The Danger in Budget Deficit Bashing

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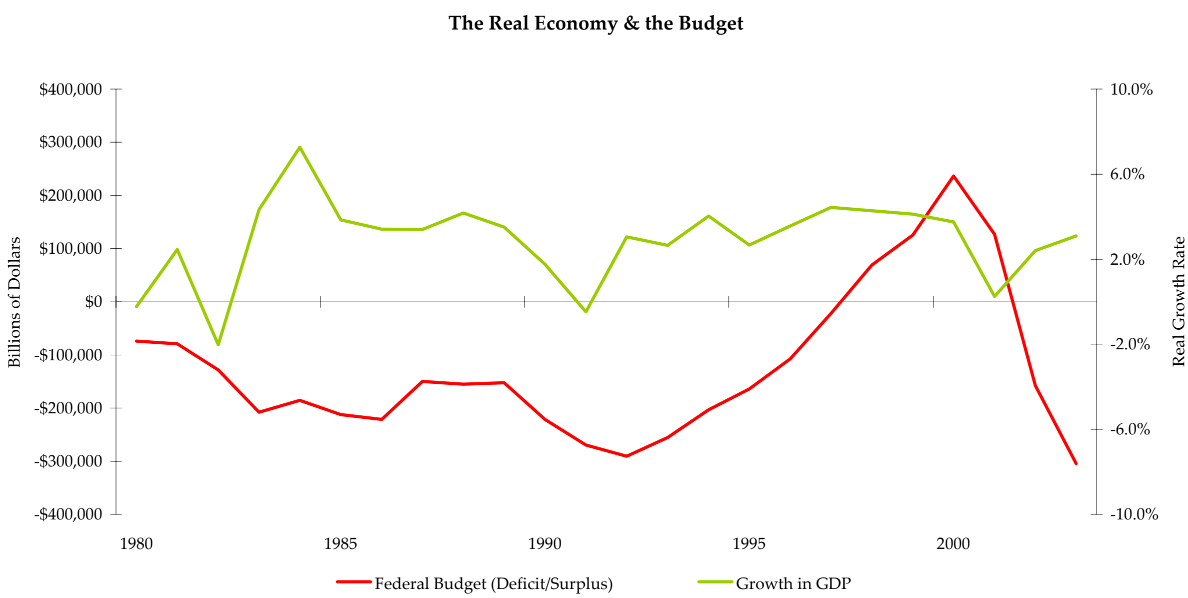
On January 26, 2004, the Congressional Budget Office forecast that the U.S. federal deficit for 2004 would be approximately $477 billion, up from an actual $375 billion for fiscal year 2003. President Bush's budget pegs this year's budget deficit at $521 billion. The CBO director, Douglas Holtz-Eakin delivered a bleak outlook for the future saying: "Deficits shift resources away from saving for future consumption" and "Running sustained large debt in the face of a full employment economy will have a negative effect." [Whatever happened to the current concern over exporting jobs and too <u>few</u> people working?]

The politicians also chimed in. Senator Kent Conrad, the ranking Democrat on the Senate Budget Committee said: "It's not just the short-term deficits that alarm me. We face an unending line of red ink, budget deficits as far as the eye can see." [Remember it was budget surpluses as far as the eye could see a few short years ago.] He also said that the increasing federal deficit could impede progress to lower unemployment by further eroding the dollar against the euro and triggering a chain reaction in the U.S. financial markets that would drive up interest rates.

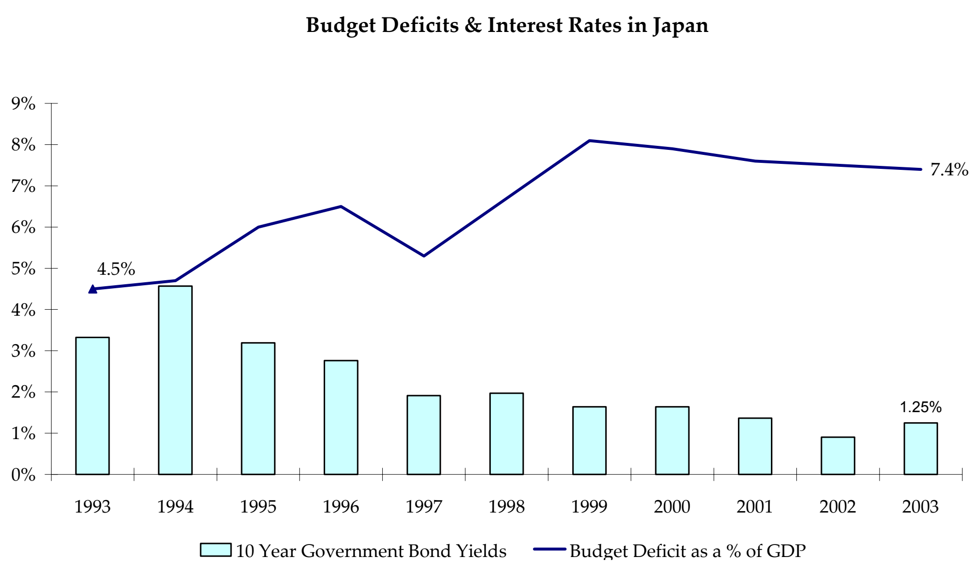
This recent criticism is not limited to Democrats. The conservative Heritage Foundation also publicized some concerns about the size of the deficit. Bill Beach, one of the Foundation's economists, said that the deficit is straying close to what economists consider the danger zone, 5% of the gross domestic product. When that happens, he said, it can cause stress on the economy, upward pressure on interest rates and a loss of confidence among debt holders.

These threatening observations should be questioned. Our recent history of large budget deficits have been coincident with strong economic growth (Exhibit #1). All during the Reagan era of budget deficits, the economy grew at an above average rate. During this same period, interest rates fell as deficits increased. The late '90s budget "improvement" i.e., the achievement of a budget surplus did little to augment economic activity. As a matter of fact, the record budget surplus may have contributed to the first economic decline of the 21st century. The reason for this assertion is that the last time we ran substantial budget surpluses they preceded the economic collapse of the 1930s and Japan's budget surplus of the late Eighties preceded the collapse of their stock market and a decade of economic stagnation. On the other hand, the U.S. budget deficit rose to a whopping 43% of GDP in 1943, a time when the U.S. economy grew 28%. From 1941 through 1946, the cumulative budget deficit as a percent of GDP was 108%. Yet, the economy recovered strongly after the war growing by 44% from 1947 through 1952. So there is little substance to claims that budget deficits are evil. Evidence is to the contrary—they provide the stimulus necessary for economic growth -- even if this is sometimes a Keynesian view. Supply-siders argue that short-run deficits caused by lower tax rates will over time be financed through expanded national income and faster economic growth.



One argument against President Bush's stimulus package is that large budget deficits drive interest rates higher. If the enemies of increased spending and lower taxes could establish this relationship i.e. demonstrate that high budget deficits cause interest rates to rise, they could argue that these higher interest rates would stymie economic activity. But if deficits raise interest rates, why is the 10-year at only 4 percent? More than one politician has argued to reverse the tax cut policies of the president in response to these theories, but there is no conclusive evidence to back them up.

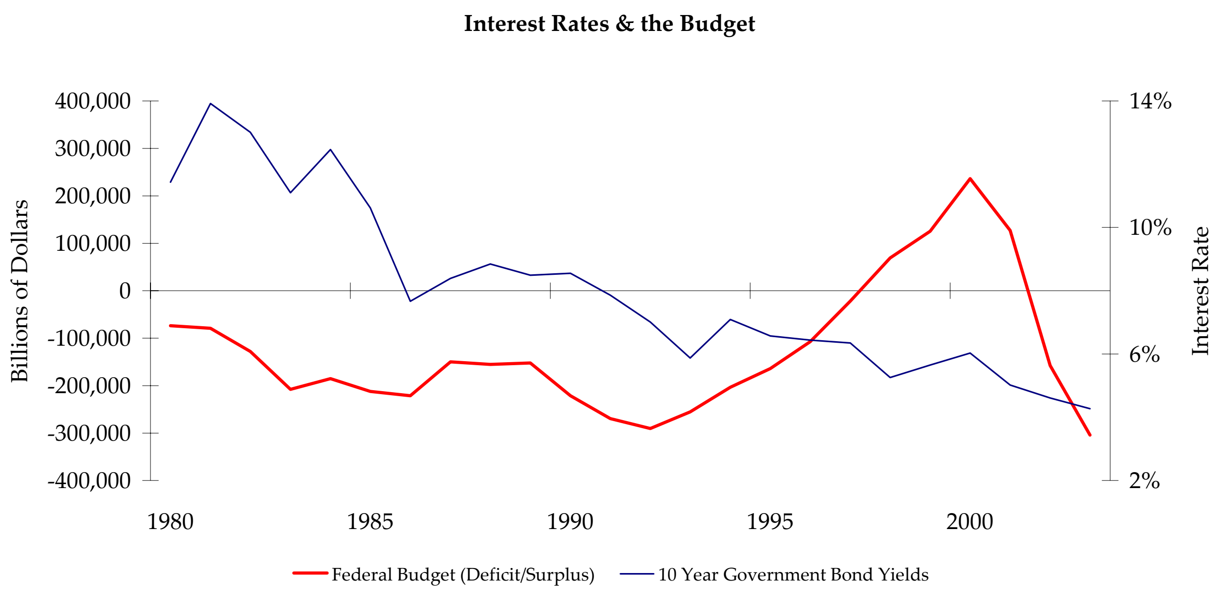
Before economists and politicians go off on a rant about how increased deficits will raise U.S. interest rates, they should take a serious look at the Japanese experience over the last 10 years (Exhibit #2). In 1993, yields on ten-year Japanese government bonds were a little over three percent and the budget deficit as a percent of GDP was approximately four and one half percent. All through the '90s, budget deficits as a percent of GDP rose and reached a peak in 2002 of over eight percent of GDP while interest rates continued to decline. In comparison, the CBO estimate of a $470 billion deficit in the U.S. for 2003 amounts to less than five percent of GDP. Don't even think about comparing short-term interest rates and the budget deficit in Japan—short rates are well below one percent.



Source: Budget Bureau, Ministry of Finance, Japan

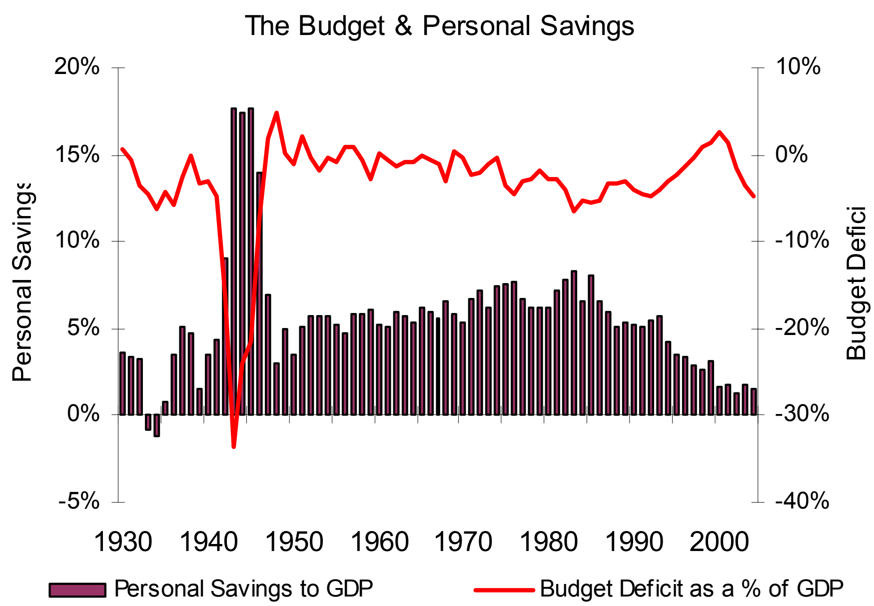
During the '80s, record budget deficits were accompanied by declines in interest rates as the U.S. economy grew out of an early-decade recession. From 1980 through the mid '90s the economy absorbed an enormous amount of government debt. During this same period, long-term interest rates declined by over 50%! Whether the budget was in deficit or surplus over the past twenty years, long-term interest rates trended down, not up.

This is principally because inflation declined for twenty years. In fact, expected inflation is the single most important determinant of interest rates. A second key influence on rates is market anticipations of real investment returns that affect the real interest rate component of government bonds.



One must also remember that the central bank in Japan and the Federal Reserve in the U.S. have something to say about interest rate levels. Since the Fed controls short-term interest rates, it also influences long-term interest rates. If the Fed so desired, operationally they could easily maintain interest rates at low levels no matter what happened to the federal deficit. When the central bank creates money by writing checks to individuals or companies, the result is an increase in bank reserves. To the extent that excess bank reserves are created, short-term interest rates will tend to fall (though long rates could rise). If the Fed is targeting interest rates, either it or the Treasury will have to sell government securities which provide interest bearing alternatives to non interest bearing reserves, thereby supporting the Fed's interest rate objectives.

Another fear, that budget deficits take away private sector savings, can also be dismissed. In fact, the opposite is true--the government deficit equals the non-government savings of financial assets as a matter of accounting. Therefore it is no accident that private sector savings of residents and non-residents collectively increase during deficit years and fall during surplus years. If history is any guide, (Exhibit #4), the message is clear, when it's time to increase private savings, run a deficit!



The U.S. and Japanese economic experience clearly point out the importance of doing your accounting homework in the real world, as well as in the laboratory, before one assumes that a relationship exists between interest rates and budget deficits. Politicians must not lose sight of the fact that stimulative fiscal policy is the critical variable in getting the U.S. economy back on a sustainable growth path. If wayward economists and biased politicians are successful in convincing the public that budget deficits are bad because they will increase interest rates then the economy will suffer the consequences. Along with President Bush, one other president had a handle on understanding the value and limits of a budget deficit:

"Is there any economic limit to the deficit? I know of course about the political limits…but is there any economic limit…there isn't, is there? The deficit can be any size; the debt can be any size provided they don't cause inflation. Everything else is just talk."

The quote is attributable to John F. Kennedy, the 35th president of the U.S. and Democrat from the state of Massachusetts. The key to addressing the size of a budget deficit is whether or not government spending is triggering an increase in inflation. As President Kennedy said, "all the rest is just talk."

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