Domestic Credit by Lydia Schulman

A stockmarket rally and looming deficit

The freeze in detente raised the prospects of increased military spending which, even in the short term, could have disastrous effects on the dollar and the economy.

Last week's stock market rally, based on the assumption that increased defense spending in fiscal 1981 will boost the incomes of defense-related companies, was sheer mania. Increased defense spending will have disastrous effects on the U.S. economy, leading in short order to a mushrooming of the federal budget deficit, a blow out on the credit markets, and wild inflation. A military build-up in the United States also presumes the imposition of wartime austerity to "contain" the hyperinflation unleashed by military waste spending; the levels of austerity envisioned by advocates of a militarization of the U.S. economy such as the London *Economist* would be possible only under conditions of "limited democracy." In short, prospects for the U.S. economy under a military buildup are hardly something to celebrate over.

President Carter is expected to unveil a $615 billion budget for fiscal 1981 with a $15 billion deficit when he delivers his budget message to Congress later this month. Realistic analysts have long since rejected the $15 billion figure as impossibly low. A month ago, we estimated that the figure could go as high as $70 billion.

The administration's projection of a 17 percent increase in revenues over fiscal 1980 is exceedingly optimistic given the current rate of the recession's progress. On the expenditure side, Carter's rash decision to embargo grain exports to the Soviet Union could add over $10 billion in government spending over the next calendar year, in support mechanisms that the government may have to put into effect. Add to this projections of stepped up military spending—which will probably exceed the 3 to 4 percent annual increase after inflation which the administration is already committed to, and the picture of a looming deficit crisis emerges.

The United States financed the Vietnam War by running a masive balance of payments deficit and dumping U.S. Treasury debt on its European and Japanese allies. Now, it will not be so easy to finance a new U.S. military build up abroad.

As of last week and the grain embargo, most money market economists had thrown their predictions of easing interest rates to the winds. The concensus now is that the grain embargo alone will keep interest rates .25 to .50 percentage points higher than they would have been otherwise. The impact of higher military spending has yet to register on the economics profession and the credit markets.

On top of its impact on federal spending and U.S. interest rates, defense spending is inherently inflationary because it repesents the diversion of productive plant and equipment and labor to nonproductive ends. The result is a shrinkage of useful tangible goods produced and the reinvestible surplus generated by the economy. It is precisely the shift from productive to nonproductive (including defense spending, services, and outright speculation) investment that has been the primary source of inflation in the U.S. economy since 1966.

It was expected that the issue of trading off defense spending and consumption to avoid inflation would be raised. Michael E. Levy, director of economic policy at the Conference Board, contends that the chief cause of escalating inflation over the last 15 years has not been defense spending, but transfer payments to nonproducers (the unemployed, the welfare population, and the aged). Transfer payments to nonproducers cause the contributors, the tax-paying, employed workforce, to perceive that they are the losers and to demand higher wages. Levy forgets that the growth of unemployed and welfare population was the result of the stagnation of the goods-producing industries from the late 1950s on, and that chopping off transfer payments to permit increased defense spending merely aggravates the problem.

In its Jan. 5 issue, the *Economist* of London proposed that the United States overhaul its tax system to promote saving and discourage consumption, dressing up its argument with the expected references to productivity and capital formation. The real message of the article, titled "America opts for guns and butter": America should embark on the route of austerity and increased defense spending.