Research Department
Federal Reserve
Bank of
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March 5, 1982

FRBSF Weekly Letter

Deficit Financing Pressures

Congress returned from its Washington-Lincoln Day recess determined to do something about reducing the size of the Federal deficits extending beyond recession year 1982. The magnitudes involved are $98.6 billion ("body temperature deficit") in the present fiscal year and—according to Administration estimates—steadily declining series of deficits thereafter, from $91.5 billion in 1983 to $53.2 billion in 1987. As a percentage of GNP, the deficits would decline from 3.2 percent in 1982 to 1.1 percent in 1987. But since many outside analysts question these estimates, it would be useful to review the assumptions outlined in the Administration's budget estimates, and also to indicate the sources of other Federal financing pressures outside the regular budget process.

Higher '82 deficit

To begin with, several factors caused the fiscal '82 deficit to be more than twice the size of the $43.6 billion figure estimated by the Administration just a year ago. The most important setback to the budgetary time-table was the current recession. (In the President's words, "While the recession will end before this fiscal year is over, its budgetary impact will spillover for many years into the future".) However, the budget deficit also has expanded because of larger-than-expected interest payments and lower-than-expected inflation rates.

Because of the recession, real GNP in 1982 probably will be about four percentage points lower than was forecast a year ago. Also, inflation this year could be roughly ½-percentage point below the original forecast. The lower GNP base, plus lower taxable incomes associated with these revised forecasts, could reduce 1982 receipts by $31 billion below the original estimate. Also, outlays for unemployment-sensitive programs may be $8 billion more than the original 1982 estimates. Meanwhile, outlays for inflation-sensitive programs—such as the indexed social-security program—may be roughly $1½ billion above original estimates this year.

Interest rates are another important factor accounting for the higher '82 deficit. The recent shift toward higher interest rates substantially increases estimated interest costs for the public debt, and for other interest-rate-sensitive programs such as subsidized housing-credit programs. Higher projected deficits also add to total interest costs. In 1982, these factors add an estimated $16½ billion to budget outlays, compared with last year's original estimate. Indeed, over the 1982-84 fiscal period, total outlays could be $84 billion more than originally estimated because of higher-than-expected interest costs.

Lower post-'82 deficits

Looking beyond this recession year, the Administration projects a series of smaller budget deficits in future years on the basis of relatively rapid economic growth, declining inflation, reduced unemployment, and lower interest rates. Underlying these deficit estimates are some crucial assumptions about real GNP growth. In this regard, the Administration's estimates are somewhat more optimistic than those of private forecasters. The Administration expects real GNP to increase by 3.0 percent in 1982 (Q4/Q4) and by 5.2 percent in 1983—and to average more than 4.0 percent growth between then and 1987. Private forecasters, however, expect 2.5 percent growth in 1982 and 4.0 percent in 1983—and expect growth thereafter to run closer to the 3.2-percent average actually achieved since the mid-1950s.

The Administration contends, however, that above-average growth rates throughout the 1982-87 period are consistent with the fiscal-policy initiatives adopted by 1981 legislation. Federal spending cuts, according to this

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argument, would contribute to a more efficient use of resources in the economy, while the present tax program would substantially boost after-tax rewards to work, save, and invest. Removing the excessive burdens of government regulation would also reduce costs to individuals and businesses, and thereby increase the nation's productivity.

Progress towards the Administration's growth projections for the mid-1980s may be hampered by a slowdown in the growth of the working-age population. During the 1965-80 period, average labor-force growth reached 2.3 percent a year, but such growth may decline to 1.7 percent or less in the 1985-87 period even with a projected increase in labor-force participation rates. For these and other reasons, the Congressional Budget Office and some private research organizations believe that real GNP will grow about 3.5 percent annually in the middle years of this decade, in contrast with the 4.4-percent Administration estimate. If that should happen, budget deficits would be somewhat larger in the next several years than the Administration is anticipating.

Deficit reductions

The attainment of the Administration's budget plan depends not only upon the realization of certain economic assumptions, but also upon a program of deficit reductions. The proposed savings and increased tax receipts are measured relative to the current-services (base line) budget, which estimates the outlays and receipts in the absence of any policy changes. If Congress adopted all of the Administration's deficit-reduction proposals, total savings of $239 billion could be achieved over the next three fiscal years.

The largest reductions—roughly one-third of the total—would occur in the area of discretionary budget programs, ranging from agricultural research to housing subsidies and manpower training. More than one-fourth of the prospective deficit cuts would cover the area of management initiatives—including programs to reduce fraud and waste, to collect delinquent debts, and to sell off underused Federal property. Another one-fourth of the total deficit cuts would flow out of reductions in the growth of automatic entitlement programs—which range from slowing the rate of increase in reimbursable physician fees to applying a needs test for guaranteed student loans.

Financing off-budget entities

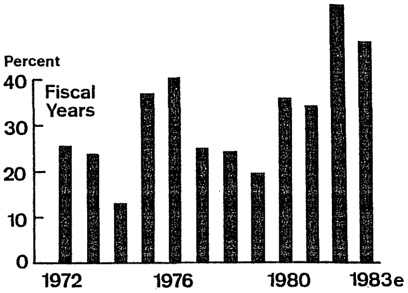
The government's financing task in 1982 and later years will be complicated by the fact that it must finance more than just the "unified" deficit. The outlays of a number of Federal entities have been excluded from the unified budget, although such outlays are actually obligations of the Federal government. With the inclusion of these off-budget financing figures, the total Federal deficit would be $118.2 billion in fiscal 1982 and $107.2 billion in fiscal 1983. Off-budget deficits would account for 17 percent of the total in 1982 and 15 percent in 1983.

Off-budget entities were established under various statutes beginning in the early 1970s, but their total outlays today are dominated by one organization—the Federal Financing Bank (FFB). The FFB's outlays do not come from programs it operates itself, but rather from purchasing the debt securities of other programs or purchasing guaranteed obligations. These other programs remain both legally and administratively within the agencies that borrow from the FFB or provide its guarantees. The most important activity until recently was the purchase of certificates of beneficial ownership from the Farmers Home Administration. The Administration expects this program to decline in coming years and other programs to assume greater importance—such as the Rural Electrification and Telephone revolving fund and the foreign military-sales credit program.

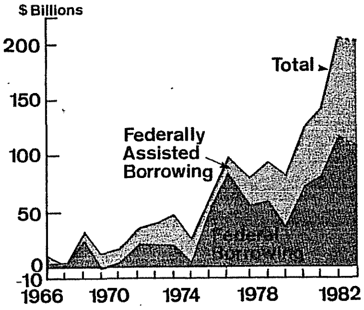
Federally-assisted borrowing

The Federal government's presence in credit markets will be felt not only from its borrowing to finance the total deficit, but also from its assistance to certain public borrowing activi-

Federal and Federally-Assisted Borrowing as a Percent of Total Funds Raised



Estimates for 1982 and 1983 — Federal Reserve Bank of San Francisco.



Estimates for 1982 and 1983 — Administration budget document.

ties. These include government-guaranteed borrowing and borrowing by government-sponsored enterprises.

Guaranteed borrowing consists of loans to non-Federal entities, for which the Federal government guarantees or insures the payment of the principal and/or interest, in whole or in part. The loan guarantees are contingent liabilities of the Federal government, and generally do not require budget outlays except in case of default. Such loans may increase from $28 billion in 1981 to about $44 billion in 1982, largely as a means of supporting the housing market—60 percent of all loan guarantees in both 1982 and 1983 will be associated with Federal guarantees of mortgage-backed securities of the Government National Mortgage Association (Ginnie Mae).

The other type of Federally-assisted borrowing includes borrowing by privately-owned enterprises which were established and chartered by the Federal government to perform specific credit functions. These enterprises borrow in the securities market, under programs which are subject to Federal supervision, and lend their borrowed funds for specifically authorized purposes. The agencies include the Federal National Mortgage Association, the Federal Home Loan Banks, the Federal Home Loan Mortgage Corporation, the Student Loan Marketing Association, and three enterprises regulated by the Farm Credit Administration. Borrowing by these enterprises may increase from $35 billion in 1981 to $47 billion in 1982. Such borrowing has increased substantially in recent years and is expected to do so again this year, largely because of the sharp increase in lending and borrowing by housing-related enterprises that typically occurs during periods of high and rising interest costs.

Overall financing impact

The overall impact of the Federal presence in credit markets can be measured by adding government-guaranteed and government-sponsored borrowing to the borrowing associated with the financing of the unified budget and off-budget programs. Total Federal and Federally-assisted borrowing may rise from $142 billion in 1981 to $206 billion in 1982 (according to Administration estimates), with substantial increases scheduled in all of these categories. (Guaranteed borrowing and sponsored-enterprise borrowing are shown net of repayments, in order to remove double counting in the total figures.)

About 55 percent of total Federal and Federally-assisted borrowing during the 1981-83 period represents borrowing to finance the combined (unified and off-budget) deficit. Historically, and especially during recessions, the need to finance the combined budget deficit has dominated overall Federal borrowing. But the present recession year also has seen a sharp rise in government-guaranteed and sponsored-enterprise borrowing.

Total Federal and Federally-assisted borrowing has increased over the past several decades as a proportion of the total funds raised in credit markets, and has come to dominate credit markets in recession years. This proportion increased from 17 percent during the 1960s to 30 percent in the 1970s. Moreover, it reached 40 percent in 1976 and (according to our staff estimates) could approach 57 percent in 1982 and 49 percent in 1983. Clearly, total Federal borrowing has come to exert a dominant influence in the allocation of funds raised in U.S. credit markets. If the Administration and Congressional attempts to control the deficits are not successful, the Federal presence will remain dominant in the next several years.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 2/17/82	Change from 2/10/82	Change from year ago Dollar	Change from year ago Percent
Loans (gross, adjusted) and investments*	157,999	926	11,078	7.5
Loans (gross, adjusted) — total#	136,713	947	12,219	9.8
Commercial and industrial	42,731	667	6,058	16.5
Real estate	56,266	102	5,200	10.2
Loans to individuals	23,544	10	– 53	– 0.2
Securities loans	1,941	– 53	434	28.8
U.S. Treasury securities*	6,253	11	– 454	– 6.8
Other securities*	15,033	– 32	– 666	– 4.2
Demand deposits — total#	41,541	2,914	– 1,257	– 2.9
Demand deposits — adjusted	26,536	– 876	– 2,003	– 7.0
Savings deposits — total	30,440	– 38	895	3.0
Time deposits — total#	89,926	– 924	12,932	16.8
Individuals, part. & corp.	80,612	–1,051	13,113	19.4
(Large negotiable CD's)	34,883	–1,123	4,797	15.9

Weekly Averages of Daily Figures	Week ended 2/17/82	Week ended 2/10/82	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (–)	151	79	49
Borrowings	63	30	109
Net free reserves (+)/Net borrowed(–)	88	49	– 60

* Excludes trading account securities.
\# Includes items not shown separately.

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