



The Deficit is a Big Problem For The Economy

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As we discussed last week, there are compelling reasons to believe that the U.S. economy will grow at a 4-5 percent pace over the upcoming eighteen months. Demand is accelerating because incomes are rising and taxes are falling. Low interest rates continue to stimulate the sales of homes and automobiles and, finally, business investment spending is rebounding. But there is a very dark cloud on the horizon: the burgeoning federal budget deficit.

Less than two years ago the federal budget generated a surplus of \$250 billion. The shift from deficits to surpluses during the Clinton years was in part responsible for the very low interest rates we enjoy today. Since then the budget situation has reversed sharply, with a projected \$450 billion deficit this fiscal year ending September 30th. This swing of \$700 billion has provided welcome support during the recession. In fact, large deficits during recessions are good policy. But the recession is over now, and the deficits have, once again, become structural in nature, meaning that the deficits will not go away once the economy grows stingily again.

Under President Bush, and with Republican control of Congress, we have experienced the startling result of the largest sustained increase in federal spending in more than twenty years! Federal spending has soared at an annual pace of more than 5 percent since Bush was elected. It's not just defense spending; all spending is soaring at a nearly out-of-control pace. And with the election coming up, each party is trying to buy your votes with your money.

The recent rounds of tax cuts have sliced federal revenues from 21 percent of gross domestic product to 18 percent of GDP. However, spending has been allowed to soar from 18 percent of GDP to 20 percent, and is rising. With the cost of rebuilding Iraq and Afghanistan added into the mix, the deficit is likely to remain excessively high over the next few years. The problem will be that as the

private economy picks up momentum and demands more funds, this rising demand will clash with soaring needs to fund the deficit. This will cause interest rates to rise sharply next year. I project gains of about 2 percent in rates!

We have been down this road before in the U.S. Back in the mid-1980s we had a similar convergence of a strengthening economy coupled with a rising deficit. The predictable result was rising rates then, and it will be the same now. By 2005 mortgage rates will be topping 8 percent, causing the recovery to slow substantially, but not to end.

If I am right about all this, a number of actions follow. Now is the time for businesses and households to take final advantage of today's low interest rates. This is also the time to prepare for a period of very strong economic growth in 2004.

This is Hank Fishkind for 90.7 FM, WMFE News.

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