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Part III
The Relation Between Inflation and Budget Outcomes

Deficits and Inflation
Allan H. Meltzer

There are few issues in economics on which popular beliefs are as widely held as the belief that budget deficits are inflationary. Practical men, professional speculators and traders, Congressmen and other noneconomists who permit themselves to be quoted are almost uniformly quoted on one side of the issue. Public opinion polls suggest that their view is a majority view. We can only guess at the qualifications and conditions that are in the minds of the practical man and the polls' respondents. It seems unlikely, however, that the qualifications would do more than state some conditions under which the positive association may be present, but not always apparent to the naked eye. For example, some may qualify their claim by asserting that deficits keep prices from falling, or inflation from declining, during recessions. Qualifications of this kind change the type of relation from simple to multivariate but they do not change the alleged positive relation between deficits and inflation. And they change the positive effect from a total to a partial effect that can be observed only if a proper set of "other things" is taken into account.

Recent experience is instructive. I do not think it is an overstatement to say that during the past year we heard monthly and, at times, daily warnings from Wall Street and Capitol Hill about the inflationary effects of budget deficits and their dominant effect on market interest rates. Yet, just at the time when a large part of the 1982-1983 deficit was to be financed, interest rates fell and the average rate of inflation resumed its decline.

Wall Street's "doom and gloom" scenario for interest rates and inflation in 1982-1983 proved incorrect. Open market interest rates reached their peaks in 1981 or early 1982. Most broad measures of inflation also reached a peak by 1981. The entrenched belief that deficits would produce high inflation and, therefore, keep interest rates from falling was as wrong in 1982 as it was in 1975-1976, the last time it surfaced above the din created by alternative forecasts.

A year or more after the most recent peaks in interest rates and inflation, the prophets of doom and gloom shuffled their papers and shifted their ground. Prime rates of 20 percent to 25 percent are no longer in sight. The new forecast is for interest rates to keep falling, on average, as the economy stagnates or declines. To this reader, the new forecasts seem much more cautious about the inflationary effect of deficits. Very little has happened to the projected deficits; "other things" must have changed.

What are those "other things"? A short list must include actual and expected income, the exchange rate and the balance of payments, the effects of tax laws and anticipations on saving, and the current and anticipated rates of money growth. Serious attempts to study the effects of deficits on prices or inflation that have taken account of these and other comovements in the economy have found no reliable effect of deficits on inflation in the United States. Neither the last 30 years nor earlier periods provide evidence to support the popular belief in a close or reliable positive association between deficits and inflation. Before deciding that this evidence is, or is not, a proper basis for concluding that deficits are not inflationary, we must consider some qualifications.

Four Necessary Qualifications
There is nothing new about budget deficits. The fiscal history of the United States, from 1791 to 1983, shows 101 years of budget surpluses and 92 years of deficits. Before 1901, the distribution is 75 to 35, but that distribution is skewed by an uninterrupted sequence of 28 years of budget surpluses from 1866 to 1893. In the years
prior to the Civil War, budget deficits were not uncommon. For example, there is only one reported budget surplus between 1837 and 1843. The Warren and Pearson index of wholesale prices fell by 50 percent from 1837 to 1843, rising only in the year of the budget surplus, 1839. The post-Civil War budget surpluses occurred during a period in which prices fell on average. The two experiences have opposite outcomes, so they do not support any firm conclusion.

Problems of comparability reduce the weight that can be placed on comparisons across the centuries. The distribution of spending between levels of government changed markedly. The definition of deficits also changed. More state and local spending was paid for by transfers from the Federal Government. Difficulties of this kind emphasize the importance of qualifications in any discussion of the effect of deficits on inflation. Simple comparisons tell very little.

Methods of Finance

The first qualification distinguishes between deficits financed by increasing the stock of money and deficits financed by selling bonds to private investors or their agents—pension funds, insurance companies, banks and other financial institutions. Inflation is often defined as a persistent or sustained rate of increase in a broad-based measure of prices. Few now dispute that a sustained rate of growth of money in excess of the sustained rate of growth of output causes inflation. Persistent deficits financed by selling government bonds, either directly or indirectly, to the central bank increase the stock of money and its measured rate of growth. The same increase in money and inflation would occur, however, if the central bank bought an equal amount of private debt and private investors bought the government debt issued to finance the deficits.

All deficits are financed, initially, by selling debt to foreign investors, domestic investors, foreign and domestic central banks. If we put aside the sales to foreigners, for the present, the question is simplified: Are sales of government debt to private investors inflationary?

Domestic private investors make net purchases of government debt from current saving. Government spending and financing decisions affect the level and distribution of private spending and saving and, therefore, affect output and interest rates. The response of the price level to such changes is difficult to separate from other transitory disturbances. At most there is a bit of fluctuation in the price level. There is no reason for a one-time deficit to produce (sustained) inflation.

Of course, increased government spending and deficits may persist for several years. During the four years 1977-1980, all the leading industrialized countries reported deficits. The OECD has attempted to produce a common measure of the deficit for each country. This measure, known as the public-sector borrowing requirement (PSBR), ranged from 2.0 percent of national product in France to 12.4 percent in Italy, on average, for the four years. The average inflation rate covered as wide a range. After allowing for the effect of average money growth, however, average rates of inflation and the PSBR ratio are negatively related. Countries with relatively large debt issues had lower rates of inflation, during these years, on average, after allowing for differences in their maintained average rate of money growth.

There are several possible explanations of the observed negative relation between debt finance and inflation. First, the appearance of deficits during a period of slow growth or recession reflects, in part, the lower rate of expenditure growth and reduced tax collections caused by the recession. The decline in the rate of inflation may reflect the effect of recession also. The negative association is, in this interpretation, the reflection of a common cause—the recession. Second, the increase in the deficit and in the demand for money may be the result of increased uncertainty about the future. For example, heightened uncertainty about future output growth can cause an increase in the demand for money and short-term assets, a decline in output and in tax receipts, higher transfer payments, and a larger deficit. The effect would not be the same in all countries for a number of reasons, including the policy reaction to the effect of heightened uncertainty, but the size of the government’s borrowing and the increase in the demand for money may be largest where uncertainty is greatest.

The finding that inflation was lower where government borrowing was larger, during 1977-1980, does not imply that persistent government borrowing reduces inflation. Yet, like the evidence from the post-Civil War period, it gives no support to the widely held view that deficits, financed by debt, are inflationary. This brings me to the second qualification.

Expected Persistence

Neither one-time increases in money nor one-time increases in government debt produce inflation. Any effect of budget deficits on inflation occurs only if deficits are expected to persist. A large deficit that maintains aggregate demand during a recession may cause a rise, or delay a decline, in the price level. Unless the spending persists, the price level does not continue to rise. There is no sustained increase in prices, so there is no inflation.

In Chile and Argentina, consolidated budget deficits rose to 10 percent or 15 percent of total output during the fiscal crises of the 1970’s. Deficits of this size are large relative to private saving or other sources of non-monetary finance, so the dominant belief is that money growth must increase. This belief was strengthened by the
goods and services and real assets for claims on the U.S. Treasury. When some of these countries became less willing to acquire additional U.S. securities, the Bretton Woods system ended. President Nixon further restricted gold sales and allowed the dollar to float.

Under floating exchange rates, central banks are not obligated to buy or sell foreign exchange or to finance deficits in other countries' budgets. Foreign central banks and monetary authorities as a group have continued to purchase U.S. government securities, however. This is particularly true of some countries in OPEC, but not only of OPEC countries. Germany and Japan continued to acquire U.S. securities during the 1970's. These purchases contributed to money growth abroad, to fluctuations in exchange rates, prices and measured rates of inflation.

If foreign central banks insist on strict control of domestic money growth, large U.S. and foreign budget deficits are financed mainly from domestic private saving. Countries in which public-sector borrowing is large relative to the sum of domestic private saving and noninflationary money growth must borrow from the rest of the world. All countries cannot borrow simultaneously; some must lend. With very large deficits relative to output or saving in many countries and relatively low response of saving rates to interest rates in individual countries, exchange rates and interest rates must change over a wide range to finance public-sector borrowing.

Changes in exchange rates change the relative prices of domestic and imported goods, and some of these changes are reflected in broad-based price levels. Fluctuations of this kind are one-time events, distinct from inflation—defined as a persistent increase in a broad-based index of prices.

Preliminary Conclusion

To discuss the inflationary effects of budget deficit I have introduced a number of qualifying phrases and conditions. The qualifying phrases are: real, persistent, sustained, in excess of expectations, relative to output, or relative to saving. The qualifying conditions are no less important. The method by which the deficits are financed matters. Deficits have often been financed by central banks. The appearance of large persistent deficits, or the expectation that deficits will persist and grow relative to output, strengthens the belief that money growth will rise. This belief is not always borne out, but it has been correct too often to be dismissed.

The qualifying phrases and conditions help to explain why the views of practical men about the inflationary effects of budget deficits are not always borne out. Governments can prevent inflation from accelerating by fiscal reform, spending reduction, or higher taxes. This lowers the deficit and the expected rates of money growth and inflation.

The "Cost" of Government

As the deficit grows, some analysts increase the size of the "the deficit" by adding off-budget activities to government spending. These efforts are an attempt to compute some measure of total government borrowing, based on the apparent belief that every dollar of government borrowing adds to the government "deficit." Others include government loan guarantees as a measure of the borrowing sponsored by government.

Many of the "off-budget" activities financed by government loans have positive productivity. This remains true even where the activity would not occur unless government subsidizes borrowers by relending at a rate below the open market rate. The subsidy increases the amount the public borrows from the government credit agencies or under the government's guarantee. Some of the borrowing is a substitute for private borrowing. Adding the entire off-budget borrowing to the deficit overstates the net addition to borrowing and has no clear relation to any meaningful definition of the budget deficit.

One reason for the measurement problem is that, as government activity expands, some former private activities are taken over by government. Activities are encouraged or deterred by taxation, regulation or subsidies. The burden the economy bears, or the benefit the economy receives, from government activity is a neglected item in the discussion of government deficits.

Suppose a private utility decides to build a power plant and, after careful planning, elects to finance most of the expenditure by issuing bonds. The sale of the bonds is an ordinary business event, in no way remarkable.

What changes if the utility is a public enterprise? Many may say "nothing," but I do not think that is the answer. Public enterprises in many countries, including the United States, frequently operate under different restrictions and often pursue different goals. They may not pay taxes. Often they do not pay dividends or a rental price for capital. They may issue more debt per unit of physical capital. In many countries, public enterprises have higher employment per unit of output (overstaffing) and lower efficiency. Pricing below cost of production is not uncommon.

The example brings out that differences in efficiency are likely to be important when comparing public and private enterprises. The social cost of public enterprises in many countries is more a reflection of the inefficiency with which these enterprises use labor, capital and other resources than of their contribution to the public-sector budget deficit.

The government's ability to borrow and subsidize is not unimportant. The subsidies delay or prevent adjustments, including plant closings, that a private firm would make. Concentration on the budget deficit, or the borrowing requirement, seems to me to neglect the more
payments and reduces tax payments. This increases the budget deficit.

Experience during the past decade in countries like Argentina, or Chile under Allende, shows the effect of relatively large budget deficits. Annual deficits of 10 to 20 percent could not be financed from private saving or capital inflow. The appearance of these deficits, and indications that public expenditure would not be restricted, generated expectations that the central bank would finance a large part, and often the largest part, of the projected deficits. People tried to reduce money balances. The rate of inflation far exceeded the rate of money growth. When the deficit fell relative to GNP or saving, the rate of inflation fell below the rate of money growth. This experience is not uncommon.

Projected deficits for the United States of 4 to 5 percent of GNP, if realized, may be followed by higher inflation. To date, this has not occurred, despite the many predictions that deficits are inflationary. Reductions in the maintained growth rate of money, if continued, will work to reduce inflation. Freely floating exchange rates remove the effect of foreign inflation. The projected deficits will not be costless, but their effect will be mainly on real activity, not on inflation, if the deficits are financed by issuing debt and money growth continues to fall in 1983 and 1984. Unfortunately, no one can be very certain about achieving that outcome.

My conclusion should not be read as a defense of current or projected budget deficits. I believe that lower inflation would be achieved at lower real cost if the reduction in the deficit could be achieved by reducing government spending and transfers. Part of the gain would come from increasing the efficiency with which resources are used. In addition, a resolution of the current fiscal stalemate would reduce uncertainty by clarifying the outlook for taxes, spending, transfer payments, and future money growth. This, too, would lower the real cost of present policies.

A more durable problem is the cost of government and the efficiency loss that society pays when that cost increases. The cost of government has risen in all western countries, as the relative size of government increased and transfer programs expanded. To limit the cost of government, we must agree, mutually, to limit demands for transfers and services financed by taxes, deficits and inflation. A properly phrased constitutional amendment to limit the size of government spending and revenue is an agreement to abide by rules under which deficits remain manageable and efficiency increases. Under a rule of this kind, deficits are likely to remain manageable.