Z.1 Flow of Funds Analysis

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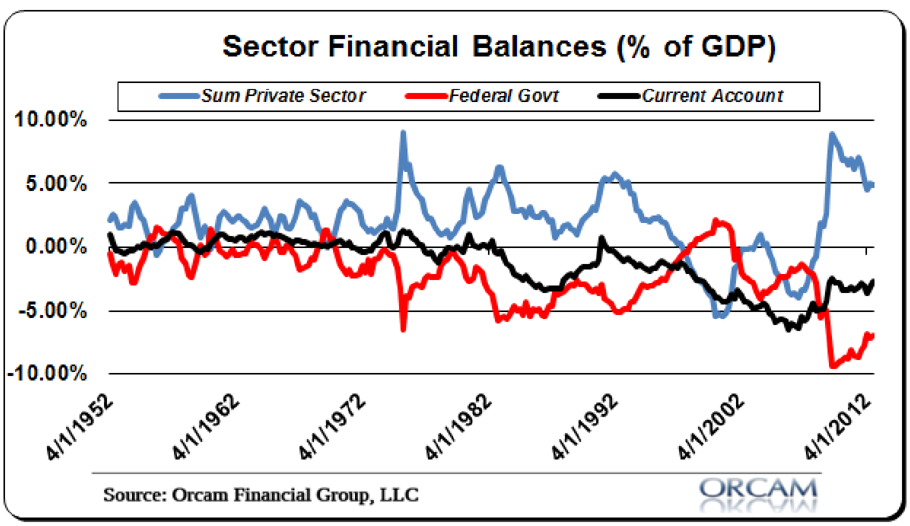
Viewing the Macroeconomy Through Flows

I often talk about how understanding the "direction of the tide" is all about understanding flows in the economy. That is, the money system is basically one big system of flows not unlike the human body. When the flow is consistent the system is getting its nutrients and we hope to feed that system in productive ways. If the flow stops the system seizes up and the nutrients don't reach the parts of the system that need nourishment.

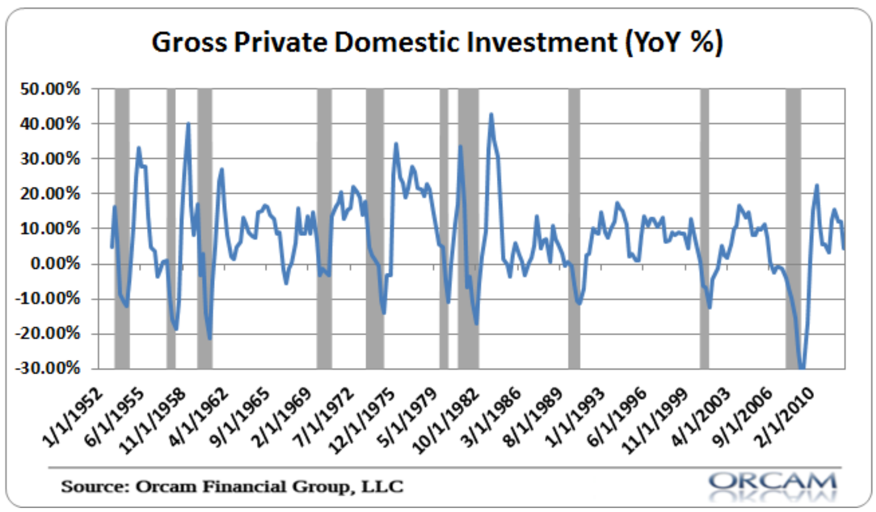
> **"To write it, it took three months; to conceive it three minutes; to collect the data in it all my life."**
>
> **F. Scott Fitzgerald**

When we study flows in the economic system there is no single better piece of data than the Federal Reserve's Z.1 Flow of Funds report. It provides a very clear ex-post (after the fact) view of the world. It's not a sure guide to the future, but when it comes to data it certainly helps to clarify what's going on at the macro level.



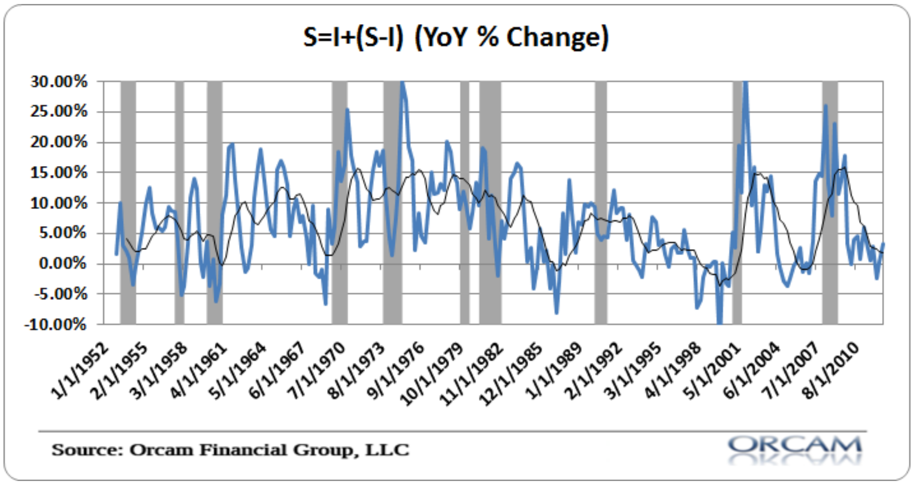
The current picture is actually slightly improved from our last update and confirms my generally bullish macro view of the US economy. The chart to the right shows Wynne Godley's 3 sector view of the economy. It shows the relationship between the 3 major sectors of the economy—the government sector, the private sector and the foreign sector. The 3 sectors necessarily add up to 0 which is why the private sector appears as a perfect mirror image of the sum of the foreign and government sectors. I won't get into the accounting behind this, but we can gauge the general health of the private sector by seeing that the private sector has a positive net saving position.

Of course, this doesn't provide an all encompassing view of the private sector. It's important to view the private sector not just through the lens of what the foreign and private sectors ADD, but also to understand what the private sector is contributing to the overall growth picture through its interactions with itself. In the USA, the private sector is the engine of growth and private investment and consumption lead this growth. So it's crucial to understand the balance sheet of the private sector to better comprehend how healthy the engine of growth is.



One of the better indications of private health is private investment. We can see this in the Z.1 report under Gross Private Domestic Investment. Private investment is currently growing at a year over year rate of 4.5%. That's not quite as strong as it was a few years ago, but the positive rate of change is still consistent with a fairly healthy private sector expansion.

I use the simple equation S=I+(S-I) to portray the health of the private sector. This combines the private sector summation via the foreign and government contributions to net saving PLUS the private sector's contribution via private investment. The chart can be seen on the following page. Even this is not a perfect picture of the economy, but it does help add more clarity to what's occurring. At present, the private sector rate of saving is 3.27%. Again, this is a moderately healthy growth rate and not consistent with a recessionary environment.



This all leads to a clear conclusion. The private sector is actually pretty healthy and aside from the risk of some sort of exogenous shock (Europe or China being the main risks there) I think the odds of a recession in the USA are relatively low at present.

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