

## **George W. Bush versus Lyndon B. Johnson on The State of the Union**

by

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George W. Bush's State-of-the-Union address on January 29, 2002 was well crafted to receive bipartisan applause and support. As expected, the President announced plans for a substantial military buildup and greatly increased expenditures for homeland security. Perhaps more surprising, he did not back off from what could be equally expensive new federal spending for education, prescription drugs for seniors, extended unemployment benefits, and a number of other worthy social programs. How the U.S. government would finance this new spending was avoided. Instead, under the guise of the need for further economic stimulus, Bush reiterated his commitment to the further tax cuts now legislated or in prospect. Higher federal budgetary deficits seem inevitable.

All this bipartisanship is uncomfortably reminiscent of the 1960s, when President Lyndon B. Johnson increased military expenditures for the Vietnam war while simultaneously co-opting potential political opponents by also introducing expensive new "great society" social programs. Initially, in 1964, Johnson too was adamant about not raising taxes to prevent the federal budget from going into deficit. This combination of policies over stimulated the economy, and inflation became significant by 1968. President Nixon essentially continued Johnson's programs so that eventually, in August 1971, the cumulative American inflation forced a devaluation of the dollar and ended the Bretton Woods system of fixed exchange rates—ushering in the great inflation of the 1970s.

Despite the similarity between the Bush and Johnson fiscal shocks to the American economy, circumstances are sufficiently different today that the history of the 1960s and '70s is unlikely to repeat itself. The most important difference is in the theory and practice of monetary policy. Like other central banks, the U.S. Federal Reserve today is functionally more independent of the government. More important, economic doctrines have changed, so that central banks have a much narrower mandate focused on stabilizing the rate of inflation—a typically close to 2 percent per year. In contrast, in the earlier Johnson-Nixon era, central banks acted as if they had the further mandate to prevent unemployment. Thus, in the late 1960s, when inflation got started because of the Johnson fiscal shock, the Fed accommodated it rather than risk disinflation, and the increased unemployment that this was then thought to bring.

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Today, if inflation threatens, Fed Chairman Alan Greenspan can be counted on to raise interest rates vigorously—as did Fed Chairman Paul Volcker in the early 1980s. But if inflation is now unlikely, how will Bush’s fiscal shock to the economy manifest itself over the next several years? The short answer is in further deterioration in America’s balance of international of payments, i.e., a widening of the trade deficit with even heavier borrowing from foreigners.

Of course, the deficit in America’s current payments with the rest of the world antedates the Bush fiscal shock. Over the past decade, American personal saving has fallen more than government saving (as manifested in budget surpluses) increased. The principal structural problem facing the American economy has been deficient national savings, where net personal saving by households has been close to zero. The huge deficit in the current account in the U.S. balance of payments, about 4.5 percent of GNP in 2000 and 2001, reflected this private saving gap. In order to support a normal level of private domestic investment, i.e., historically about 17 percent of U.S. GNP, America has had to draw heavily on the saving of the rest of the world.

But under further pressure from the Bush fiscal shock, the Federal Government’s saving (surpluses) of 2 percent or so of GNP from the 1990s looks set to vanish and become negative. Thus, a reasonable presumption is that American trade deficits will become even bigger in the future.

Starting from the country’s huge net debtor position of about \$2.7 trillion in 2002, will even more sharply rising foreign indebtedness be a problem in the future? For the United States, it will not a problem in the usual sense, i.e., when creditors suddenly demand their money back from an impecunious and overstretched debtor—as with the crises in Mexico in 1994, Russia in 1998, or Argentina now. Rather, because the world is on a dollar standard—the dollar is the definitive money in making international payments, and U.S. debts to foreigners are all dollar denominated—the United States cannot literally go broke. As long as the dollar’s purchasing power over goods and services remains stable courtesy of Fed Chairman Greenspan, the U.S. economy collectively (but certainly not every household and firm in it!) can always find a way to roll over existing dollar claims held by foreigners.

By serendipity, America’s central position in the world’s monetary system gives the country a virtually unlimited international line of credit. This is manifested by its ability to run trade deficits for the last 20 years *without* having to pay higher interest rates on that dollar-denominated debt as it was accumulated by foreign creditors.

Nevertheless, a major problem remains: an across-the-board decline in America’s international competitiveness into the new millennium. The extraordinary inflow of capital, from both private and official foreign sources, keeps the dollar unduly strong in the foreign exchange markets—a form of what economists sometimes call the “Dutch Disease”. As the real value of the dollar appreciates into the new millennium with continuing U.S. trade deficits, aircraft exporters like Boeing will become less and less

competitive with Airbus, steel producers will continually claim unfair foreign dumping, movie moguls will shoot more films abroad, high tech industries will outsource even more, and so on. American productivity growth could well diminish.

One consequence is that American companies and unions are becoming even more protectionist—which puts the World Trade Organization (WTO) at risk in trying to preserve free multilateral trade.

Another consequence is that the world's richest most mature industrial economy is essentially draining capital from the rest of the world. This is particularly hard on natural debtors like emerging markets and other developing countries. Decreasing support for America's small official development assistance programs for poor countries may be no bad thing, but inadvertently grabbing the lion's share of the huge flow of internationally available private financial capital certainly is.