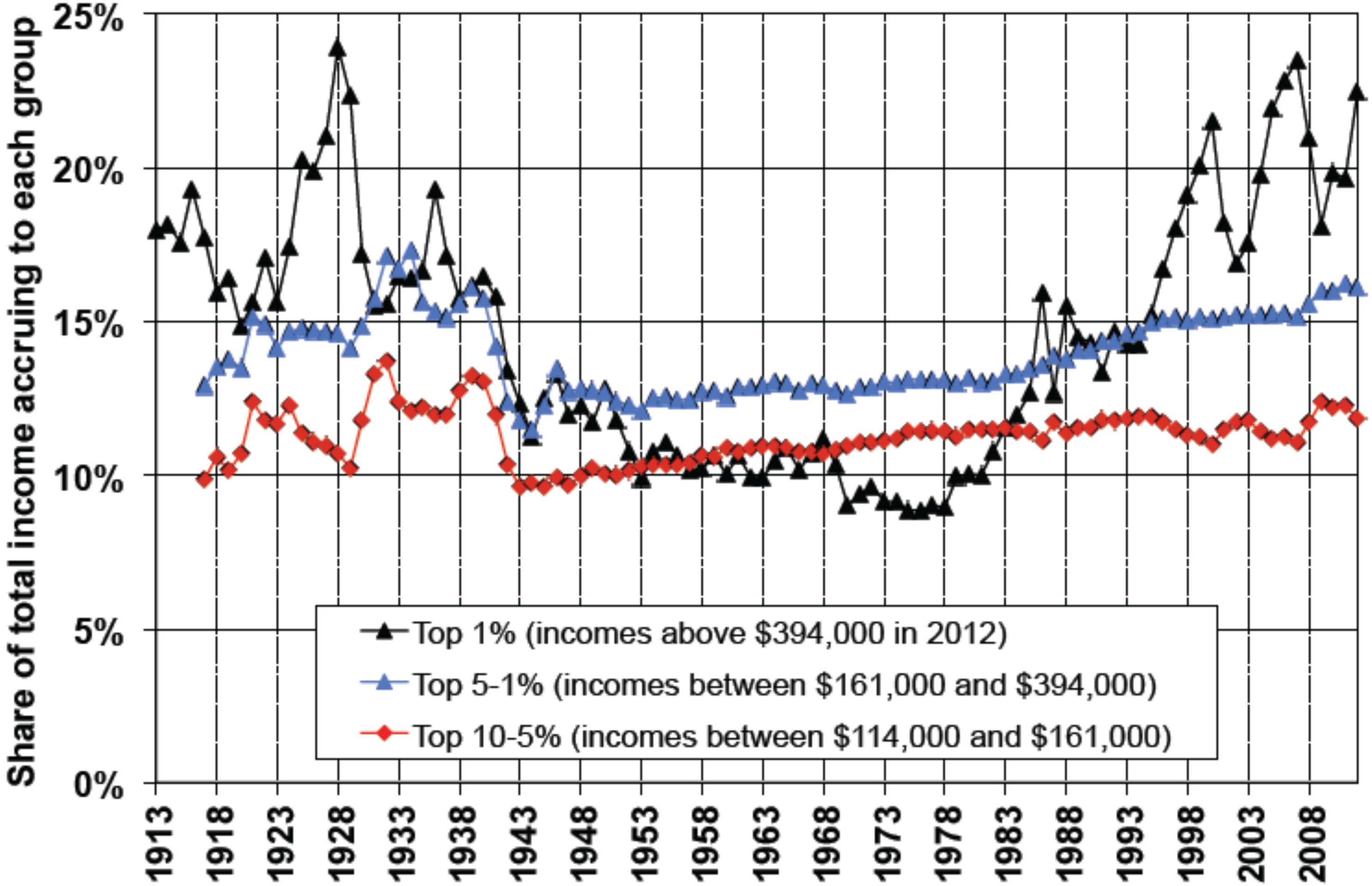


FIGURE 2

Decomposing the Top Decile US Income Share into 3 Groups, 1913-2012

Source: Saez (2013), http://elsa.berkeley.edu/~saez/saez-UStopincomes-2012.pdf.

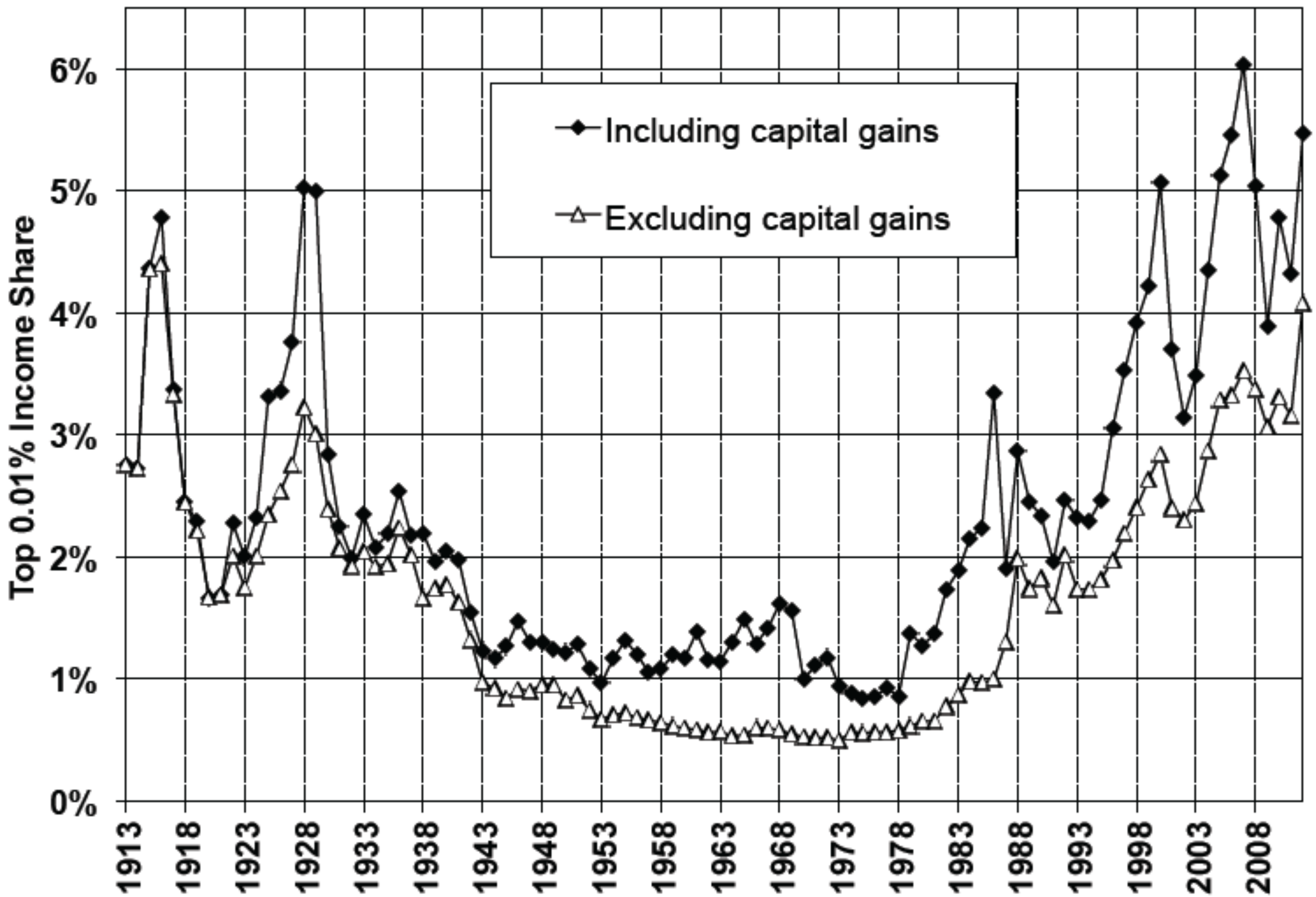


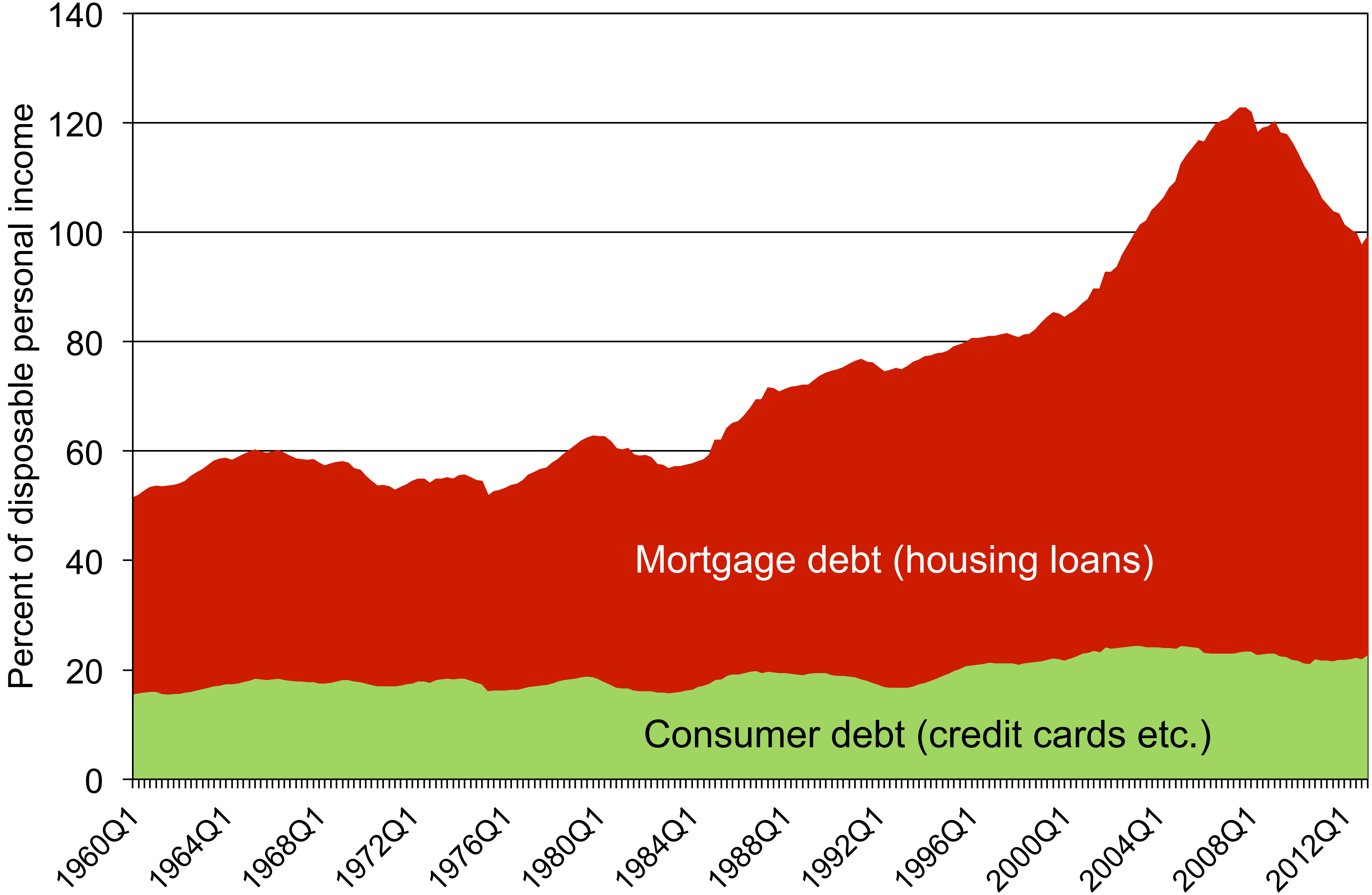
FIGURE 3
The Top 0.01% Income Share, 1913-2012

Source: Saez (2013), http://elsa.berkeley.edu/~saez/saez-UStopincomes-2012.pdf.

Household debt

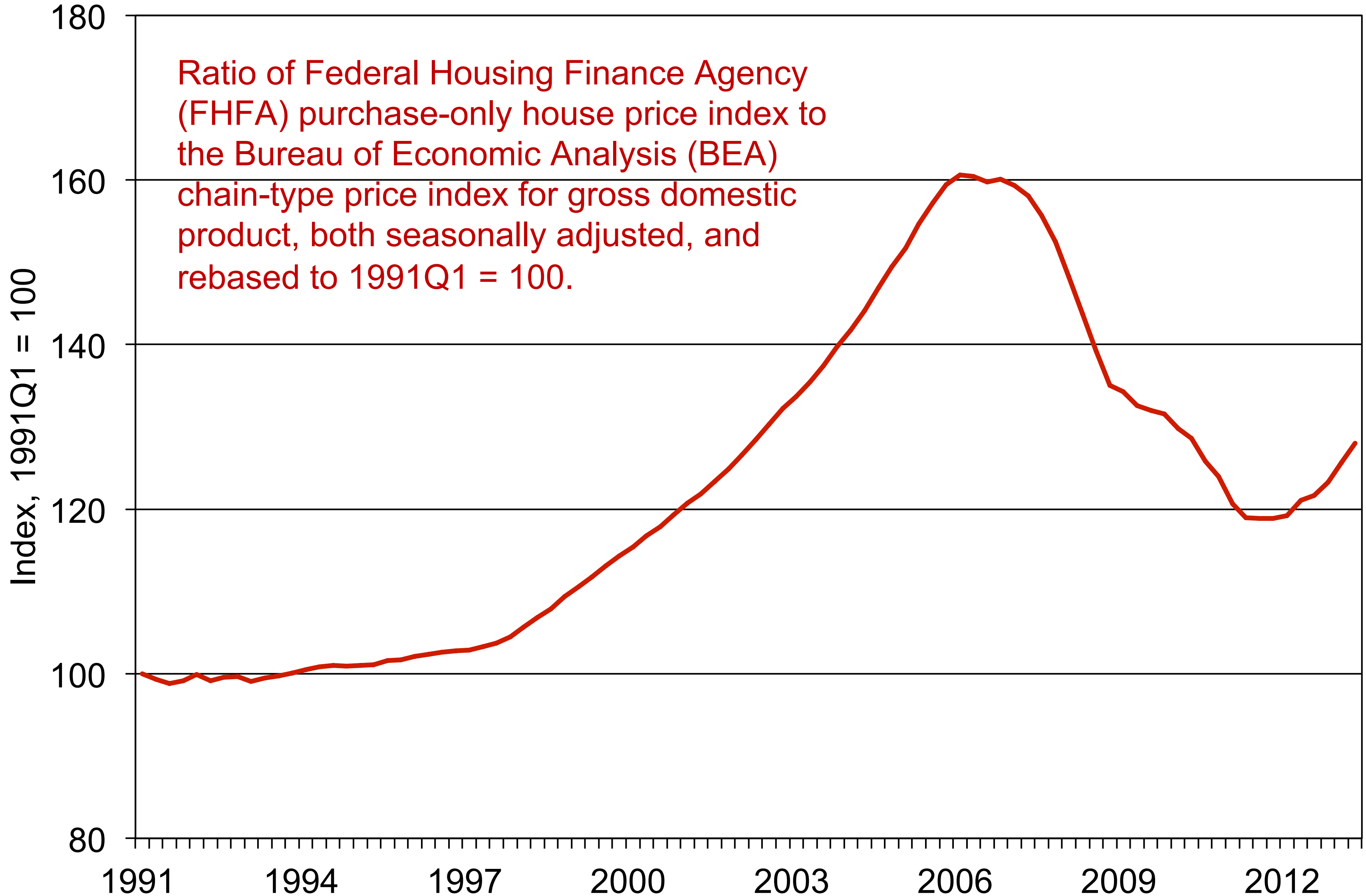
- Before the crisis, the middle class attempted to compensate for stagnant earnings by borrowing for consumption (and housing)
  - This was encouraged by a deregulated financial system that offloaded the risk from the banks that originated the loans
- Most of the growth was in mortgages, which are used mainly to pay for purchases of housing
  - However some of the borrowed funds could be used directly or indirectly to pay for additional consumption expenditures...
    - ...directly via “home equity loans”
    - ...or indirectly simply because funds are fungible
- But rising debt service burdens, the collapse of house prices, and then rising unemployment after the bubble burst in 2007 put an end to this debt-led boom

Household debt (consumer + mortgage) as percentage of disposable personal income, US, 1960Q1 to 2013Q1



Sources: Federal Reserve, Financial Accounts of the United States (Z.1), http://www.federalreserve.gov/releases/Z1/default.htm; BEA, NIPA Table 2.1, www.bea.gov; and author's calculations.

U.S. Real House Price Index, Quarterly, 1991Q1 to 2013Q2 (seasonally adjusted)

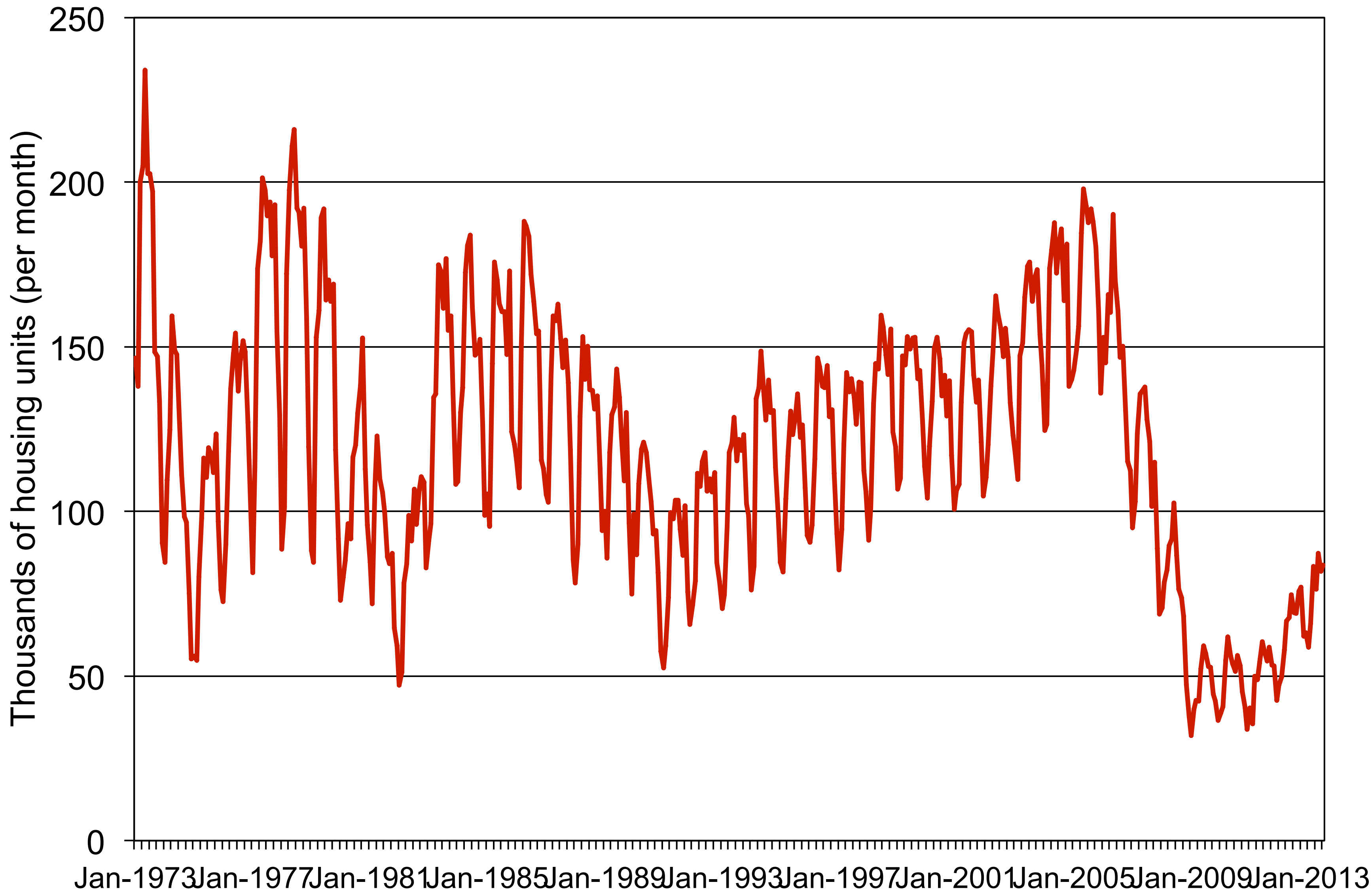


Source: FHFA, www.fhfa.gov, data released August 22, 2013; downloaded 9/12/13; BEA, www.bea.gov, NIPA release of 8/29/13; author's calculations

Investment has been weak in the recovery (4 years after the trough)

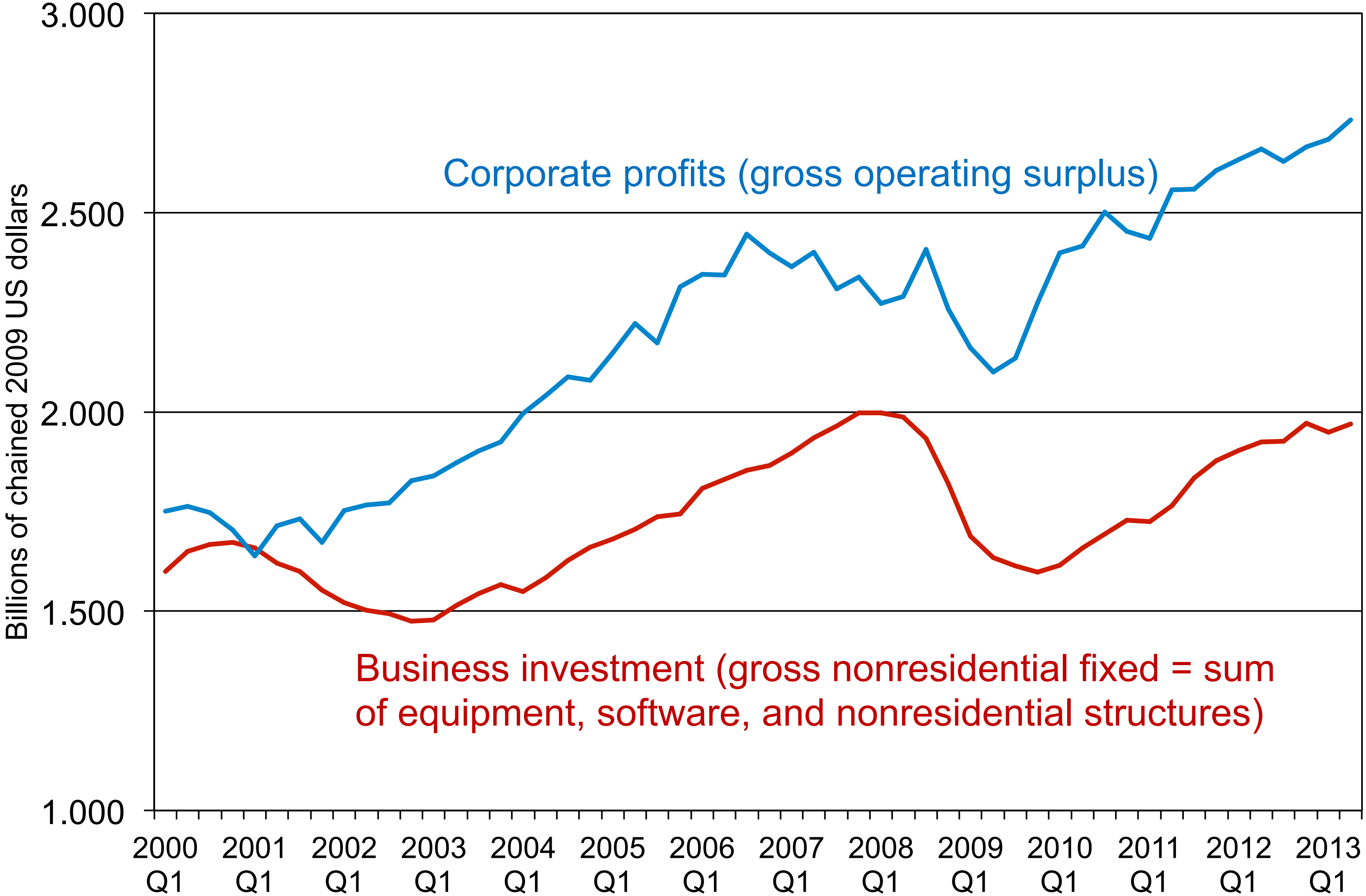
- The construction industry is still depressed
  - Housing construction has just barely begun to pick up from the bottom of the crisis
  - Nonresidential construction is still flat
- Business investment is relatively weak
  - It is increasing very little for this stage in a recovery, in spite of record profits
  - Equipment and software expenditures are doing relatively better than nonresidential structures (construction)
  - Slow growth is inhibiting investment via the accelerator mechanism, in spite of low interest rates, high profits, and a low dollar
- Equipment and software improvements contribute to productivity growth and hence to increases in output that don't create jobs
  - In a situation with slow overall growth of demand

U.S. Housing Units Started, Monthly, January 1973 to July 2013 (not seasonally adjusted)



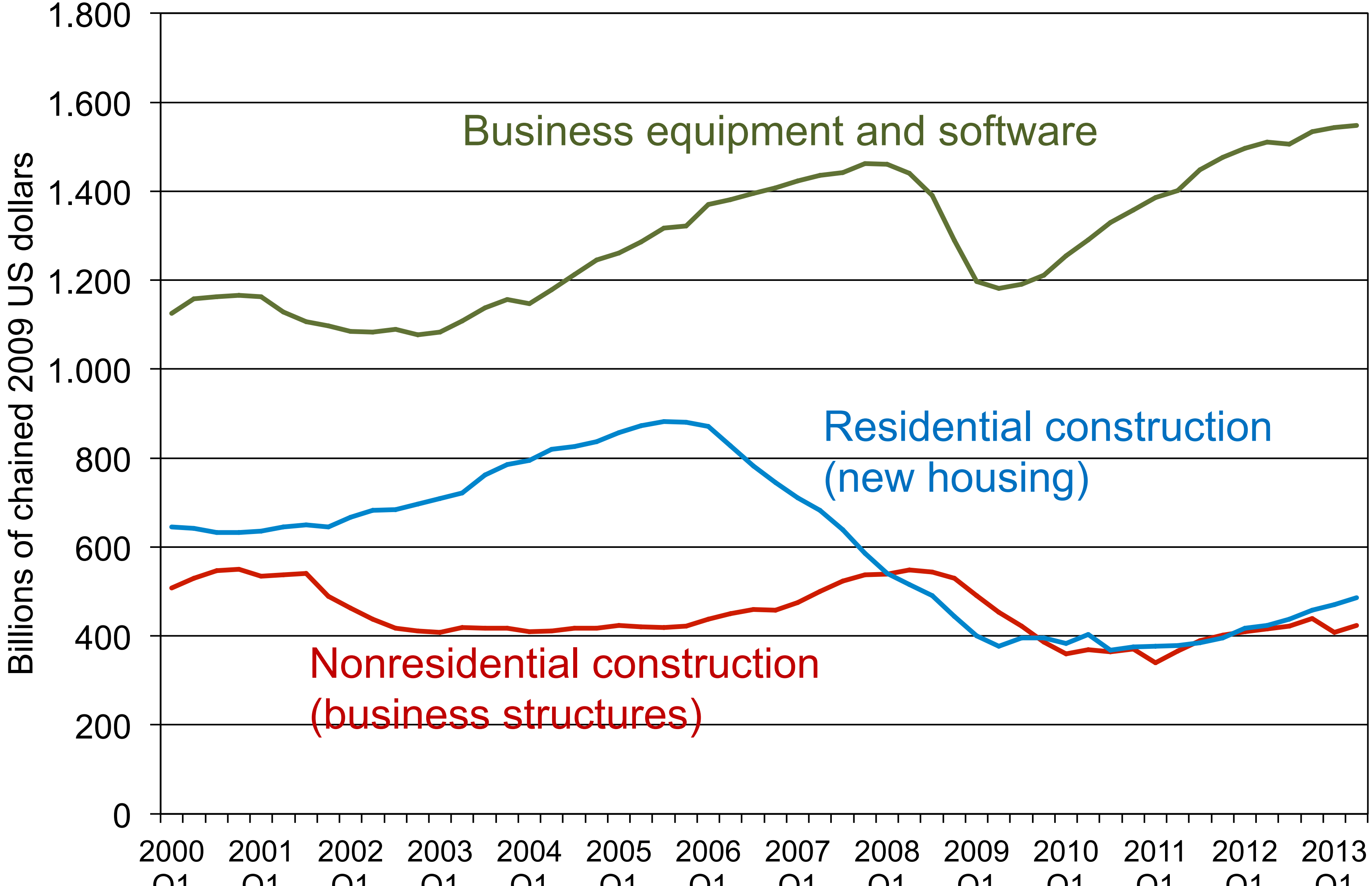
Source: U.S. Census Bureau, www.census.gov, Business and Industry Surveys, downloaded September 12, 2013.

Real gross profits of nonfinancial corporations and gross nonresidential fixed investment, US, 2000Q1-2013Q2



Source: US Bureau of Economic Analysis, www.bea.gov, NIPA Tables 1.1.3, 1.1.6, and 1.14, data revised 29 August, 2013.

Components of US real gross fixed investment, quarterly, 2000Q1 to 2013Q2

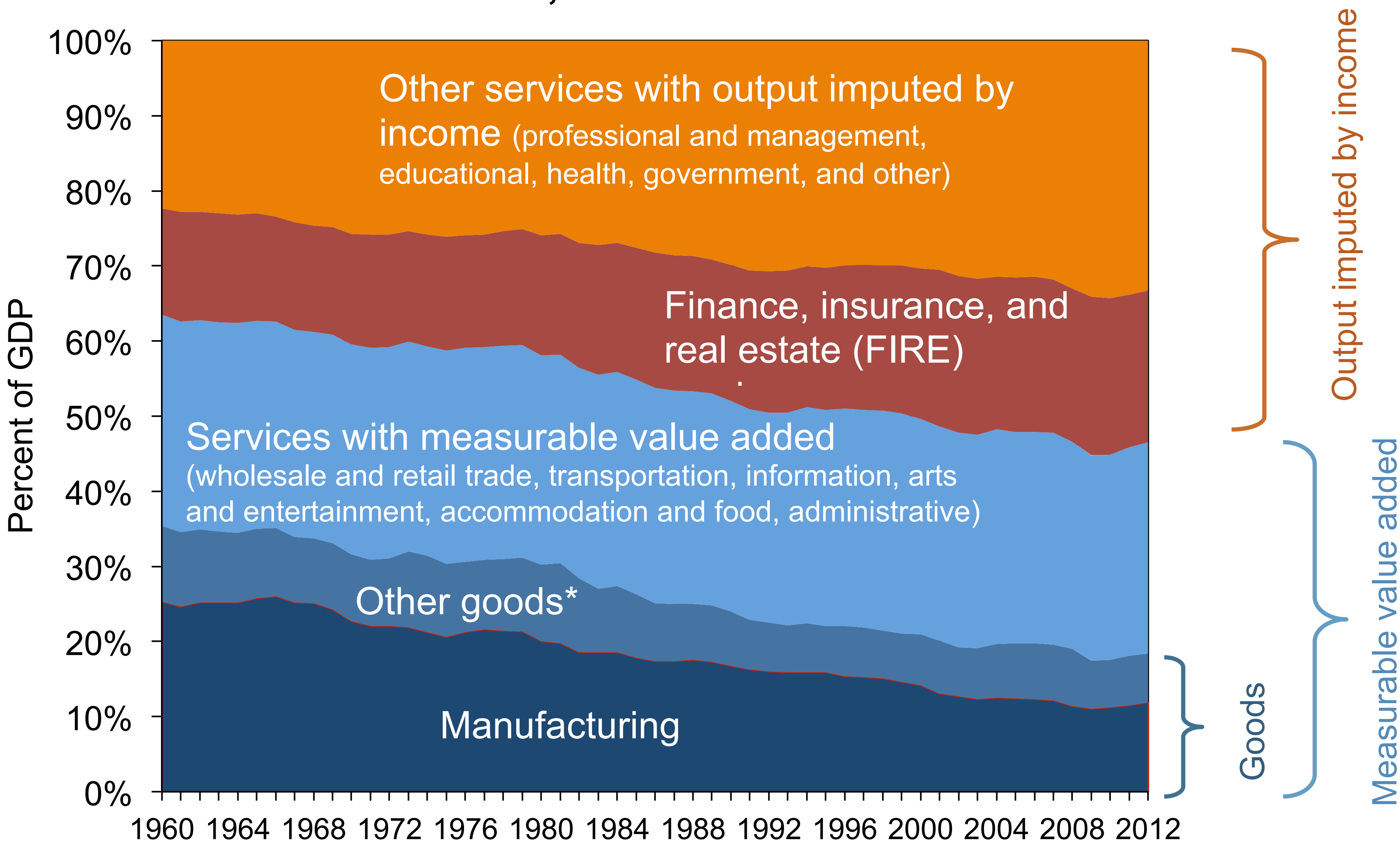


Source: US Bureau of Economic Analysis, www.bea.gov, NIPA Table 1.1.6, data revised 29 August, 2013.

Longer-term structural changes in the United States

- There are both structural shifts among industries and profound transformations within industries
  - The share of manufactures and other goods in GDP is falling; the share of services is rising
- But not all services are equivalent (Basu and Foley, 2013)
  - Some services (e.g., wholesale and retail trade, transportation, information) have "measureable value added" and create jobs in proportion to (net) output
  - Others don't have measurable value added; their "output" is imputed based on their income, and not closely related to job creation
    - Especially the FIRE sector (finance, insurance, real estate)
- What remains of manufacturing needs very little labor due to both technological innovations and offshoring (vertical specialization)
- **The result of all these changes is that output growth is becoming delinked from employment growth**

Composition of U.S. Output (GDP by Industry), Annual, 1960-2012

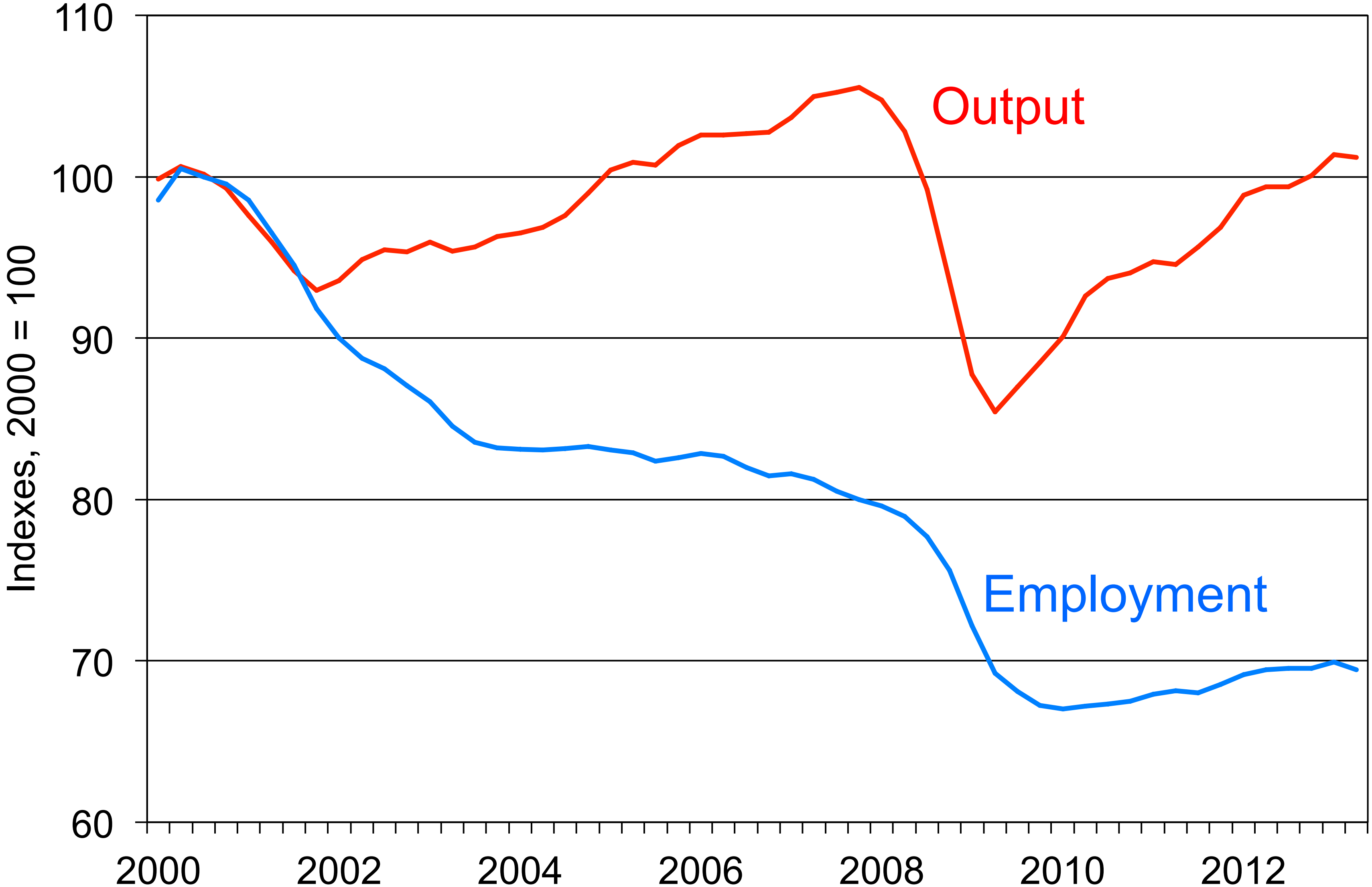


Source: BEA, www.bea.gov, GDP by industry tables; author's calculations. Categories suggested by Basu and Foley (2013).
*Other goods consist of agriculture, forestry, and fishing; mining; construction.

Is there a revival of US manufacturing?

- There are many positive stories about a recovery of U.S. manufacturing in the news media (business press) and Obama administration propaganda
  - Some particular industries are doing relatively well (e.g., automobiles)
  - There is some "reshoring" of industries to North America from China or East Asia, some to the United States and some to Mexico
- However, so far there is little sign of more than a cyclical recovery (not a longer-term expansion) at the aggregate level
  - Manufacturing output has had a decent cyclical rebound, but is still below its pre-crisis peak almost 6 years later
- Manufacturing employment has never recovered since the 2001 recession (when China joined the WTO)
  - It has barely turned up from its 2009-10 trough and remains 30% below its level in 2000

U.S. Manufacturing Output and Employment, Quarterly, 2000Q1 to 2013Q2 (Indexes, 2000 = 100)

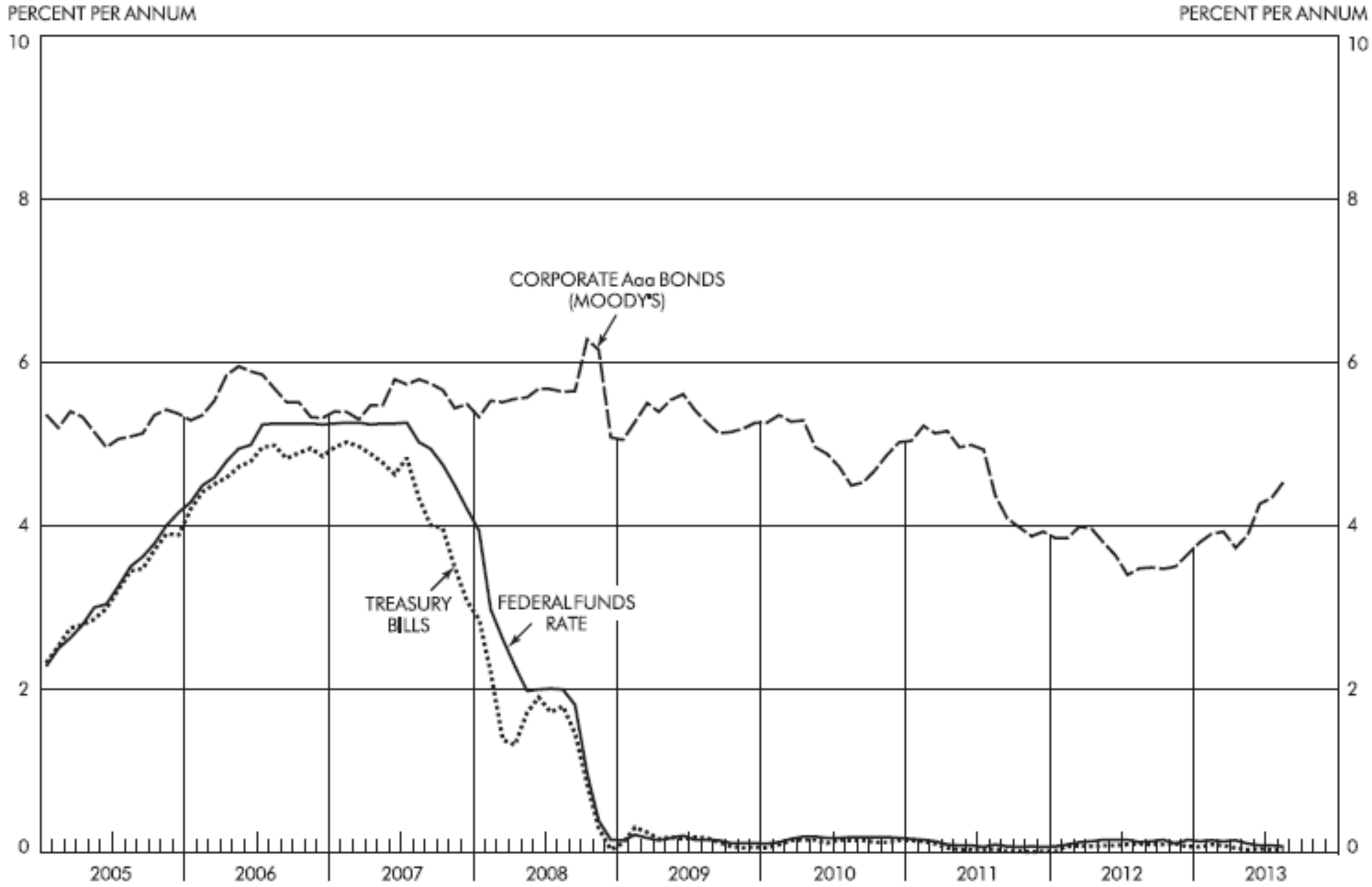


Source: US Bureau of Labor Statistics, www.bls.gov, Productivity and Costs; and author's calculations.

Policy responses: Monetary

- Quick and strong responses of the Federal Reserve since 2007-8
  - Policy target rate (federal funds rate) has been at zero lower bound since late 2008
  - Major bailouts of banks and other institutions (AIG), huge increases in Federal Reserve assets
  - These responses helped to "unfreeze" the financial system after the Lehman Brothers collapse in the fall of 2008 and to end the recession by mid-2009
- The U.S. is still caught in a "liquidity trap" → Fed is trying new policy tools
  - Massive injections of reserves into the commercial banks
  - "Quantitative easing" (QE) = purchases of longer-term bonds to flatten yield curve
  - But lending has not grown enough; banks are holding excess reserves
- None of this has sufficed to engineer a strong recovery
  - Low interest rates help mainly in the housing sector and in keeping the dollar low
    - The exchange rate effect was not the main intention, and has only weakly affected net exports
  - Not much impact on domestic business investment
  - Households are taking advantage of low interest rates to pay down debt and restore their financial positions (slow process)

US interest rates since the housing bubble and the financial crisis

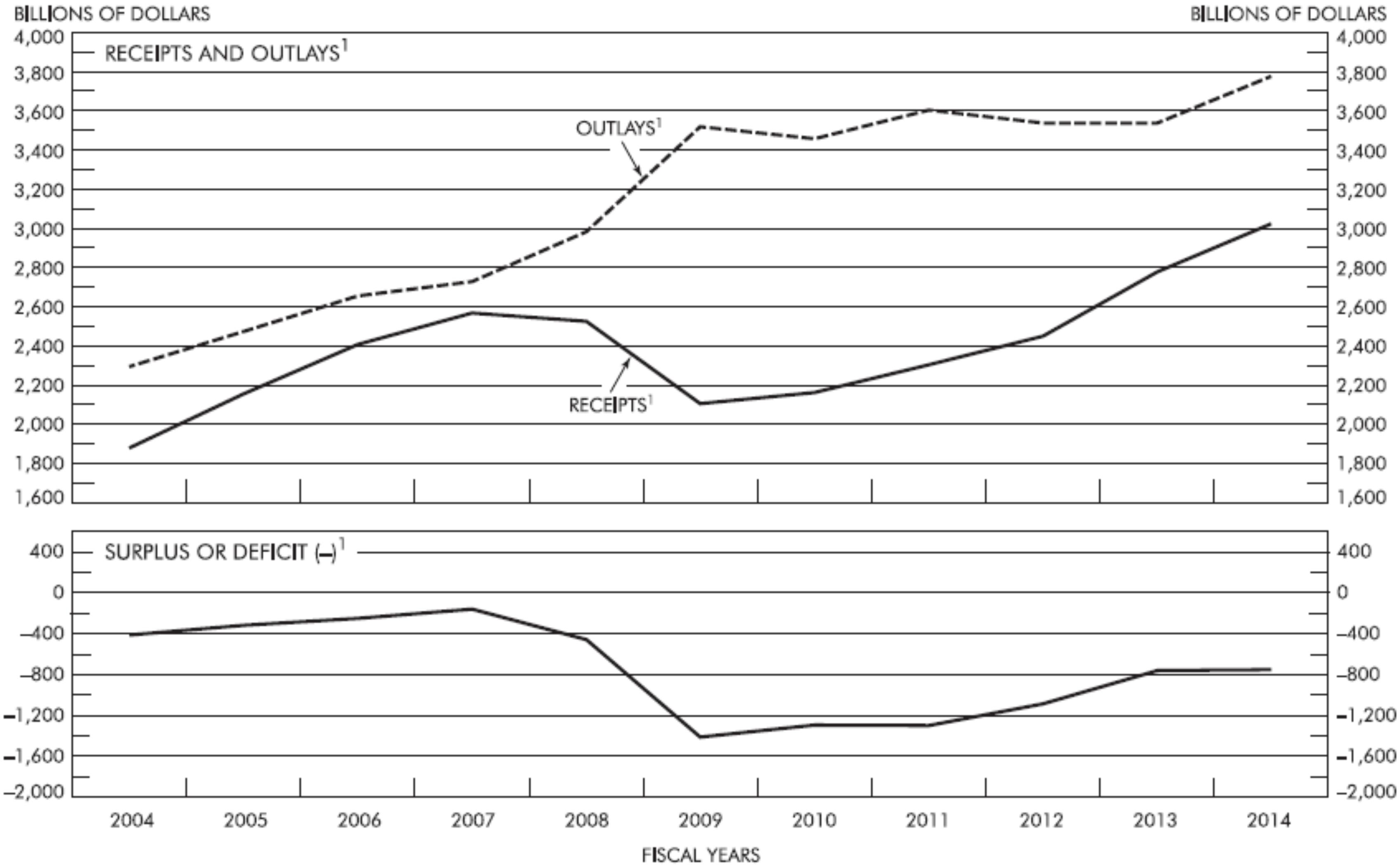


Source: US Council of Economic Advisers, *Economic Indicators*, August 2013.

Policy responses: Fiscal

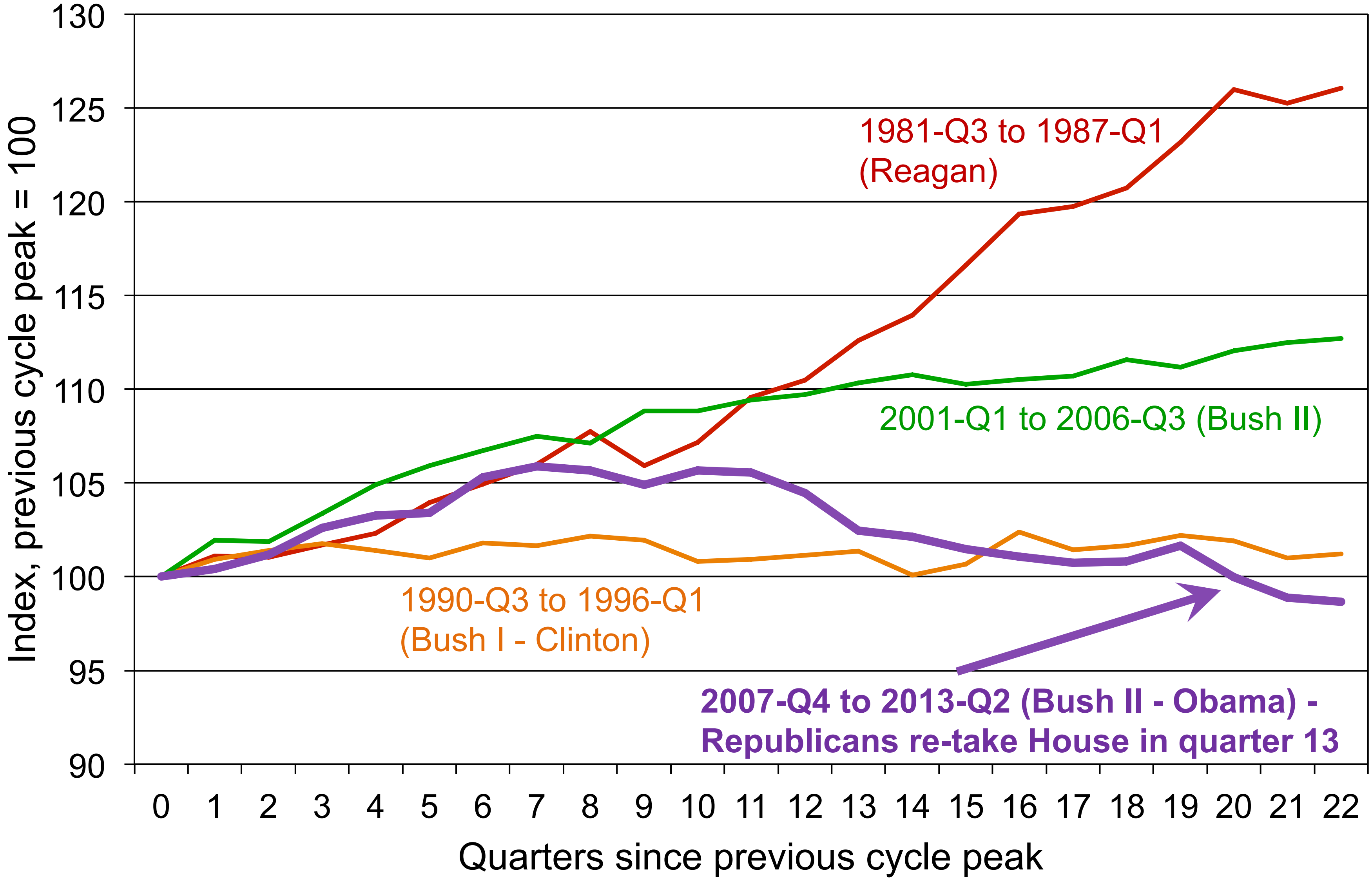
- Stimulus policies: too little, too late, too short
  - Small tax cut under Bush, spring 2008
  - Combined tax cuts and spending increases under Obama, 2009-10
  - Also several extensions of unemployment benefits
  - *Fiscal austerity began immediately after Obama's stimulus ended (2010) but before a robust recovery took hold*
- Government expenditures have been cut repeatedly since the Republicans retook control of the House of Representatives in 2011,
  - Debt ceiling compromise (2011) led to the fiscal cliff and sequestration (2012-13)
  - The Republicans allowed some tax increases on the rich in January 2013
  - But mostly they have exacted major spending reductions as a condition to avert a government shutdown or raise the (artificially imposed) debt ceiling.
- State and local governments have also made major budget cutbacks
  - They cannot run large deficits like the federal government

Federal government outlays, receipts, and surplus or deficit (budget basis)



Source: US Council of Economic Advisers, *Economic Indicators*, August 2013. Note fiscal years are October 1 to September 30; data for FY 2013 and 2014 are estimates. Outlays include transfer payments and net interest payments as well as government purchases of goods and services.

US Real Government Consumption Expenditures and Gross Investment in the Last Three Recessions and Recoveries



Source: US Bureau of Economic Analysis, www.bea.gov, NIPA Table 1.1.6, data revised 29 August, 2013, and author's calculations, with thanks to Paul Krugman for suggesting this approach: http://krugman.blogs.nytimes.com/2013/08/08/what-janet-yellen-and-everyone-else-got-wrong/?_r=0.

Federal government fiscal indicators, selected years

	Pre-crisis 2007	Recession trough 2009	2012	2013*
Federal net lending or borrowing/GDP	-2.5	-10.2	-7.5	-4.3
Federal debt held by public/GDP**	34.6	52.5	69.0	72.9
Federal net interest payments/GDP	2.8	2.5	2.6	2.6

Notes:
*Second quarter at an annual rate, except for federal debt.
**Fiscal years ending September 30. Data for 2013 are estimated.

Conclusions on fiscal policy

- Most of the increase in the budget deficit in 2008-9 came from revenue reductions due to the recession, not from spending increases (in fact, spending has been falling since 2010)
  - This came on top of Bush's tax cuts of 2001-3, which have been only partly reversed
  - But the Republicans have shifted the blame to spending
    - They (especially Tea Party) have used the cyclically induced rise in the budget deficit as an excuse to launch an ideologically based campaign to reduce the size of government
- Unless there is a surprise compromise today, the U.S. government will shut down because the fiscal year starts October 1, Congress has not passed a budget, and the House and Senate cannot agree on a "Continuing Resolution"
  - The House Republicans are holding the entire federal government hostage to their crusade to abolish Obama's health care policy

The U.S. has the wrong macro policy mix

- When an economy is in a “liquidity trap” or at the “zero lower bound,” monetary policy becomes ineffective and fiscal stimulus is necessary
  - Crowding out of private investment cannot occur when interest rates are so low
- The U.S. needs another fiscal stimulus now
  - Expenditures should be targeted on future-oriented, productivity-enhancing activities such as education, infrastructure, energy, environment, etc.
  - At present there is not a political coalition to support this
- However, a bigger and more sustained fiscal stimulus would not solve all problems of the U.S. economy
  - It would strengthen the recovery and reduced the hardship
    - But the lingering effects of the housing collapse and financial crisis would still remain...
    - ...and the long-run structural problems will only be addressed if the fiscal stimulus is designed in ways that can create new opportunities for job creation (e.g., in alternative energy, infrastructure construction, information technology, etc.)
    - The U.S. also needs a strategic (re-) development plan!

Lessons of the U.S. case

- The Keynesian **paradox of thrift** still applies in a depressed economy
  - Highly indebted households must increase their savings to restore their balance sheets by paying down debts in a weak economy (*individually rational*)
  - But higher savings do not boost the aggregate economy when it is below full employment; they simply reduce consumer demand (*collectively irrational*)
- The United States still has **wage-led aggregate demand**
  - Reducing labor costs relative to labor productivity and increasing the profit share does not lead to higher output or employment
  - Instead lower wages depress consumption expenditures and create a tendency toward stagnation unless offset by other factors (e.g., debt)
    - The academic literature confirms this even after controlling for investment, net exports, and financialization (e.g., Onaran et al., 2011)

Lessons for the rest of the world

- **Fiscal austerity is not expansionary**
  - Under present conditions, private investment is not crowded out by government deficits
  - Fiscal austerity merely reduces demand and employment further
  - Ideologically driven budget cuts are slowing the recovery and preventing job growth
    - By slowing GDP growth, austerity fails to lower the debt-GDP ratio
- **Fallacy of composition in export-led growth**
  - Export-led growth cannot work for all countries unless they mutually provide reciprocal demand for each other's products
  - Otherwise export-led growth in some countries requires other countries to run large trade deficits and accumulate debts that eventually become unsustainable
    - Then emerging market nations are in competition with each other for limited export market opportunities (Blecker and Razmi, 2008, 2010)

Conclusions

- The United States is stuck in a long-term depression of demand
  - A slow recovery from the crisis has turned into a Lesser Depression
  - Fiscal policy is making matters worse instead of better while monetary policy has reached its limits
- To have a more robust recovery and a renewed long-term expansion, the United States will need to follow one of two paths:
  - Another debt-led, finance-driven boom
    - After households and lenders repair their balance sheets they start borrowing and lending more again (perhaps accompanied by another bubble of some kind)
    - But this would not be sustainable and would inevitably end in another crash

  or

  - Solve the distributional and structural problems that inhibit U.S. growth
    - Redistribute income to workers and the middle class to create the purchasing power to support consumer demand without excessive debt
      - Get wages to increase with productivity; curb power of financial sector
    - Find new centers of job creation to replace declining sectors such as manufacturing

Implications for the global economy

- The triangular pattern of demand injections of the 1980s to the early 2000s is no longer functioning to sustain global growth
  - There has not been a true rebalancing—only a slowdown in growth in many countries post-crisis
- Therefore the manufacturing exporters and primary commodity producers need to generate more of their own demand
  - They cannot rely on external demand from the U.S. and other deficit countries to sustain their growth
  - They will have to provide more of a consumer market for their own and each other's products
  - They will also need to ensure greater distributional equity and that real wages keep up with labor productivity
  - A key player in this will be China—can it move to more internally-driven growth? is it moving in that direction already? (see Pettis, 2013)
  - Enhanced "South-South" trade (among the developing and emerging market countries) will play a pivotal role

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