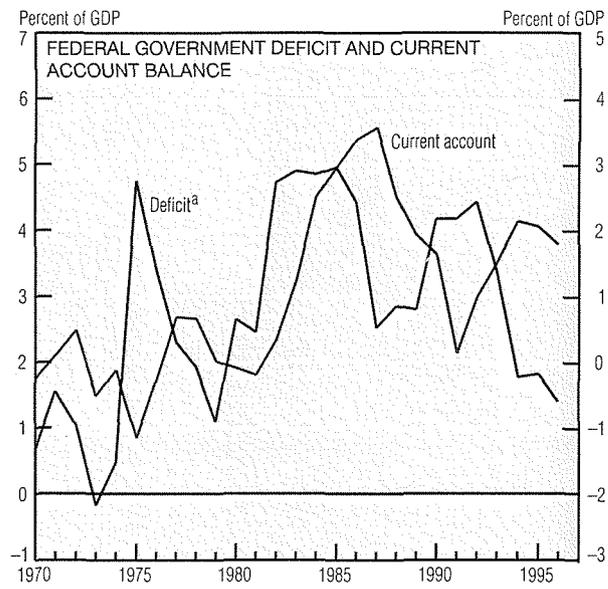
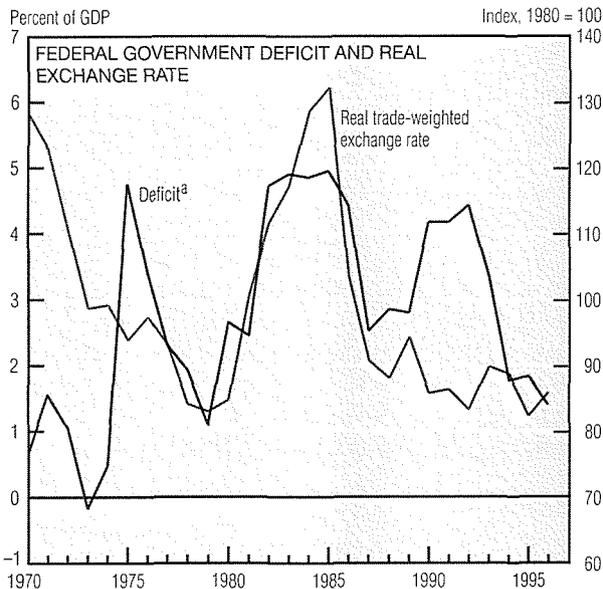
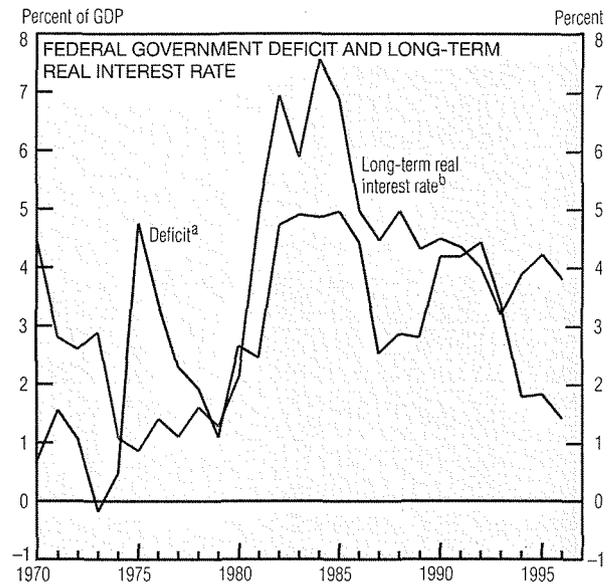
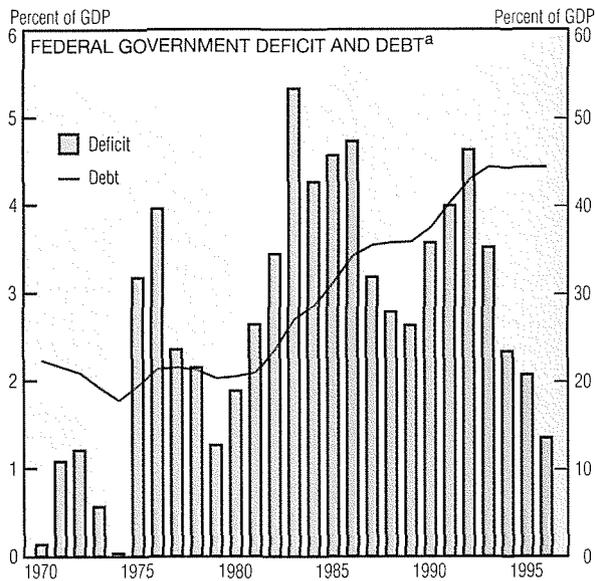


Federal Deficits and the Economy



a. U.S. federal government debt is debt held by the public less that portion held by the Federal Reserve System. Deficit is the year-to-year change in the federal government debt.

b. Calculated using the 10-year Treasury rate and the expected inflation rate from the Survey of Professional Forecasters.

NOTE: 1996 data are the average of the first two quarters.

SOURCES: Board of Governors of the Federal Reserve System, *Flow of Funds Accounts of the United States*; and the Federal Reserve Bank of Philadelphia, *Survey of Professional Forecasters*.

According to conventional wisdom, U.S. government budget deficits compete against private investment for a fixed supply of loanable funds. The resulting increase in real interest rates attracts foreign lenders, who bid up the dollar's exchange value in their zeal to acquire higher-yielding U.S. securities. A dollar appreciation results in a current account deficit, which is a necessary counterpart to an inflow of foreign savings (see page 19).

The problem with this accepted progression is that except for the fiscal expansion of the early 1980s, the relevant data do not seem to march in step. Statistical analyses of these connections also fail to offer unequivocal support.

An alternative way of examining fiscal policies focuses on how particular tax and spending programs influence savings, production, and work effort, rather than on the deficit per se. To illustrate this idea in the extreme, we could conceiv-

ably lower the deficit by raising taxes on capital gains, on the wealthiest individuals, and on payrolls, while simultaneously cutting expenditures for roads and ports. Although such policies might lower the budget deficit, they almost certainly would raise real interest rates by discouraging saving and hampering production. In this view, deficits become like shadows cast by more deep-seated and consequential fiscal distortions.