Research Department
Federal Reserve
Bank of
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FRBSF Weekly Letter

Budgets and Recessions

This must be the first year that the President's Council of Economic Advisers has flatly predicted a recession—certainly the first time any Council has predicted a recession in an election year. Strangely, this recession forecast comes at a time when many private forecasters are beginning to back away from earlier recession warnings, at least partly because of the substantial increase in defense spending called for in the President's budget message. But many other analysts claim that a recession is still likely because the budget, in overall terms, is becoming increasingly restrictive.

The one certain thing is the uncertainty of forecasts—budgetary and otherwise—in the present economic and political climate. For one notable example, the deficit for the 1980 fiscal year, originally projected at $29 billion, is now likely to reach $40 billion or even more. (The famous spending "shortfalls" of several earlier years are now but a memory.) Similarly, the projected FY81 figures—a $16-billion deficit with total spending of $616 billion—may also be outdistanced by events.

Stimulus vs. restriction

Generally, a deficit is considered stimulative because it adds to the income stream of the private economy, whereas a surplus is considered restrictive because it represents a net absorption of income from the private sector. However, the most relevant figures for this purpose are not the "actual" dollar figures, such as the projected deficits of $28 billion in 1979, $40 billion in 1980 and $16 billion in 1981. Rather, to compare the fiscal effect on the same basis from year to year, economists use the "high-employment" budget concept, which assumes that the economy is constantly running at the same level of employment. This approach requires certain adjustments, to compensate for the fact (for example) that revenues increase as fewer people become unemployed, while spending declines as less is paid out for unemployment-compensation benefits.

On this high-employment basis, the budget would become progressively more restrictive under the existing tax structure. Specifically, it would shift from a $12-billion deficit in fiscal 1979 to a modest surplus of $4 billion in 1980 and a much larger surplus of $57 billion in 1981 (see chart). All else being equal, the economy would generate significantly more revenues at full employment, outstripping projected expenditures this year and next. It should be noted, however, that government analysts use a benchmark unemployment rate of 5.1 percent when computing the high-employment budget whereas many studies indicate that the rate more compatible with a nonaccelerating rate of inflation would be closer to 6.0 percent. If a figure of that type were used in the computation, the high-employment budget probably would remain in deficit in fiscal 1980 and would show a much smaller surplus in 1981, although the general movement would still be in the direction of restrictiveness.

The actual budget figures—not the hypothetical "high employment" figures—are important for the credit markets, where most of the deficit is financed. The Treasury must compete for funds in the credit markets, like any other would-be borrower, but it is a very formidable competitor there because it can offer relatively risk-free debt instruments. When the Treasury runs a substantial deficit, it can thus generate a "crowding out" effect, denying full access to credit to other prospective borrowers. But that point aside, the "high employment" concept is a powerful tool for analyzing the economic effects of budget trends—and by that standard, the current figures indicate an increasingly restrictive budget stance for the next year or so.

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Toward stimulus?

Still, the proposed restrictive budget could turn stimulative if the political economy generates a substantial tax cut in this election year. The prospects, of course, depend on just how weak the economy becomes as the year goes on. The unemployment rate jumped from 5.9 to 6.2 percent of the civilian labor force in January, and if that movement continues, the demand for stimulative tax cuts might increase over time.

The trend toward increased stimulus could be even greater on the expenditure side, given the pressures to expand spending for defense and energy purposes, not to mention social-welfare programs. Defense outlays are scheduled to rise by $15.3 billion in 1981, to $142.7 billion. The U.S. in the past two years has already met its NATO commitment to increase defense spending by 3 percent annually in real terms. In fiscal 1981, however, it plans to go beyond that and increase real spending by 5 percent, in response to the Middle East crisis. The budget calls for development work on the new MX land-based missile, expansion of the Trident missile-submarine program, and perhaps most important, the build-up of a ready deployment force to deal with trouble spots around the world. This 5-year, $9-billion program will require support equipment as varied as cargo planes and tankers and navy ships to be "pre-positioned" with combat equipment and supplies.

Spending on energy programs is expected to rise only about 5 percent in fiscal 1981, to about $8.1 billion. However, the Administration also has earmarked almost one-third of its requested new obligational authority for a variety of energy-related programs—programs as diverse as the strategic petroleum reserve, heating-bill assistance for low-income families, and transportation energy conservation. Meanwhile, to help offset the added costs of defense and energy, the Administration has outlined potential savings in a number of areas, such as the hospital cost-containment program, reform of the student-loan program, and reform of military and civilian pay schedules. But action is not certain, because at least some of these proposed cutbacks would require new legislation.

Today vs. yesterday

The present economic situation differs considerably from the last defense build-up of 1966-68. In that earlier period, the nation's physical plant and labor force were fully employed, even though the inflation rate averaged only about 3.7 percent annually. But the decisions taken then—to fund the social programs enacted in the mid-1960's, to expand defense expenditures substantially, and to do all this without levying new taxes to keep aggregate demand in check—together laid the groundwork for the severe inflation of the past 15 years.

The current situation is much more delicate. On the one hand, the inflation rate is higher now than at practically any other time of the past generation. This suggests the need for greater budgetary restraint. On the other hand, the economy is sluggish and on the point of recession, which precludes the use of additional taxes to fund defense spending. Indeed, a tax cut ordinarily would be in order

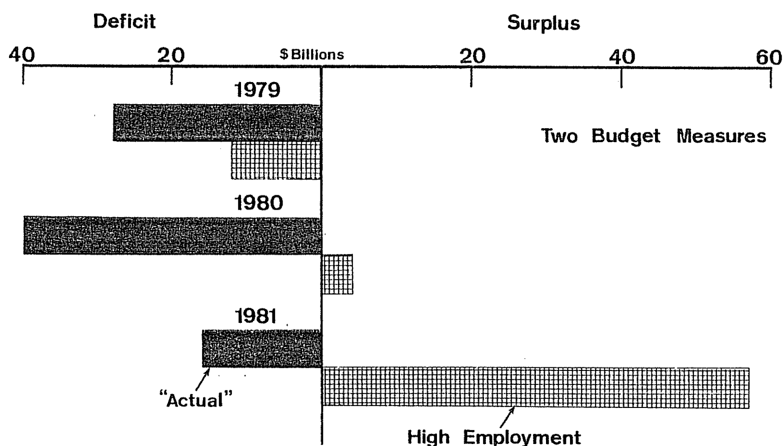
to stimulate the economy, except that a tax cut at this juncture appears likely only to generate more inflation, especially if the resulting deficit is accommodated by the monetary authorities.

Stagflation?

In general, continued stagflation may be the most likely outcome, given the current economic climate and the increasingly restrictive stance of fiscal and monetary policy. This picture comes out clearly in the 1980-81 forecasts produced by both the President's Council of Economic Advisers (CEA) and the Congressional Budget Office (CBO). Both groups of forecasters expect a decline in real GNP in calendar 1980—a drop of 1.0 percent for the CEA and a drop of 1.3 percent for the CBO. (All comparisons are on a fourth-quarter to fourth-quarter basis.) Again, both expect only a modest recovery in 1981, with real growth of only 2.8 to 3.0 percent. Consequently, they expect unemployment to increase; indeed, the CBO expects the jobless rate to rise over both years, reaching 8.0 percent in the final quarter of 1981.

At the same time, both organizations expect only modest progress against inflation over this two-year period. Even the CEA, the more optimistic of the two groups, expects an 8.6-percent increase in 1981 in the GNP deflator—the broadest measure of price change—compared with the 9.1-percent increase of 1979. The imbedded nature of the underlying inflation, plus continued price shocks from the OPEC cartel, make for very sober forecasts, and thereby provide a strong argument against stimulative policies.

Herbert Runyon



Source: Budget of the United States Government

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 1/23/80	Change from 1/16/80	Change from year ago @ Dollar	Percent
Loans (gross, adjusted) and investments*	137,010	− 574	+ 16,278	+ 13.50
Loans (gross, adjusted) — total#	114,322	− 575	+ 16,220	+ 16.50
Commercial and industrial	32,673	− 256	+ 3,947	+ 13.70
Real estate	44,016	+ 153	+ 8,633	+ 24.40
Loans to individuals	24,579	+ 45	+ 4,196	+ 20.60
Securities loans	1,371	− 188	− 170	− 11.00
U.S. Treasury securities*	7,167	+ 20	− 481	− 6.30
Other securities*	15,521	− 19	+ 986	+ 6.80
Demand deposits — total#	42,994	−3,213	+ 3,308	+ 8.30
Demand deposits — adjusted	31,591	−2,005	+ 1,490	+ 5.00
Savings deposits — total	28,378	− 186	− 1,661	− 5.50
Time deposits — total#	59,323	+ 346	+ 8,236	+ 16.10
Individuals, part. & corp.	50,460	+ 333	+ 9,060	+ 21.90
(Large negotiable CD's)	21,642	+ 164	+ 2,538	+ 13.30

Weekly Averages of Daily Figures	Week ended 1/23/80	Week ended 1/16/80	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (−)	2	68	− 27
Borrowings	69	208	73
Net free reserves (+)/Net borrowed(−)	− 67	− 139	− 100
Federal Funds — Seven Large Banks			
Net interbank transactions [Purchases (+)/Sales (−)]	+1,139	+1,807	+1,243
Net, U.S. Securities dealer transactions [Loans (+)/Borrowings (−)]	− 306	− 68	+ 583

* Excludes trading account securities.
# Includes items not shown separately.
@ **Historical data are not strictly comparable due to changes in the reporting panel; however, adjustments have been applied to 1978 data to remove as much as possible the effects of the changes in coverage. In addition, for some items, historical data are not available due to definitional changes.**

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