

Bruce Greenwald on Structural Imbalances in the Economy

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April 24, 2012



Bruce Greenwald likes to say that he is constituted to disagree with everybody about everything, and he was true to his word at the recent Hyman P. Minsky Conference in New York. Taking immediate exception with the virtually unanimous characterization of the economic crisis as a balance-sheet recession, Greenwald, a professor of finance at Columbia University, argued that, far from being unusual, balance-sheet recessions can in fact be found at the heart of almost all business cycles.

Greenwald's talk reflected research he has done with Joseph Stiglitz, his colleague at Columbia and the 2001 Nobel Prize recipient in economics.

The upshot of Greenwald's talk was that, although we are technically out of recession, troubling structural imbalances remain and continue to drag down growth and employment. I'll discuss Greenwald's current sentiments more later, but first let's examine the general outlook that led Greenwald to his conclusions – his views, true to his contrarian image, are unconventional.

A Minskian view of recessions

Greenwald's view of recessions coincides with the outlook of Minsky – the late namesake of the conference at which he spoke, who was most famous for arguing that financial stability, fragility, and even crisis are all parts of the natural economic cycle.

Recessions occur in Minskian fashion, Greenwald argued as risk-taking ratchets up as euphoria grows, until the cyclical nature of expansion causes it to tail off. The gap between excess capacity and demand widens, and businesses begin to pay the costs of overleveraged balance sheets. Equity profit-taking accelerates the cycle's turn, eventually triggering panic and significant market sell-offs.

The classic Minsky recession, therefore, is a short sharp recession followed by a long, slow recovery. Companies reduce investment in working capital – physical plant, equipment, and hiring – which cuts output, Greenwald said. Over time, losses slow and cash flow improves as balance sheet health gets restored. Then, according to Greenwald, as firms recover and get better recapitalized, they look to sail close to the wind again, until the next shock occurs.

This is why recessions will always be a fact of life.



But hold on. Is this crisis – marked by protracted high unemployment, even as corporations have gotten healthier and accumulated soaring cash reserves – a Minskian balance sheet crisis?

Greenwald concluded no. “There is something much more striking going on,” he said.

When the driver can't steer

Since 1990, Greenwald said, traditional monetary policy has no longer helped the economy get out of trouble. “If the problem is fixing balance sheets, what policy has to do is to provide equity, either directly or indirectly through banks,” he explained. But a major change in Fed open market operations has weakened the effectiveness of monetary policy. Prior to 1970, according to Greenwald, demand deposits were zero-interest-rate sources of funds for the banking system that never shrank. In other words, they effectively represented equity capital for banks, and Greenwald said that in the 1960s you could see a clear correlation between changes in M1 and nominal GDP growth – as bank balances grew, so did the economy. The repeal of the ceiling on demand-deposit interest took place in several steps over the course of the late 1970s and 1980s.

But when the policy of zero-percent interest rates was scrapped in the 1980s, money supply growth no longer had as visible an effect on economic growth. So while Alan Greenspan was receiving accolades for the way he was managing the economy, Greenwald argued that the then-Fed Chairman was in fact “irrelevant.”

“When he got in the driver’s seat,” Greenwald quipped, “the steering wheel had been disconnected from the wheels.”

Going the way of the farm economy?

The second point Greenwald made was even more profound. He looked at the last time the US economy enjoyed full employment, between 2005 and 2007. He credits that state of affairs, he said, to a zero-percent household savings rate that held up aggregate demand – hardly a sustainable state of affairs, Greenwald and most other economists would agree..

Prior to the financial crisis, Greenwald said, the top 20% of household breadwinners generated at least 40% of the income, saving about 15% of what they earned. That translated to only a 6% saving rate across the economy, however, as the bottom 80% of households, who had the remaining 60% of the income, were spending 110% of their income every year to sustain a modicum of full employment. This level of saving and spending could not generate strong growth over the long term.

“That doesn’t look like a financial crisis,” claims Greenwald, “but more like a sustained, real imbalance.”



To identify the source of that imbalance, Greenwald looked back to the Depression.

In the 1930s, when 35% of the country's population was in the agricultural sector, Greenwald said America experienced a structural convulsion comparable to what we're now going through. For many decades, farming had enjoyed annual productivity growth of 4-5%. But this was colliding with demand growth of only 1-2%. After World War I, prices were on a downward trajectory, a trend that the Depression cemented.

Structural change did not occur until World War II, when farmhands were literally forced off the land and into cities – what Greenwald called an “inadvertent but brilliant industrial policy.” The relocations spurred a manufacturing boom to support the war effort and started the accumulation of consumer purchasing power. All this led to a virtuous, self-sustaining cycle that continued well after the troops came home, when there was enough urban demand to keep people in the cities.

Today, Greenwald argued, manufacturing is dying for the same basic reasons that signaled the demise of the farm economy: productivity growth is running at 5-6% a year, while annual demand is only growing 2-3%. This is true in various nations – Japan, China, Korea, and Germany – which are fiercely competing with one another, abetted by flexible exchange rates – all believing that successful economies are based on making things.

What it means for today

As a result, today competition and enhanced efficiencies are driving prices lower and eroding the manufacturing sector's worldwide economic viability.

The other result is that surpluses in China and elsewhere must eventually be invested in dollars, which systematically drives down interest rates. “The availability of that money creates the bubbles and financial difficulties that ultimately lead to the collapse of financial markets,” Greenwald said.

In this context, Greenwald explained, “if we are importing 9% more of our GDP than we are exporting, it is very difficult to sustain full employment. And in a slow-growing economy where productivity growth [in general] is running between 2-3% a year, unemployment will increase.” In a 2009 [interview](#), Greenwald said the true unemployment rate would trend toward 15%. The true unemployment rate is currently over 13% and did exceed 15%. It is computed by taking 67% of the population from 16 to 65 (the usual fraction in the labor force) in good times, dividing by employment from the household survey, subtracting from one and then adding the fraction of that ideal labor force working part time that want full time jobs. Current participation is about 63.5% way below 67%, the difference being workers who have left the labor force, according to Greenwald.

“While we've [since] fixed the banks,” explained Greenwald, “the fundamental economic imbalance hasn't gone away, which is going to mean slow growth.” He posits that the long-term solution is to shift people out of manufacturing into industries that will continue to



enjoy strong demand, such as health care, education, and financial services. Those sectors, he said, have strong long-term growth prospects, although not necessarily over the short term. In addition, he said these shifts need to take place in the chronic export-oriented economies (China, Japan, Germany, Korea et al.) more than in the US.

Greenwald didn't discuss the role infrastructure investment could play in structurally addressing the country's core deficiencies. Many economists contend that much-needed repair and expansion of US roads, bridges, rail, and energy networks could spur the next great wave of economically sound job creation.

The end of manufacturing?

Greenwald, on the other hand, is skeptical that government intervention can do nearly as much; he's focused on demand. If the US trade deficit is not reduced, Greenwald said, he doubts the American consumer will be able make up the difference.

"If you look at spending data for households – disposable income, expenditures, and consumption – the difference between expenditures and consumption is largely what households pay for financial debt. There has been an enormous reduction in that, as US households have largely deleveraged. But savings rates still have not gone back to zero."

Greenwald said that when countries try to dominate a dying sector like manufacturing, they must do it through exports. "Until people make the transition to services," he explained, "we will have a chronic deflationary bias, because they are all trying to export their way to health – which will drive prices lower. Nobody is talking about this. Manufacturing jobs are not going to survive, especially here in the US."¹

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¹ An interesting contrast to Greenwald's point can be seen in a special section about manufacturing and innovation in the April 21st issue of *The Economist*, entitled "A Third Industrial Revolution." "As the number of people directly employed in making things declines, the cost of labour as a proportion of the total cost of production will diminish too. This will encourage makers to move some of the work back to rich countries, not least because new manufacturing techniques make it cheaper and faster to respond to changing local tastes."

See: <http://www.economist.com/node/21552901>