The Return of Private Sector Deficits

Will They Sustain the Post-Pandemic Recovery?

ECONOMIC DEMOCRACY INITIATIVE

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- In the last two years, the private sector in the US experienced both its largest surpluses in the postwar era and their fastest evaporation.
- These surpluses were supported by government transfer payments, interest income, and government subsidies, and not by government investment or direct purchases of new goods and services.
- The rapid fiscal contraction over the last year has shrunk the government deficit to levels consistent with those observed prior to past recessions.
- The corresponding return of private sector deficits and increase in the current account deficit were well underway before the Fed began tightening.
- High interest rates have not yet slowed down consumer credit, nor do they prevent the government from relaxing its fiscal position.
- An increase in public sector deficits is likely necessary - but improbable - to produce a soft landing, stop the deterioration in private sector balances, and prevent a possible recession.
- While all eyes are on the Fed, macroeconomic trends will largely depend on the shifts in the private, public, and rest-of-world sector balances.
- Absent meaningful fiscal action, the fate of the recovery has become contingent on the private sector's continued willingness to draw down its savings and take on more debt, at a time when interest rates are rising.

Recent gains in US economic growth and employment have become more and more on the willingness of the private sector to spend in excess of its income. If history is any guide, this makes for a fragile recovery. Private debt-fueled growth cycles do not end well. With a slowdown in economic growth across much of the rest of the world and little prospects of a more accommodative public sector balance, private sector deficits will be needed to sustain the recovery. Yet this requires the private sector – households in particular – to continue dissaving and go further into debt.

We've seen this story before (Godley & Wray 1999). The US economy experienced record private sector deficits in the late 1990s and early 2000s. In both cases, recessions followed. The structure of the US economy is biased towards exactly these sorts of recoveries. As the importer-of-last-resort, current account deficits are baked into the workings of the US economy. Whatever benefits imports may have, they do constitute a spending leakage. If not adequately offset by public deficits, growing US current account deficits will push private sector balances into the red.

The immediate fiscal response to the pandemic supported private incomes. The recovery generated ever-higher tax revenues, drawing down private sector balances in the process. These dynamics are a testimony to the broad-based effectiveness of the public sector's pandemic response, but the rapidly declining rate of government spending and smaller resulting government deficits have become a drag on economic growth. As a result, the recovery's momentum is increasingly dependent on deficits in the *private* rather than the *public* sector.

To be clear, the deterioration of private sector balances has little to do with recent Federal Reserve interest rate hikes. The process was already underway well before the Fed began its tightening cycle in the Spring of 2022. Nor do rising interest rates in any way prevent policymakers from increasing public spending to offset the process of dissaving. This does not mean that interest rate policy is without consequences. In the face of increased private sector indebtedness, they will make a difficult scenario worse. But even if the Fed were to reverse course, or leave interest rates unchanged, the sharp contraction in the public sector balance over the past eighteen months is pumping the breaks on the current expansion.

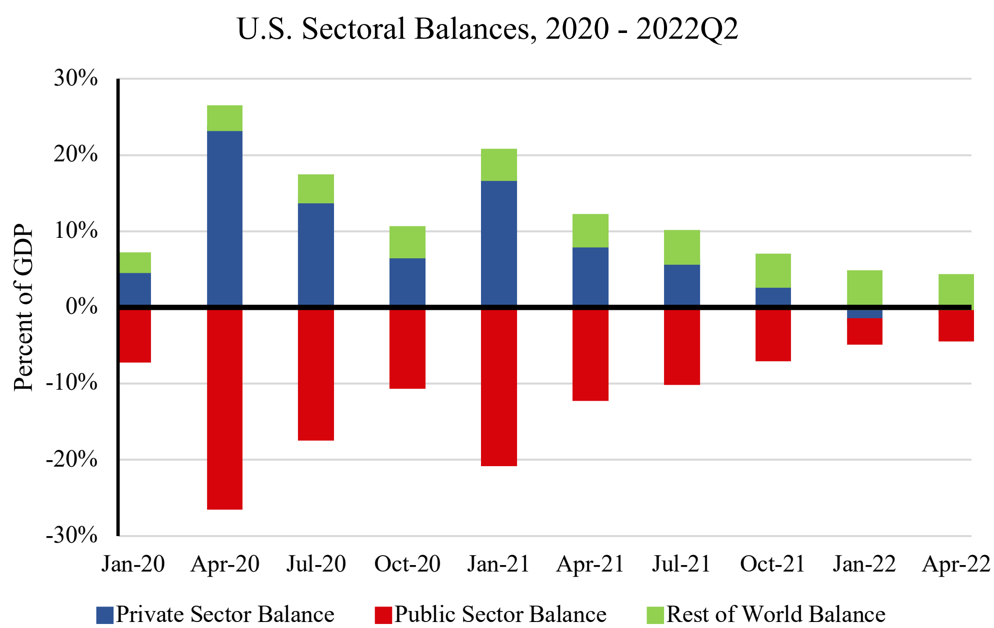
In the remainder of this note, we use a sectoral balances perspective to consider the sustainability of the current recovery. We caution that the recent trends of private sector deficits, if allowed to continue, will put the recovery on an increasingly precarious and unsustainable path. That process could carry on for some time. If there is any hope for a soft landing that averts a recession, we believe that greater fiscal support would be needed to temper the rise in private sector indebtedness. But we are not optimistic that such support will come in time.

U.S. Sectoral Balances over the Course of the Pandemic

The sectoral balances perspective summarizes the interrelated flows of spending and income across different sectors of the economy (Godley 1999). Since spending and income are equal at the macroeconomic level, it is impossible for any one sector to run a surplus (receiving more in income than it spends), without at least one other sector running an offsetting deficit (spending more than it receives in income). Surpluses in one sector are only possible if there are corresponding deficits in another.

Figure 1 below shows the private, public, and rest-of-the-world balances for the U.S. from the beginning of the pandemic in 2020 to the most recent available data for Q2-2022. During the second quarter of 2020, unprecedented public sector deficits generated record-setting private sector surpluses. Since 2021 however, in the face of sharp slowdowns in the pace of public spending, a steep rise in tax collections, and a growing current account deficit, private sector balances have fallen dramatically. Reductions in public sector deficits are causing private sector surpluses to fall. Over the first six months of 2022, the private sector surpluses disappeared altogether. *In the span of two short years, the private sector experienced both its largest surpluses in the postwar era and their fastest evaporation.*

Figure 1 U.S. Sectoral Balances as a Share of GDP



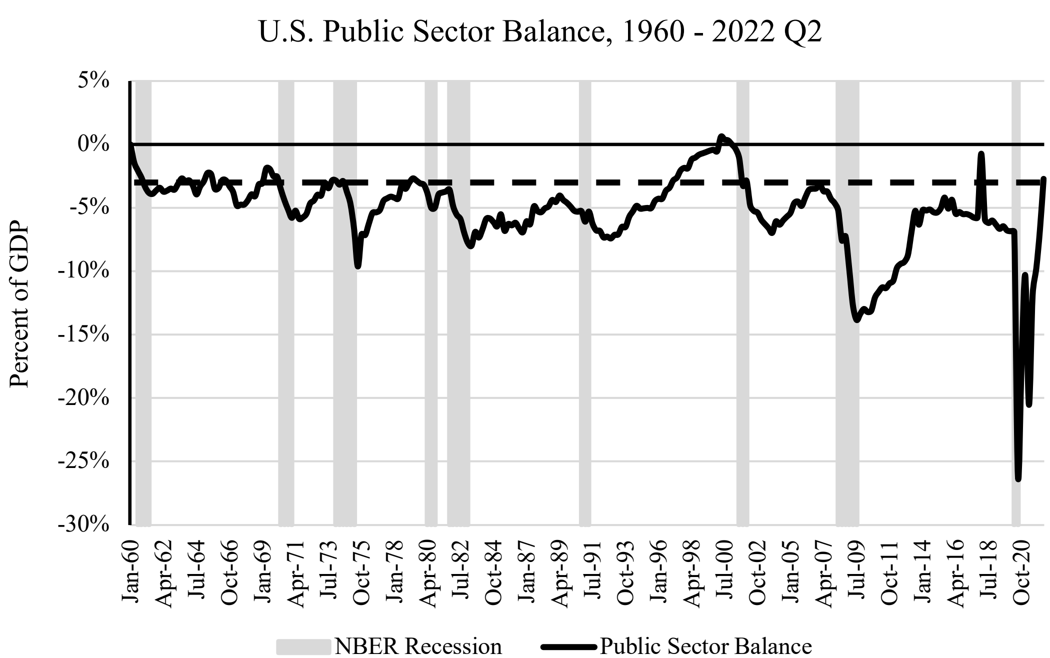
Source: Authors' calculations from Federal Reserve Economic Data (FRED)

The Public Sector Deficit

The size of the consolidated public sector deficit, composed of state, local, and the federal government, has rapidly decreased over the past eighteen months. Yet given its magnitude earlier in the pandemic and the fact that the public sector continues to run a deficit, it can be difficult to appreciate the scale and pace of their recent decline. Over the course of 2021 for example, public sector deficits fell from twenty-percent of GDP at the beginning of the year to less than seven percent of GDP by the fourth quarter. The public sector deficit continued to shrink over the first quarter of 2022, falling to below three percent of GDP.

Relatively small public deficits of similar magnitude (3 percent of GDP or less) have hardly been the norm over the past few decades. Nor have they proved to be long-lasting, save for the late 90s, as indicated by Figure 2 below. The dotted line in Figure 2 shows a public sector deficit of 3 percent of GDP. Over both expansions, first in the 1990s and then again in the early 2000s, public sector deficits shrank as Clinton's unprecedented budget surpluses ushered in a private sector debt bubble which grew well into the early 2000s. In both cases, recessions followed, automatic stabilizers kicked in, and large public deficits returned.

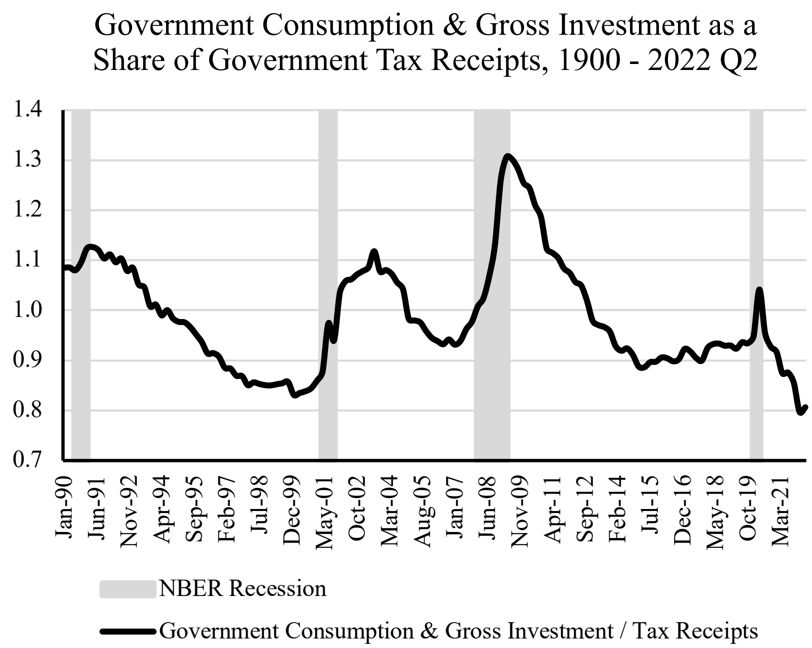
Figure 2 US Public Sector Balance as a Share of GDP



Source: Federal Reserve Economic Data (FRED)

The speed and magnitude of the fiscal contraction since 2021 is likely a far greater drag on the economy than the impact of rising interest rates on spending or investment. To get a sense of how the recent contraction in public sector deficits compares to previous recoveries, we compare two simple measures of net government spending. The first is the ratio of government consumption and gross investment to tax receipts. This measure is essentially the '*G*' component – government spending on newly produced goods and services – of GDP and is shown in Figure 3 below.

Figure 3 First Measure of Net Government Spending

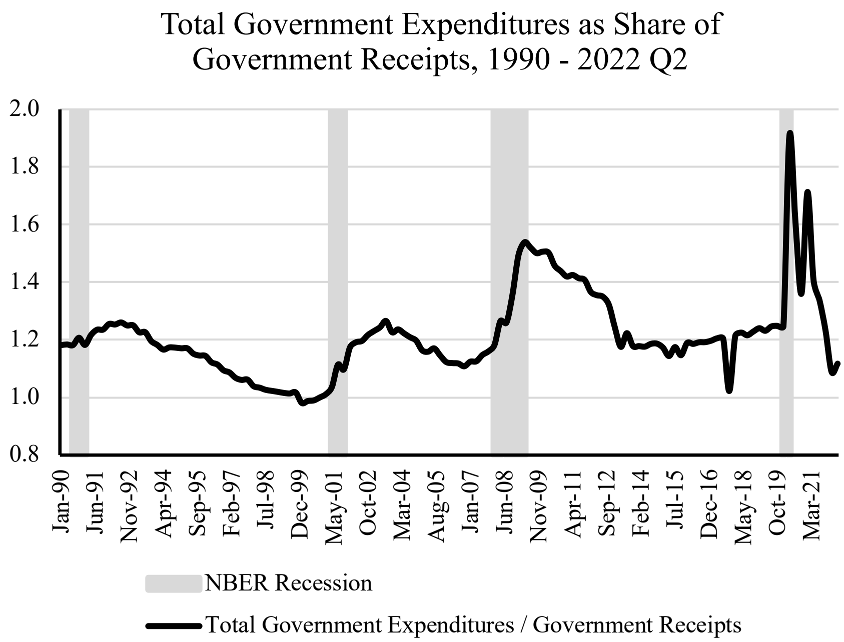


Source: Authors' calculations from Federal Reserve Economic Data (FRED)

The second measure is the ratio of total government expenditures to total government receipts. Unlike the first, it includes other types of government spending that are excluded from GDP, such as transfer and interest payments and subsidies to businesses. Figure 4 plots this second measure. Each measure gives a rough indication of the amount of government spending relative to the amount of income received by the public sector.

Both measures have declined sharply over the past two years, indicating that government spending has slowed considerably relative to government income. The first measure is currently at a historic low, even (slightly) lower than in 2000 when fiscal surpluses precipitated the 2001 recession. The second measure shows a similar trend. Although this measure is not currently as low as its value in the late 1990s, it has fallen from its historic highs two years ago back to values last seen in 2006, just before the 2007-09 recession. Comparing the two measures to one another shows that, *over the past two* *years, transfer payments, interest income, and government subsidies did the heavy lifting to sustain private sector surpluses rather than government investment or direct purchases of new goods and services.* As these former types of spending have receded over the recovery, their contribution to private sector incomes has collapsed to levels not seen since the era of Clinton's surpluses and the Great Financial Crisis. While there is no magic threshold beyond which a recession is imminent, when viewed from aa longer-term perspective, the fiscal contraction in the US is an increasingly concerning aspect of the current recovery.

Figure 4 Second Measure of Net Government Spending

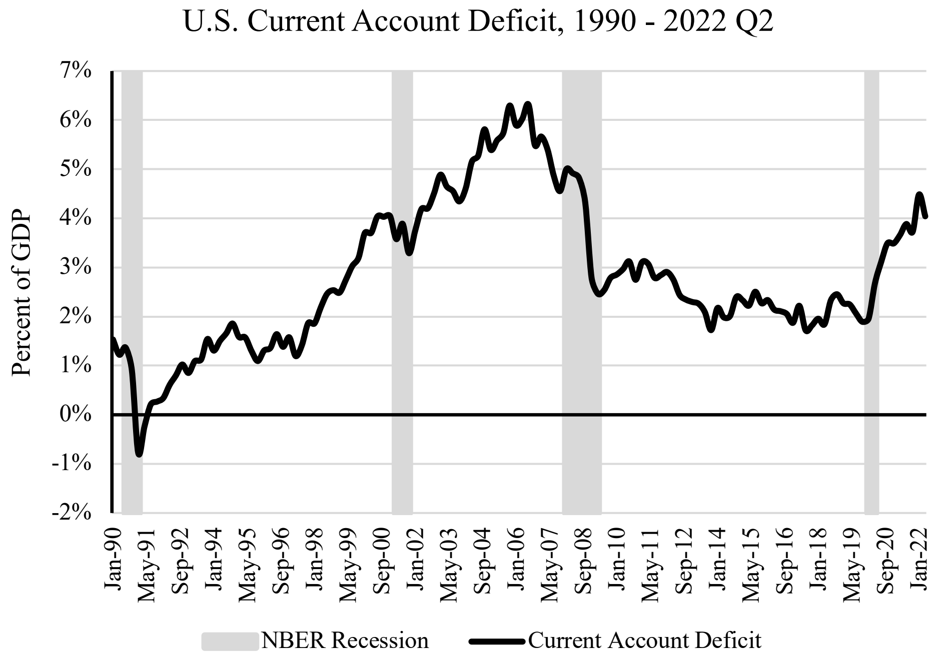


Source: Authors' calculations from Federal Reserve Economic Data (FRED)

Current Account Deficit

The current account deficit has roughly doubled over the two and a half years since the pandemic began. With a larger current account deficit, fiscal policy becomes even more important for stabilizing private sector balance sheets. While increased imports in the face of a stronger dollar may help reduce inflationary pressures, a widening current account deficit constitutes a substantial spending leakage. With economic growth slowing in most of the rest of the world, there is little chance that foreign demand for U.S. products would generate strong enough export growth to reverse the recent rise in the current account deficit. Energy exports from the U.S. to Europe, especially of natural gas, will most likely rise going forward as the continent faces a cold winter. But higher energy costs at home will also likely depress other discretionary spending, imparting another contractionary influence over the coming months.

Figure 5 US Current Account Deficit as a Share of GDP



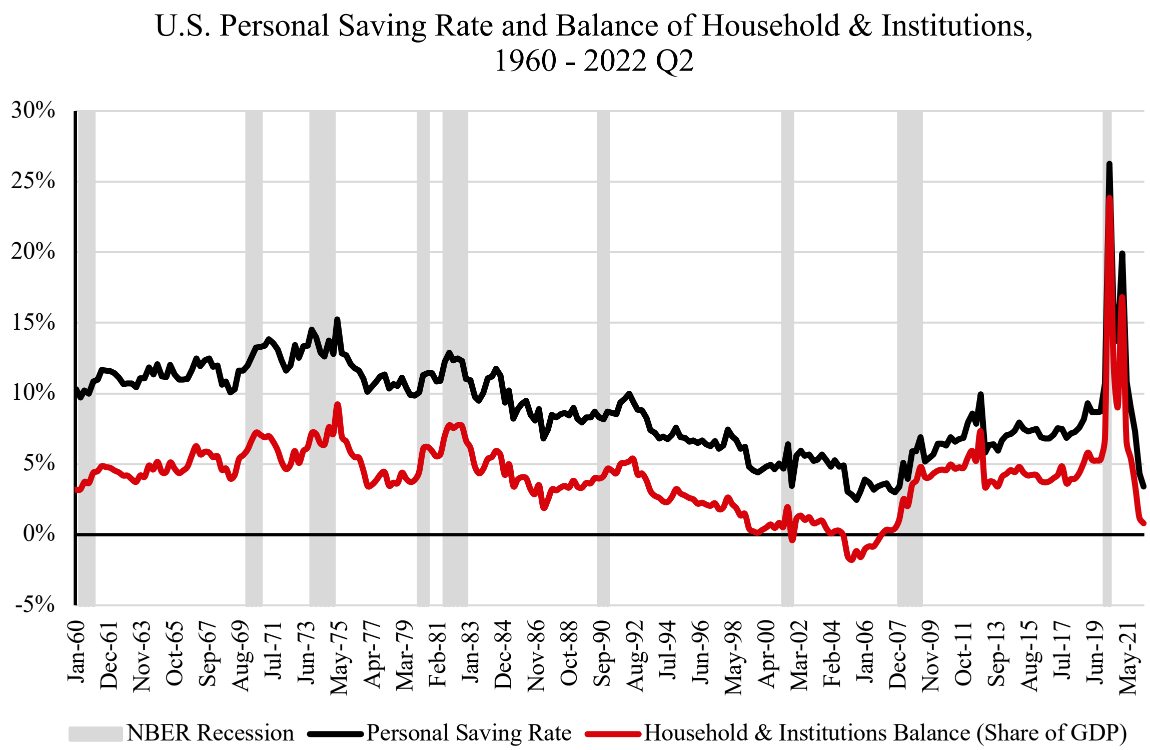
Source: Federal Reserve Economic Data (FRED)

Private Sector Dissaving and Rising Indebtedness

With a shrinking public sector deficit and a rising rest-of-world surplus, private sector deficits have returned. Private sector dissaving has quickened alongside increasing private sector borrowing. We consider the latest data on each. As Figure 1 showed, the large fiscal deficits from the public sector generated record-setting private sector surpluses as well at the start of the pandemic. As a result, the personal savings rate increased drastically.

Figure 6 below shows that the personal savings rate closely tracks the balance of households and institutions, a subset of the overall private sector balance. With a retrenchment in fiscal support, private sector spending, especially by the household sector, has been financed by drawing down the savings which were generated earlier by large fiscal deficits. This decline in savings has continued at such a rapid pace (which of course mirrors the fiscal contraction) that households have gone from record high personal saving rates to the very low rates last observed during the late 1990s and early 2000s in the span of just two years. In no other period on record has the decline been so large and so rapid. Each of these two periods, the late 1990s and early 2000s, saw large private sector deficits precede recessions.

Figure 6 Personal Saving Rate and Balance of Households & Institutions



Source: Authors' calculations from Federal Reserve Economic Data (FRED)

The behavior of the two series in Figure 5 also illustrates that at the macro level, savings rates are more dependent on income earned than on spending decisions. Absent an additional source of income, either from greater investment and employment or public sector spending, the personal saving rate will continue to fall.

The process of dissaving has been accompanied by an increase in consumer borrowing. With savings drawn down and no new source of spending from another sector likely to be forthcoming, households have quickly turned to borrowing. A report from the New York Fed published in August 2022 found that a steep $46 billion jump in credit card balances in the first quarter of 2022 made for the largest quarterly increase in credit card balances in over twenty years. The report went on to note that non-housing balances grew by $103 billion as well, a 2.4% quarterly growth rate and the largest increase since 2016 (Federal Reserve Bank of New York, 2022).

Over the past two years, there has been a close negative relationship between the personal savings rate and the growth in consumer loans. Earlier in the pandemic, when the personal savings rate rose quickly, in lockstep with additional public spending, the volume of consumer loans fell. To be sure, some of this decline was likely due to changes in bank sentiment as well. Faced with plenty of uncertainty, job losses, and social distancing policies, banks may have cut back on lending to households and individuals. But debt payment moratoria and fiscal deficits also allowed millions to pay down outstanding debt rather than take on more. As already discussed, falling public sector deficits are a primary cause for falling private sector savings. And as this wave of dissaving gains momentum, households will be continuing to borrow more. So far rising interest rates have not been a deterrent.

The increase in household borrowing does not necessarily mean that widespread defaults are just around the corner. By most measures, average loan quality is much higher now than in previous years. Delinquency rates are quite low by historical standards as well. Higher rates of inflation over the past year may also have somewhat eased the burden of older debts for many households as well. Altogether, these factors may provide more scope for the private sector to continue running deficits. But, as we have learned from the private debt boom in the 90s and 2000s, this process cannot last forever.

Conclusion

With a few exceptions (Papadimitriou et. al. 2022), a sectoral balances perspective is not receiving adequate attention in the current debates about the possibility of a soft landing or averting a recession. All eyes are on the Fed and consensus opinion will likely hold the Fed responsible for whatever economic changes lay ahead. By contrast, we believe that the macroeconomic trends over the next year would largely unfold as a consequence of changes in private and public sector balances.

The sectoral balances perspective shows that private sector deficits are now sustaining the recovery. Absent a change in the fiscal position, it can only continue if households continue to draw down their quickly dwindling savings and increase their indebtedness. Higher interest rates will certainly worsen this situation, but they are not its cause. Should a recession occur, we believe that fiscal policy should feature just as prominently in the post-mortems as monetary policy undoubtedly will.

Works Cited

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