

COMMENT

Americans will eventually learn that deficits do matter.

By KENNETH ROGOFF

1,101 words

18 July 2007

Financial Times

London Ed1

Page 11

English

(c) 2007 The Financial Times Limited. All rights reserved

The Bush administration was beside itself with glee earlier this month when it announced that the fiscal year 2007 federal deficit was set to fall to just over Dollars 200bn (Pounds 97.7bn), or 1.5 per cent of US gross domestic product. Although the continuing deficit hardly makes the US a picture of fiscal prudence, the dollar amount is less than half what it was in 2004.

Publicly, some Democrats are still condemning Bush II profligacy and preaching a return to Clinton I fiscal conservatism. Privately, though, many are starting to question why a 2008 Democratic president should bother improving the government's balance sheet if the end result is just a bigger pot for a future Republican president to lavish on his or her friends. Certainly the 2000s, even as long-term interest rates normalise, seem to have thrown cold water on the notion that sustained US budget deficits will automatically lead to high interest rates and low growth. Or have they?

First, the good news. Explosive financial globalisation has made US federal budget policy far less important as a determinant of global real interest rates. Instead of interest rates going up sharply, low levels of public and private saving in the US have helped sustain a massive current account deficit. Continuing foreign inflows are probably holding down US real interest rates by at least 1.5 per cent and possibly more.

And let us give credit where credit is due. The Bush administration's decision to borrow massively, over a period where global long-term interest rates fell massively, was not a bad market call. With developing Asia and the petro-states willing to supply cheap cash, and with low global investment demand, the US has been able to borrow vast amounts at far lower rates than one might have imagined possible six to seven years ago. One can question whether the Bush administration should have skewed tax cuts towards the wealthiest Americans and made the tax system more complicated. One can complain how money was thrown away on the catastrophic invasion of Iraq. But the Bush deficits have not been the short-term growth disaster that some predicted.

Of course, when Bush administration officials were first mooted tax cuts, they probably did not envision hitting up China, Saudi Arabia and Russia for money. Instead, the political types were seduced by the misguided belief that if the government cut marginal tax rates, the economy would grow so much that total tax revenues would actually rise.

Unfortunately, although the famous Reagan-era "Laffer" curve has an important element of truth, the effect was hardly big enough to keep this decade's US federal budget from going deep into the red. Remember, too, that the Dollars 200bn figure President George W. Bush cited is for the "unified" deficit that incorporates the surplus on Social Security. Without this accounting gimmick (which the Bush administration did not invent) the projected 2007 deficit would be more than twice as large.

Both the Organisation for Economic Co-operation and Development and the International Monetary Fund have argued that US deficit policy is much more damaging than it seems. The US ought to be racking up big surpluses in preparation for impending old-age retirements and rising medical costs. The OECD and the IMF espouse the same conventional wisdom about most rich countries. Ben Bernanke, the US Federal Reserve chairman, framed it very eloquently when he described the current good fiscal news as "calm before the storm". The US Congressional Budget Office, for example, predicts that US federal spending on Medicare, Medicaid and Social Security, now about 8.5 per cent of GDP, will rise to 15 per cent by 2030 and 20 per cent by 2050.

But does it really make sense to extrapolate future paths for pension and medical spending when current policies are so obviously unsustainable? It is well understood that the Social Security pensions system can be fixed by indexing the retirement age to life expectancy and by modestly raising taxes. Medical care involves far trickier challenges in balancing redistribution and incentives for quality care and innovation. It is one thing to guarantee everyone equal access to medical care when health expenditures account for 5 per cent of GDP, as they did in the early 1950s in the US. It is another thing to do so when health expenditures reach 16 per cent of GDP as they do today and it will be even more

problematic if expenditures rise to 30 per cent of GDP, as some leading economists such as David Cutler, Robert Hall and Charles Jones have predicted. With healthcare at 30 per cent of GDP, efforts to maintain equality may begin to seem like Marxism.

In practice, most countries around the world will eventually have to confront massive inconsistencies in their unsustainable policies. Of course, there will be some countries that simply cannot resolve the resulting intergenerational frictions. The result will be paralysis, with huge potential implications for interest rates, inflation rates and growth. But this need not occur and in the case of the US, it is hard to tell how the Bush tax cuts will play out. Perhaps, rather than breed catastrophe, they will simply bring forward the necessary conversations on pensions and medical spending. Of course, they might also bring forward a catastrophically divisive debate.

If there is a shorter-term Achilles heel to US government deficit policies, it is dependence on foreign financing. The US is borrowing at the rate of Dollars 800bn a year, more than 6 per cent of GDP. Incredibly, US borrowing accounts for roughly two-thirds of total net saving of all the world's surplus countries. Although rebalancing of the world economy is likely to help bring down the US current account somewhat this year, the global and US economies remain quite vulnerable to a scenario that forces faster rebalancing. A geopolitical shock that forces the US to cut its trade and current account deficits by, say, half, would be quite jarring, driving the trade-weighted dollar down by 20-25 per cent.

Here's betting that the next US president, Democrat or Republican, is not going to end up going too far towards restoring fiscal prudence. Unfortunately, continuing this approach will eventually bring a shipwreck, particularly if global real interest rates rise significantly further. The US government's big shift into the red may have been fortuitously timed, but eventually, the deficits will matter.

The writer is professor of economics at Harvard University and former chief economist of the IMF

20070718L111.043

Document FTFT000020070718e37i00027