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Statement by Allan H. Meltzer before the Committee to Investigate a Balanced Federal Budget of the Democratic Research Organization

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Deficit Finance, Inflation and Growth
by Allan H. Meltzer

I welcome the opportunity to appear before the Committee to Investigate a Balanced Federal Budget. Few subjects have received more attention and provoked more controversy than the subjects of budget deficits and deficit finance.

I have tried to respond to many of the questions in Dr. Noller's letter by providing some background against which my answers may be interpreted. I discuss the effect of the budget on inflation first. Then I discuss the budget and interest rates and the problem of "crowding out." I will be pleased to develop my answers more fully or to respond to other questions as time and your interest permit.

Inflation and the Budget

The past decade, and particularly the past two years, provide useful evidence about the way the economy responds to budget deficits and their financing. By the end of this calendar year we will have increased the stock of U.S. government debt held by non-government agencies nearly 50% in two years. This is an enormous increase by any past peacetime standard. It is all the more remarkable because the increase in debt has been accompanied by a falling rate of monetary expansion.

The growth rate of money -- currency and demand deposits of the public -- has not reflected the large increases in debt because the Federal Reserve has chosen not to finance most of the government deficit by printing new money. The deficit has been financed instead by sales to
banks and other financial institutions and to the public. The rate of monetary expansion has been held near 5 per cent per annum. The U.S. economy is now recovering from recession. The rate of inflation has fallen. Other countries that controlled the growth of money, particularly Switzerland and Germany, have succeeded also in slowing inflation during the recovery from recession. These three countries now have lower rates of inflation than their trading partners. Each of the three set a target rate of monetary growth as a guide for monetary policy. Each separated the control of money from the financing of budget deficits.

In early 1975, there was much greater doubt about the policy we would choose. Two very different approaches were urged as appropriate policy during the period of severe recession and high inflation.

One view, that received considerable attention, was that the recession had many of the features of the 1930's depression. Those who took this view urged a larger deficit than the $73 billion Federal deficit experienced in calendar 1975 and urged rates of monetary expansion of 12% or more.

A second group favored tax reduction, reductions in the growth of government spending and an average rate of monetary expansion not to exceed 5-1/2%. Members of this group argued that lasting solutions to the problems of inflation and unemployment cannot be achieved unless government adopts policies that move the economy toward lower unemployment rates without raising the rate of inflation.

Many countries experienced the combination of deep recession and high inflation. Some chose to stimulate the economy by running large budget deficits and financing the deficits by printing money. Britain
is an example. The United States, Germany and Switzerland were able to a considerable extent to separate budget deficits and the rate of monetary expansion.

The results are markedly different. In Britain the rate of monetary expansion increased and the rate of inflation rose above 20% in 1975. Countries like France, Canada and Italy continued high rates of monetary growth and continued to experience high rates of inflation.

The different experiences provide evidence of the relation between budget policy, monetary policy and inflation. Brazil offers additional evidence. There, the budget deficit is small but the rate of monetary growth is high. The central bank finances the private sector by printing money at a high rate. The rate of inflation is high, despite the low budget deficit, and rises or falls with the maintained average rate of monetary growth.

Two principal conclusions drawn from recent monetary experience reinforce the evidence from centuries of monetary experience. One, the rate of inflation rises as the maintained rate of monetary growth rises and falls as the rate of monetary growth falls. Two, the sources of monetary growth are far less important in determining the rate of inflation than the rate of monetary expansion.

Let me turn from this background to answer some of the questions about deficits and inflation in Dr. Noller's letter. By inflation, I mean the maintained average rate of change of a broad index of prices. By a budget deficit I mean the amount that the government must finance by issuing bonds and money. The greater the amount of money issued to finance the deficit the higher the
subsequent inflation. The principal reason deficits lead to inflation
is that deficits are often financed by printing money. In the past,
about 1/3 of the budget deficit was financed by monetary expansion. Last
year, and this year, the proportion of the deficit financed by issuing
money is much less than 1/3, nearer to 1/9 or 1/10, so it has been possible
to lower the rate of inflation despite the large budget deficit.

Interest Rates and Deficit Finance

Suppose the deficit of the past two years had been financed mainly
by expanding money. At first, market interest rates would have been
reduced. Lower market interest rates would have encouraged additional
borrowing and additional spending on goods and services.

Monetary expansion would also lower the exchange rate. The decline
of the dollar relative to other currencies means that more dollars would
have to be paid to buy foreign exchange. The decline in interest rates
and the exchange rate would cause a flow of capital abroad. Security
holders would sell in the U.S. and buy abroad, raising interest rates
in the U.S. and lowering rates abroad. The increase in money and its growth
rate would lead, after a time to a rise in the price level and a higher rate of
inflation. The higher rate of inflation would add to interest rates and
further reduce the exchange value of the dollar.

Again, recent experience, in several countries, is broadly consistent
with my discussion of the effects of inflation. Where the rate of monetary
growth has been reduced, interest rates have fallen, as inflation has fallen.
The U.S., Germany and Switzerland have lower rates of interest than Canada,
France, or Britain.
Budget deficits raise interest rates most if the deficits are financed by money. The principal reason is that maintained monetary expansion raises the actual rate of inflation and the anticipated rate of inflation. Market rates of interest rise with anticipated inflation.

Deficits financed by selling bonds also raise market interest rates. The effect on interest rates of selling bonds is not the same, however, as the effect of printing money. Sales of government debt absorb real saving. If real saving is used to finance government deficits, less real saving is available to finance private investment. This is the basis for any crowding out that occurs.

Let me develop the meaning of crowding out by presenting two sides of a familiar story. Those who deny that deficits crowd out spending reason as follows. In an economy that has idle resources and unemployment, increased government spending creates employment. Increased employment raises income by a multiple of the additional government spending, let us say by two or three times. The addition to income is divided between spending and saving. Since income is higher following the deficit, saving is higher. The addition to saving finances the deficit.

If the above reasoning was entirely correct, there would be no problem of crowding out. A critical difference between those who believe that crowding out is a problem comes at the very last step where the assumption is made that the deficit is financed entirely by additions to saving that would not have occurred without the deficit. If this is not entirely correct, a deficit financed by the sale of bonds crowds out some private spending.
Crowding out occurs in this way. The deficit is financed by selling bonds. Interest rates rise, and the rise in interest rates reduces private investment. Private investment is less than it would have been if the same level of income had been achieved without the deficit. The economy moves toward full employment with more public debt and less private capital held in the portfolios of private wealth owners. Some investment has been "crowded out."

The additional deficit spending has some desirable effects. There is more output, more employment and more spending in the months following the deficit. However, there is also some "crowding out." Saving does not rise enough to finance the additional deficit.

The 1975 deficit was one of the largest budget deficits in the peacetime history of the country. The saving rate -- the percentage of income saved -- increased in 1975 to 8.3% from 7.5% in 1974 and 8.0% in 1973. The increase in the saving rate is not nearly large enough to finance the additional deficit. Part of the deficit was financed by raising interest rates and "crowding out" private spending.

Mentioning the rise in interest rates requires that we distinguish between two types of interest rates, real rates of interest and market rates. The rates quoted in newspapers and discussed in meetings of this kind are called market rates. The rates affected by "crowding out" are called real rates. The difference between the two is a measure of the rate of inflation that savers and investors expect. Market rates can decline while real rates rise if the rate of inflation falls. The recent decline in long-term rates is mainly the result of lower rates of current
and future inflation. The large deficit in the government budget has kept rates from declining with inflation as much as they would have declined.

The short-term responses of saving, investment and interest rates to deficit finance are one part of the total effect of the deficit. A second effect is often overlooked. Much of the growth in spending by all levels of government is for labor services. In the thirty years since the end of World War II, the number of total wage and salary workers rose 65%, while the number employed by Federal, state and local governments rose 90%. Much of the growth in employment has occurred at the state and local level, but much of the increase in cost is paid from the Federal budget.

A high rate of absorption of labor by government raises several difficult and as yet unresolved issues. If productivity in the public sector rises more slowly than in the private sector, faster growth of public sector employment reduces productivity in the economy as a whole. Society uses resources less efficiently and output grows more slowly. The size of these effects is not well known.

A third effect of large deficits is that the mix of goods and services produced by the society is altered. Many government programs encourage consumption and reduce investment. A shift in resources from investment to consumption lowers the capital stock and by lowering the capital stock lowers the growth rate. This effect is a longer-term consequence of deficit finance.

Many of the responses of long-term growth that I described may seem small and may be difficult to detect. What is small or large is, however, a matter of perspective. The difference between real growth of 3% and
real growth of 4% is one percentage point a year. That one percentage point looks much larger when it is described as a 25% reduction in the rate of growth of real income and standard of living or when we recognize that per capita income doubles approximately every 25 years at a 3% rate of growth and every 18 years at a 4% rate of growth.

The point to be emphasized is not that we should maximize the growth rate but that we should give more attention to the effects of deficits and government programs on the way in which we use resources. The market system is a comparatively efficient system. Large deficits, programs that are socially wasteful, the absorption of labor by government, and the crowding out of private investment all tend in the direction of lowering efficiency and the growth of real output.

Loan Guarantees

At times, Congress or the Executive seeks to avoid spending and deficit finance by offering loan guarantees. Questions seven and eight ask about guarantee programs and their effects.

In every economy, there are risks inherent in nature and production. These risks must be borne, but the cost of bearing the risk can be shifted to others or can be combined or pooled in a way that lowers the cost of bearing risk. We recognize many of the ways in which risks are shared by the names of the institutions that perform the service. Insurance companies, mutual funds and diversified manufacturing firms are institutions that pool risks to reduce the cost of bearing risk.
Government agencies are a large and diversified group that make generalization difficult. The original FHA concept offered insurance to lenders in exchange for a premium to be paid by borrowers. For many years the program increased homeownership by reducing the risk in mortgages to any individual lender. With hindsight we know that the premium charged was sufficient to cover the default losses, so the agency operated like an insurance company.

In the mid-1960's the FHA program expanded. The guarantee was extended to a very different class of risks. Default losses on the class of risks were much larger than insurance premiums paid, so a general budget charge is made and financed by taxes, borrowing and money creation.

We can generalize from these experiences. Government guarantees of loans or debt encourage an activity making it possible for individuals or groups to obtain loans at lower rates of interest. Unless there is some change in the underlying risk, and usually there is none, the government defers costs to the future. The costs take the form of payments for defaulted loans that must be paid from some future budget.

Government can insure citizens against illness, but insurance does not reduce illness. The cost of medical care is shifted from the individual to the community when insurance is offered by government at prices below the prices charged by competing insurance companies. The additional costs must be paid. They are a charge against future budgets that will be paid by taxes or financed by future issues of debt and money.

I have tried in these remarks to combine my responses to several of the questions asked. I will be pleased to respond to the questions I omitted or to answer more fully.