

WHAT LARGE DEFICITS WILL DO IF THEY CONTINUE
(AND WHAT WILL HAPPEN IF THEY ARE REDUCED)

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ABSTRACT

Projections of deficits in excess of \$200 billion a year through 1990 and beyond have raised considerable concern about the economic damage they will cause. Yet, many find it hard to describe exactly what harm deficits will bring, or how such harm will come about. This report provides a brief qualitative description of what economic analysis suggests that large deficits will do to the economy, and what the likely consequences of their reduction will be.

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INTRODUCTION

The Congressional Budget Office (CBO) estimates that the Federal Budget deficit will exceed \$200 billion throughout the five-year period over which CBO makes its projections. ^{1/} This exceeds 5 percent of Gross National Product (GNP) in each year. It is almost instinctive to feel that there is something wrong with running such large deficits. Yet, if pressed to say just what harm will come from them, many find it difficult to come up with an adequate answer. Among the reasons given, one can hear that deficits will drive up interest rates and halt the economic recovery, causing a new recession. Another argument is that the deficits will reduce capital formation and long-term growth. Inflation is promised by some observers as the consequence of budgetary imbalance. Large trade deficits and job loss can also be traced to deficits, according to some.

This report briefly describes what economic analysis says about deficits and what they do. In the first chapter, some of the things deficits do not do -- in spite of what is said to the contrary -- are discussed. Chapter two explains what the adverse consequences of deficits are. The way in which predictions of recession enter into the analysis is presented in chapter three.

^{1/} Congressional Budget Office. Economic and Budget Outlook for Fiscal Years 1986-1990. February 1985.

Finally, chapter four describes the likely economic outcome of a major deficit reduction.

I. WHAT DEFICITS ARE NOT LIKELY TO DO (IN CONTRAST TO WHAT IS FREQUENTLY REPORTED)

Three assertions that are frequently made concerning the projected level of deficit spending are that it threatens to arrest the current economic expansion or precipitate a new downturn, that it will be inflationary, and that it creates joblessness through its effect on international trade. None of these propositions is consistent with what mainstream economic analysis says about how deficits and the economy work. 2/

A. Recession and Trade Effects

The assertion that the deficits threaten continued economic expansion stems from their effects on interest rates. The argument is that large increases in the level of Government borrowing (a consequence of bigger deficits) drives up interest rates, which in turn reduce business investment in plant, equipment, and inventory, as well as household purchases of consumer durables and housing. As a consequence of the reduction in demand for these items, employment and income fall in these critical sectors of the economy.

2/ While it may be impossible to state precisely what is and is not "mainstream" economic thinking, it might best be defined as the analysis taught in most graduate and undergraduate economics courses or as expressed in the country's best-selling textbooks. Consult, for example, the country's two best-selling intermediate macroeconomic textbooks: Gordon, R.J. *Macroeconomics*. Little Brown, Boston, 1984; and Dornbush, R. and Fischer, S. *Macroeconomics*. McGraw Hill. 1983.

A similar story is told with respect to international trade. As interest rates rise, U.S. assets become more attractive relative to lower-yielding assets abroad. As a result, foreigners want to buy more U.S. assets and Americans wish to buy fewer foreign ones. Since purchases of U.S. assets must be made in dollars, foreigners attempt to obtain more dollars in order to make these acquisitions. At the same time, fewer dollars are made available by U.S. citizens trying to buy foreign assets. The combined effect of this increased dollar demand and decreased dollar supply is an increase in the value of the dollar in markets where it is exchanged for other currencies. The higher value of the dollar makes imports cheaper (it takes fewer dollars to buy the foreign currency needed to buy imports) and exports more expensive (because more foreign currency is needed to buy the dollars necessary to purchase the exports). U.S. exports decline, and domestic demand for goods that compete with imports falls. The result is a rise in unemployment.

The problem with this analysis is that it is only part of the total effect of deficits. While reducing employment and income in some sectors of the economy, larger deficits also increase employment and income in other sectors. Indeed, the increases can be expected to exceed the decreases for a net gain in economic activity as a consequence of bigger deficits.

An increase in the level of borrowing (which is what drives up interest rates), implies an increase in the deficit -- either as a consequence of more Government spending or reduced taxes. If it is due to an increase in Government spending, demand will increase in those industries producing goods (or in those producing services) purchased by the Government. 3/ If the deficit increase

3/ Or those purchased by individuals receiving transfer payments from the Government.

is due to a cut in taxes, the disposable income (that income which is left for spending after taxes) rises for individuals, prompting a greater demand for consumption goods. 4/ The loss of demand from the effects of the deficit on investment and net exports cannot exceed the gains from Government purchases and consumption.

This can be easily illustrated. The extra borrowing by the Government must equal the extra demand it directly creates by increasing its deficit. If borrowing increases by \$100, for instance, direct demand stimulus equals \$100. For the resulting rise in interest rates to hurt economic recovery, then, private investment (or net exports) must fall by more than \$100. Yet, if Government borrowing rises by less than private borrowing falls, total demand for borrowing goes down -- and a fall in demand for borrowed funds implies a reduction in interest rates. Hence the proposition that additional Government borrowing hurts recovery is based on a contradiction. It simultaneously argues that interest rates go up while implying that they fall.

Indeed, the above explanation is the worst-case scenario -- where the extra demand boost from Government borrowing is exactly offset by the demand reduction resulting from the interest rate effect. Most likely the offset will be incomplete, so that a net stimulus to employment occurs. The interest rate increase affects the general desire of the public to hold interest-earning assets like securities as opposed to money (which earns little or no interest). In an effort to switch from money to earning assets, the public pushes security prices

4/ Of course, individuals might choose to save the extra disposable income. If they did, however, they would be introducing an additional supply of saving on credit markets that would satisfy the extra demand from Government borrowing. The two effects would offset each other, interest rates would not rise, and no employment or unemployment effects would occur.

up, which moderates the interest rate increase. ^{5/} Consequently, interest rates do not rise enough to reduce demand in interest-sensitive sectors as much as demand increases in other sectors. As long as resources are unemployed and the economy is operating below capacity, the economy can produce more in response to the stimulus; more gets saved as a consequence of the increased income; and the need for saving to finance the extra borrowing is satisfied.

This explains why, for so many years, deficits were regarded as part of economic stimulus. It is true that the growing international integration of the economy has increased the responsiveness of capital flows, and that this has weakened the stimulative demand effects of larger deficits by increasing the employment offset coming from poorer export performance. However, there is still good reason to believe that the net effect of larger deficits is stimulative, and that employment is improved -- not hurt -- by growing deficits.

B. Inflation

The notion that deficits will significantly worsen inflation is difficult to analyze because the means by which Government borrowing is supposed to affect prices is rarely specified by those making the claim. The argument probably has its roots in the principle explained in the last section -- that increasing deficits stimulate demand. A demand stimulus -- especially when supply is insufficient to meet it -- can generate an increase in prices.

However, inflation is the change in prices, not their level, so that it is the change in the deficit and not its level that is the real fiscal

^{5/} The price of an asset earning a fixed rate of interest rises as prevailing interest rates fall and vice-versa.

determinant of the rate of inflation. 6/ Current and projected deficits are very large; but that is irrelevant because deficits must be increasing to increase prices. Current projections of the structural deficit (the part not caused by changes in economic activity) 7/ show only relatively minor increases. Thus, any inflation from the effects of deficit changes on demand is likely to be small.

It may be argued that deficits are monetized by the Federal Reserve System (that is, financed by creating money), or that the debt that is issued to finance deficits is a close enough substitute for money that its accumulation is potentially inflationary. Evidence suggests, however, that neither of these phenomena occurs to any extensive degree. 8/ Consequently, inflation does not appear to be a very likely outcome of even \$200 billion deficits over the next five years.

C. Summary

It is said that deficits threaten to halt the current expansion through their effects on interest rates, that they cause job loss due to their international trade effects, and that they are potentially inflationary. None of

6/ See U.S. Library of Congress. Congressional Research Service. Deficits and Macroeconomic Stabilization: Is it How Big they Are or How Much they Change that Matters? CRS Report No. 85-47 E, by G. Thomas Woodward. Washington, 1985.

7/ For an explanation of structural deficits, see U.S. Library of Congress. Congressional Research Service. Structural Deficits: Definition and Measurement. CRS Brief MB84217, by Thomas Woodward. Washington. Continuously updated.

8/ Or to the extent that monetization occurs, it is not a necessary consequence of deficits. See Deficits and Economic Stabilization.

these claims are supported by mainstream economic theory or evidence. The first two claims neglect the offsetting employment and demand effects of deficits which can result in a net stimulus to employment -- rather than a contraction. The last neglects the crucial distinction between changes in deficits which can push up demand (and, possibly, prices) and levels of deficits -- which do not.

II. WHAT DEFICITS PROBABLY WILL DO (IF THEY CONTINUE TO BE LARGE)

If the large deficits that are projected through the beginning of the next decade are neither likely to slow the current expansion nor significantly raise inflation, it is natural to wonder just what harm they will do. Indeed, it might seem undesirable to reduce or eliminate them if that is the case. The answer to this is that stimulating and reducing demand in the economy is not the only economic process one needs to be concerned with.

A. The Allocation of Output and Future Consumption

As explained above, changes in the Government's budget deficit affect the level of investment, net exports, and foreign ownership of U.S. assets. This means that the deficit affects the kinds of goods produced in the economy and ultimately how much the country will be able to consume in the future.

To the extent that larger budget deficits tend to reduce investment, the capital stock grows more slowly than it would have otherwise. A smaller capital stock in the future will generally mean less output than could otherwise be produced by the same labor force. This reduces potential future consumption.

To the extent that investment is largely unaffected, but that net exports fall, the capital stock will grow as fast as otherwise, but a larger proportion of it will belong to foreigners. Consequently, while future output may be unaffected by the Government's fiscal policy, a smaller amount of that output

will go to Americans. Future potential consumption, again, will be smaller than it would be without the large deficits.

Thus, the real adverse effect of large deficits is long-run in nature. Instead of hurting the short-run demand for goods and services, they hurt long-run supply. Deficits may not reduce income levels now, but they should reduce future income and/or consumption. They permit an increase in current consumption only at the expense of consumption in the future.

B. Deficits, Debt, and Interest Outlays

While the effects of deficits occur largely in the future, and while the expected effects may at this point may be relatively small, there is another feature of the budget that makes deficits potentially more damaging. This is the feedback effect deficits have on debt, Government interest outlays, and future deficits.

A large deficit produces substantial increases in the debt (the cumulative amount the Government owes). Since the Government must pay interest on its borrowings, additions to the debt add to Government interest outlays. This means that even without legislated changes in expenditures, or increases in outlays due to adverse economic conditions, Government outlays still increase as a consequence of rising interest obligations. If the interest bill rises faster than economic growth can push up revenues, the deficit -- because it is already large -- must also grow. Tax increases and/or expenditure cuts are required just to keep the deficit from getting bigger.

Hence, a large deficit which may not have very great effects on future consumption (and may not have them soon) has the potential to become a very large deficit that does have such effects if it is left unattended. Deficit

reduction can be required just to keep the deficit from growing. Immediate deficit reduction can be desirable because the growth of interest obligations over time increases the size of the tax increases or expenditure reductions that will ultimately be needed to balance the budget.

C. Summary

Deficits may be regarded as harmful to the economy because of their potential to reduce future consumption. This result can occur because the interest rate effects of Government borrowing either reduce investment or encourage capital inflows. Consequently, either less is produced in the future than would be otherwise or a smaller amount of what is produced winds up as income for Americans. In addition, very large deficits can cause a growth in Government indebtedness and interest obligations so rapid that outlays or taxes must be adjusted just to keep the deficit from growing. Thus, it may also be desirable to reduce current deficits just to prevent future deficits from getting out of hand.

III. HOW A RECESSION MAY ENTER THE PICTURE (IF IT IS NOT TO BE CAUSED BY DEFICITS)

The fact that large deficits will not cause a contraction does not mean there will not be one. Indeed, a number of economists, aware that the deficits do not threaten a downturn, nonetheless expect a contraction in economic activity next year. These expectations are largely due to assumptions about monetary policy. There is widespread belief that monetary policy is responsible for the last four recessions, and that it may cause the next.

Transactions in a developed economy must be conducted through the medium of money. The use of barter in exchange significantly constrains commerce. Hence, an economy's ability to generate income depends to a significant degree on there being sufficient quantities of money. Given the factors that determine how much money people wish to hold and given the prices that have been set for the goods and services to be exchanged, the quantity of money will determine the level of income. In the longer run, when prices can adjust as necessary to keep income at levels consistent with the economy's capacity output, the quantity of money becomes an important determinant of the level of prices.

As a result of this, control of the supply of money is essential in controlling the long-run increase in prices (that is, controlling the rate of inflation). In addition, efforts to reduce inflation by reducing monetary growth will typically result in short-run reductions in income (that is, economic contraction).

Efforts to reduce inflation, therefore, often imply recession. This problem is further complicated by the fact that money growth is not easily measured, that the "right" quantity of money for a given level of income can not be determined with much accuracy, and that control over the money supply is incomplete. Even without deliberately pursuing a policy to slow monetary and economic growth, monetary authorities can easily do so unintentionally.

The anti-inflationary monetary policy begun in late 1979 met with considerable success during the 1981-82 recession. The gains made during that period appear to have been maintained. Yet, while the inflation rate has been halved (or better), a rate of four to five percent price increase is expected to persist for some time to come. This level of inflation was considered intolerably high in 1971 (enough to bring about wage-price controls). Consequently, it is not unlikely that a new concerted push to reduce inflation further through slower monetary growth could be forthcoming some time in the next few years.

If such events transpire, it is important to recall that it is not the continuing large deficits that precipitate them. The contraction, however, while not caused by the deficits, will have an effect on them. The reduction in tax revenues and swelling of Government expenditures that result from reductions in economic activity would balloon the size of the deficit to perhaps \$300 or \$400 billion dollars. This would significantly aggravate the feedback effect on debt and interest payments -- so much so that without efforts to bring the budget under control, the deficit would continue to increase rapidly as a result.

IV. LIKELY CONSEQUENCES OF DEFICIT REDUCTION

As the previous chapters have demonstrated, large deficits, continuing for the foreseeable future, are likely to have, if anything, salutary short-run effects on employment and income and adverse long-run effects on potential future consumption. It stands to reason that the opposite is true of the effects of significant deficit reduction. Future consumption possibilities should be enhanced by reducing the deficit, while the immediate cyclical impact may be deleterious.

Because increases in the deficit tend to stimulate aggregate demand and employment, a substantial reduction in the deficit should slow the economic expansion. This much is largely unambiguous. The real question is how much. Given the size of the potential deficit reduction, the possibility of inducing a new recession as a consequence of bringing the budget closer to balance is real.

On one hand, as explained earlier, many indications exist that changes in the size of the deficit exert only weak pressure on demand. Much of the stimulus from cutting taxes and increasing expenditures appears to be offset by the foreign capital flows and net export reductions brought about by the interest rate effects of Government borrowing. ^{9/} Hence, one could expect that the

^{9/} For a more detailed discussion of the implications of international trade and exchange rate regimes on stabilization policy, see U.S. Library of Congress. Congressional Research Service. U.S. Economic Policy in an International Context; Deficits, Taxes, and Monetary Policy; by Jane G. Gravelle and G. Thomas Woodward. CRS Report no. 84-125 E. Washington, 1984.

depressing effect of a reduction in the budget deficit would also be weak, offset in part by the stimulus from an increase in net exports.

On the other hand, two factors -- the timing of the stimulus and contraction, and the price effects of dollar devaluation -- may nonetheless work to cause a temporary contraction in economic activity.

Because financial flows can shift quickly, a budget reduction large enough to affect the interest rate can produce a fairly immediate effect on the value of the dollar. However, exports and imports react to exchange rate changes with some lag. Indeed, given factors like the time goods spend in transit, many international commercial commitments are made in advance of the exchange of currency, so that changes in the value of the dollar will have next to no effect on net exports at first.

This means that the depressing effect of the deficit reduction on demand comes first. The partially offsetting stimulus to net exports comes later, so that the immediate result of deficit reduction will probably be more contractionary than its ultimate net effect. The short-run impact could be enough to precipitate a downturn.

In addition, because a fall in the dollar raises the price of imports, a component of the general level of prices rises. In the short-run, this can be a particularly pronounced phenomenon, since the inability to escape many international commercial commitments means that American importers have little choice but to demand foreign currency in the face of reduced willingness to sell it -- driving the dollar down in value temporarily below the level it will eventually assume. This exacerbates the price effect described above. The price increase is further spread as import-competing industries face reduced competitive pressures and raise their prices, and as all these price increases pass through the economy.

Yet, the price increases cannot be sustained without additional money creation. Unless the Federal Reserve becomes more accomodative, the end result is a contraction in economic activity that will persist until the general level of prices is adjusted downward. The Federal Reserve could, of course, raise the rate of expansion of the money supply, but this would make the price increase permanent and possibly raise the inflation rate thereafter.

Briefly then, a major reduction in the deficit will have virtually the opposite effect of that expected by many casual observers. Rather than "super-charge" the current expansion, it will probably slow it down and may even cause a contraction accompanied by a temporary surge in prices. The benefits of deficit reduction are long term -- not short term -- in nature.

CONCLUSION

The real damage that continuing large deficits do to the economy is not in reducing employment or threatening the completion of the recovery. Indeed, the aggregate short-run effects of deficit growth are to help increase employment and income.

Current projections of deficits do not carry much threat of worsening inflation, either. It is how much deficits grow rather than how big they are that puts upward pressure on prices. The current and projected deficits, while large, are not growing enough to significantly increase inflation.

The adverse consequences of deficits come from their long-run effects on future potential consumption. To the extent that they shift the allocation of output away from investment, a smaller future capital stock is available to produce output later on. Less income results. To the extent that deficits shift the allocation of output from net exports, they induce capital inflows that cause a larger proportion of the capital stock to be owned by foreigners. Less of the output produced in the future is left over for Americans to consume.

Even though these effects are in the future, and even though they may be relatively small compared to total consumption (given the size of the deficits), large deficits have an additional effect that may nonetheless make it desirable to reduce them now. Large deficits cause substantial additions to the Government's debt. This increases its interest burden -- possibly faster than the growth of the economy can increase tax revenues. As a consequence, deficits grow larger and have greater economic effects over time.

Moreover, the longer it takes to reduce the deficit, the bigger expenditure cuts or tax increases have to be to do the job.

A contraction can, nevertheless, be in the picture some time soon. Monetary policy aimed at reducing inflation further could precipitate a slowdown in economic activity. Ironically, a reduction in the deficit could do the same in the short run, especially if the response of exports and imports to a fall in the dollar exchange rate is slow. A temporary surge in prices would also be a consequence of deficit reduction. Clearly, the rationale for reducing the deficit is long-run and not short-run in character.