

ECONOMICS U\$A  
21<sup>ST</sup> CENTURY EDITION

PROGRAM #24  
FEDERAL DEFICITS

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(MUSIC PLAYS)

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FRANK STASIO: Economics USA: a 21<sup>st</sup> Edition audio supplement designed to explore 21<sup>st</sup> century challenges to micro and macroeconomic principles. In this edition we'll investigate the impact of federal budget deficits. My guest is Richard T. Froyen, a Professor of Economics at the University of North Carolina at Chapel Hill. I'm Frank Stasio.

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FRANK STASIO: Professor Froyen, welcome. It is good to have you here.

RICHARD FROYEN: "Well, thank you for having me."

FRANK STASIO: There seems to be a lot of confusion about the impact of federal budgets. In 1980 Ronald Reagan ran on a campaign promise to balance the federal budget. He then proceeded to run up the biggest peace time deficit in American history, and members of his administration were saying in effect, 'No big deal.' Had something changed?

RICHARD FROYEN: “Well there, I suppose we can approach it. There are two kinds of deficits. Economists look at what’s called cyclical deficits and structural deficits, and deficits are cyclical due to low tax collections during recessions, and high levels of various types of government outlays like unemployment compensation. Then they’re not necessarily the problem. I think in the early years of the Reagan administration that was the case. That was the most serious recession up to this one in the post war period: '81, and '82. Later on, people did think that the deficits were a problem in the Reagan years, but they were still nowhere near the level that they are now; and the other distinction is deficits in the short run, and then looking at long run projections and seeing where the deficit's going, and there the question is sustainability. There was never in the 80’s the feeling that these deficits were unsustainable, that there were reasonable adjustments that we could make if we decided we wanted to in fact balance the budget, which really in a series of things in the 90’s, we actually did. Now, people look at these long run trends, and they look unsustainable. It just looks like the ratio of spending to GDP would get very high and the ratio of some programs to the total spending would get very high. So it’s a more serious long-term and structural problem.”

FRANK STASIO: What impact did those deficits in the 80’s have on the economy, both in the short run, and over that long run, until finally in the late 90’s when the deficit was eradicated?

RICHARD FROYEN: “Well, sometimes they were probably beneficial because they were compensating for weakness in the economy by substituting government spending for private spending, and reducing taxes to encourage people to consume more when they weren’t consuming enough to buy all of the GDP. They had some effects, and another way to look at some of the negative effects is that they led to fairly high interest rates and those led to the dollar being quite high; and so they were tied in during the 80’s with the trade deficit which emerged as a problem, and so they had pluses, and minuses there, depending on the timing and depending on

basically what the Federal Reserve was led to do by the deficit. If the Federal Reserve was led to raise interest rates then it had this effect on investment, and then on trade.”

FRANK STASIO: By the end of the 1990’s, the deficit had in fact been erased and in the last three years of the Clinton Administration, the Federal Government had actually generated a surplus. How is that achieved?

RICHARD FROYEN: “Basically if your tax revenues are greater than your spending then more money is coming in, and then what you are always doing is issuing a new debt to roll over the old debt; and then if you are running a deficit you are issuing new debt which increases the total debt, so reverse that, and if you are running a surplus. Then as the debt rolls over you just retire it, and so the national debt goes down.”

FRANK STASIO: Maybe I’ll stop you there and ask you to make that distinction between the national debt and a budget deficit.

RICHARD FROYEN: “Well, so the debt is basically there are different measures of it, but it’s basically the accumulation of past deficits. It’s what we borrowed before, so when there is a deficit the only thing the treasury can do is sell securities to the public and then it complicates things; but later on the Fed can buy some. Basically they’re selling new debt each year by the amount of the deficits, so that’s what’s being added on to the existing debt. So on the other hand if they have a surplus then it’s being subtracted from the existing debt. So by the year 2001, the projections based on the current law were that we would pay off the whole national debt by about today. “

FRANK STASIO: What impact did the end of the deficit, the fact that the, that we’re running a budget surplus, what impact did that have on the economy?

RICHARD FROYEN: “Well, along the tax increases, and the spending cuts that produced that. What they did was to keep inflation low. The economy was growing well in the late 90’s, so they didn’t hurt the growth in the economy. We could afford to pay this back. We didn’t need the demand that the government would create by spending more or could create by tax cuts, but then several things happened, and one was there was a recession in 2001. So that led people to say, ‘Well, we shouldn’t keep running a surplus right now, or at least as big of surplus.’ So Democrats would say, ‘It’s alright to have tax cuts now,’ and Alan Greenspan would say, ‘It’s alright to have a tax cut now, and let the surplus get smaller,’ but then the other side was that the Bush Administration just felt for longer-run growth it would be good for the economy to have low tax rates, low marginal rates that you pay on your income. It would stimulate the economy and in a non-inflationary way, because it would stimulate growth, and so they wanted much bigger tax cuts and prolonged tax cuts, so not just in 2001, but tax cuts in 2003, and that, by 2004, we were running structural deficits again. In effect, the recession was over, and that had some good effects and some bad effects, but the bad effect was that during those years from 2004 until 2007, we were running deficits when they weren’t needed to stimulate the economy, and we weren’t reducing the debt to take account of these long-run structural problems that we had-- mainly a health care problem, health care cost problem.”

FRANK STASIO: Was that the result of just a miscalculation? The cuts were too deep, but they had miscalculated the impact on the deficit.

RICHARD FROYEN: “To an extent. To an extent they may have been that the economy didn’t grow as fast in response to the tax cuts as the Bush Administration thought. The deficits over that period were in the wrong direction. They weren’t huge. By the time we got to 2007 or so they were just larger than they probably needed to be to stimulate the economy, and the cumulative debt over that period is a good part of the debt that we have.”

FRANK STASIO: So what are the ways the government can manage deficits?

RICHARD FROYEN: “For the short run, given that the recovery hasn’t been going on for so long, and we’re still quite a bit below GDP, in my view, we need a substantial change. The proper fiscal policy, spending, and tax rates would result in a substantial deficit for a couple of years. So the real thing is what can we do to manage the long run deficit? And there are really only two things we can do. One is make very severe cuts in discretionary spending, and in the projections for entitlement spending, or have a pretty significant increase in tax revenues. I mean the deficit is the difference between the two. The other factor of course is with given tax rates, the growth in the economy; the reasonable projections don’t show that we can grow our way out of this problem.”

FRANK STASIO: Is there anything in the way of monetary policy that can be added to this mix that would also help?

RICHARD FROYEN: “No, not the long run structural problem. I mean, directly the Fed, by say in the last six months, buying up government debt obviously doesn’t decrease the debt. It just means the Fed holds the debt, instead of it being held by the public, which might ease the effects on interest rates of the debt, and also any effect that the debt would have by raising the interest rate and raising the dollar that goes in the opposite direction. So in the short run, they can affect the composition of the debt and the amount that the treasury has to sell to the public. When you look at the long run projections then it’s really just the government budget, just spending, and tax decisions.”

FRANK STASIO: We hear during the political debate, a lot about the fact that the government is going bankrupt. These deficits are rising so high, and the overall debt is rising so high that the

government is on the verge of going bankrupt. In a practical sense is that possible since the government always has the possibility, the power, to raise taxes?

RICHARD FROYEN: “Well, it’s even kind of a last bastion of our credit. They also have the ability to print money. So while the Fed can’t solve the deficit problem, it can effectively keep the debt financed. We really, in the foreseeable future, can’t go bankrupt unless we bankrupt ourselves by simply saying we won’t borrow, which is not raising the debt limit, so that’s not saying that we’re bankrupt, that we can’t borrow, but if you as a household said, ‘I will not borrow anymore,’ and you had contractual payments that you needed to borrow for, you would be bankrupt. If you simply said, ‘I need to borrow more to pay for my car, so I won’t pay for my car,’ and then you would default on some obligations; but the problem in the longer run is that if creditors, if people who buy bonds look, and they look out 30 years, because we are selling 30-year bonds, and they see problems there, in terms of our willingness to tax, then they’ll just view us as a somewhat riskier prospect and charge us more to lend to us, but they’ll still lend to us. And then, in terms of their worries, even though we can always print money so we’ll pay them, we won’t go bankrupt in the sense of not meeting our obligations. If we need to print too much money then we will cause inflation, and then what they get paid back, which in dollars will be worth less to them than what they get paid back on a 30- year bond in Euros. Right now, I think that the thing the debate sort of doesn’t take enough account of, is that there’s an awful lot of wealth or a lot of funds in the world economy that have to be invested in certain kinds of assets. So for many investors the choice is among dollar-denominated bonds, euro-denominated bonds, yen- denominated bonds, there aren’t many Norwegian kroner-denominated bonds, and then they can go to corporations in the different countries, and buy corporate bonds, and the fact that we are still borrowing at such low rates is just an indication that we are one of the safer assets, and in the near future we are still going to be one of the safer assets.”

FRANK STASIO: Is there an economic or financial model that economists, or investment bankers, use when determining how to make these investments, and I'm thinking about the ratio of debt to GDP? Does that matter when you are making these investments?

RICHARD FROYEN: "I think it does and that's the negative for us-- these projections. If we don't do something about the federal government's commitment to healthcare expenses, if we don't do something about that; things look very bad in the long term. Not necessarily worse than for many other countries, but they just look like some adjustment has to be made, and the way that shows up is just projections about the debt to GDP ratio and the actual one, which is going up, so it's one factor. It's not a uniform factor across countries. So for example, we borrow almost uniformly in dollars, and that means that again we have always the ability to create dollars, so if we are given debt to GDP ratio, if your debt is in your own currency, it's much less a problem, than if you're say Argentinean, and your debt is in dollars."

FRANK STASIO: Professor Froyen, thank you very much.

RICHARD FROYEN: "OK."

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FRANK STASIO: I've been talking with Richard T. Froyen, a Professor of Economics at the University of North Carolina at Chapel Hill. I'm Frank Stasio.

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