Domestic Credit by Richard Freeman

Is a budget deficit inflationary?

Japan's and Germany's are proportionally higher, their inflation lower; a look at credit shows why.

The Dow Jones industrial average has lost almost 50 points on the news that the budget deficit in President Reagan's fiscal 1982 budget, which the President originally projected to be $42.5 billion, will be closer to $70 to $80 billion.

As I wrote last week, we anticipated the higher estimates for the budget deficit. But why should the stock market collapse and the financial markets' panic on the news of a $70 billion budget deficit? What does it matter to the real physical economy if there is a $70 billion deficit in fiscal year 1981, or even one as high as $100 billion, which Chase Manhattan Econometrics chief Lawrence Chimerine is predicting?

The financial markets have been too much influenced by the snake-oil prescriptions of quack economist Milton Friedman. According to the Nobel laureate's scheme of thinking, a large budget deficit must be financed by the issuance of Treasury debt. To the extent that all or a portion of this new debt is monetized by the Federal Reserve, the Fed buys this debt and pays for it by creating new money. The money supply swells and this causes inflation.

In fact, there is no causal connection between the size of a budget deficit and inflation. The argument is a fraud.

As Jacques Rueff, the architect of President Charles de Gaulle's magnificent program for the successful restoration of the French economy in 1959, and an impassioned enemy of the Friedman school, wrote in his 1959 Treasury documents outlining the French economic recovery, a nation can disregard the size of the public debt and instead focus on the rate of savings and production levels.

What is debt? It is the overhead cost of an economy for certain services, some of which are useful and some of which are not, and for internal improvements, like roadbuilding, and for sustaining science. Whether an economy can afford this overhead depends on its level of production and savings.

The useful side of government expenditures is that they contribute to the expansion of educational and other capacities of the workforce, and to vital services which allow our industrial base to be upgraded. If a sufficient level of savings exists in an economy, these savings can first of all serve as a pool of funds for the purchase and financing of Treasury debt, thus relieving the Fed of having to monetize it.

The U.S. savings rate for 1970-1980 averaged 6 percent, while in Germany the rate was 15 percent, and in Japan almost 20 percent. These countries were able to have higher deficits without inflation. Japan's budget deficit for fiscal year 1981 is $53 billion, and if Japan's budget were the size of the U.S. budget, Japan's budget deficit would be $159 billion. If Germany's budget were the size of the U.S., its fiscal year 1981 budget deficit would be $126.5 billion, Yet, Japan's inflation rate for 1981 is 5 percent, and Germany's is 6 percent, while the underlying U.S. inflation rate is above 10 percent. Surely if Friedman were correct, Japan's and Germany's inflation rates should be triple or quadruple the U.S. inflation rate.

But savings also serve as an investment pool for lending, by way of the banking system, for industrial expansion and technological upgrading.

This role of savings can be supplemented and expanded by the creation of fiat credit, provided that the latter is issued by the Fed in the form of 50 percent participations by the Fed in commercial bank loans to industry. Under those circumstances, it is not only not inflationary, but in fact counterinflationary.

How so? Say each new issue of credit is called Y. If for each new issue of Y, a corresponding output of production equal to or exceeding Y in value is produced, then the amount of new credit is paid back. Let us call this new output S', representing an economy's surplus. If the growth of S' exceeds the growth of Y, then goods production is outpacing money supply. In this case the growth of money supply is not dangerous, but in fact to be welcomed.

Further, to the extent that the pool of savings and the new fiat credit are used by industry to buy new technology, then the new technology will lead to cheapened costs. In this case, an economy can afford to support its overhead cost of government budget deficit without ill effects.