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The deficit debate: Is the U.S. on a path to "inflating away" the debt?

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Who Owns the Deficit?

President Barack Obama conducts a town hall meeting on health care reform, Thursday, June 11, 2009, at Southwest High School in Green Bay, Wis. (AP Photo/Morry Gash)

President Obama has barely completed his first five months in office, but already the conservative media has been hammering him on his "deficit spending-spree," and the perceived lack of return on his $787 billion stimulus bill—a plan that he readily admitted would take about 18 months to fully work its way through the economy.

Right-wing entertainers and newsmakers have declared the president a big government, liberal socialist, who seeks to destroy the U.S. economy in favor of one resembling Zimbabwe, or the Weimar Republic. Newt Gingrich, the disgraced, former Speaker of the House, is furious; going so far as to call Obama's presidency a failure—a bold statement by those who insist "history will judge George W. Bush."

To be fair, President Obama readily acknowledges that the U.S. is currently engaging in deficit spending that cannot be sustained over the long-term; we must address ways to cut spending and/or raise taxes in order to get the fiscal sheets back in balance, and soon.

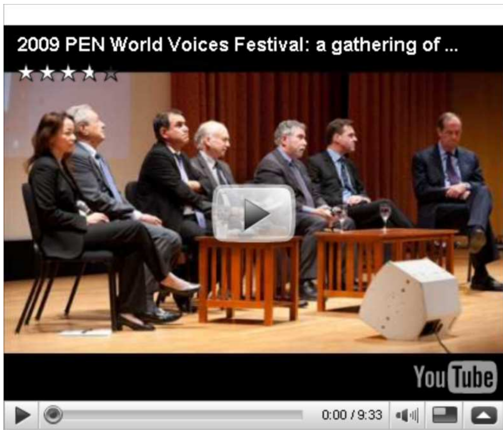
This is more credit than I can lend to Obama's self-proclaimed, "fiscally conservative" predecessor, whose idea of limiting government included: increasing military spending for two wars, increasing farm subsidies, bailing out Wall Street and the airline industry, and a Medicare prescription entitlement program that covers even those who don't need it.

In addition, were tax cuts for the wealthy; ushered in by an evolving platform that, as Benjamin Friedman notes in the Harvard Magazine, began with a need to return the surplus dollars created by the Clinton administration to the taxpayers. However, when it became clear that the recession had already absorbed any surplus dollars, the Bush administration insisted the tax-cuts were necessary to stimulate the economy. They also quickly abandoned their proclaimed fiscal principles in favor of deficit spending, which helped create and/or save jobs during the economic downturn.

Then, the economy turned around, and a boom followed, so the tax-cuts were further justified on the basis that the government was too large, and so by "starving the beast," republicans could limit the scope and power of government—of course, the Bush administration lacked the political will to actually follow-through on any tough spending cuts, leading to deficits unseen since World War II.

It is curious that Obama's deficit-spending over the past five months has managed to garner such a political firestorm, particularly when viewed through the prism of an eight-year Bush legacy, which did not receive even a fraction of the inflationary, socialistic rhetoric and teabaggery that the current administration has endured.

Apparently, Obama's opponents suffer from "political amnesia," and I would suppose, a great deal of cognitive dissonance trying to convince each other that somehow, Obama is to blame for the economic crisis. Particularly those such as Stanford's John Taylor, who as Daniel Gross with Slate notes, was not a critic of deficit-spending when he worked in the Bush Treasury Department, but has now become a "fiscal scold" when the government engages in similar spending to rescue the economy.



How Legitimate is the Threat of Inflation?

The fear of inflation is not entirely unfounded, and as Krugman and other economists acknowledge:

> It's true that the Fed has taken unprecedented actions lately. More specifically, it has been buying lots of debt both from the government and from the private sector, and paying for these purchases by crediting banks with extra reserves. And in ordinary times, this would be highly inflationary: banks, flush with reserves, would increase loans, which would drive up demand, which would push up prices. But these aren't ordinary times. Banks aren't lending out their extra reserves. They're just sitting on them — in effect, they're sending the money right back to the Fed. So the Fed isn't really printing money after all.

Indeed, during an economic downturn, individuals and businesses alike tend to increase their savings, and reduce their consumption—inflation will be worrisome *after* the recession has ended and spending has resumed.

There has been a vigorous debate between thoughtful economists on both sides about whether the U.S. faces a future of inflationary disaster, which indicates the effect that an individual's ideological lens may have when interpreting a set of data. Most recently, both sides have claimed recent data on 10 and 30-year treasury bonds supports each of their respective positions.

On one side is historian Niall Ferguson, who claims that the recent spike in rates—from a low of 2.07 in December 2008 to a high of 3.715 on June 1—indicates inflationary worries. On the other side of the debate, is the winner of the Nobel Prize for Economics, Paul Krugman, who claims that a rise in the bond rate actually indicates market stabilization after a disastrous free-fall. According to Gross,

> Government bonds were so low last December because the world's investors were totally freaked out about risk. They sold everything—U.S. stocks, emerging market government bonds, corporate bonds in Europe, Indian stocks—and parked their cash in the safest, most liquid investment around: U.S. government bonds. In the months since then, as the stimulus and bailouts have helped stabilize the economy, investors have started to relax. The indicators of market stress have improved. And so investors this spring began to sell the low-yielding bonds and start buying stocks and other assets again.

The chart in question seems to support Krugman and his allies' position that the December figure was an "aberration" to market normalcy. Ben Bernanke, the chair of the Federal Reserve, took a middle-of-the-road approach recently, stating that both are likely factors contributing to the spike.

With respect to the deficits, Ferguson writes, "For only on Planet Econ-101 (the standard macroeconomics course drummed into every US undergraduate) could such a tidal wave of debt issuance exert 'no upward pressure on interest rates.'" Krugman admits that the danger of high interest rates could become a reality if people "grow dubious about the financial solvency of governments."

One must assume Krugman is referring to the fact that our debt is currently being financed by foreign governments, most notably, China. If for some reason, China lost faith in American consumerism—which seems unlikely since they are so dependent upon it for their own economic health—and decided to stop funding our debt, then the U.S. may have no choice but to print money, and inflate the debt away. Exactly why Congressman Mark Kirk is telling China not to trust the U.S. government's declaration of fiscal health despite this information is a bit worrisome.

Fergusonians are also pointing out the percentage of national debt to GDP, which has been noted as a predictor of future inflation. According to current forecasts from the Congressional Budget Office, that figure could reach 100% by 2017 if current deficit spending continues and the president fails to cut spending, and/or raise taxes. Further, Fergusonian's contend that raising taxes stifles growth, so the only viable option is to cut spending, which they either fail to realize, or disclose, would also stifle growth.

Krugmanites point to post-World War II debt, which reached 120% of GDP, but did not result in the government attempting to inflate it away. Though not unprecedented, Krugman simply points out that the likelihood is not as prescient as the doom-and-gloom crowd would have us believe. He points out more recent examples, in which Belgium, Canada, and Japan have all experienced a debt percentage exceeding 100% of GDP, and did not resort to inflation policy.

Recent indicators of economic health illustrate improvements over the month of May, while the number of jobless claims dropped by the largest amount in seven years. Furthermore, as Krugman notes, consumer prices are actually falling, which if anything, indicates deflation. If we were to rely on economic indicators alone, the argument for an impending inflation seems difficult to make at the present moment.

Deficit Hypocrisy and the GOP

At the end of the day, we have to question the motives of those who constantly cry wolf. There are the traditionalists, like the Cato Institute, who have stirred inflationary worries for decades, but the rhetoric has failed to live up to the hype. This does not mean their claims are unfounded, but it signifies there are other factors at work.

Politicians on both sides are guilty of using deficits to their advantage; claiming they will bring Armageddon-like disaster if the opposing party engages in them, or entirely discounting their relevance, as Dick Cheney did when he claimed "Reagan proved deficits don't matter." At least Obama readily admits they are problematic and unsustainable.

The advantage in demonizing the opposition for their handling of the economy is a tested method of political assassination, which has particular resonance during a period of economic turmoil if the incumbent party fails to generate perceived improvement in the eyes of the public. Republicans are well aware of their own hypocrisy, but are relying on the short-term memory of voters to emerge as the sole alternative to Obama's "out-of-control spending frenzy;" much to the chagrin of libertarians, to be sure.

The republicans supported the TARP bailout under Bush, but not the follow-up that his successor ordered, because it required that CEO's take a little responsibility the second time around, and it had—brace yourself—strings attached. Imagine the gall of democrats for requiring some accountability for taxpayer's who are footing the bill for the irresponsibility of greedy lenders. Is it any surprise that banks are now crawling over themselves to return the TARP money?

The political posturing makes it difficult to believe a word that comes from the republican leadership, and their perceived "flip-flopping" between inflationary fear-mongering, and historically record-breaking deficit creation, makes the legitimacy of their most recent threats questionable.

So, what now?

As Friedman points out, there is much more at stake than simple measures of economic health:

> Living standards have improved over most of our country's history, and over time our society has become more open and tolerant and our democracy has broadened and strengthened. But even in America these basic values are at risk when our living standards stagnate. Median U.S. family income showed virtually no increase, beyond inflation, from the early 1970s to the early 1990s. Much of what happened during that time—the rise of the "militia" movement, the wave of ugly xenophobia, the open retreat from generosity toward our own most disadvantaged citizens—was the predictable pathology of a society whose citizens knew they weren't getting ahead.

In other words, we need to be focusing our attention toward economic sustainability over the long-term. As much criticism as we may hear directed toward big government, neither of the major parties has shown a willingness to cut into the safety net programs of Medicare/Medicaid, and social security, which as indicated by this chart, are much more problematic over the long-term.

The president's agenda seeks to address these problems by reforming healthcare—a separate topic that I will pay homage to in the future--by combining American ingenuity through our capitalistic processes, thereby increasing competition, while further easing costs in a variety of ways, including electronic medical records to reduce duplication and errors, and preventative care, as opposed to disease management. The root of containing future governmental obligations lay, at least partially, in Obama's ability to reform healthcare, and to eliminate our reliance on foreign energy to sustain our economy. These structural, economic reforms will be financially painful in the short-term, but are immeasurably vital to our future health as an independent nation.

Concluding Remarks

I admit ignorance to all of the internal workings of the economy, and while I may have to rely on the interpretations of others to draw conclusions, it seems that the study of economics is fickle enough to warrant its predictability obscure to even the most highly regarded experts. President Obama is in the company of some of the greatest minds advising him on this crisis, including Bernanke, who was nominated by his predecessor, so it cannot be said that he is a stooge of the president.

As Gross points out, "The notion that the market is telling us something—anything—ultimately rests on the erroneous assumption that financial markets represent the collective wisdom of rational actors processing information efficiently." No such method exists that can control for every contributing factor to our economic health.

There are mechanisms, and tools that the government has at its disposal to ease the pain of an economic downturn, and they have utilized them when conditions required it. Back in September, when there was talk of another Great Depression and the global collapse of the financial markets, analysts on both sides insisted that Wall Street was "too big to fail." The consequences would be catastrophic, we were told. Jobs would be eliminated, food would be rationed, and the situation would inevitably lead to social unrest.

Without debating the merits of whether any entity should be allowed to exist that is "too big to fail," suffice it to say, the global financial markets seemed to be, for all intents and purposes, too big to fail, and inaction was simply not an option. I admire the president for taking the bold and sometimes unpopular, but proactive measures necessary to stimulate the economy—inaction is arguably why the U.S. suffered as badly as it did during the Great Depression.

It was Milton Friedman, the staunch, free-market capitalist, who argued that the Fed could have prevented the Great Depression if they had provided the banks enough liquidity to stave-off a run, so the idea of taxpayer intervention, or corporate welfare, is neither novel, nor may it be termed "socialist," just because the opposition is in power.

While the solution may not be a perfect one, it is the only viable alternative and has proven its efficacy many times over since Keynesian economics emerged in the 1930's. I have more confidence in the brain power of Obama's pinky finger than I had of the entire Bush administration, and in this instance, I defer to the experts advising the president, and those economists who agree with the approach his administration is taking.

For more info:

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Federal Debt, 1940-2009 (As a percentage of GDP)

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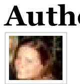

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