

WILL ANY PRESEDENT BEFORE 2012 SOLVE THE DEFICIT PROBLEM?

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The short answer is no.

Why am I so pessimistic on this issue? Doesn't it have implications for long-term bond rates in the future? Who will hold this debt? Won't the retiring baby-boomers put stress on the social security system starting in 2014? This last question lays the foundation for my answer.

Why would any politician, of any party affiliation, philosophy or hue, want to solve a problem now using all their political capital when the uncertain payoff is in the distant future? I will explain this reasoning using the concept of incentive compatibility of actions, which simply put means "What's in it for me?" W will be gone by 2008, that's what the term-limit law mandates. You can argue that he cares about his legacy or wants to benefit a future president from his own party. But let's see if that argument holds any water.

Let's assume for a moment that this is true. W does all the work—raises taxes, cuts spending, streamlines benefits, privatizes accounts, fixes the CPI to favor government payments, you name it—and in comes in a successor in 2008. After all these actions, it will be a miracle if a Republican president is ever get elected again, but I digress! He or she in their first term will be worried most about their reelection, as it's the only incentive and this requires oodles and oodles of spending.

Now, this successor (can be from either party) is busting the bank to get the votes to get reelected. Bush has proven that this strategy works very conclusively from his first term. Clinton did the same but was masked by new tax revenues from the stock market bubble. He was a very smart operator. No wonder Cheney had said to Paul O'Neil "Deficits don't matter as President Reagan showed us".

Then comes in 2012, the incumbent wins the reelection and then has two options: solve the mess or leave it for the next President. What do you think he/she will do? You can't predict that it will be solved as the next President may not want to follow through on the plan. That President may just bust the bank by thinking that a few more years of deficit and this problem is not mine. After all, history books seem to glorify a President who was a big spender for public works. We constituents are gluttons for pork-barrel spending if it's in our own neighborhood, but are very conservative if somebody else gets the pork.

The two recent Nobel laureates, Finn Kydland and Edward Prescott, got the prize in part for their work proving the fact that promises to be prudent will fail because of the what's-in-it-for-me problem. Their exact analogy was that of a central government/bank trying to be prudent with money to control inflation. It seems that authorities break their promise as the current benefit

from stimulating the economy is pitted against costly inflation down the road, which is always very tempting. So what stops this cheating, or deviation, from the optimal path of behavior?

The answer is markets, not rules or laws or impassioned appeals. In the end it boils down to somebody actually holding government debt. It could be us, in which case the interest rates, will rise quite a bit, or it could be China, India, Mexico, Brazil or how about Bangladesh. Sounds radical but I think it will happen. My assertion is that we can run a small deficit, measured as a percentage of GDP, for a long-time, as it is the servicing cost of debt that matters. This debt will be held by the rest of the world, especially since the dollar or T-Bond is the new gold brick of the global economy's financial transactions. Hence, a continuously increasing supply of this instrument is needed to facilitate the world economy as it grows over time. What is the optimal federal deficit to GDP ratio? I don't know but as long as China is a command economy that wants to grow at 9.0% a year, doesn't become a democratic place with Western style markets in the next twenty years, we should be fine. To every tough problem there is a simple think-outside-the-box solution. The accompanying table of long-run projections shows what kind of economy to expect in the coming decades, and my prognosis, to say the least, is very upbeat.

Some main points of the long-term forecast are as follows:

- Long-term projections for the GDP growth estimate a 3.1% annual growth rate for the years 2005 to 2015, followed by 2.8% growth for the years 2015 to 2025. This will be half a percent lower than the 1990's. The optimistic forecast for the coming decade arises from the likely effects of technological advances in communications, computers and biotechnology. Although the precise source of productivity is difficult to measure, most experts believe that the massive investment in information technology (IT) during the 90's deserves much of the credit for the recent productivity surge. It remains unclear whether modern technological innovations have the economic impact as primary inventions such as electricity or the combustion engine. However, the belief is that
- productivity gains from computers will gradually become more apparent in the data. Labor productivity growth will likely stay above 2% in the coming decades, reversing the productivity slowdown from 1975-95 when it grew by 1.5%. The unemployment rate will drop from its 5.4% average in the coming decade to 5.0% in the 2015-2025 period.
- Inflation won't be a problem; the central bank won't allow it to be. Hard won lowered price appreciation expectations from inflation fighting efforts in the late 70s onward (which were very costly initially), will be maintained. Consequently, inflation will drop from its annual average of 2.4% of the last decade to 2.3% in the 2005-2015 time period. The producer price index is expected to grow at a 0.6% annual rate during the 2005 to 2015 period, and then increase to a 1.1% annual rate during the 2015 - 2025 time period. These inflation estimates are reflected in the interest rate forecast for the 10-year bond rate, which is expected to average 6.0% in 2005 - 2015, compared to a 5.3% average for the 1995 to 2005 time-period. It later rises mildly to average 6.5% in the 2015 - 2025 time period.
- The single most expected beneficial outcome of low, stable inflation and interest rates is on investment and capital accumulation. Real business fixed investment, as a percentage of real GDP in 2025 will be 22.9%, almost three times the ratio seen before 1970. Capital growth, on the other hand, is expected to decelerate a bit to a 6% rate in the 2015 - 2025 time period from 6.4% in 2005 - 2015. Large increases in technology investment are responsible for both the rising share of GDP and the slowing growth of capital. Considerable amounts of investment in computers and communication devices imply that a large amount of future capital will be required simply to replace worn-out equipment. As more capital is necessary to restore the existing stock, it becomes harder to sustain high growth rates of new capital. The rapid obsolescence and quick turnover of many technology investments also leads to high depreciation rates that become a significant fraction of national income.