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The Curse of Rubinomics

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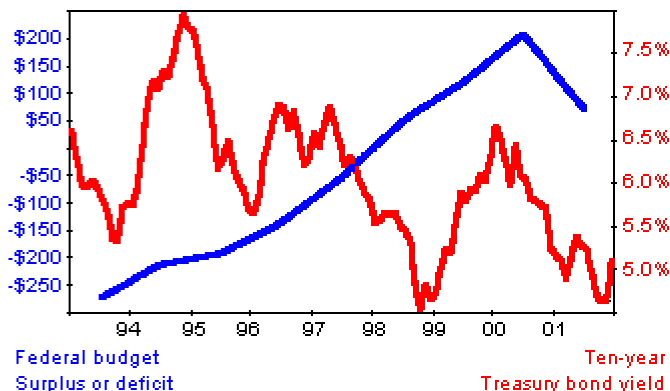
The dead hand of Clinton-era economic fallacies puts Bush's tax package at risk.

The notion that changes in the federal budget balance are a primary factor determining movements in market interest rates once again threatens to pose an obstacle to pro-growth tax policy changes. With **President Bush's** new tax proposal sporting a static revenue "cost" of nearly $700 billion, the fiscal policy designs of the current administration are being placed in bold relief against the supposedly halcyon days of **Bill Clinton**, when **Rubinomics** reigned and budget surpluses defined economic nirvana. Already, reports have it that potential **Senate Republican** defections over this issue are placing the president's tax package in significant jeopardy. This is how the *New York Times*, reporting on **Vice President Cheney's** speech to the **US Chamber of Commerce**, put it last weekend: "The vice president's remarks reflected the tax-cutting, supply-side beliefs of the president's conservative supporters and placed him in direct opposition to a central economic philosophy of the Clinton administration: to put deficit reduction first as a way of bringing down interest rates and so creating an economic boom."



Indeed, one of the things "everyone knows" is that the Clinton years were a time of steadily declining interest rates in keeping with the budget moving from deficit to surplus. That this formulation survives as nearly unquestioned accepted wisdom in the face of an abundance of readily available data that so clearly refutes it is nothing short of remarkable. The chart at right, for example, plots the 10-year Treasury yield against the federal deficit/surplus position from 1993 through 2001. Were the folklore about the connection between budget balance and interest rates correct, the chart would show a consistently inverse relationship, with yields falling as the deficit is reversed.

Instead, we observe first that yields rose, on net, from below 5.5% in late1993 to about 7% in early 1997, even as the deficit fell from nearly $300 billion to less than $100 billion. From1997 through most of 1998, yes, rates fell as the fiscal balance continued to improve. Note, though, the sharp reversal from1999 into early 2000, with yields rising by nearly 200 basis points, during a period when the budget moved solidly into surplus. Most recently, of course, yields have touched multi-generational lows even as the surplus has evaporated and large deficits loom again.

Any objective analysis of this empirical record, in other words, would have to conclude that of all the things that have influenced interest rates, swings in the budget balance must not be among

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them. That's because, with some $3.5 trillion in publicly held debt outstanding, the relative changes in the supply of new bonds are dwarfed by factors affecting the value of the stock of existing debt. And that is primarily determined by two factors: 1) the rate at which inflation or deflation is expected to erode or enhance the value of the bond's nominal repayment stream, and 2) the real rate of return.

The nearly 300 basis point plunge of the 10-year note in the past three years can be seen representing a combination of both factors, as **the Fed's** deflationary anti-growth *jihad* first crushed any lingering inflation expectations and then collapsed economy-wide returns. In the latter half of this period, since early summer 2001, the real yield on inflation-indexed 10-year Treasury debt has fallen by some 125 bps, from 3.5% to about 2.25%, and the nominal 10-year yield has fallen on net by about the same margin, from about 5.25% to a range just above 4%. Rather than falling interest rates begetting rapid economic growth, they have reflected a monetary-policy-induced sub-par rate of expansion.

The Rubinomics fable embraced by the *New York Times* and the keepers of conventional economic wisdom, then, is completely contrary to real-world economic experience. As opposed to the belief that falling deficits brought down interest rates and created an "economic boom," the fact is the economic boom threw off huge gains in tax revenues which turned deficits to surpluses. And with the boom giving way to a period of sustained economic sluggishness, the return of deficit financing has corresponded with a sharp decline in interest rates.

The lessons of this reality seem fairly straightforward. For politicians placing top priority on putting the budget back on the path toward balance, that objective will remain a pipedream without restoration of rapid economic growth. Our analysis is that the Fed's policy stance no longer poses a monetary obstacle to expansion. There's no question, however, that after the economic deluge of the past three years, fiscal incentives to put at capital at risk and thus seed the process of grassroots capital formation and wealth creation are badly in need of repair. Whether that message gets through to the luminaries on Capitol Hill not widely known for their ability to distinguish forests from trees remains very much an open question. TM