Combating Recession With Government Spending

Remarks by
Darryl R. Francis, President
Federal Reserve Bank of St. Louis
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As you are all aware, the United States has been suffering from the most serious economic recession since the 1930s and the most severe inflation since World War II. Progress is being made in alleviating both of these problems. Inflation began moderating late last year, and real production turned upward this spring. I am confident that these favorable trends will continue in the near future. However, because of actions which are being taken to stimulate economic activity, I am not so sanguine about the longer-run outlook, and I would like to share some of my concerns with you today.

Fiscal Actions Appeal to Policymakers

The United States Government has launched an extremely ambitious program of fiscal action to combat the recession. The program consists of a substantial expansion in Federal expenditures combined with a series of tax reductions and rebates. As a result, the Federal

deficit in the national income accounts budget ran at an $80 billion annual rate during the first half of this year. Projections are that massive budget deficits are likely to continue through mid-1976. By comparison, the previous peak was $55 billion in 1944 during the all-out war effort. The largest previous deficit incurred for the purpose of contributing to economic recovery was $22 billion in 1971.

The Canadian economic situation and corresponding government response have been somewhat similar to those in the United States. Hence, my remarks regarding the United States have some relevance for Canada. Canada also has experienced a recession and rapid inflation since early 1974. However, partly because of Canadian petroleum resources, the recession has been milder than in the United States. In Canada, as in the United States, it appears that a recovery has begun, accompanied by a major fiscal effort, especially when spending by provincial governments is included.

The argument for aggressive economic stimulation seems persuasive to most policymakers. They see that the economy is not performing at its potential. Unemployment in the U. S. is currently

above 8 percent of the labor force, and real production is about 7 percent below a level reached nearly two years ago. At the same time, the inflation problem has been receding, and some economists have argued that this permits a more forceful attack on the recession without danger of renewing inflation.

Proponents of Government fiscal action point out that lowering taxes increases the disposable incomes of individuals and businesses, tending to bolster private expenditures for goods and services. Demand for goods and services can be affected quickly and directly when the Government itself increases its outlays. Government actions, it is alleged, affect total demand with a multiplied effect as the funds "freed" or injected by the Government are spent over and over in the private sector. Greater demand, in turn, is the catalyst which will bring economic recovery by encouraging production, employment, and income.

Fiscal Actions Are Unnecessary and Harmful

A Government program of massive spending, combined with tax rebates, may provide some short-run stimulus to the economy, but in my view such a program is not essential to provide

for a sound economic recovery. Moreover, aggressive Government spending restricts the amount of resources available to the private sector of a nation's economy and reduces economic freedom. Also, it is likely to hamper real economic growth, foster more inflation and add to economic instability.

It seems rather obvious that as the Government spends more and raises the necessary funds by taxation or borrowing from the public, individuals and businesses are left with smaller shares of total income to spend as they choose. As the Government takes a larger share of saving to finance deficits, less remains to be invested for future growth. As Government deficits trigger more rapid monetary expansion, inflation will accelerate, and if restraint is applied later to resist the inflation, production and employment will be affected adversely.

The current recession and inflation, as well as earlier ones, were not primarily caused by developments in the consumer or business sectors or internal breakdowns in the economic system. Our research indicates that other forces, usually well-intentioned Government actions, have been a chief cause of all recessions and inflations in the past fifty years. The major destabilizing force, as we have observed, has been variations

in the rate of monetary expansion brought about in part by changing Federal deficits. In the past several years the economy also has been adversely shocked by a number of constraints on supply, including the much higher cost of energy, crop failures, increased environmental regulations, and wage and price controls. But, there is little that stabilization policies can do to replace the resources lost through such developments.

The view that changes in Government expenditures and tax rates exercise a powerful and enduring influence on total spending does not give adequate recognition to the problems of financing of Government expenditures. Our research indicates that Government spending financed by taxes or by borrowing from the public reduces other spending to such an extent that there will be little, if any, net increase in total spending after about two quarters. This process of Government expenditures "crowding out" private spending can be observed in the capital markets today. As the Government seeks more and more funds to finance its spending, interest rates are bid up to ration the remaining supply of funds to the

businesses, homebuyers, and municipalities that demand them.

If Government expenditures are financed by money creation, the stimulative effects on production and employment remain longer. The greater Government spending is not initially matched by a contraction in private demand, since individuals and businesses temporarily retain all of their purchasing power.

Nonetheless, the stimulation flows from the money creation, and it is not essential for the Government to run a deficit to obtain any desired money growth. In fact, when the Government runs huge deficits, the probability of excessive monetary expansion increases. Rapid monetary expansion acts as a spur to real economic activity for a time, but a different form of crowding out does ultimately occur. As individuals and businesses with greater money demand bid for limited goods and services, prices are forced up until the markets clear. Our studies indicate that any beneficial effects of a large deficit financed by increases in the money stock gradually erode, leaving only a higher level of prices after several years.

Past Government Spending and Its Effects

Let me give some perspective on the course of U.S. Government spending and its effect on the economy. In the first half of 1975, Federal expenditures in the national income accounts budget were running at a $350 billion annual rate. This was up at an 11 percent annual rate from 1965, following a more modest 4 percent rate in the previous twelve years.

The greater Government expenditures provided few, if any, stabilization benefits of a lasting nature. They did, however, contribute to a number of economic problems. Acceleration in the trend of Government spending since 1965 was accompanied by a substantial increase in the Federal debt, a marked rise in market interest rates, rapid increases in the monetary base and money, and a much higher rate of inflation. Nevertheless, despite any short-run stimulative effects on real output these Government actions may have had, the average level of unemployment has been roughly the same since 1965 as in the previous twelve years -- about 5 percent of the labor force. Since 1968 the average level of unemployment has risen to 5.6 percent. The average growth rate of real output has slowed from a 3.5 percent annual rate in the 1953 to 1965 period to less than 2.5 percent in

the decade since 1965.

In my view these developments were not coincidental. The pronounced rise in Government spending was financed in part by increases in debt, even though tax receipts rose much faster than personal income. Net Government debt, exclusive of that held by Government agencies and trust funds, rose at an average rate of over $10 billion per year from 1965 through 1974 after increasing $2.6 billion per year in the previous twelve years.

The greater Federal borrowing took a major share of the nation's saving, reducing the amount of funds available for the private sector. Government also contributed to less saving by channeling a larger portion of the nation's income through Social Security and other transfer payments, which tended to bolster consumption relative to saving. Partially as a result of these developments, the growth rate in real private domestic investment dropped about one-third after 1965. Real investment, which is the basis of economic growth, slowed to a 2.8 percent annual growth rate from 1965 to 1974 after increasing at a 4.1 percent rate in the previous twelve years. Many individual investment programs were

completely crowded out and others were trimmed as the price of available funds rose.

In part to moderate the abrupt increases in interest rates accompanying the Government borrowing, the Federal Reserve purchased about $46 billion of Government securities from 1965 through 1974. This was at an average annual rate of $5 billion, or over four times as much as during the 1953-65 period. Purchases of Government securities by the Federal Reserve add directly to the monetary base, the dominating factor determining the money supply. Largely as a consequence of these purchases, the money stock rose at a 6 percent rate from 1965 to 1974 after rising at about a 2 percent pace in the previous twelve years.

The trend growth rate in the money stock is the chief factor in determining the trend rate of increase of prices. From 1968 to 1974, consumer prices also rose at a 6 percent annual rate following an increase at a 2 percent rate in the previous twelve years.

It is true that Government spending and deficits, by themselves, do not necessarily lead to the increases in the rate of growth of the money stock; nor do they cause inflation. The inflationary impact of a deficit depends upon the

Federal Reserve monetizing the deficit through open market purchases and the resulting growth in the money stock causing aggregate demand to exceed growth of productive capacity. Yet, during periods of heavy Government borrowing, and rising market interest rates, the Federal Reserve tends to accumulate Government securities at a rapid rate even though it progressively permits money market conditions to tighten. For example, from February 1972 to March 1973 the Federal funds rate jumped from 3.3 to 7.1 percent. Nevertheless, growth in the money stock accelerated to an 8 percent annual rate from first quarter 1972 to first quarter 1973 after increasing at a relatively rapid 6.3 percent rate in the previous year.

Some of us believed at the time that monetary expansion should have been much slower in 1972, but others felt that the expansion was essential to prevent still more rapid short-run increases in interest rates during this period of sizable Government borrowing. More rapidly rising rates, it was alleged, might choke off the economic expansion.

In short, increased Government spending and huge deficits placed monetary authorites in an

unenviable position. The choice was either to monetize the debt with a resulting acceleration in inflation, or to refuse to monetize it and permit more rapid rises in interest rates in the short-run, hence, according to some economists, risk halting or reversing an economic expansion. When faced with these alternatives, central bankers generally have accepted some monetization. They generally view unemployment as a greater hardship than rising prices, and it is hoped that inflation, which usually occurs with a much longer lag, can later be avoided or prevented.

The Current Situation

Since the current rate of increase in Government spending and borrowing exceeds the rapid trend of the past decade, I am even more concerned now about possible adverse impacts on the economy. The rapid expansion in Government spending in the 1965 to early 1975 period, which intensified many of our economic problems, was at an 11 percent annual rate. In the past year Government spending has jumped at a 22 percent rate, and it has been accompanied by rebates and a reduction in tax rates. As a result, the Government deficit in the national income accounts budget, which ran at an average $10 billion per year from 1965 through

1974, is estimated to be about $70 billion in the current fiscal year. All of this comes when inflation is still a serious problem, and when the demand for funds in the private sector will probably rise substantially as the recovery progresses.

Selling sufficient securities to finance the massive deficit places great direct upward pressure on interest rates. Also, much of the expansion in Government expenditures, such as unemployment compensation and other transfer payments, tends to bolster current consumption at the expense of saving, giving still more upward thrust to interest rates.

These developments again place the monetary authorities in a difficult position. The Federal Reserve System presently has a target range of a 5 to 7 1/2 percent rate of growth in money, which is expected to provide a sound recovery. To obtain the target range, net purchases of Government securities by the Federal Reserve System from now until next spring will accommodate less than 10 percent of the projected net Government borrowing. This is substantially less than the 23 percent of outstanding debt the System now holds.

If the System monetizes a much smaller portion of this debt than it has in recent years

and the economic expansion progresses as envisioned, market interest rates will rise sharply. The higher rates, in turn, will perform their function of allocating the available credit to fewer businesses and consumers so that resources can be transferred to the Government. Given the massive budget deficit, this may be the best scenerio to provide for longer run economic stability. However, high interest rates are politically unpopular, especially at a time when production is below potential and when many private ventures are contracting or failing.

On the other hand, if the Federal Reserve System abandons its target range for money and seeks to moderate the rise in interest rates by continuing to purchase an amount equal to about one-quarter of the new Government debt, interest rates may not rise rapidly this fiscal year. However, interest rates would gradually rise to an even higher level later. At first, the larger Government borrowing will increase demand for funds, even though the Federal Reserve monetizes a larger amount, but constant share. Moreover, such sizable System purchases of Government debt would cause the growth rate of the money stock to be in the 15 to 20 percent range, highly inflationary by any standard. If not reversed

at a later date, a monetary expansion of this magnitude would be consistent in the longer run with prices rising at a rate of over 15 percent per year, pushing nominal interest rates to about 20 percent. Transfer of resources from the private to the public sector would be accomplished by the crowding out effects of both higher interest rates and higher prices.

At some point, it is likely that the public would demand that actions be taken to reduce the rate of inflation. Then, unless the stimulus of huge Government deficits financed by rapid monetary expansion is removed only gradually, the economy would again suffer from inadequate demand, falling production, and rising unemployment.

Summary and Conclusions

In conclusion, the economy is currently operating substantially below its optimum level, as evidenced by the decline of real production since late 1973 and the relatively high level of unemployment. The recession was caused initially by constraints on supply, such as the oil embargo and crop failures. Other constraints on production were imposed by Government actions such as the wage and price controls and environmental and safety

regulations. Last fall and winter the economy was retarded further as monetary expansion slowed markedly, causing a reduction in the growth of the demand for goods and services.

The removal of these adverse exogenous forces which hamper economic activity is imperative. In fact, a number of them already have been relaxed or eliminated. The wage and price controls have been abolished, the nation had an exceptionally good harvest, and the implementation of environmental programs has been moderated. Furthermore, the monetary authorities have announced a target for money growth in the 5 to 7 1/2 percent range for the year ending next spring, up from the lower rate observed in the latter half of 1974. The economy is adapting to other adverse forces which cannot or have not been removed, such as the high price of energy. For these reasons, I am optimistic that in the short-run economic conditions will improve. This process of adjustment would be even faster if Governmental interference in markets were reduced further.

In short, I believe that it is highly desirable to remove those factors which shove the economy off course or interfere with its resiliency once it is depressed. Our research

has found no lasting benefits flowing from a massive Government spending program designed to swell demand, production, and employment. A healthy recovery will occur without such a program, provided monetary expansion is moderate and no further large adverse shocks are experienced. For those desiring to speed the recovery, I suggest more effort be devoted to removing constraints on economic expansion. Laws and regulations which hamper production and which discriminate against private capital formation tend to slow the rate of recovery.

Vast Government spending programs, financed in part by deficits, create many problems. As the Government's sphere enlarges, economic freedom of individuals and businesses shrinks. As the Government bids away more of the investment funds, less is left to finance factories, machines, and inventories -- ingredients essential for growth. Then, too, huge Government deficits are usually accompanied by more rapid monetary expansion, as monetary authorities seek to minimize possible adverse affects of sharply rising interest rates. The monetary expansion leads to inflation, and as the inflation is later resisted, a new recession is fostered. Such stop-and-go policies, based on fighting

the most serious current problem with little regard for the future, contribute to instability, not stability.

One of the greatest delusions of our generation is that all evils can be cured by legislation and aggressive Government intervention in the functioning of markets. Although Government strives to better economic conditions, it frequently becomes a major obstruction and nuisance.