Economics focus

The price of profligacy
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Do bigger budget deficits cause higher interest rates?

MITCH DANIELS, the top budget man in the Bush administration, last week acknowledged what private economists have known for months: that America has “returned to an era of deficits in the nation’s public finances”. Only two years ago, Mr Daniels was touting a projected ten-year budget surplus of more than $5 trillion as proof that America could easily afford a big tax cut. Now he expects deficits of between $200 billion and $300 billion (2-3% of GDP) over the next couple of years and modest spills of red ink “for the foreseeable future”. What is more, these deficits exclude both the cost of a war in Iraq and President Bush's planned $670 billion tax cut.

No one disputes that the speed of America's fiscal deterioration has been dramatic. But is it a cause for concern? A fierce political debate is raging. Democrats (and many Republican fiscal hawks) worry that rising budget deficits will harm the economy by reducing total national saving and pushing up interest rates. Just as the shift to budget surpluses in the 1990s helped to reduce interest rates and boost corporate investment, they argue, so the return to deficits will do the reverse.

Nonsense, say the administration and its allies. Mr Daniels claims there is no reason to “hyperventilate” about budget deficits. The vice-president, Dick Cheney, argues that there is no evidence that interest rates move “in lockstep” with deficits. Other conservative commentators dismiss the idea that deficits affect interest rates as "Rubinomics" (after Robert Rubin, Bill Clinton's treasury secretary). The evidence, they claim, has never supported this crackpot idea.

The foundations of Rubinomics

In fact, Rubinomics is well grounded in economic theory. Few economists deny that, other things equal, a higher long-run budget deficit—or a smaller surplus—reduces national saving. This could be avoided only if larger deficits were fully offset by higher saving in the private sector, as households, recognising that deficits today meant higher taxes tomorrow, saved more to make up for the government's profligacy. In practice, there are few signs that savers are so far-sighted.

It is probable, then, that total saving will fall. This implies a higher interest rate as the government competes with firms for limited investment funds. This effect is muted when a country has access to foreign capital, because the budget deficit can be financed from abroad. But even in a global capital market, economic theory suggests that a bigger deficit in a large economy, such as America, would push up global interest rates.

At issue, however, is by how much. The political slanging-match in Washington is not about...
whether deficits could raise interest rates in theory, but whether they do so significantly in fact. Those sceptical of Rubinomics point out that deficits were tame in the 1970s, while interest rates soared. Interest rates fell in the 1980s, while deficits ballooned. And in the past two years long-term interest rates have fallen as the budget outlook has darkened. These commentators also note that the formal econometric evidence is inconclusive: plenty of studies find a statistical link between interest rates and deficits; plenty find none.

Quite right. It is hard to disentangle the effect of changes in today's budget deficit from other factors affecting interest rates. As well as fiscal policy, monetary policy and the economic weather play a role. During the past couple of years, a weaker economy and looser monetary policy have probably pushed long-term interest rates down, outweighing any impact from bigger deficits. On top of this, it is not enough simply to look at the effect of today's budget deficit (as many studies do). Investors' expectations about future deficits are likely to influence long-term interest rates. So they should also be estimated and taken into account.

According to a new paper* by William Gale and Peter Orszag, two economists at the Brookings Institution, the evidence that deficits affect interest rates becomes clearer once a measure of expected future deficits is included. Mr Gale and Mr Orszag sifted through 58 econometric studies. At first sight the sceptics are right: the evidence is inconclusive. Fewer than half of the studies (28) found that higher deficits increased interest rates significantly. Nineteen studies found no significant effect and 11 had mixed results.

However, Mr Gale and Mr Orszag argue that only 17 of these studies included a careful measure of expected future deficits. No fewer than 12 of these found a significant relationship between deficits and interest rates. The authors conclude that a projected rise in the budget deficit of 1% of GDP raises long-term interest rates by 0.4 to 0.6 percentage points.

These results are similar to the numbers built into many macroeconomic forecasting models used by official and private-sector organisations (including the Federal Reserve and the IMF). They all assume that there is a connection between changes in budget deficits and long-term interest rates. On average, they suggest that long-term rates would rise by half a percentage point after one year and a full point after ten years if America's budget deficit rose by 1% of GDP.

This paper will not settle the debate in Washington, not least because Mr Gale and Mr Orszag are both prominent Democrats. Indeed, their work has already been dismissed as partisan politicking on the Wall Street Journal's editorial page and elsewhere. That is a pity. The paper may have flaws, but it does attempt to re-examine the evidence and so deserves serious discussion. Unfortunately, in Washington today the argument over whether deficits affect interest rates has more to do with ideology than with economics.

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* "The Economic Effects of Long-Term Fiscal Discipline"