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BUDGET DEFICIT THREATS OVERESTIMATED, ACCORDING TO NEW LEVY ECONOMICS INSTITUTE STUDY

ANNANDALE-ON-HUDSON, N.Y.—As economists and policymakers of both political parties consider ways to reduce the U.S. federal budget deficit, a new study from The Levy Economics Institute of Bard College contends that the case for viewing current and future deficits as a deeply threatening phenomenon is surprisingly weak. In a new Public Policy Brief, *Breaking Out of the Deficit Trap: The Case against the Fiscal Hawks*, Levy Institute Senior Scholar James K. Galbraith argues that there is little evidence to suggest that current and future budget deficits will lead to higher interest rates or reduced national saving, and that addressing the deficit is not America’s most pressing economic policy priority.

The focus of Galbraith’s deficit analysis is a recent paper by William G. Gale and Peter R. Orszag of the Brookings Institution and Tax Policy Center. In their paper, “Budget Deficits, National Saving, and Interest Rates,” Gale and Orszag’s main assertions, according to the Levy Institute study, are that sustained budget deficits reduce national saving and investment and threaten to reduce growth and raise interest rates in the future. Applying a Keynesian perspective to their study, Galbraith contends that Gale and Orszag’s theories have serious flaws, by disregarding the stimulative impact of expansionary fiscal policy and thereby overestimating future debt-GDP ratios caused by budget deficits. “It is not possible to stimulate nominal GDP through fiscal policy without experiencing some actual expansion of nominal GDP,” he writes, stressing that the expansion may be real in part or inflationary in part. “Whatever the division between real and price change, the resulting ratio of debt-GDP will be smaller than would be the case had no stimulus occurred.”

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Furthermore, Galbraith refutes the theory that budget deficits automatically lead to higher interest rates, either through foreign creditors demanding higher premiums or a reduction in output. Regarding the latter, he says the antideficit camp completely ignores the impact of financial markets and monetary policy on long-term interest rates. Addressing the former, he says driving down the value of the dollar goes against the self-interest of creditors. Creditor nations “cannot drive the dollar’s price down too far without gravely endangering their own competitiveness, wrecking their own industries, and devaluing their portfolios,” he writes. “This limits their leverage over our interest rates.”

To show that budget deficits have yet to hurt investment in the United States, Galbraith points to current economic conditions. “Currently private investment as a share of GDP is at 16.9 percent—about a point higher than its long-term historical average going back to 1950. Can anyone believe that present deficits are causing an investment shortage?” he writes, maintaining a nominally higher interest rate would not affect investment either. “Can anyone believe that a rise in the interest rate of one percentage point five years hence would be a disaster from which private businesses could not recover their financial footing—despite the fact that just five years ago they were borrowing furiously at much higher rates?”

In concluding, Galbraith suggests that policymakers have more pressing economic issues to address than budget deficits. “Those who oppose the drift of America under Cheney and Bush ought to stop hiding behind platitudes of public finance. They ought to be looking for a bolder, more substantial, more coherent economic program, one that addresses real problems—such as jobs, health care, energy, global warming, and the risks and costs of war,” he writes.

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Public Policy Brief No. 81, *Breaking Out of the Deficit Trap: The Case against the Fiscal Hawks* (6.22.05)