Federal Deficit Prevents Profit Meltdown
21 Aug 2009
David A. Levy

Economic forecaster David Levy contends that the private economy may have to rely on huge federal deficits to prop it up for the next several years because the private sector will have severe impediments to generating profits on its own.

Polls show little popular support for the huge federal deficits. Despite the massive flow of government red ink, the economy has experienced a severe recession with soaring joblessness, and it is easy to conclude that deficit spending has not helped. Easy, but dead wrong. Without huge deficits, the economy would have collapsed. Profits, the lifeblood of any private enterprise economy, would have given way to a net business sector loss (national income and product account basis), a situation far worse than anything witnessed since the Great Depression. Moreover, the private economy may have to rely on huge deficits to prop it up for the next several years because the private sector will have severe impediments to generating profits on its own, and without profits firms cannot stay in business and meet their financial obligations.

Measuring the impact of federal government deficits on GDP is a tough task, one that depends on difficult estimates of various multipliers. However, there is a more direct link between federal deficits and the economy: through aggregate corporate profits. Like GDP, profits are a key measure of the economy's health. The equation for aggregate corporate profits—an accounting identity—reveals that, all else equal, a decrease in government saving (increase in the deficit) will be matched by an increase in business saving, in effect profits. The reason: deficit spending directly or indirectly adds to business revenue without adding to business expense, leading to a bidding up of profit margins. (For an explanation of the sources of profits, see *Where Profits Come From*, available free at **levyforecast.com**).

For the most part, the economics discipline ignores the flows of funds that determine aggregate profits. But in simple terms, profits are the new wealth created in the economy (investment in the creation of new assets) less the shares of that wealth obtained by sectors besides business—personal saving, government saving, and foreign saving. In the second quarter of 2009, for the first time since the Great Depression, all of the profit sources combined excluding the federal government deficit appear to have been substantially negative. In other words, the federal deficit accounted for all of domestic corporate profits! If the economy seems poor now, imagine it without the government's huge injection of wealth (in the form of its own IOUs) through deficit spending.

Why did the nonfederal profit sources collapse? They were casualties of an implosion in private sector balance sheets. For decades, balance sheets—both assets and liabilties—have grown faster than incomes, creating an increasingly unstable financial structure. Soaring debt-income ratios and asset multiples were supported by a secular decline in interest rates and increasingly rosy rationalizations. But balance sheets became too big, and began to contract, and this time interest rates ran out of room to fall. Since the profit sources are closely tied to balance sheet expansion, profits tanked. Wealth creation plunged as investment crashed, and as credit dried up, the profit sources were largely choked off.

Looking ahead, it appears likely that profits will remain heavily if not entirely dependent on government deficit spending for most of the next several years. The only way the private economy would be able to generate significant profits on its own would be through a resumption of rapid expansion of private balance sheets. While theoretically possible, this scenario appears unlikely. The household sector has far more debt than it can handle under present circumstances, and home prices and construction cannot recover without mortgage borrowing. The nonfinancial corporate sector has record-high debt levels, and the financial sector is under numerous pressures to deleverage.

Like it or not, federal government deficits are likely to account for most of, if not all of, domestic corporate profits for the next several years. There are major challenges ahead, but at least we have not experienced the collapse of our economy, a calamity that could have been worse than that of 1930s. In the next few years, any efforts to trim the federal government's deficit would be damaging and possibly disastrous. Unfortunately, continued dreary economic conditions over the next couple of years and persisting unemployment problems may lead many people to conclude that the federal government's large deficits have failed to address the economy's problems. They will have little way of knowing that without the deficits, the economy would have been severely worse.

David A. Levy*, Chairman and Director of the* ***Jerome Levy Forecasting Center****, is a leading expert in applying the Profits Perspective to economic analysis, with over 30 years of professional forecasting experience.*