

THE IMPLICATIONS OF BUDGET DEFICITS

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Professor Brunner (1986) has provided a far-reaching analysis of the implications of budget deficits with a paper that covers various aspects of the question. He throws a great deal of light on the relationships between deficits and interest rates, as well as on related questions of economic growth, allocation of resources, inflation, and real rates of interest. The most important contribution of this paper is contained in the mathematical analysis presented in the last section. In an extension of the Sargent and Wallace (1981) analysis, Brunner develops a dynamic process relating the stock of federal debt to inflation, real growth, and real interest rates. This approach provides valuable insights into the implications of the deficit.

First, it demonstrates the importance of the relationship between the real interest rate and the normal rate of real growth to the stability of the financial system. When the real rate of interest exceeds the normal growth rate of the economy, which is surely an apt description of the current situation in the United States, the dynamic process is highly unstable, implying that real debt will rise relative to GNP without limit. This analysis confirms the concerns which are widely held about the current fiscal situation.

Second, Brunner's model demonstrates the inflationary implications of permanent deficits of 5 percent of GNP, which is implied by extension of the current services budget. We should not anticipate double-digit inflation; look for triple digits! The conclusion, which Brunner correctly points out, is that a noninflationary monetary policy and a permanent deficit policy cannot coexist in the long run. He concludes, and I concur, that the monetary regime is more likely to be adjusted, leading to higher inflation.

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An extension of Brunner's model to include economic growth and the real interest rate is a logical next step and a promising area of research. By adding explicit assumptions about monetary policy, fiscal policy, and growth of productive capacity, a relatively simple model that concentrates on the joint determination of the real interest rate, inflation, the federal debt, and economic growth should be obtainable. Within such a framework the implications of the deficit for real interest rates, growth, and inflation could be explored more fully within a small model whose properties easily could be demonstrated.

Brunner strongly criticizes the concerns market participants have with the deficit. I have a great deal more respect for the basic instincts of market participants. Their statements of the issues may not always be complete, but they have gone through the best learning process yet devised by man, the market which constantly tells them whether they are right or wrong. Thus I would like to offer an alternative interpretation of what worries Wall Street, an alternative that is quite consistent with Brunner's conclusions.

Wall Street is concerned that the deficits will persist. Merely looking at the current deficit is too simple. At a minimum, it is necessary to adjust for the stage of the business cycle to analyze the implications of the deficit for interest rates (Congressional Budget Office 1985). I attended a meeting in 1981 in New York at which a Treasury Department official presented graphs of interest rates and budget deficits and claimed that there was no relationship. The professional investors at that meeting realized that the relationships are more complicated, that budget deficits and interest rates are affected by other variables, particularly the stage of the business cycle. They also knew that tax changes had reduced future revenues to a degree that had not been paralleled in previous business cycles. Investors have also expressed serious concern about the implications of unfunded liabilities in medical programs and Social Security.

Investors therefore conclude that the political process cannot deal with the problem of controlling government spending. Entrenched special interests cannot easily be made to give up their benefits under a representative democracy, unless and until we can devise more effective means for budgetary control. In the end monetary policy will have to give way to the reality of inflationary pressures emanating from the fiscal regime. Monetary expansion will exceed prudent limits, ensuring serious bouts of inflation in the future.

The precise implications are unclear, but the conclusion is that imbalances in fiscal policy impart an inflationary bias to our economy that evidently cannot be resolved. Consequently, my reading of

investor concerns indicates that Wall Street would agree with much of Brunner's analysis.

The perspective of market experience, however, leads me to disagree with Brunner's view of the irrelevance of flow analysis. Brunner argues that the simple analysis that high deficits mean higher interest rates influenced market participants to overpredict the inflation rate. In fact, the biggest errors in forecasting the 1984 inflation rate were made by those who relied primarily on a monetarist approach, emphasizing links between monetary growth and inflation. This approach was misleading partly because of distortions from new kinds of deposit instruments and because of the strength of the dollar.

The flow analysis commonly used by market analysts to predict interest rates is done in a more complete flow-of-funds framework. This approach emphasizes the longer term implications of deficits, including the problems associated with a mature business cycle in which deficits persist at 5 percent of GNP. The conclusion is that inflation and interest rates will be rising, perhaps sharply, as the economy approaches full capacity utilization. The claim that flow analysis is irrelevant requires instantaneous adjustment to every kind of new information. Investment decisions are made by individuals, not computers, and the human mind is incapable of continuous analysis of all relevant variables. Consequently portfolios are influenced by the history of investment decisions, as well as by transactions costs and accounting and legal requirements that prevent or delay full adjustment.

I would also argue that when fully understood and fully specified, flow analysis is not inconsistent with stock analysis, but is rather a different way of looking at the same phenomena. However, changing expectations and uncertainties in the financial markets prevent or delay instant reflection of equilibrium stock adjustments.

Relating these thoughts to investor concerns about the deficit, investors are impressed with the fact that \$200 billion deficits imply that the federal government must raise, on average, net new funds of \$4 billion weekly. I have often heard the comment, "Why extend maturities now, the market will persistently be hit with new supply." The implications are often referred to by the term the "Europeanization" of the bond market. The meaning is that, as in many European countries, our market will become dominated by government issues and private issuers will only be able to sell much shorter maturities than in the past.

I contend that this already has happened. Many institutional portfolios, which used to make little use of government debt, are dominated by governments because they are the only issues that have

much liquidity in the marketplace. Private debt has been shortened considerably. In 1975–78 private issuers floated about \$17–18 billion of long-term bonds of 20 years maturity or longer, approximately 70 percent of all new bonds. In 1984 only 15 percent or \$10 billion of new issues were 20 years or longer (Kimelman and D’Oelsnitz). These developments could be said to describe a “collision” or a “crowding out” of private borrowers by the deficit, although this is a different sense of the term from that used by the *Wall Street Journal* in its editorials during the mid-1970s.

Finally, three additional points concerning the relationships between interest rates and deficits should have been discussed more fully in Brunner’s paper.

First, the extraordinary strength of the dollar has held inflation down and has helped in the financing of strong demands for credit. Had the dollar not been so strong, might we not already be seeing the increases in interest rates and inflation associated with the imbalances in fiscal policy? And what will happen when the dollar declines? The common fears might then be quickly realized.

Second, the yield curve had a flat to negative slope throughout most of the 1980–82 period. This is certainly consistent with the conclusion that monetary policy was tight. When combined with stimulative fiscal policy there is a logical explanation for high real interest rates (Blanchard and Summers 1984). I would argue that this is a reasonable alternative to Brunner’s explanation. In fact, it may only be another way of looking at the same phenomenon.

Third, the combination of budget deficits and financial deregulation creates considerable uncertainty about future interest rates. The question that arises is whether, without constraints on interest rates, the next cyclical peaks in rates will be higher than ever. On the other hand, high real rates could imply that the economy would remain weak enough to prevent extreme levels of rates. This question is a concern in the market that so far has received little attention from analysts.

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MONETARY POLICY AS A FISCAL INSTRUMENT

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Introduction and Summary Recommendations

The depression of the 1930s resulted in the creation of many federal agencies that served reasonably well for several decades. Beginning late in the 1970s and continuing into the 1980s, a thorough review and reassessment of the performance of most government agencies has been underway. In the areas of transportation, communications, and banking, significant reforms have been instituted. In other areas they are under consideration. It is entirely appropriate that the U.S. approach to central banking also be reconsidered. The Banking Act of 1935 considerably altered the powers and responsibilities of the Federal Reserve, mainly because the design of 1913 had not prevented the Great Depression. Now we know that the present design was not successful in preventing the great inflation of the 1960s and 1970s. In view of the massive current and prospective federal deficits, it is natural to desire institutional safeguards against the possibility of the fiscal environment resulting in a permanently high inflation era.

The three instruments of monetary policy—the discount window, reserve requirements, and open market operations—are obvious candidates for possible changes. The following reforms should be evaluated:

Discount Window—A floating “penalty rate” on loans by Federal Reserve Banks to private depository institutions should be required. There is no justification for subsidized lending rates to the borrowing banks.

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