The Relationship Between Budget Deficits and Interest Rates--and a Fun Story

By David Henderson

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On Wednesday, Cato Institute economist Ryan Bourne wrote me the following:
In the UK right now, there's a Conservative leadership race. Liz Truss is promising to cancel the tax rises her opponent Rishi Sunak instituted as Chancellor. If she reverses all of them, it would be circa 2% of GDP cancellation of tax rises. Sunak claims this would make inflation much worse.

Today in *The Times* newspaper there was an op-ed citing David Stockman on the 1980s about how Reagan cut taxes and then couldn't cut spending. The implication was that, despite Truss's promises to cut spending too, she won't and the UK will be left with higher deficits pushing up inflation and leading to higher interest rates.

I pointed out to the author of the op-ed that inflation fell under Reagan and, in any case, was a monetary phenomenon and he said "ok, but what happened to interest rates?" I checked and to my surprise nominal interest rates fell after the very early 1980s, although still remaining historically high in real terms. Now the economic research on the link between the larger structural deficit and those high real rates seems to give mixed results. Ben Friedman and Krugman say deficits pushed up real rates; Hendershott and Peek that it didn't have much effect either way.

I wondered if you had navigated this debate at all and had any thoughts about who is right?

I had, and so I wrote back the following:

I DID have strong priors about the connection between deficits and real rates all through the late 1970s and early 1980s. But the experience that you refer to dashed my priors. Not only that, but in the discussion from about 1984 on, lots of people, both academic economists and fairly smart politicians like Dick Cheney, argued that there wasn't a connection. The politicians weren't clear about WHY there wasn't much connection.

Some of the economists—I have in mind Paul Evans of the University of Houston in the mid to late 1980s—did give a reason: Ricardian equivalence. I recommend that you track down and read this article from the Journal of Political Economy in 1987:

https://www.journals.uchicago.edu/doi/abs/10.1086/261440

And then I added my fun story because it involved my boss at the Council of Economic Advisers, Martin Feldstein. Marty was a deficit hawk who believed that there was a strong connection between deficits and real interest rates. Here's the story:

I was a senior economist with President Reagan's Council of Economic Advisers from August 1982 to July 1984. I got there a few weeks before Marty Feldstein got there as chairman, the day after Labor Day in 1982. At the first meeting he called, he told us that if we ever saw him doing something wrong or making an incorrect statement we should call him on it. (I tried the next day on a fairly small issue and got some pretty negative feedback, which is what I expected.)

Fast forward to the writing of the 1**983 *Economic Report of the President***. It's crazy time. It starts around early November and goes to late January. CEA hands exaggerate how hard we worked but it is true, nevertheless, that we worked harder than usual. So people are pumped up. It's our exciting time. There was a junior staff economist named David S. Reitman, an undergrad whom Marty had brought with him from Harvard. Over lunch sometime in late December or early January, I think it was, David said that he wasn't sure he would "let" Marty say that higher deficits implied higher real interest rates. His point, which was well taken, was that the evidence for this relationship was awfully slim.

I silently laughed because I knew that if Marty wanted to say it, he would say it. He did, on p. 86.