Forced Reconversion to that “Old-Time Fiscal Religion”

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October 17, 2023

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– October 17, 2023 Reading Time: 3 minutes

Greg Ip, chief economics commentator at the *Wall Street Journal*, recently wrote an interesting column about government budget deficits and interest rates. Ip’s key claim, which I think is correct, is that big structural deficits (i.e., routinely spending greatly in excess of revenue) partly explain the recent spike in bond yields. “Suddenly, fiscal policy matters again,” Ip writes, not in the usual economic-stabilization sense, but in terms of the government’s basic ability to marshall resources.

If you’re interested in fiscal and monetary policy, read the article. It’s a good overview of contemporary challenges for Treasury officials and central bankers. Here, I want to offer some mild corrections to some of the article’s secondary arguments.

Ip writes that central banks, “worried about too-low inflation and stagnant growth,” kept interest rates near zero for a long time. This is a common point among the commentariat about post-2008 monetary policy. But we should be cautious. Yes, the Fed has greater administrative leverage to affect interest rates since the switch from a corridor system to a floor system. But that doesn’t mean central banks can suppress capital markets for a decade or longer. The combination of slow real-income growth (supply side) and a reconfigured path for nominal spending growth (demand side) plausibly explain the post-financial-crisis years. Hence, the cause of low interest rates was a less-than-vigorous economy for much of the post-crisis era.

The second point — and this is central bankers’ fault, not Ip’s — is that there’s no inherent connection between “too-low inflation” and “stagnant growth.” I’m sure many central bankers worry these necessarily coincide, but that is because they are, at heart, naive, demand-side fundamentalists. Economies can grow quickly with low inflation, they can grow slowly with high inflation, or anything in between. The growth rate of nominal spending (aggregate demand) compared to the growth rate of the real economy (aggregate supply) determines inflation. But the growth rate of the real economy is largely independent of monetary policy.

Ip notes that recent deficits are quite large by historical standards. In fiscal year 2023, it was 7 percent, “larger than any deficit since 1930 outside of wars and recessions.” This point estimate understates the problem, however. Federal debt held by the public totals nearly $25.5 trillion. That exceeds 90 percent of GDP. And there’s an even bigger problem: as Vero De Rugy recognizes, 67 percent of US debt matures in the next five years. Much of that debt was issued when interest rates were quite low. The refinancing costs will be enormous, putting increased strain on the national treasury.

Circumstances beyond our control will likely compel us to revert to something like the “old-time fiscal religion” of balanced budgets during ordinary times, reserving deficits for extraordinary times. Americans simply won’t tolerate the tax rates necessary to solve our deficits problem on the revenues side alone. And given the lingering (justified) anger over inflation, central banks likely won’t be able to do much to finagle government borrowing costs. The longer we refuse to recognize and adapt to reality — and yes, this necessarily includes reforms to Social Security, Medicare, and Medicaid, which are the major drivers of structural deficits — the more painful the eventual realignment will be.

One way forward would be to return to the fiscal trend line that existed through 2019, the final fiscal year before the pandemic. We shouldn’t treat COVID-induced fiscal profligacy as a *fait accompli*. We can gradually shrink the burden of government spending by limiting topline increases to the sum of population growth plus inflation. That will keep inflation-adjusted spending per person constant, allowing economic growth to erode the costs of

excessive debt. The fiscal rule will constrain politicians and administrators, giving central banks the leeway and independence they need to stabilize aggregate demand. We could do much worse — and part of me worries we will.

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