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A sound fiscal plan can clear a path to prosperity

By Ricardo Caballero

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After months without a severe shock, almost every signal in the US now points towards an increase in confidence and economic activity. John Snow, Treasury secretary, has described the economy as a "tightly coiled spring" ready to jump. Is all this optimism justified?

The most optimistic forecasts see the recent downturn as a transitory fall in aggregate demand that is close to being resolved; the most pessimistic point to an excess of capacity caused by the exuberance of the 1990s that will take much longer to correct. My perspective is somewhat different. Like the pessimists, I think the uncertainties are mostly structural; however, I disagree that the problem is necessarily one of excess capacity and that the forecast is inevitably dark.

The critical question is whether the US economy can return to the speculative growth path of the 1990s. For this, two things must happen. First, the factors that drove the growth and asset valuations of the 1990s - technological progress and availability of funds - must be restored and maintained. Second, there must be space for structural adjustment. That is, the factors driving the 1990s-style growth still must imply additional long-term capacity.

Does the US really have a structural "excess capacity" problem at the aggregate level? Let us look at the numbers: the current capital-output ratio for the business sector is 1.36; this ratio probably would be about 1.22 if the 1990s boom had not occurred. Unused capacity is currently 26 per cent, compared with a normal level of about 15 per cent. The increase in excess capacity is of the same order of magnitude as the excess of investment (over normal times) during the second half of the 1990s. While pessimistic analysts would argue that these facts support their claim, I believe it to be a specious comparison; the correct comparison instead is between the current capital-output ratio and the long-run equilibrium ratio under plausible conditions.

If we follow the latter strategy, and assume that private saving remains at its (recent) historical levels, the conclusion is very different from that of the pessimists: the new equilibrium capital-output ratio should be about 1.6, well above the current 1.36. In other words, the 1990s boom still had energy when it was interrupted. What lies behind this jump in the long-run capital-output ratio? The accelerating decline in machinery prices, which is a consequence of technological progress in machinery-producing sectors. (Here I conservatively assume that the decrease returns to its historical trend, slower than that of the 1990s.)

But not everything looks so favourable. In the calculations above I assume that the sources of funding available during the 1990s remain in place. In particular, I assume that fiscal saving does not disappear and that external saving decreases only gradually. Are these assumptions warranted?

If all goes well, the external side is less complicated than is generally thought. The \$500bn in external financing that the US requires each year is a huge amount - but we are talking about the US at a time when the global alternatives are not very exciting or are too small to make a difference. Of course, the dollar may suffer turbulence in the medium run. This could happen if, for political reasons, the US keeps pressing China and other Asian economies to revalue their currencies; this would entail a fall in those countries' reserve accumulation, most of which is being invested in US government securities.

However, the real danger lies in the other source of funds: public savings. If the fiscal accounts - particularly for the medium and long term - are not improved, the whole benign equilibrium may collapse. In the capital output calculations above, I assumed balanced fiscal accounts. If we assume sustained fiscal deficits of 4-5 per cent of gross domestic product that are not compensated for by a one-for-one increase in private savings (which seldom happens), the new equilibrium capital-output ratio falls as low as 1.1. In this scenario, the pessimists are correct and the US has a large excess- capacity problem; the obvious corollary of this is a huge increase in the long-run interest rate.


The US economy is indeed a "tightly coiled spring", with plenty of growth potential - definitely enough for a very good second half of this year and beginning of next year, but also way beyond that. However, this opportunity will be squandered unless a much sounder fiscal path is credibly outlined soon.

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