

THOMAS I. PALLEY

## **Economic contradictions coming home to roost? does the U.S. economy face a long-term aggregate demand generation problem?**

***Abstract:** Many argue that the current recession is the product of a temporary stock market wobble. This paper argues that the U.S. economy confronts deeper-seated problems concerning the aggregate demand generation process. For two decades, these problems have been obscured by a range of demand compensation mechanisms—rising consumer debt, a stock market boom, and rising profit rates. Now, these mechanisms are exhausted. Fiscal policy adjustments and dollar depreciation are the only stable exits from this impasse, but they must be accompanied by measures rectifying the income distribution imbalances at the root of the problem. Absent this, deficient demand will reassert itself.*

***Keywords:** aggregate demand, debt, income distribution, saving rates, stock market.*

The U.S. economy slowed dramatically in the second half of 2000, and formally entered recession in March 2001. Now there are indications that the recession may be ending, though dangers of a double-dip or W-recession still abound. Even if this pessimistic double-dip scenario does not transpire, there is a danger that the economy may find itself trapped in a jobless recovery or growth recession such as obtained in the early 1990s. Recalling that period, the recession was declared as formally over in March 1991, but the unemployment rate did not actually start falling until October 1993.

Chairman Greenspan has himself acknowledged in Humphrey-Hawkins testimony to the Congress (February 2002) that the recovery may be tepid. His reasoning is that since the recession has been so mild, with

The author is Assistant Director of Public Policy at the AFL-CIO, Washington, DC.

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spending on housing and consumption remaining strong, there is little pent-up demand to propel a vigorous recovery. This paper challenges this “lack of pent-up demand” hypothesis, and instead argues that the danger of a lasting growth recession reflects the emergence of systemic contradictions in the U.S. economy that pose a long-term aggregate demand generation problem.

The aggregate demand generation thesis maintains that for the last 20 years demand growth has been generated by an increasingly unsustainable process that rests on rising stock prices, rising household debt, mortgage refinancing driven by disinflation, and falling household saving rates. These processes have helped cover up the aggregate demand implications of deteriorating income distribution, but they are now exhausted. The stock market remains at extremely high valuation levels on a historical basis, which means that covering the shortfall of aggregate demand with further equity price increases enjoins the contradiction of an asset price bubble. Consumer borrowing has also offset the problem of aggregate demand, but consumers are now approaching debt ceilings, and further rapid growth of borrowing risks a consumer debt crisis. Saving rates are close to zero and, therefore, have little room left for further decline. Finally, the pool of high interest rate mortgages suitable for refinancing has been eroded by successive waves of refinancing, leaving a much smaller base on which to pin demand growth fueled by reduced mortgage interest burdens.

The bottom line is that the boom of the 1990s may have been built on a combination of forces that are unsustainable. These forces helped cover up the contradictions between deteriorated income distribution and aggregate demand generation, but further staving off these contradictions is only possible at the cost of deepening of existing unstable financial positions.

### **Income distribution: the dog that hasn't barked—yet**

The deterioration of U.S. income distribution is a phenomenon that has been proceeding steadily for the last 20 years, and it is well documented (see Mishel et al., 2000). Between 1979 and 1999 the top one-fifth of families increased their income share from 41.4 percent to 47.2 percent, whereas the share of income going to the bottom 60 percent of families fell from 34.5 percent to 29.8 percent. The ratio of family income of the top 5 percent relative to the lowest 20 percent increased from 11.4 in 1979 to 19.1 in 1999. Over the same period, family income of the top one-fifth grew by 42 percent, whereas that of the bottom 60 percent

grew by just 3.3 percent. This worsening of family income distribution was accompanied by generalized income and wage stagnation. Whereas median family income had grown at an annual rate of 2.75 percent between 1947 and 1973, it grew at only 0.52 percent per year between 1973 and 1999—and this at a time when female labor force participation was increasing and average hours worked grew by over 10 percent.<sup>1</sup> Real average hourly earnings of production and nonsupervisory workers (who constitute roughly 80 percent of employment) grew at an annual rate of 2.25 percent between 1947 and 1973, but then fell at an annual rate of 0.12 percent between 1973 and 1999.

These trends in the distribution of family income and average hourly real wage growth have been amplified by shifts in the functional distribution of income, which have raised the profit share at the expense of the labor share. Table 1 shows business cycle peak-to-peak profit rates. The pretax profit rate rose from 9.2 percent in 1979 to 12.1 percent in 1999—a 31.5 percent increase, and the posttax profit rate rose from 4.9 percent in 1979 to 8.1 percent in 1999—a 65 percent increase. Side by side, the profit share also increased, rising from 17.7 percent in 1979 to 20.5 percent in 1999—a 15.8 percent increase.

Figure 1 places these income distribution trends in a unified framework and illustrates how working families have been squeezed at two margins. First, the shift toward profit income has reduced the wage share. Second, within the wage share component there has been a shift away from production and nonsupervisory workers to managerial workers. These two trends have added up to increased family income inequality. However, whereas the increased profit share has been relatively unproblematic and may even have done well in the form of increased investment spending, the changed composition of the wage share has been unambiguously damaging.

An old adage is that a mass-production economy needs mass-consumption markets to support it. Behind this claim lies the implicit belief that robust mass-consumption markets rest on a healthy distribution of income. Yet, despite the clear worsening of income distribution, the last two business cycles have seen the U.S. economy still generate substantial increases in aggregate demand. This has cast doubt on the core Keynesian proposition that market economies are prone to failure regarding aggregate demand generation, as well as casting doubt on the claim that income distribution matters for aggregate demand.

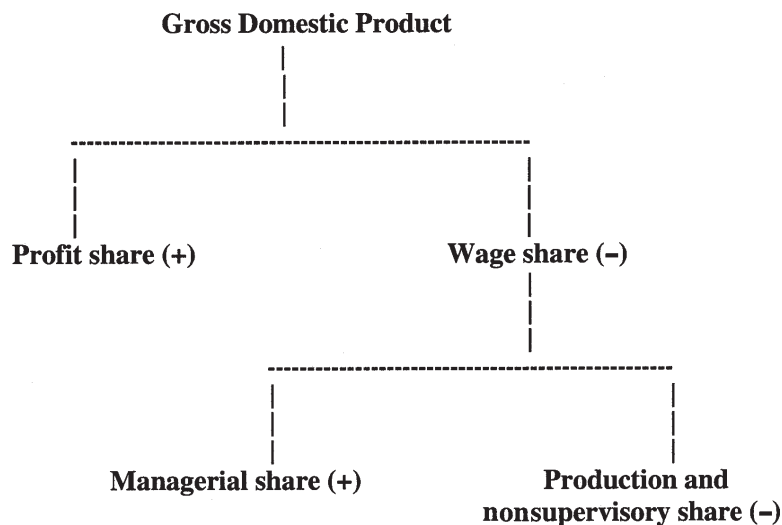
<sup>1</sup> All of the above numbers are either taken directly from Mishel et al. (2000), or are based on calculations using their numbers.

**Table 1**  
**Profit rates and shares at business cycle peaks, 1959–1999**

Corporate sector profit rates	1959	1969	1973	1979	1989	1999
Pretax (percent)	12.0	12.5	10.9	9.2	10.0	12.1
After tax (percent)	6.4	6.8	6.0	4.9	5.7	8.1
Income shares						
Profit share (percent)	21.9	19.7	18.2	17.7	18.2	20.53
Labor share	78.1	80.3	81.8	82.3	81.8	79.5

*Source:* Mishel et al. (2000, p. 91).

**Figure 1** The division of gross domestic product



*Note:* Signs in parentheses represent direction of change in shares 1979–1999.

The argument that is developed below maintains that both Keynesian claims remain solidly intact—market economies can have a problem generating sufficient aggregate demand, and income distribution matters for aggregate demand. Making this argument involves showing how the process of demand generation over the last two business cycles has served to mask the impact of deteriorating income distribution. Moreover, this existing process is unsustainable. Consequently, the U.S. economy now confronts the risk of systemic demand shortage.

The recession of 2001 has already contributed to a revival of public awareness of Keynesian-styled concerns with deficient aggregate demand—though it is also the case that this awareness is still often coded as a problem of excess capacity (*Business Week*, April 9, 2001).<sup>2</sup> However, the linkage between “sustainable” aggregate demand generation and income distribution remains less understood.

### **The generation of aggregate demand: what has covered for worsening income distribution?**

Whereas much has been written about the causes of worsening income distribution and stagnating wages, little has been written as to why the deterioration of income distribution has failed to impact aggregate demand.<sup>3</sup> For Chicago School economists, the fact that the income distribution/aggregate demand dog has not barked is of little surprise since they discount the problematic of aggregate demand, and they believe that all households have a common propensity to consume regardless of income level.<sup>4</sup> However, for Keynesian economists, accounting for this silence is important, and explaining the absence of demand effects of deteriorated income distribution is a necessary step in making the claim of a contradicted economy.

At the most abstract level, the reason the demand effects of deteriorating income distribution have not yet shown up is because modern financialized economies possess many margins of compensation, and these margins can operate for lengthy periods of time before they are

<sup>2</sup> The one place where the problem of aggregate demand shortage is openly expressed is in connection with the global economy. For the last several years, the United States has acted as global buyer of last resort, providing demand in an otherwise demand-short global marketplace. Now there are fears that a U.S. slowdown could cut global demand, thereby triggering recession in East Asia and Latin America (for example, see *The Economist*, March 31, 2001).

<sup>3</sup> The reasons for the deterioration of income distribution and the stagnation of average hourly wages is deeply contested. The mainstream of the economics profession maintains that it is the result of a shift in the composition of labor demand away from unskilled to skilled workers (Bound and Johnson, 1992; Katz and Murphy, 1992). An alternative view is that it is due to changed labor market bargaining conditions resulting from reduced union density, weakening of labor market institutions that underpin the wage floor, globalization, and less robust macroeconomic conditions (Palley, 1998a).

<sup>4</sup> This belief is based on Friedman’s (1956) permanent income theory of consumption.

exhausted.<sup>5</sup> These margins of compensation have served to mask and keep at bay the problem of demand shortage.

### **Federal budget deficits**

One of the most important margins of adjustment has been the growth of debt—both public and private. The worsening of U.S. income distribution gathered steam in the 1980s, but this coincided with the enormous Reagan administration budget deficits. Between 1980 and 1990, gross federal debt jumped from \$909.1 billion to \$3,206.6 billion, and during this period, the federal government ran budget deficits every year. In absolute terms, the deficit (on a fiscal year basis) peaked at \$221.2 billion in 1986, and over the course of the decade it averaged (on a NIPA basis) 3.4 percent of gross domestic product (GDP). The federal deficit, funded by a growing federal debt, therefore served to inject demand into the economy. This contributed to offsetting the negative demand impact of the shift in income distribution from low income/higher propensity to consume households to high income/lower propensity to consume households.

Whereas public sector deficits were an important engine of aggregate demand in the 1980s, this engine began to slow down in the 1990s as the government deficit started falling and the federal budget began its steady climb toward surplus. This change in direction of federal financial policy began with the Omnibus Budget Reconciliation Act of 1993, but it is important to recognize that deficits persisted through 1997. Thus, although the size of the federal stimulus to aggregate demand was falling during this period, it remained positive. The impact on aggregate demand only turned negative in 1998 with the emergence of the first federal budget surplus in over a generation.<sup>6</sup>

<sup>5</sup> For historians, with their longer time horizons, such a process of gradual deepening of contradictions is readily plausible. However, economists, with their emphasis on fast-adjusting competitive markets and “Chicago School”-styled rational expectations, find such descriptions profoundly problematic. Instead, they maintain that rational agents will extrapolate forward and see how the current economic configuration implies future trouble—albeit 20 years away. These same agents will then unravel the implications of future trouble through a process of backward recursion, thereby bringing it into the present and forcing markets to confront the problem today. Such reasoning explains why the economists are resistant to casting policy arguments in a historical, structural frame of reference.

<sup>6</sup> Prior to 1998, the last time the federal government ran a surplus was in 1969.

### Declining private sector saving

Large federal deficits for most of the last 20 years have been one important factor maintaining aggregate demand in the presence of deteriorating income distribution. A second, even more important factor has been changed private sector saving behavior that has made for a steady decline in the private sector's saving rate. Moreover, the decline in the private sector saving rate accelerated in the 1990s just as the federal government began to reverse its financial course, so that the private sector stepped in and more than compensated for the declining size of the federal deficit in generating aggregate demand. The change in private sector saving behavior is illustrated in Figure 2, which shows the private sector deficit, the government deficit, and the current account deficits as shares of GDP from 1959–1999. In 1992 the private sector had a net financial surplus, defined as the difference between total private sector saving and investment, of 4.2 percent of GDP. However, by 2000, this surplus had been transformed into a deficit of 6.2 percent of GDP. Thus, in the space of just eight years the annual private sector saving rate had fallen by an amount equal to 10.4 percent of GDP.<sup>7</sup>

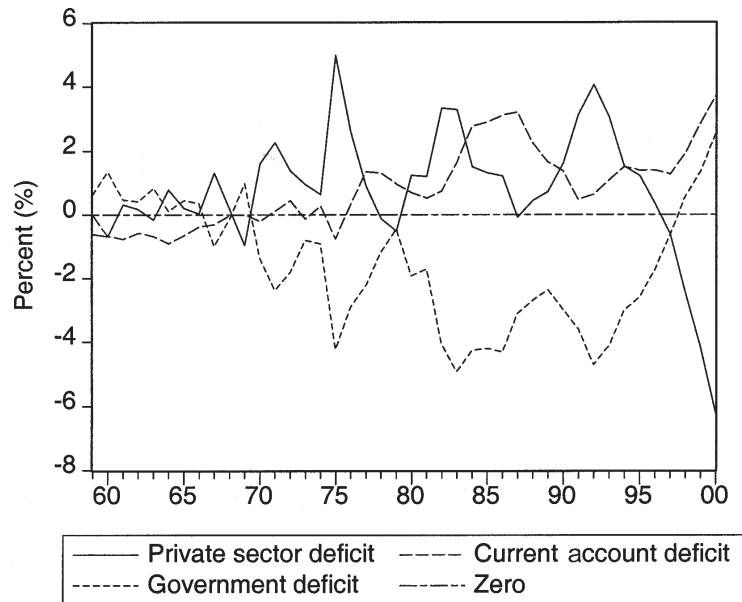
Godley (2000) has emphasized the current size of the private sector deficit. At 6.2 percent of GDP, the private sector is now issuing liabilities at a rate that exceeds growth of income, giving rise to a rapidly rising liability-to-income ratio, which Godley concludes is likely to prove unsustainable. Godley's analysis is conducted at a highly aggregative level and focuses on the private sector as a whole. However, it is useful to decompose the private sector into component parts, as this serves to link with other analyses, which have emphasized the significance of household debt in the business cycle (Palley, 1994, 1998a). It also sheds further light on the mechanisms that have helped defer the aggregate demand impact of worsened income distribution, as well as shedding light on why the current configuration is unsustainable.

The private sector balance is defined as

$$\begin{aligned} \text{private sector balance} &= \text{private sector saving } (S) \\ &\quad - \text{private sector investment,} \end{aligned} \tag{1}$$

<sup>7</sup> From the national income account identities, the private sector deficit is defined as  
private sector deficit  $(S - I) =$  government balance  $(G - T)$   
+ current account balance  $(X - M)$ .

**Figure 2** The private sector, government, and current account deficits as shares of GDP, 1959–2000



where saving and investment are defined as shares of nominal GDP. Figure 3 shows the evolution of private sector saving and investment as shares of GDP. The figure shows a dramatic decline in the private sector saving rate since 1984 and a recovery in the private sector investment share after 1990. The implication is that both saving and investment behavior have contributed to maintaining robust demand. Rising investment spending has directly fueled aggregate demand, whereas a declining private sector saving rate has fueled consumption spending. However, the private sector saving rate has fallen to historical record lows, whereas the investment share remains well within the bounds of normal highs. This indicates that changed saving patterns have played the greater role.

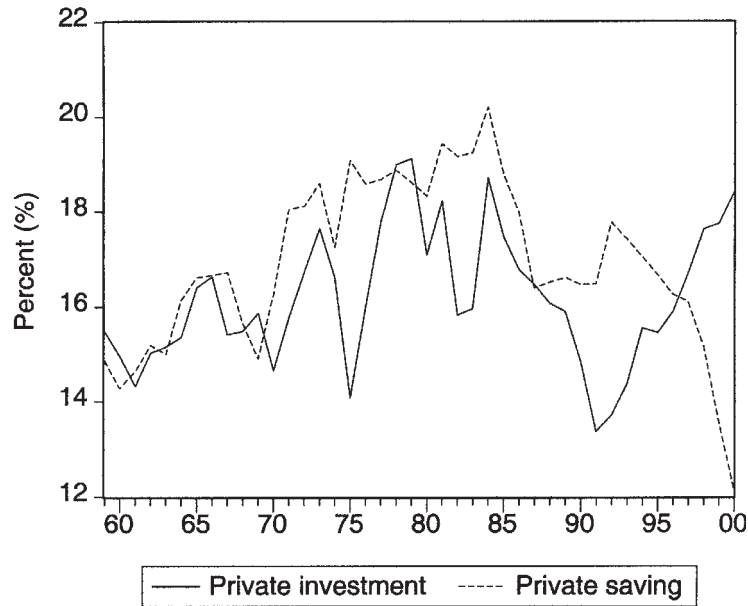
Private sector saving share can in turn be decomposed into personal and business components so that the private sector saving share becomes defined as

$$\text{private sector saving} = \text{personal saving} + \text{business saving}. \quad (2)$$

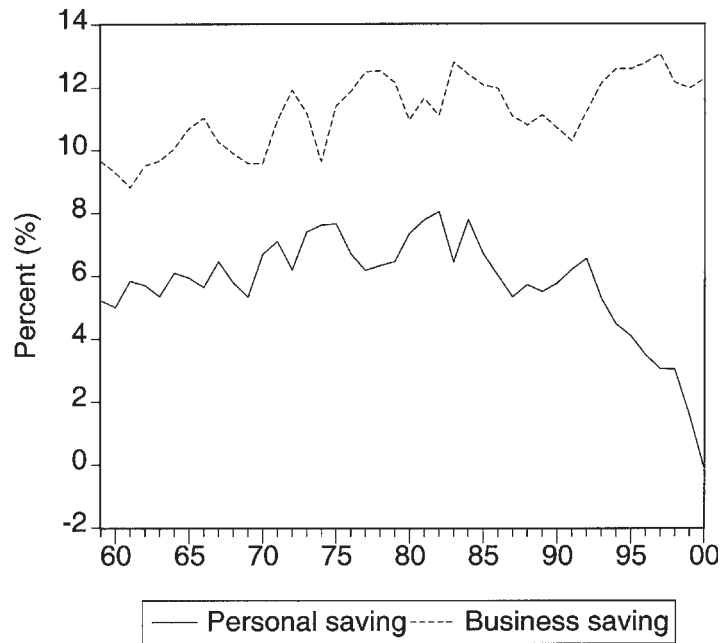
Figure 4 shows personal and corporate saving as shares of GDP. This figure sheds important light on the process of private sector demand generation. The business sector saving share has been largely unchanged,



**Figure 3** Private sector saving and investment as shares of GDP, 1959–2000



**Figure 4** Personal and business sector saving as a share of GDP, 1959–2000



and all the change in the private sector saving share has therefore been driven by a collapse in the personal saving share. Prior to 1980, personal saving was slightly above 5 percent of GDP, but since then it has steadily drifted down, and in the last quarter of 2000 and the first quarter of 2001, it actually turned negative. Few countries have experienced negative personal saving rates. Two that have are Norway and Sweden in the second half of the 1980s, and both experienced severe, hard landings.<sup>8</sup>

Finally, the share of personal saving can in turn be written as

$$\begin{aligned} & \text{personal saving share} \\ &= \text{personal saving/personal disposable income} \\ & \times \text{personal disposable income/GDP.} \end{aligned} \quad (3)$$

Figure 5 shows the evolution of these two components of the personal saving share. This figure shows how the decline in the personal saving share has been driven by falls in both the rate of saving out of personal disposable income (a behavioral propensity) and the personal disposable income share of GDP. The decline in the personal saving rate began in the early 1980s and has proceeded steadily. The decline in the personal disposable income share began in 1990, and it reflects the twin influences of a shift to government budget surplus and a rising business sector saving rate. From a historical perspective, it is again noteworthy that the personal disposable income share is well within the normal range, whereas the personal saving rate is abnormally low. This raises questions as to whether such a low saving rate is sustainable.

### Household sector debt

The decline in the personal saving rate has helped finance household sector consumption spending. Another development is the increase in consumer debt, and household borrowing has financed additional consumption spending. Figure 6 shows the evolution of household debt-to-personal disposable income ratio. This figure shows a cyclical pattern around an upward trend, and the ratio now stands at a record high level.

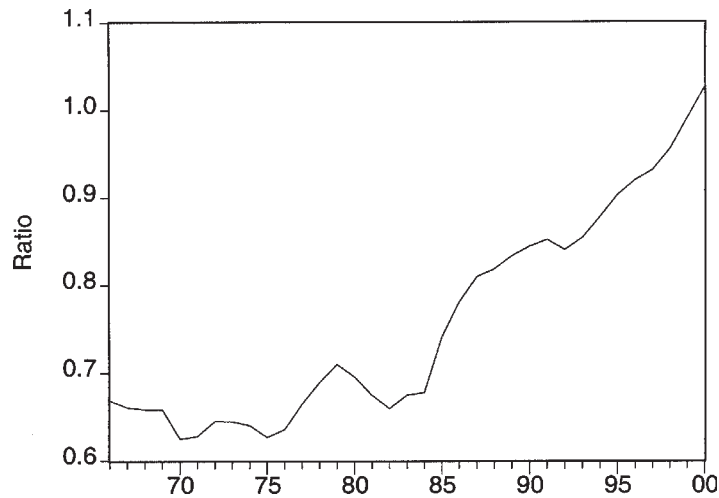
Figure 6 reveals two important features. The first is the rising trend of the household debt–income ratio. This rising trend reflects the extensive

<sup>8</sup> A number of other countries (Canada, Australia, New Zealand, Sweden) also have unusually low personal saving rates today. If the low saving rate augurs trouble—for reasons discussed below—these economies may also find themselves hit by hard landings.

**Figure 5** Personal disposable income as a share of GDP and personal saving as a share of personal income, 1959–2000



**Figure 6** Ratio of total household sector debt to personal disposable income, 1966–2000



process of financial innovation in the U.S. economy over the last 25 years. Such innovation has given households increased access to credit,

thereby increasing their ability to borrow to finance consumption. The increased use of credit cards, with their extensive credit facilities, is one example of this innovation. A second example is home equity loans, which have allowed households to tap wealth that was previously illiquid. These innovations have come on stream steadily and have been gradually and continuously diffused into the economy. This long and steady process has been a critical factor explaining how demand problems have been kept at bay. Indeed, the continuing importance of home equity loans has been shown in the current recession, and may help explain why it has been so mild. With housing prices remaining robust throughout the recession, households have been able to access home equity loans to sustain consumption spending despite job losses.

The second important feature of Figure 6 is that it shows that the debt-to-income ratio rose rapidly in the 1990s. Borrowing has therefore risen faster than income, and this at a time when national income has been rising rapidly. In 2000, the debt-income ratio was 1.02, which is 22 percent higher than its previous cyclical peak of 0.834 in 1989. The scale of the increase suggests that households may now be approaching their debt ceiling ratios, and this promises to put a stop to using debt-financed consumer spending to compensate for the deteriorated underlying aggregate demand generation process.<sup>9</sup>

Figure 6 provides data on the economy average debt-income ratio. This average ratio may conceal deeper problems. Household sector saving can be decomposed into two parts:

$$\begin{aligned} \text{household saving} &= \text{saving of creditor households} \\ &+ \text{saving of debtor households.} \end{aligned} \quad (4)$$

In effect, there are two types of households—financially affluent households and financially strapped households. The former have positive savings, whereas the latter have negative saving and borrow from the financially affluent. Financial distress in the strapped group of households may be much more advanced than is suggested by aggregate numbers.

Evidence for this proposition comes from the Federal Reserve's 1998 Survey of Consumer Finances (2000). Table 2 decomposes the results

<sup>9</sup> The exact level of this ceiling is impossible to predict, as the ceiling has risen with every cycle, owing to the gradual diffusion of financial innovations within retail financial markets, which has more and more households taking advantage of them. It is this type of change that makes forecasting business cycles so difficult.



**Table 2**  
**Household debt distribution by income**

Household type	Average income (\$)	Average debt (\$)	Average mortgage (\$)	Average other debt (\$)	Debt share (%)	Mortgage share (%)	Other share (%)	Debt/ income	Mortgage/ income	Other/ income
Less than \$50,000 (66.2% of households)	23,090	68,918	36,305	32,614	46	45	48	2.98	1.57	1.41
More than \$50,000 (33.8% of households)	112,232	157,681	87,417	70,264	54	55	52	1.40	0.78	0.63
					100	100	100			

*Source:* Author's calculations based on Federal Reserve 1998 Survey of Consumer Finances



of the survey into households earning less than \$50,000 and households earning more than \$50,000. For households earning less than \$50,000, the debt-to-income ratio was 2.98; for households earning more than \$50,000 it was 1.40. In 1999, the median family income was \$48,950. Putting the pieces together indicates the divided state of household sector finances. The top half of households have debt burdens that are unproblematic, but the bottom half have heavy burdens.

Two important implications follow. First, interest rate cuts may be relatively ineffective in stimulating consumer borrowing because the top half of households are not liquidity-constrained and have little demand for new borrowing. Side by side, the bottom half of households are constrained, but credit risk is more important than the cost of wholesale financial funds in setting their interest rates. This means that the marginal impact of Federal Reserve interest rate cuts is likely to be small. The second implication is that reducing debt burdens to create the conditions for another expansion of consumer lending could take considerable time, and during this period of transition the economy is vulnerable to a vicious circle of lending contraction—which is the twin of the recent virtuous circle of lending expansion. Thus, a contraction of income causes an increase in the debt-income ratio, which lowers lending and income, thereby further raising the debt-income ratio. This is the model of the debt-driven business cycle presented in Palley (1994).

Finally, an interest rate mechanism that has been critical in spurring household-consumption spending is mortgage refinancing. This has reduced household interest burdens, freeing income for consumption spending. The last 20 years have witnessed a steady secular decline in mortgage interest rates. The average annual rate on a new 10-year mortgage peaked at 15.14 percent in 1982, and then fell to 9.19 percent in 1988. There was a small increase back to 10.13 percent in 1989 as the Fed tightened, but the rate then fell in fairly steady fashion to 7.04 percent in 1999, and in 2001 it was 7 percent.<sup>10</sup> This secular decline in long-term rates, driven by disinflation and the unwinding of the Fed's earlier tight monetarist positions, has made for a steady stream of mortgage refinancing waves. Each wave has served to relieve the household sector, helping sustain consumer spending. When faced by aggregate demand weakness, the Fed has simply had to lower interest rates, thereby triggering a new refinancing wave.

<sup>10</sup> *Economic Report of the President*, p. 406, February 2002.

Now this process of disinflation-based mortgage refinancing may be exhausted. Mortgage interest rates have been around 7 percent for the last four years, and getting further significant stimulus will require them to fall to around 6 percent. This is certainly feasible, and could happen if there is a significant lasting economic downturn. However, initially, credit markets stand to be resistant as inflation expectations will have to adjust down. Thus, the mortgage interest rate response may be slow in coming, as was the case in 2001, when long-term rates remained essentially unchanged even as short-term rates plummeted. Second, with many households now heavily extended through home equity loans, many will find it difficult to refinance. Third, with housing prices at record levels, a downturn could impose equity losses on many homeowners, and this too will make refinancing problematic. In sum, though there may exist room at the margin for some further mortgage-refinancing stimulus, this mechanism is likely to be less powerful than in the past.

### **Investment exhilarationism**

An examination of the household sector shows how reduced saving rates and increased consumer borrowing have been important factors offsetting the negative demand effects of worsened income distribution. A second important factor has been increased investment spending, which has risen steadily over the course of the 1990s. Investment spending as a share of GDP bottomed at 13.4 percent in 1991, but then rose to 18.4 percent in 2000. Two principal factors can be identified with this rise—one systemic, the other temporary—and both are riven by contradiction. This suggests that any further increase in the investment share is unlikely.

On the temporary side, the rise in investment spending in the second half of the 1990s was helped by the exuberance promoted by “New Economy” chatter. An examination of the record of investment spending shows a dramatic acceleration in 1997 of spending on equipment and software. This acceleration transformed what had previously been a subpar business cycle expansion into a record expansion. However, the exuberance that drove this spending had the hallmarks of a bubble, and it has now become evident that translating new economy developments into private profit is a difficult task. With the bursting of the bubble’s expectations and the stark realization about the difficulties of turning new economy developments into profits, growth of investment spending on equipment and software has fallen dramatically and has actually turned negative. The new conditions suggest that it will be hard

to maintain existing levels of investment spending, let alone grow them, and this points to an urgent need for new sources of aggregate demand generation.

On the systemic side, the rising investment share of GDP has also been driven by the rising profit share and rising profit rates that were documented in Table 1. These favorable capital income trends have increased incentives to invest, and they correspond to a regime that Bhaduri and Marglin (1990) term “exhilarationist.” In such a regime, rising profitability spurs an increase in investment that more than compensates any reduction in consumption spending attributable to worsened income distribution. However, the critical unknown is whether exhilarationist regimes (high profit rate/high profit share) are permanently sustainable, or whether the initial rise in investment and profit rates eventually peters out. This can occur if the worsening of income distribution—be it the result of a shift to profits or a shift within the wage distribution to upper income groups—results in a situation in which there is insufficient aggregate demand to absorb the additional capacity created through new investment. At this stage, excess capacity would begin to emerge, competitive pressures would start to erode profit rates, and investment spending would be scaled back. The extensive presence of excess manufacturing capacity both domestically and internationally suggests that this could be happening.<sup>11</sup>

#### *The role of the stock market*

The stock market boom of the last 20 years has been another prominent feature of the U.S. economy and it has played an important role in explaining both the declining saving rate and the strength of investment. In January 1980, the Dow Jones index stood at 904, and by January 2000, it had reached 11,281. This tremendous increase in stock market values has provided another mechanism for compensating the negative aggregate demand effects of deteriorated income distribution. Moreover, the fact that the stock market has risen almost uninterrupted for 20 years again serves to illustrate the long time period over which these demand compensation mechanisms can operate. However, as with consumer indebtedness, there are now indications that this mechanism may also be exhausted, with the market hitting a valuation contradiction. Even if corporate earnings are sustained, current price–earnings ratios look

<sup>11</sup> As of March 2000, total U.S. industry capacity utilization was 82.25 percent, and U.S. manufacturing capacity utilization was 81.6 percent.



rich, and the picture only gets worse if earnings start to fall because of deficient demand.

A second reason the stock market is unlikely to provide price appreciation on the scale enjoyed over the last 20 years is that part of earlier rise in prices was due to a change in portfolio preferences. This had households shifting their wealth into stocks, and this shift was reinforced by changes in pension arrangements, which had firms shifting from defined benefit to defined contribution arrangements—such as 401(k) plans. Both of these shifts increased demand for stocks, and drove up prices. However, both are also of a non-repeatable nature, and cannot therefore drive future stock price appreciation.

The increase in stock market prices has positively affected consumption spending through three channels—a wealth effect channel, a confidence channel, and an expectations channel. The wealth effect is the most widely recognized channel, yet it may in fact be the least important.<sup>12</sup> The wealth effect has rising equity prices contributing to greater household wealth, thereby encouraging households to consume more and save less.<sup>13</sup> This effect has likely grown in size given the extensive shift in the composition of household portfolios, which has resulted in more households owning stock. Moreover, this shift has been amplified by the spread of 401(k) saving plans and by the shift in pension arrangements toward defined contribution plans away from defined benefit plans. Both of these arrangements contribute to households directly owning more stock, and they also encourage households to view pension wealth as if it were standard private wealth. However, despite these changes, equity ownership still remains enormously concentrated at the top end of the income distribution, and for this reason it is unlikely that the wealth effect has been the main channel of transmission of a stock market effect.<sup>14</sup>

The second channel is the “consumer confidence effect,” which has consumers interpreting a rising stock market as an indicator of robust

<sup>12</sup> It is important to distinguish between the “stock market wealth effect” and the “property market wealth effect.” Whereas the aggregate impact of the stock market wealth effect has likely been small, the impact of the property market wealth effect has been huge. The evidence of the impact of property wealth on consumption is evident in home equity borrowing. Rising home prices have allowed consumers to take out home equity loans that have then financed consumption spending.

<sup>13</sup> Saving less also includes borrowing more since borrowing constitutes a form of negative saving.

<sup>14</sup> In 1998, the top 10 percent of households owned 86.1 percent of all common stock, including pensions (Mishel et al., 2000, p. 265).

real economic conditions. Whereas the household wealth effect is restricted to operate only on households who own equities, the consumer confidence effect affects all households. Consequently, its impact can be far more widespread.

The third channel is the “stock market expectations effect.” This has households extrapolating current price gains into the future, leading them to believe that their future wealth will be significantly larger. Even households with small current holdings of equity can be significantly influenced by the expectations effect, and this means it can also be widespread. Thus, low wealth households, believing that their small holdings will multiply in value over time, may increase consumption and reduce saving now.

Whereas the wealth effect is a stock market “price level” effect, the confidence and expectations effects are driven by the “rate of change of stock prices”—that is, they depend on a rising stock market. This is a critical distinction. The latter two effects are probably the most significant because of their application to all households, and not just the wealthiest, but they require a steadily rising stock market. It is this feature that ultimately generates contradiction, since stock prices must eventually get pushed to implausibly high valuations. Once equity prices stop rising (note they do not even need to fall), the stock market confidence and expectations effects can even kick into reverse.

Finally, in addition to affecting consumption spending, the rising stock market may also have influenced aggregate demand through its effect on the cost of capital. The logic here is that rising stock prices lower the cost of equity capital, thereby encouraging firms to finance increased investment spending with new equity issues. This investment channel may have been particularly important in the information technology sector, which was marked by a tidal wave of initial public offerings (IPOs). However, even here it may not have been the cost of equity capital *per se*, but rather the irrationally exuberant expectations about the payoffs to new technology investment.<sup>15</sup> With these expectations now revealed as unjustified, investment in the new technology sector and stock prices of new technology sector companies have collapsed together.

All of these channels have enabled a rising stock market to help compensate for deterioration in the underlying demand generation process. However, for reasons discussed earlier, the stock market is unlikely to

<sup>15</sup> To the extent that investors had wildly optimistic expectations about future profitability in the new technology sector, the cost of equity capital (measured in terms of expected future profits given away) may even have been quite high.

repeat its past price appreciation, and it even risks price declines. This means that the stock market is also exhausted as an engine of demand compensation.

### **The trade deficit and the budget surplus**

Whereas reduced household saving rates, increased household indebtedness, and a rising stock market have contributed to maintaining aggregate demand, the worsening of the U.S. trade deficit has contributed to draining aggregate demand out of the economy. However, just as there are doubts about whether the above processes of demand compensation can be maintained, so too are there doubts whether the trade deficit leak can be plugged in a non-destabilizing fashion.

For all of 2000, the United States ran a current account deficit of \$435 billion, or 4.4 percent of GDP. On the surface it would appear easy to plug this demand leak by simply reducing imports. Here, the goal is to bring about a reduction of imports through expenditure switching (that is, shifting spending toward domestically produced goods). Lowering the exchange rate to accomplish this would seem the easiest way to accomplish such switching, but it is in fact problematic. First, a lower exchange rate stands to raise imported inflation, and this risks an errant Federal Reserve interest rate response. Second, a lower exchange rate and reduced U.S. imports stand to reduce global demand and trigger recession in the rest of the global economy, which in turn risks feeding back and amplifying the demand shortage in the U.S. economy. Over the last two decades, the United States has taken on the role of “buyer of last resort” for the global economy. Ending this role risks major global disruptions, particularly since the International Monetary Fund (IMF) and the World Bank have pushed developing countries to pursue development strategies predicated upon export-led growth. Putting the pieces together, it is unlikely that the United States can look to its external account to be the engine of demand growth. Instead, considerations of the external account actually show how contradictions in the aggregate demand generation process extend into the global economy.

The federal budget surplus has been another major source of demand leakage. In 2000, the total federal surplus was \$236 billion, or 2.4 percent of GDP. Tax cuts and increased defense spending in 2001, combined with the automatic stabilizer design of the fiscal system, have eliminated this surplus and pushed the budget into approximate surplus. From a macroeconomic policy stance, these developments have been welcome and have helped mitigate the depth of the recession, and point

to the continued efficacy and relevance of fiscal policy. But here too there are policy risks owing to continued flawed understandings of the economic impact of budget surpluses. In particular, most economists continue to argue that deficits are bad because they decrease national saving and capital accumulation, whereas surpluses do the reverse. Such thinking has elevated surpluses as a goal of policy, and this thinking is most deeply reflected in the commitment to pre-fund Social Security through large surpluses that will continue for almost two decades.

Although current political and economic conditions have reduced the budget surplus, the underlying misunderstanding remains intact. This gives rise to the following danger. In the event of a prolonged economic slowdown, the surplus is likely to start automatically and rapidly disappearing owing to falling incomes and tax receipts. At this stage policy-makers may try to protect the surplus by cutting spending and raising taxes, and evidence of the likelihood of such a response is provided by repeated discussions about spending triggers linked to deficit outcomes. Such a reaction would effectively reduce aggregate demand at a time of demand shortage, thereby amplifying the downturn.

Moreover, even if this worst-case scenario does not materialize, fiscal policy still looks to be calibrated to exert significant fiscal drag. Thus, the 2003 Bush administration budget (released February 2002) treats 4.9 percent unemployment as full employment, and has budget policy calibrated to produce small rising surpluses at this benchmark. This means the economy stands to face a systematic head wind if it attempts to push below 4.9 percent unemployment.

### **Conclusion: economic policy in the contradicted economy**

The 2001 U.S. recession has been demand-driven. The dominant view among economists is that the recession is a passing problem, and that there is nothing wrong with the economy's underlying demand generating process. However, this paper has argued that the recession reflects considerably more intractable structural problems associated with the process of aggregate demand generation, and these problems are directly related to the severe worsening of income distribution that has taken place over the last 20 years.

The aggregate demand effects of the worsening of distribution have been kept at bay over two long business cycles through a number of mechanisms—reduced household saving rates, increased household borrowing, a rising profit share that has stimulated investment spending, and a prolonged stock market boom. The demographics of the “echo”

baby boom have also helped. These combined mechanisms have been so powerful that they have even at times been capable of creating conditions verging on excess demand. However, the ending of the “Great Expansion” of the 1990s suggests that these mechanisms are approaching exhaustion, and the dangers posed by this exhaustion are compounded by the deflationary stance of fiscal policy and the intractable nature of the U.S. trade deficit. Together, these considerations suggest that the U.S. economy is entering a period when systemic demand shortage is likely to be the major difficulty.

The underlying policy problematic concerns how to restore a solid basis to the aggregate demand generation process. Tackling this problem involves the huge task of confronting the misguided intellectual understandings that now guide policy.

1. The easiest part of the problem is monetary policy where the Fed must be implement a regime of low real interest rates. But low interest rates are unlikely to be sufficient, as shown by Japan’s experience over the last half decade.
2. The problem of the federal on-budget surplus can be readily solved by a combination of tax cuts and spending increases. But here political conflicts intervene. The best policy would be a combination of immediate tax cuts aimed squarely at middle- and low-income households, and sustained spending to meet health, education, and infrastructure needs.
3. The problem of the off-budget Social Security surplus is deeply intractable with policy-makers of all stripes committed to pre-funding Social Security. Pre-funding, whether it be through private saving accounts or the publicly owned Social Security Trust Fund, exerts a deflationary drag.<sup>16</sup> The existing payroll-based Social Security funding system compounds the problem by imposing job costs that amplify corporate incentives to shift jobs offshore. This suggests turning to a pay-as-you-go-system that is partially funded out of general revenues.
4. Just as it is important to remedy the drag imposed by the budget surplus, so too, there is a need to remedy the drag imposed by the trade deficit. The contradictions inherent in a trade strategy exclusively focused on import reduction suggest that the solution is to

<sup>16</sup> Both private and public pre-funded systems exert a deflationary drag, but public systems have a range of other advantages associated with collective insurance and intergenerational income insurance (Palley, 1998b).

increase world demand growth, and thereby raise demand for U.S. exports. However, expanding global demand and trade does not mean more NAFTA-style trade agreements. Instead, it means new development policies that pay attention to income distribution, and a new international financial architecture that provides stable flows of development capital. Such measures can allow developing countries to consume an increasing share of the goods they produce, while still retaining access to financial resources to fund their growth and development.

5. In addition to a pro-growth global economic agenda, there is also a need to remedy the overvalued dollar problem (Palley, 2001). The appreciation of the dollar over the last five years has directly affected U.S. manufacturing, which has been at the epicenter of the current recession. The U.S. economy has been the locomotive of the global economy, but the strong dollar has been cannibalizing that locomotive by undermining manufacturing jobs and investment. A gradual depreciation of the dollar, coordinated by the world's major central banks, can reverse this development without imposing financial disruptions. At the same time, it will bring terms-of-trade benefits to the rest of the world, which increase standards of living and alleviate burdens associated with servicing dollar-denominated foreign borrowing.
6. Each of the above measures can contribute to alleviating the underlying demand problem. Yet, at the end of the day, there is a need to repair U.S. income distribution. In particular, the traditional focus on the functional distribution of income (profits versus wages), but exclusive focus on profits is too narrow. A healthy profit rate is good for investment and growth. U.S. profit rates are up and may have gotten a little out of line, warranting some downward reduction. But they are not steeply out of line, either historically or internationally. The real problem is the distribution of the wage share, which has shifted to upper income corporate managers and professionals at the expense of nonsupervisory and production workers. Remedying this calls for rebuilding the institutions that gird the labor market, including the minimum wage and union density. However, in today's globalized economy, these domestic institutions must be accompanied by core labor standards that can gird the new global economy.

The above set of policy prescriptions is summarized in Figure 7. Policymakers face choices regarding macroeconomic and microeconomic

**Figure 7** The macroeconomic–microeconomic policy matrix

	Level playing field labor markets	Business-dominated labor markets
Expansionary macropolicy	A. Sustainable Growth	B. Unsustainable Growth (U.S.)
Contractionary macropolicy	C. Stagnation (Europe)	D. Deep recession

Source: Palley (1998c).

policy variables. The U.S. economy is currently positioned in box B—unsustainable growth. The European economy is positioned in box C—stagnation. Policy stands at a critical juncture. Failure to repair the damage done to income distribution risks setting in train a process of aggregate demand contraction that could force the economy into prolonged and deep recession. The needed policy mix is that described in box A (expansionary macroeconomic policy, level playing field labor markets), which produces sustainable growth. The challenge is getting there in the face of an economics profession and public understandings that lean to box D.

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