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UP AND DOWN WALL STREET DAILY

Be Careful If You Wish for Deficit Cuts

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The cure for budget gaps could be worse than the disease.

WHO DOESN'T HATE deficits? Like pledging allegiance to the flag, everybody stands and salutes balanced budgets. Now, the American public apparently is having misgivings about the Obama fiscal stimulus. Warren Buffett, meanwhile, warns Washington's red ink will sink the greenback.

But, says David Levy, chairman of the Jerome Levy Forecasting Center, without those deficits, we would be facing a rerun of the Great Depression. Indeed, he contends, the federal budget deficit more than accounts for the total of corporate profits.

That's an unconventional view of deficits, which are increasingly seen as an evil that's no longer necessary. According to The Wall Street Journal/NBC News Poll in July, 34% of respondents thought the fiscal stimulus was a good idea while 43% didn't. That was a reversal of January's poll, when 43% favored the fiscal program and only 27% disagreed.

Similarly, the Oracle of Omaha wrote in Wednesday's New York Times that, while the Federal Reserve and the Bush and Obama Administrations reacted "ably" to the crisis and averted a meltdown, it's time to begin to withdraw the "enormous doses of monetary medicine." The "greenback emissions" threaten the dollar's value, Buffett asserts, whose "destiny lies with Congress."

This recalls the complaints about the Reagan-era budget deficits, which other countries complained were playing havoc with the dollar's exchange rate. Only then, the dollar was soaring as the deficit widened -- exactly the opposite of the current concern. So, which is it: does a rising budget deficit cause a weak or a strong currency?

Back in the early 1980s, interest rates were staggeringly high, reaching double digits for riskless Treasury securities, which some blamed on the Reagan deficits. Now, Treasury yields are near record lows, with an even bigger budget gap. Again, does a rising budget deficit push interest rates higher or lower?

Any theory that asserts that budget deficits can alternatively push the dollar or interest rates either up or down has some deficiencies.

Big government expenditures and a lender of last resort were what the economy needed, contends Levy. And while he figures there is a 60% chance the recession has ended, this cycle won't be like last ones in which the Federal Reserve could simply ease, reliquefy the financial system and kick-start a new credit expansion.

Indeed, Levy contends the U.S. is mired in what he calls a "contained depression," in which the massive fiscal and monetary stave off the full affliction. "The government is holding the financial sector together with duct tape with its support," he quips. Even so, a credit expansion -- the necessary spur to a real recovery -- will be difficult as the private sector is deleveraging.

Moreover, the government deficit exceeded domestic corporate profits in the second quarter for the first time since the Great Depression, Levy contends. Without the government sector, he continues, there would have been no profits in the second quarter -- the earnings numbers that spurred the stock market's advance since early July.

"The economy will remain heavily if not entirely dependent on government deficit spending for most of the next several years. The only way the private economy would be able to carry a large part of its own weight would be through a resumption of rapid expansion of private balance sheets. While theoretically possible, this scenario hardly appears likely," Levy wrote in a research note to clients.

Credit problems actually are deepening as default rates rise, he adds in an interview. Businesses, especially small, independent ones, still face serious borrowing constraints. Banks, moreover, are not fully prepared for rising default rates, even if there is a little recovery. That will be the lagged effect of housing deflation.

Given this "contained depression," slashing the budget as the American public or the Sage of Omaha favor would have serious side effects. That was the experience of the '30s, when fiscal and monetary policy were tightened prematurely and caused a relapse of the Great Depression in 1937-38.

As BCA Research explains in its Daily Insights, fiscal stimulus programs were ended and Social Security taxes were collected for the first time in 1937, slashing the federal deficit to 1.2% of gross domestic product from 5.4%.

At the same time, the Federal Reserve tightened policy, causing a sharp contraction in the money supply. Unemployment, which had been lowered to 14% from 25% during the rapid, 9% GDP growth in 1933-36, jumped back to 19%.

Levy points out the U.S. debt soared to 110% of GDP after World War II, but the percentage was pared in half in the following decade. Post-war growth expanded GDP, which made the debt burden lighter without Draconian measures.

The real potential debt crisis is posed by demographics and entitlements over the long term, not the current deficit. Growth is what's needed to reduce deficits, as the '50s and the '90s demonstrated. A premature cure for the deficit may prove worse than the disease.