

ABSTRACT OF PAPER

A CRITIQUE OF "RUBINOMICS": DID THE FALL IN BUDGET DEFICITS AND THE BRIEF EXPERIENCE WITH SURPLUSES "MAKE ROOM" FOR MORE INVESTMENT IN THE 1990s?

Economists claim that budget deficits produce "crowding out." When borrowing, government competes with private sector investment for national savings, thus raising interest rates. That rise discourages some private investment leading to a decline in economic growth. In addition, government borrowing leads to inflationary expectations which causes borrowers and lenders to agree on a high "inflation premium" in all fixed interest rate loan contracts. Expectations induced by high and rising budget deficits have the long run consequence of increasing uncertainty and thus dampening down investment planning beyond the reductions caused by the rise in interest rates.

The deficits of the 1980s, showed that such budget deficits can be accommodated without either raising interest rates or stimulating inflation so long as foreign savings flows to the United States to supplement our national savings. Nevertheless, no less a personage than Alan Greenspan advised President-elect Clinton in December of 1992 that he had to get the government's fiscal house in order so as to reduce both the negative expectations of investors in the bond market and inflationary expectations of those who were contracting loans. In Greenspan's words, "... no single overall economic event could do more to help the economy, businesses and society as a whole than a drop in the long-term interest rates ... Establishing credibility about deficit reduction with the markets would lower rates and could trigger a series of payoffs for the economy..." [Bob Woodward, *Maestro*].

This essay will critique Greenspan's advice and Robert Rubin's celebration of what Clinton did in his book *In An Uncertain World*. If rising budget deficits lead to "crowding out" of private investment (or a rising trade deficit to accommodate the flow of savings from abroad) then a corollary to this should be that the decline in budget deficits in the late 1990s followed by the brief experience with surpluses in 1998, 99 and 2000 should lead to the opposite of "crowding out," what I call "making room." Declining deficits which become surpluses mean less borrowing followed by the retiring of some of the National Debt. Some businesses and households rearrange their portfolios to carry less government debt and, initially, more cash. Assuming they consume the same percentage of their current income, this extra cash is then converted into some asset. The closest thing to a government bond would be a high quality Corporate Bond. This expands the ratio of private saving to GDP raising national saving. If nothing else changes, this will lead to a decline in real interest rates even if inflationary expectations do not change. Detailed evidence from the 1990s will be presented to see if the prediction of increased savings, declining interest rates and increased investment actually was borne out. Careful analysis of the timing of changes in interest rates, investment as a percentage of GDP, and the various components of national savings casts doubt on the picture painted by both Rubin and Greenspan.