

The 'Structural-Deficit' Myth

By JOHN RUTLEDGE

As the 7:05 pulled into Penn Station, Stan Morgan, big time Wall Street money manager, had already pushed his way to the front of the car; he was first to hit the platform when the doors opened. On an ordinary Monday he would have stopped for breakfast on his way to the office. But this was no ordinary Monday.

At 9:01 Stan's senior analyst burst into his office waving a two-foot length of broad tape. Stan's worst fears were confirmed: An administration spokesman had announced a revision in the estimate of the 1988 structural deficit from \$268 billion to \$305 billion. Stan hit the button of the squawk-box on his desk and barked out orders to his traders. "Sell everything we've got in the bond portfolio," he yelled, "and I mean everything. This looks like real trouble." His work for the day done, Stan leaned back, bit the end from one of his expensive cigars and poured a shot of bourbon.

If you believe the story about Stan Morgan, chances are you are either a professional economist or a member of Congress. Both labor under the impression that investment managers are "act-first, think-later" types who make too much money (at least when compared with economists and politicians). But if you would have ended my story with Stan yawning and telling his analyst to come back when he had something important to say, you are probably an investment manager.

With a few quotable exceptions, most people on Wall Street couldn't care less when some economist revises his 1988 budget forecast. Their attitude is understandable: 1988 is a long way off, and there are more immediate concerns to worry about. Also, no one is quite sure what \$300 billion in government borrowing would do to the financial markets in 1988 since we don't know what else might be happening by then (war, crop failure, pestilence). Economists have enough trouble predicting what's going to happen six months from now.

Unfortunately, Stan Morgan, Bond-seller, is the central character in the latest Washington drama. The halls of Congress are buzzing with the voices of our good congressmen and senators saying the specter of a \$300 billion 1988 budget deficit will scare the Stan Morgans away from the bond market, keep interest rates high and prolong the recession. I have never seen such a banding together of Republican and Democratic members of Congress as we now have in the name of balancing budgets. All are in agreement that the budget is in crisis, and that we must do something about it.

When Congress decides to "do something," however, it usually does it to us, the taxpayers. The momentary concern over structural deficits that we now see in Congress doesn't represent a renaissance of fiscal virtue as much as the realization that "structural-deficit" arguments are the perfect way to get rid of tax indexing. Tax indexing will rob Congress of the revenues

it receives when inflation forces us into higher tax brackets. Over the past two decades, Congress has developed an acute dependence on these revenues to finance its desires to spend more and more of our money.

The structural deficit is simply an updated label for the discredited idea of the full-employment deficit. Both are used to imply that there is something imbedded in the economy that will produce a deficit even during a boom. Liberals used the full-employment deficit notion for years to justify the higher spending that supposedly would make unemployment and stagflation go away.

Like the full-employment deficit, however, structural deficits cannot be estimated without first accepting a forecast of how fast the economy is going to grow. And relatively innocent-looking changes in real-growth forecasts can imply enormous differences in deficit estimates after several years.

The White House Office of Management and the Budget has estimated that, in rough terms, each one percent of additional real GNP raises tax revenue by \$14 billion, lowers expenditures by \$6 billion and, therefore, results in a net reduction in the federal deficit of \$20 billion. Using these estimates, a one percentage point underestimate of average annual real growth between 1983 and 1988 implies a more than 6% underestimate of the level of real GNP in 1988 (remember compound interest), and an implied overestimate of the budget deficit for the fifth year of about \$120 billion.

The \$300 billion-plus 1988 deficit estimates that were in vogue in Washington earlier this year generally were calculated by assuming the economy would grow only 3.5% a year during the next five years. This is approximately the growth rate experienced during the 1950-1979 period, so it had a ring of historical credibility, even though growth rates already are being revised upward sharply.

If the government had used a more realistic 5% instead of 3.5% for its growth assumption in making budget projections, it would have reported an 11% higher real-GNP level in 1988, an adjustment that would have reduced the 1988 deficit estimate by more than \$200 billion. Although \$100 billion is still a lot of money—even to a politician—it is a lot less than \$300 billion. More important, \$100 billion is within the range of the spending-cut proposals that some of the more courageous members of Congress are throwing around—a solution that is vastly preferable to increased taxes.

My point is not that "five" is the best of all numbers to insert into a budget-guessing exercise. The important point is that structural-deficit forecasts six years out are tremendously sensitive to changes in the economic assumptions used in their construction. You should have no more confidence in a particular forecast of the 1988 deficit than you have in the economic

forecast that stands behind it.

Extrapolating the weakness that has plagued the U.S. economy since 1979 into the future is a mistake. The soft economy of the past three years didn't happen by accident. As I argued on this page more than a year ago, the economy from 1979-1983 can best be understood by examining the changes in the cash flows and balance sheets of the individual households and firms that make up the economy that were caused by the abrupt and unanticipated purging of inflation which took place over this period. This sharp disinflation forced a series of wrenching changes in the structure of the economy. Altogether, I believe that this disinflation transition represents the most radical disturbance that has hit

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the U.S. economy since the Second World War.

In the rising inflation period, people learned to make money by buying tangible assets—real estate, antiques, precious metals and durable goods—on borrowed money. A lot of these investments counted on prices rising fast enough to offset negative cash flows. When inflation slowed, and their prices stopped rising, tangible asset investments became increasing burdens to many investors. At first they reacted by trying to borrow more money to sustain these investments; this led to the ultra-high interest rates early in the Reagan administration. But then, attracted by the high yields available on money-market investments, reflecting optimism over the Reagan program of disinflation and tax cuts, investors put increasing volumes of tangible assets up for sale, and prices had to be cut to attract buyers.

The result was a significant decline in the value of real estate and other tangible assets held in private portfolios during 1982. Durable-goods producers were hit hard. The cash-flow pressures and high interest rates that came with disinflation caused many people and businessés to postpone purchases of autos and equipment and to cancel planned capital expenditures.

Beginning in late 1982, however, there were signs that the inflation cure had started to produce the results. The other side of the soft tangible-asset markets we observed in 1981-82 was the incredible security-market strength. To date, the value of privately held securities has increased by more than \$500 billion. Corporations were forced to become leaner, more-effi-

cient operations. Chrysler's much-celebrated breakeven level, for example, has been reduced to 1.2 million cars a year, compared with 2.5 million cars three years ago. U.S. Steel has reduced its breakeven point by 10% of capacity.

The gradual nature of the spending rebound of the past year in the face of booming security markets should be taken as a sign that we are in the final stages of the disinflation cure. That implies stronger, not weaker, future real growth. Monetary policy occasionally may get off course, producing the sort of upward blip in interest rates that we now seem to be experiencing. But if the monetary authorities and the Washington grayhairs don't panic and do something rash—always a possibility in a world where concepts like "structural deficits" are taken seriously—the recovery will continue. The balance-sheet strengthening that has accompanied the stock and bond market boom is creating the foundation for a sustained period of high growth once the adjustments have been completed.

I don't agree with those who claim deficits have no effect on interest rates. Additional sales of government securities must, in and of themselves, depress securities prices and raise interest rates above the level they would be in the absence of government borrowing. But the question is "how much?" In my opinion, the economists and politicians who are behind the structural-deficit myth are guilty of dramatically overstating the effects of deficits on interest rates in order to buttress their case for short-circuiting tax indexing.

Structural-deficit theorists rely on a flow-of-funds framework that argues that interest rates are determined in a sort of farmers' market where savers bring wagonloads of funds to the market for the purpose of buying securities. Corporations and government agencies show up at the market to borrow funds (sell securities). The interest rate is the price that clears the market, so that if the government showed up with unusually large borrowing plans, the interest rate would have to rise until sufficient additional funds had been coaxed from the savers and enough other borrowers had been discouraged, to allow the market to clear.

This view of the capital markets leads one to expect swings in the deficit to have very large effects on interest rates by forcing one to compare the deficits with the normal size of savings flows—roughly \$350 billion in 1982. One popular estimate from one of the large econometric models is that each additional \$100 billion of government borrowing would raise the level of interest rates by about five percentage points, so that even at 5% inflation in 1988 a \$300 billion deficit implies 16% to 17% Treasury bill rates. It is the fear over those rates that is presumably making Stan Morgan shake in his Gucci loafers.

Back in December 1981, the same group was telling us that the projected \$100 billion (gasp!) 1982 deficit would surely lead to higher interest rates during the next year. My argument was that rates would go down—not because deficits don't mat-

ter, but because the impact of \$100 billion in government borrowing was going to be small compared with changes taking place in people's desired asset holdings.

This view asserts that the flow-of-funds framework isn't useful for forecasting interest rates. Asset markets are large—at the end of 1982 people in the U.S. owned more than \$22 trillion in assets. Due to the enormous size of private asset holdings, a seemingly minor change in the public's asset holdings can result in large dollar adjustments in the markets. For example, historically, a one percentage point increase in the yield on the public's \$10 trillion holdings of tangible assets (inflation) causes the public to move about 1% of assets, or \$200 billion, out of securities and into tangibles.

Clearly, higher government deficits mean higher interest rates in this framework as well. But, in the asset-market view, the relevant question is not, "What increase in interest rates is necessary to attract sufficient savings to finance a \$300 billion deficit?" Instead, the relevant question is, "What must happen to the structure of prices—and therefore yields—on more than \$20 trillion in private assets in order to make people willingly own an additional \$300 billion in Treasury securities?" Thus, the relevant question is a comparison of the proposed security issue with the size of the asset market, not with savings flows. Clearly, one could imagine a government debt issue accepted by the market even if there were no savings at all.

Once we have posed the question in this way, the answer seems obvious. It would be surprising if \$100 billion in government borrowing had a big impact on interest rates because \$100 billion just isn't very much money when standing next to \$20 trillion.

Or, put differently, those who would like to argue that \$100 billion in deficits raises interest rates by five percentage points must either explain how so paltry a sum can raise the yield on *all* assets by something like that amount (which would increase the yield on private assets by about \$1 trillion a year—not likely), or why households would be willing to tolerate yields on their security holdings five percentage points higher than yields on the rest of their assets without restructuring their holdings. All in all, neither argument makes much sense.

The evidence suggests that each \$100 billion of government borrowing, in and of itself, raises the level of interest rates by about sixty basis points, or six-tenths of one percentage point. This suggests that \$300 billion deficits, if they were to occur, might raise the level of interest rates by as much as two percentage points. At 5% inflation in 1988—higher than our forecast—this would put Treasury bill rates at 7% to 8%, hardly a catastrophe by current standards. And hardly a reason for Stan Morgan or any other sensible investment manager to pay much attention to the panicky cries of those around him.

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