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Statement of

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It is a pleasure to appear before this distinguished commission to discuss the federal government deficit. My thesis today is that federal government deficits do matter. It may appear misplaced to focus on this issue before a commission whose very existence presupposes the need to reduce the deficit. But, there is a significant counterview, fortunately to date a minority opinion, that in fact deficits do not matter much, or in any event that there is no urgency in coming to grips with them.

The bulk of my opening remarks will concentrate on the long-term corrosive impact of the deficit. From this perspective, the case for bringing down the deficit is compelling. But first, I want to stress that the long run is rapidly turning into the short run If we do not act promptly, the imbalances in the economy are such that the effects of the deficit will be increasingly felt and with some immediacy.

It is beguiling to contemplate the strong economy of recent years in the context of very large deficits and to conclude that the concerns about the adverse effects of the deficit on the economy have been misplaced. But this argument is fanciful. The deficit already has begun to eat away at the foundations of our economic strength. And the need to deal with it is becoming ever more urgent. To the extent that some of the negative effects of deficits have not as yet been felt, they have been merely postponed, not avoided. Moreover, the scope for further such avoidance is shrinking.

To some degree, the effects of the federal budget deficits over the past several years have been muted by two circumstances, both of which are currently changing rapidly. One was the rather large degree of slack in the economy in the early years of the current expansion. This slack meant that the economy could accommodate growing demands from both the private and public sectors. In addition, to the extent that these demands could not be accommodated from U.S. resources, we went abroad and imported them. This can be seen in our large trade and current account deficits. By now, however, the slack in the U.S. economy has contracted substantially. And, it has become increasingly clear that reliance on foreign sources of funds is not possible or desirable over extended periods. As these sources are reduced along with our trade deficit, other sources must be found, or demands for saving curtailed. The choices are limited; as will become clear, the best option for the American people is a further reduction in the federal budget deficit, and the need for such reduction is becoming more pressing.

Owing to significant efforts by the administration and the Congress, coupled with strong economic growth, the deficit has shrunk from 5 to 6 percent of gross national product a few years ago to about 3 percent of GNP today. Such a deficit, nevertheless, is still very large by historical standards. Since World War II, the actual budget deficit has exceeded 3 percent of GNP only in the 1975 recession period and in the recent deficit experience beginning in 1982. On a cyclically adjusted or structural basis, the deficit has exceeded 3 percent of potential GNP only in the period since 1983.

Government deficits, however, place pressure on resources and credit markets, only if they are not offset by saving elsewhere in the economy. If the pool of private saving is small, federal deficits and private investment will be in keen competition for funds, and private investment will lose.

The United States deficits of recent years are threatening precisely because they have been occurring in the context of private saving that is low by both historical and international standards. Historically, net personal plus business saving in the United States in the 1980s is about 3 percentage points lower relative to GNP than its average in the preceding three decades. Internationally, government deficits have been quite common among the major industrial countries in the 1980s, but private saving rates in most of these countries have exceeded the deficits by very comfortable margins. In Japan, for example, less than 20 percent of its private saving has been absorbed by government deficits, even though the Japanese general government has been borrowing almost 3 percent of its gross domestic product in the 1980s. In contrast, over half of private U.S. saving in the 1980s has been absorbed by the combined deficits of the federal and state and local sectors.

Under these circumstances, such large and persistent deficits are slowly but inexorably damaging the economy. The damage occurs because deficits tend to pull resources away from net private investment. And a reduction in net investment has reduced the rate of growth of the nation's capital stock. This in turn has meant less capital per worker than would otherwise have been the case, and this will surely engender a shortfall in labor productivity growth and, with it, a shortfall in growth of the standard of living.

The process by which government deficits divert resources from net private investment is part of the broader process of redirecting the allocation of real resources that inevitably accompanies the activities of the federal government. The federal government can preempt resources from the private sector or direct their usage by a number of different means, the most important of which are: 1) deficit spending, on- or off-budget; 2) tax financed spending, 3) regulation mandating private activities such as pollution control or safety equipment installation, which are financed by industry through the issuance of debt instruments; and 4) government guarantees of private borrowing.

What deficit spending and regulatory measures have in common is that the extent to which resources are preempted by government actions, directly or indirectly, is not sensitive to the rate of interest. The federal government, for example, will finance its budget deficit in full, irrespective of the interest rate it must pay to raise the funds. Similarly, a government-mandated private activity will almost always be financed irrespective of the interest rate that exists. Borrowing with government-guaranteed debt may be only partly interest sensitive, but the guarantees have the effect of preempting resources from those without access to riskless credit. Government spending fully financed by taxation does, of course, preempt real resources from the private sector, but the process works through channels other than real interest rates.

Purely private activities, on the other hand, are, to a greater or lesser extent, responsive to interest rates. The demand for mortgages, for example, falls off dramatically as mortgage interest rates rise. Inventory demand is, clearly, a function of short-term interest rates, and the level of interest rates, as they are reflected in the cost of capital, is a key element in the decision on whether to expand or modernize productive capacity. Hence, to the extent that there are more resources demanded in an economy than are available to be financed, interest rates will rise until sufficient excess demand is finally crowded out. The crowded out demand cannot, of course, be that of the federal government, directly or indirectly, since government demand does not respond to rising interest rates. Rather, real interest rates will rise to the point that private borrowing is reduced sufficiently to allow the entire requirements of the federal on- and off-budget deficit, and all its collateral guarantees and mandated activities, to be met.

In real terms, there is no alternative to a diversion of real resources from the private to the public sector. In the short-run, interest rates can be held down if the Federal Reserve accommodates the excess demand for funds through a more expansionary monetary policy. But this will only engender an acceleration of inflation and, ultimately, will have little if any effect on the allocation of real resources between the private and public sectors.

The Treasury has been a large and growing customer in financial markets in recent years. It has acquired, on average, roughly 25 percent of the total funds borrowed in domestic credit markets over the last four years, up from less than 15 percent in the 1970s. For the Treasury to raise its share of total credit flows in this fashion, it must push other borrowers aside.

The more interest responsive are the total demands of these other, private borrowers--the less will the equilibrium interest rate be pushed up by the increase in Treasury borrowing. That is, the greater the decline in the quantity of funds demanded, and the associated spending to be financed, for a given rise in interest rates, the lower will be the rate. In contrast, if private borrowing and spending are resistant, interest rates will have to rise more before enough private spending gives way. In either case, private investment is crowded out by higher real interest rates.

Even if private investment were not as interest elastic as it appears to be, crowding out of private spending by the budget deficit would occur dollar-for-dollar if the total supply of saving were fixed. To the extent that the supply of saving is induced to increase, both the equilibrium rise in interest rates and the amount of crowding out will be less. However, even if more saving can be induced in the short run, it will be permanently lowered in the long run to the extent that real income growth is curtailed by reduced capital formation.

But aggregate investment is only part of the process through which the structure of production is affected by high real interest rates. Higher real interest rates also induce both consumers and businesses to concentrate their purchases disproportionately on immediately consumable goods and, of course, services. When real interest rates are high, purchasers and producers of long-lived assets such as real estate and capital equipment pull back. They cannot afford the debt carrying costs at high interest rates, or if financed with available cash, the forgone interest income resulting from this expenditure of the cash. Under such conditions, one would expect the GNP to be disproportionately composed of short-lived goods--food, clothing, services, etc.

Indeed, statistical analysis demonstrates such a relationship--that is, a recent decline in the average service life of all consumption and investment goods and a systematic tendency for this average to move inversely with real rates of interest. That is, the higher real interest rates, the heavier the concentration on short-lived assets. Parenthetically, the resulting shift toward shorter-lived investment goods means that more gross investment is required to provide for replacement of the existing capital stock as well as for the net investment necessary to raise tomorrow's living standards. Thus, the current relatively high ratio of gross investment to GNP in this country is a deceptive indicator of the additions to our capital stock.

Not surprisingly, we have already experienced a disturbing decline in the level of net investment as a share of GNP Net investment has fallen to 4.7 percent of GNP in the 1980s from an average level of 6.7 percent in the 1970s and even higher in the 1960s. Moreover, it is low, not only by our own historical standards, but by international standards as well.

International comparisons of net investment should be viewed with some caution because of differences in the measurement of depreciation and in other technical details. Nevertheless, the existing data do indicate that total net private and public investment as a share of gross domestic product over the period between 1980 and 1986 was lower in the United States than in any of the other major industrial countries except the United Kingdom.

It is important to recognize as I indicated earlier that the negative effects of federal deficits on growth in the capital stock may be attenuated for a while by several forces in the private sector. One is a significant period of output growth in excess of potential GNP growth--such as occurred over much of the past six years--which undoubtedly boosts sales and profit expectations and, hence, business investment. Such rates of output growth, of course, cannot persist, making this factor inherently temporary in nature.

Another factor tending to limit the decline in investment spending would be any tendency for saving to respond positively to the higher interest rates that deficits would bring. The supply of domestic private saving has some interest elasticity, as people put off spending when borrowing costs are high and returns from their financial assets are favorable. But most analysts find that this elasticity is not sufficiently large to matter much.

Finally, net inflows of foreign saving can be, as recent years have demonstrated, an important addition to saving. In the 1980s, foreign saving has kept the decline in the gross investment-GNP ratio, on average, to only moderate dimensions (slightly more than one-half percentage point) compared with the 1970s, while the federal deficit rose by about 2-1/2 percentage points relative to GNP. Net inflows of foreign saving have amounted, on average, to almost 2 percent of GNP, an unprecedented level.

Opinions differ about the relative importance of high United States interest rates, changes in the after-tax return to investment in the United States, and changes in perception of the relative risks of investment in various countries and currencies in bringing about the foreign capital inflow. Whatever its source, had we not experienced this addition to our saving, our interest rates would have been even higher and domestic investment lower. Indeed, since 1985, when the appetite of private investors for dollar assets seems to have waned, the downtrend in real long-term rates has become erratic, tending to stall with the level still historically high.

Looking ahead, the continuation of foreign saving at current levels is questionable. Evidence for the United States and for most other major industrial nations over the last 100 years indicates that such sizable foreign net capital inflows have not persisted and, hence, may not be a reliable substitute for domestic saving on a long-term basis. In other words, domestic investment tends to be supported by domestic saving alone in the long run.

Let me conclude by reiterating my central message. The presumption that the deficit is benign is clearly false. It is partly responsible for the decline in the net investment ratio in the 1980s to a sub-optimal level. Allowing it to go on courts a dangerous corrosion of our economy. Fortunately, we have it in our power to reverse this process, thereby avoiding potentially significant reductions in our standard of living.