The Washington Times

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Originally published 05:01 a.m., January 13, 2010, updated 07:17 a.m., January 13, 2010

RAHN: The problem with spending

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Even though the government is running massive deficits, interest rates and inflation are low. So, what's the problem? The following discussion will clarify the problem. Next week, I will explain the consequences of this reckless spending, and the week after, what we should do to right our economic ship.

How fast an economy can grow is largely a function of the quantity and quality of labor, and the amount of investment funds available for what economists call capital formation. Good, high-paying jobs cost money. You don't have truck drivers if no one has the money to buy trucks. More capital investment and more research and development (R&D) per worker usually enable workers to produce more per hour, which makes them more valuable and hence, able to command higher wages. The greater the number of people making higher wages, the greater the demand by these people for more goods and services, which, in turn, creates many more jobs.

The amount of investment capital available is largely a function of the quantity of savings provided by individuals and businesses (both domestic and foreign) and government. Individuals save and invest to protect themselves against loss of income, unanticipated expenses, and for such things as cars, vacations and retirement. Businesses save in order to weather downturns and invest in new plants and equipment and more R&D.

As can be seen in the accompanying table, the total amount of savings available for investment (as a percent of gross domestic product) has fallen sharply over the past decade. Individual and business savings have risen, but this rise has been swamped by the deficits in the government sector, and this is not likely to get much better.(Remember, in the late 1990s, the federal and many state and local governments were running surpluses, which enabled them to pay down their debt.)

The United States is now in a situation in which the government is taking a very large share (40 percent) of the nation's savings to finance its deficit spending, leaving a diminished pool of capital to meet the needs of both families and businesses. You might be thinking, if there are not enough savings available for investment needs, why are interest rates so low? The answer is that the Federal Reserve (Fed) has been creating money by loaning the banks nearly free money and buying mortgages from Fannie Mae and Freddie Mac. Soon, as even the Fed acknowledges, it will have to start selling the mortgages it owns to private parties and increase short-term interest rates to avoid saddling the country with high inflation. In sum, inflation cannot be avoided without a big increase in both long- and short-term interest rates.

To understand what is happening, imagine you have a family farm that produces fruits and vegetables. Your consumable income is dependent not only on the selling price for your fruits and vegetables, but the amount you spend for fertilizer, irrigation and high-yield seeds, which, in turn, largely determines the amount you produce. Typically, you borrow money to pay for the fertilizer, seeds, irrigation equipment, and the planting and harvesting equipment, and then pay back the money when you sell your crop. Now, if it becomes more difficult and costly to borrow because of higher loan standards and higher interest rates, your family has a choice - reduce consumption and still borrow at higher interest rates to grow the same amount of produce, or borrow less.

If your family borrows less, it will have to use less or inferior fertilizer, lower-quality seeds, less irrigation, and older equipment - all of which are likely to result in a reduced crop for sale. If you multiply this situation by tens of millions of other small and even large businesses, you begin to understand the problem of diminished savings and productive investment.

The United States has been very fortunate in recent years because it has received several trillion dollars from foreign individuals, businesses and governments. These foreign entities purchased both government and private bonds and stocks, but also invested directly in the U.S. economy. By supplementing the domestic supply of savings, they enabled the United States to grow much faster than it otherwise would have. But the party is likely over. Foreigners understand that this country is facing both higher inflation and slower growth, so they are likely to diminish their investments, which will only increase the problem of inadequate capital formation.

Next week: the consequences of the savings drought.

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Pork Spending Deficit Spending Unemployment Rate National Debt Federal Economy