

Federal Reserve Bank of San Francisco

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Deficits vs. Investment

Early this year, the Congressional Budget Office (CBO) expressed the view shared by many analysts that federal budget deficits would increase from about \$185 billion in 1984 to just under \$245 billion by 1987 if current tax and spending programs remain unchanged. These deficits average just over 5.0 percent of GNP, according to the CBO, or more than double their average share of income in the 1970s. Proposals to save between \$150 billion and \$180 billion over the next three years are significant steps in the right direction, but these savings would still leave substantial deficits. For instance, the Reagan-GOP compromise budget plan to save about \$150 billion would still leave a deficit of \$198 billion in 1987—4.3 percent of GNP according to the CBO.

Should we be concerned with the size of these deficits? This *Letter* explores the economic effects of cyclical and structural deficits and evaluates the possible impact of prospective deficits on new capital investment in the U.S.

Cyclical and structural deficits

Deficits that occur during recessions often play a positive, supporting role for the economy. They represent increases in government transfers, such as unemployment benefits, at a time when federal revenues fall more than income because of the progressive income tax structure. As a result, these "cyclical" deficits help cushion the severity of the recession by providing people, rather than the government, with revenue.

Sizeable deficits that linger on as the economy recovers and operates close to full employment may not have positive economic effects. Such "full employment" or "structural" deficits that result from a basic mismatch between tax revenues and spending are expected from 1984 through 1987. If they occur, it will be at a time when private credit demands for the nation's available

savings are growing. The result will be increased competition for savings that puts upward pressure on interest rates. In turn, higher interest rates will discourage, or "crowd out," private sector spending on items especially sensitive to interest costs, such as housing and business capital spending on plant and equipment.

There are, however, a number of factors that may dampen, although not completely eliminate, the interest rate and crowding out effects of structural deficits. These include possible supply-side benefits that boost national output and additional savings from abroad attracted by higher interest rates in the U.S.

Supply-side effects

Federal tax and spending programs may lead to an increase in the nation's productive capacity and savings, and thereby provide the additional income and savings needed to finance large federal expenditures. Such programs may include government investment in the nation's infrastructure (roads and dams, for instance) and tax or other incentives to increase the supply and productivity of our work force and private capital investments.

In 1981, we began hearing claims of positive supply-side effects for budget programs that sought to increase incentives to work, save, and invest by cutting tax rates. Until recently, the benefits of these programs have not been discernible. Indeed, in the past recession, individual and business savings rates fell substantially below values predicted by past trends. The accelerated depreciation allowances given businesses in the Economic Recovery and Tax Act of 1981 probably encouraged the pick-up in business spending that began in mid-1983, but, according to business spending plans and forecasts, they will not be sufficient to lift the nation's longer term growth rate much

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above the average 3.0 percent rate of the past 20 years. As yet, most economists do not foresee any positive supply-side effects large enough to generate sufficient revenues to make much of a dent in prospective federal deficits.

Net foreign savings

In addition to any impact on domestic savings, deficits may generate flows of foreign savings into the U.S. Of course, some U.S. savings are also moving abroad so it is net foreign savings, or investment flows, that are pertinent. Deficits will be associated with a positive net inflow of savings into the U.S. when they raise interest rates here relative to those abroad. The higher returns in the U.S. attract foreign savings, which increase the pool of savings available for domestic investments and the budget deficit and, in turn, ease interest rate pressures in the U.S. The net savings inflow also tends to raise the international value of the U.S. dollar and thereby reduce the competitiveness of U.S. exports and increase the attractiveness of foreign imports. The result, and the other side of the savings inflow, is a deterioration in our foreign trade position.

To the extent that there are net foreign savings coming into the U.S., private capital spending need not be crowded out of U.S. markets, but industries depending on exports and those that compete with imports will bear the brunt of the burden of higher federal budget deficits.

Sources and uses of savings

These remarks have emphasized the need to evaluate the economic effects of budget deficits in terms of the amount and type of savings available to finance them. In this regard, net savings (total savings less depreciation) is the important concept for it represents the amount of income available for both government deficits and domestic investment after replacing the worn out capital stock.

The major sources of net savings in the U.S. are individuals and business, and the most

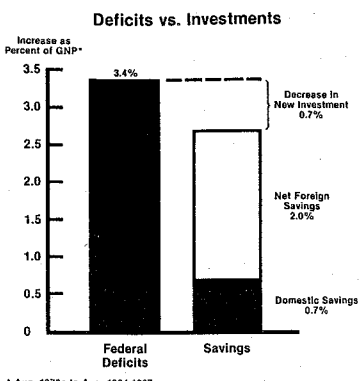
important characteristic of these savings is their relative constancy. The net private domestic savings rate has been a fairly steady 7.2 percent of Gross National Product since the end of the Second World War.

Any major increase in federal deficits as a percent of GNP therefore is likely to lead to a decline in net domestic investment as a share of GNP unless there are compensating increases in the two other sources of savings: state and local government budget surpluses and net foreign savings flows into the U.S. Although these other savings have increased as a percent of GNP over the post-war period, they have not increased as much as budget deficits. Consequently, during the post-war period, the growing federal deficits have meant a decline in net domestic investment in the U.S. measured as a share of GNP.

Between the 1950s and the 1970s, the total U.S. net savings rate increased by roughly 1.2 percentage points. Over the same thirty-year period, federal budget deficits as a share of GNP increased 1.9 percentage points, from a small surplus of 0.1 percent of GNP in the 1950s to deficits of 1.8 percent of GNP in the 1970s. The difference of 0.7 percentage points between the increase in the total net savings rate and federal deficits represents both a savings shortfall and the amount of decline in net domestic investment—from 6.9 percent of GNP in the 1950s to 6.2 percent in the 1970s. This period is widely associated with the slowdown in productive investment in the U.S., and both declines in productivity and in longer term economic growth.

The prospective savings shortfall

What will happen to new capital spending in the U.S. if federal deficits increase from 1.8 percent of GNP in the 1970s to average 5.2 percent over the 1984-1987 period, as estimated by the CBO under current tax and spending programs? To maintain the same rate of net investment spending as in the 1970s, total net savings would have to increase by the same 3.4 percent of GNP as the deficits.



The outlook for future savings is highly conjectural, and the forecasting task is all the more difficult because the net private domestic savings rate fell substantially during the 1980s, in part because of the two back-to-back recessions. If we assume that the net private domestic savings rate will return fairly rapidly to its 7.2 percent post-war average rate over the next four years, and add to that rate state and local government surpluses of 1.5 percent of GNP (their 1983 value which is likely to continue along with the current economic expansion), the combined savings rate would be 8.7 percent. This figure is only 0.7 percentage points higher than its 8.0 percent average in the 1970s, and a far cry from the necessary 3.4 percentage point increase.

While increases in domestic savings alone will probably not match increases in federal deficits, they are likely to be supplemented by an increased amount of savings from abroad. The counterpart of the expected large foreign current account deficits in the U.S. over the next four years, which could increase from \$35 billion in 1983 to \$90 billion by 1987, is an increase in expected net foreign savings flowing into the U.S.; these may amount to roughly 2.0 percent of GNP. As a result, the total amount of net savings in the U.S. from both domestic and foreign sources may average close to 10.7 percent of GNP between 1984 and 1987, or an increase in the total net savings rate of 2.7 percentage points from that in the 1970s.

Even so, this increase in total net savings falls short of the 3.4 percent needed to finance the mounting deficits without reducing new capital spending in the U.S. The savings shortfall will show up as a further decline in net domestic investment—in both housing and business spending—from 6.2 percent of GNP in the 1970s to a possible 5.5 percent over the next four years. This is as large a decline in net investment as has occurred in the last 30 years.

The budget savings proposed by Congressional leaders of about \$150 billion would reduce deficits as a percentage of GNP about 0.6 percentage points during the 1984-1987 period. Accordingly, net domestic investment could absorb these funds and average about 6.1 percent of GNP over that time—almost equal to its 6.2 percent rate in the 1970s.

Risks in the outlook

The risks to this scenario appear formidable. For one thing, the large capital flows from abroad depend upon continued deficits in our foreign current account which, in turn, depend upon the political and economic policies of other nations and foreigners financial portfolio preferences. For another, they depend upon a fairly rapid pick-up in the net private domestic savings rate, which has not begun as yet.

Federal deficits of the size projected for the next four years will require unprecedented amounts of the nation's savings. During the 1960s, federal deficits absorbed four percent of total net savings and during the 1970s, 22 percent. In comparison, they may absorb between 40 and 50 percent of total net savings over the next four years, depending upon whether budget savings proposals under Congressional consideration are adopted.

Structural deficits of this size seriously threaten to impede the rate of spending on new capital for both business purposes and residential housing. In the absence of an historically unprecedented increase in the private savings rate, it appears that new investment over the next four years may average at best no more than it did in the 1970s, when it was at its lowest in the post-war period.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount	Change	Change from 12/28/83	
	Outstanding 6/13/84	from 6/6/84	Dollar	Percent Annualized
Loans, Leases and Investments ^{1 2}	180,073	- 101	4,048	4.9
Loans and Leases ^{1 6}	160,754	- 79	5,399	7.5
Commercial and Industrial	48,521	70	2,558	12.0
Real estate	60,061	134	1,162	4.2
Loans to Individuals	28,280	42	1,629	13.2
Leases	5,003	- 6	60	- 2.5
U.S. Treasury and Agency Securities ²	11,939	- 34	568	- 9.8
Other Securities ²	7,380	12	783	- 20.7
Total Deposits	188,582	-1,126	2,415	- 2.7
Demand Deposits	44,910	- 700	4,327	- 19.0
Demand Deposits Adjusted ³	30,213	- 174	1,118	- 7.7
Other Transaction Balances ⁴	12,435	- 350	340	- 5.7
Total Non-Transaction Balances ⁶	131,236	- 77	2,251	3.7
Money Market Deposit Accounts—Total	39,063	- 256	534	- 2.9
Time Deposits in Amounts of \$100,000 or more	39,477	19	1,312	7.4
Other Liabilities for Borrowed Money ⁵	17,773	-1,794	5,234	- 49.2
Weekly Averages of Daily Figures	Week ended 6/4/84	Week ended 5/21/84		
Reserve Position, All Reporting Banks				
Excess Reserves (+)/Deficiency (-)	32	- 16		
Borrowings	115	41		
Net free reserves (+)/Net borrowed(-)	- 83	- 57		

¹ Includes loss reserves, unearned income, excludes interbank loans

² Excludes trading account securities

³ Excludes U.S. government and depository institution deposits and cash items

⁴ ATS, NOW, Super NOW and savings accounts with telephone transfers

⁵ Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources

⁶ Includes items not shown separately

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