The Washington Times
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Risky Unrealism

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Published April 26, 2011

Pie-in-the-sky budget forecast to end in pie with the face

Keep this column until April 2013. In the accompanying table, you will see two forecasts for federal debt-related items: the official Congressional Budget Office's forecast (which is close to the Obama administration's) and a pessimistic forecast (mine). No forecast is perfect, but it is likely that I will be closer to the mark than the CBO/administration because my assumptions are more realistic.

The official forecasts assume real growth rates of roughly 3 percent and inflation rates of well under 2 percent (which would be below the current level). Three percent growth rates are not sufficient to increase the level of employment as a percentage of the adult population at work. Thus, the Federal Reserve will be under continuing pressure to keep up "quantitative easing," i.e., printing money. This is likely to result in a continuing fall in the dollar, which will cause inflationary pressures to grow, and/or a continuing fall in real wages, as has been the case in recent months.

If the administration and Congress were suddenly to reduce spending enough to reduce the deficit from roughly 10 percent of gross domestic product (GDP) to 3 percent, the Fed could stop printing money and inflationary pressures would ease. But that is not going to happen because President Obama and many of his Democratic allies in Congress signaled that they are not serious about reducing spending. As has been widely commented on, the president's budget speech two weeks ago was a disgrace in which, rather than taking the opportunity he had been given to lay out a constructive alternative to Budget Committee Chairman Paul Ryan's specific plan, he chose to demagogue Mr. Ryan and others.

The Republicans, despite good intentions, are not going to be able to reduce the growth in spending very much in the next two years because they will have to compromise with the Democrat-controlled Senate and the Obama administration to get the budget and specific appropriations bills passed. Even if the Republicans do make headway on "discretionary" spending, they can do almost nothing about the big entitlement expenditures (i.e., Medicare, Medicaid, Social Security, etc.) that account for the vast majority of spending.

In the 1970s, the Carter administration and the Fed believed they could keep increasing the money supply under the naive Keynesian belief that the new money would create jobs

and not cause inflation. It did not work out that way. Inflation reached an annual rate of 14 percent in one quarter, and the prime rate rose to 21 percent. Average interest cost on the debt reached almost 10 percent - 9.86 percent to be precise. Even though the amount of government debt was approximately a third of what it is today as a percentage of GDP - and one-tenth in nominal dollars - the interest payment burden increasingly became a problem.

U.S. PUBLIC DEBT
(The Past and the Future)

	1980	2007	2011	2012 (CBO Forecast)	2012 (Pessimistic/Realistic Forecast)
Debt held by the public as a % of GDP	26.1	36.2	68.9	73.4	80.0
Inflation rate (%)	12.5	4.1	1.6	1.3	5.2
Debt interest rate (%)	9.86	5.06	2.06	2.23	4.8
Interest paid as a % of GDP	1.9	1.7	1.4	1.6	4.5

Sources: CBO, U.S. Treasury, BEA

Because the Fed has been the biggest purchaser of federal debt, interest rates have been artificially low and debt service costs have been very low - in part by shorting the maturity dates of the debt (for instance, selling many more short-term notes rather than 10-year bonds). The government is entering the same type of trap many people got into when they used short-term adjustable loans to finance their mortgages rather than a 30-year fixed rate. When interest rates rise, as they must, debt service costs are likely to explode.

Interest rates on government debt will almost certainly rise rapidly because the Fed has said it will stop buying the debt (and it has been the single largest purchaser); the next two largest purchasers, China and Japan, are unlikely to buy any more and are more likely to be net sellers. So the only way the Treasury will be able to sell more debt is by greatly increasing interest rates. Without an offsetting cut in other spending to compensate for the increased debt-service costs, the debt/GDP ratio will rise above the level forecast.

At some point, the debt-service ratio begins to spiral out of control, as in Greece, where some government bond rates were about 18 percent last week. If you think I am wrong, go back and look at the rosy scenario official forecasts and statements at the beginning of the Carter administration - with only one-third of the government debt as a percentage of GDP that this administration and the Fed have to contend with now - and even Jimmy Carter was more serious about controlling spending growth than Mr. Obama.

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