

THE ECONOMIC IMPACT
OF LARGE FEDERAL BUDGET DEFICITS

Comments by
Roger Guffey
President, Federal Reserve Bank of Kansas City

Mid-Continent Small Business United
Kansas City, Missouri

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Mike Milvain's kind invitation to meet with you today to make some brief comments was particularly welcome, given the important, if not critical, issue you will be considering here. That issue is the impact of the Federal budget deficit on our economy. I am particularly pleased to be here with the distinguished chairman of the U.S. Senate Finance Committee. We in the Federal Reserve share with Senator Dole a mutual concern about the problems related to the current and prospective federal budget deficits.

As many of you know, Federal Reserve Chairman Paul Volcker was among the first to voice public concern about the deficits. And he and many of my colleagues within the Federal Reserve have continued to voice concern because large budget deficits seriously complicate our ability to implement an effective monetary policy and therefore threaten the economic expansion now under way. My own convictions about the dangers of the deficits have been stated often on public platforms throughout this region.

My comments today will focus solely on the economic consequences of the deficit problem, as I see them, while I am sure the senator will address the difficulties of finding an appropriate political solution to the problem.

Why do we in the Federal Reserve worry about the deficits? And why are many thoughtful business and political leaders now trying to awaken the public consciousness to the dimensions of the deficit problem?

My concern about the deficits, which I know is shared by many, centers upon the effects of the deficits on our nation's economic performance both now and in the future. In my view, the current deficits have a number of negative implications, some of which are only partly visible today in the midst of our current business expansion.

While it is true that Federal deficit spending has spurred economic growth and helped end the deep recession of 1981-82, it also is true that Federal spending and the huge deficits have resulted in a level of interest rates higher than they otherwise would be. As a result, many credit-sensitive sectors such as housing and autos have been less vibrant than would have been expected. In addition, business investment spending has been deterred somewhat. Consequently, the current economic expansion has been unbalanced and the economic picture has been distorted.

High interest rates are also a problem because they keep the U.S. dollar unusually strong, making many of our goods uncompetitive in world markets. The export sales we lose contribute to unbalanced economic growth. A further problem of high interest rates is manifest in the difficulty faced by many debtor nations struggling to repay their international debts. High rates here and a strong dollar cost borrowers more and certainly complicate and delay resolution of the international financial situation.

Despite the disturbing scope of current economic distortions caused by the deficits, I am even more concerned about the

pernicious and pervasive effects of the recurring large budget deficits in future years.

As the economic expansion continues this year and, hopefully, next year, growing business and consumer credit demands will surely clash with government borrowing needed to finance the deficits, leading to the problems of "crowding out" and rising interest rates. It is clear to me that the problems associated with crowding out tend to raise public fears about renewed inflation. Such rising inflationary expectations will surely weaken the foundation for lasting economic recovery that has been laid at such a very great cost to this nation. With only a limited pool of savings available, the crowding out of private investment by a shift of the available resources to the government will reduce capital formation substantially. As you know, accumulation of capital is a key determinant of future growth in productivity. And if productivity does not increase, economic growth, real wages, and our standard of living will stagnate.

For all these reasons, I cannot overstate my concern about the current and prospective budget deficits. I sincerely believe that the nation stands at a critical crossroads; if we choose the correct policies, we now have the opportunity to make the current economic upturn a long-lasting period of expansion. If we do not as a nation have the courage and political will to choose the correct policies, we risk losing much of the progress we have gained against inflation and we raise disturbing questions about the long run health of our economy.

As for resolving the deficit problem, there are no easy answers, though the alternatives seem clear. We can cut spending or we can increase revenues, or we can do some of both. But deciding where to cut spending or how to increase revenues is fortunately not within the province of the Federal Reserve. Such decisions are made in the political arena and are related to the will of all Americans.

In summary, I am encouraged about the sincerity and intensity of the public debate over the budget deficits. I applaud the courage of people in public life such as Senator Dole who take a stand on this issue and I remain hopeful that our political processes will produce an appropriate solution soon.