We admit we were knocked out by last week's stunning disclosure that Rubinomics was right after all -- that budget deficits do push up interest rates. At last Fermat's Last Theorem of economics had been solved. So we downloaded the proof, in the form of a paper by two Brookings Institution economists, with wildly beating heart.

Well, nice try. It turns out that William Gale and Peter Orszag do not prove that there is any connection between deficits and interest rates. Instead they have gathered a small portion of the hundreds of papers on this issue and extracted an estimate that an increase in the projected deficit of 1% of GDP will raise long-term rates between all of 50 and 100 basis points. Even this is a weird conclusion given that many of the papers they review show no significant impact on interest rates. But what really weirded us out was the fact that the rest of the paper undercuts their conclusion in hilariously obvious ways.

First, the economists admit that many factors, other than budget deficits, determine interest rates. Second, the economists admit that their interest rate argument takes full advantage of the "all-things-being-equal" dodge and that there are lots of unequal things -- such as taxes.

They acknowledge that a full analysis of the effects of deficits should take into account the impact of the spending programs or tax reductions financed by the deficit. For example, cuts in marginal-income tax rates would boost economic output. But the economists dismiss the tax cut solution in a few sentences, asserting that the negative impact from the Bush tax cuts will outweigh any economic boost from those cuts.

Okay, everybody is entitled to his or her opinion, since it is opinion
we are dealing with here. But it's a shame the economists don't examine the impact of government spending because one of their very own tables suggests that this could be major-major.

The table looks at the impact on interest rates from a 1% increase in the deficit relative to GDP caused either by tax reductions or spending increases as estimated by a dozen models. The range of impact from a spending increase on 10-year bonds, after one year, is 27 to 100 basis points and after 10 years the range is from 20 to 220 basis points. By contrast, the impact from tax reduction falls within the same range, from 25 to 100 basis points after one year. But after 10 years the numbers are smaller, with a range from 5 to 143 basis points. So according to their own evidence, a deficit caused by spending is worse than one caused by tax cuts.

Drawing on an accounting-identity truism (national savings equals domestic investment plus net foreign investment), they then come to what they call their "more important" point. If national savings declines because of a budget deficit, balance can be restored either by an offsetting increase in private domestic savings, or an increased flow of investment funds from abroad or, absent full restoration, an increase in interest rates. In other words, there are three possible scenarios generated by an increase in the budget deficit and only one results in higher interest rates.

The economists then swiftly move on to declare that unless budget deficits are fully offset by an increase in private savings they reduce national savings. (Well, duh, that's what the accounting identity mandates.) And then comes their triumphant summary: "[A]lthough the tax and spending policies that reduce the surplus or raise the deficit can have positive effects on economic activity, the fundamental point of this paper is to document that there are also important costs to dissipating the budget surplus. In particular, a reduction in the surplus reduces national saving and hence future national income, regardless of its effects on interest rates."

We do wonder, however, what the economists make of Japan, which has a huge budget deficit, 8% of GDP (and national debt of 140% of GDP), yet interest rates are 0.95%. Perhaps if they had explored further their own argument that interest rates are determined by factors other than deficits, they might have come to what, actually, determines interest rates.

Here's a hint: Interest rates consist of two components, real rates plus expected inflation. Real rates depend on investment demand, which is shaped by prospects for production and employment through fiscal policies, and expected inflation depends on monetary policy. Interest rates in Japan are low because investors expect low growth and deflation, not because of the budget deficit.
But maybe we expect too much. This is a political document, much as Robert Rubin's theorem is all politics too. Its point is to argue against the Bush tax cuts and especially against making them permanent. The economics are incidental.

(See related letter: "Letters to the Editor: How Deficits Affect Interest Rates" -- WSJ January 9, 2003.)

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(See related letters: "Letters to the Editor: Tax-Rate Cut vs. Deficit Reduction" -- WSJ Jan. 20, 2003)