The Shortfall in Domestic Savings

Even if debt is not explosive, a persistent structural deficit in the neighborhood of 5 percent of GNP—as projected by the CBO—poses a serious threat to long-term economic growth. The danger stems from the current imbalance between domestic savings and credit demands—an imbalance that is likely to continue.

Historically, the private domestic savings rate has been stable, and impervious to the level of interest rates and credit demands of the federal government. In this situation, a large increase in federal credit demands must be met either by an increase in foreign savings (a net capital inflow) or by a decline in private credit demands.

The present concern is that federal demands will crowd out private credit demands and thereby stifle private investment. So far this has not happened because the shortfall in domestic savings has been met by a sharp increase in the net inflow of foreign savings. In the past year alone, this net inflow approached $100 billion, amounting to almost one-third of the net private domestic credit demands and to more than one-half the budget deficit.

Financing a large structural deficit with foreign savings is not without cost, either in the short run or in the long run. The immediate costs are clear. The net inflow of savings has encouraged a very strong dollar. The strong dollar, in turn, has made goods produced in the United States more expensive relative to goods produced abroad and thereby has contributed importantly to the record trade deficits. Thus, while the large budget deficit has not yet had a discernible adverse effect on domestic investment, it has crowded out exporters, farmers, and businesses that compete with imports.

This has put the current economic expansion in a precarious position. If the dollar were to strengthen significantly this year, the growing imbalances in the export sector could spill over into the general economy, leading to a slowdown in overall growth. What’s more, the adverse impact on certain sectors of the economy would lead to additional political pressures for trade restrictions and economic relief which, in the long run, would only make the situation worse. Ironically, a slowdown in the economy would also worsen chances for substantially reducing the Federal deficit.

Many analysts believe that a rapid decline in the dollar is a greater risk. This would be accompanied by a weakening in foreign savings that would put upward pressure on interest rates.

At the same time, the falling dollar would also put upward pressure on the inflation rate.

The long-run costs of the deficit depend on how long the net inflow of foreign capital can be sustained. If it is to continue, holdings of U.S. assets by foreigners must grow at unprecedented rates. Most economists believe that foreign portfolios will eventually become saturated with dollar-denominated assets.

The inflow of foreign savings would then cease, unless interest rates were to rise. In either case, federal credit demands would then begin to crowd out private investment. A slowdown in private investment reduces the rate at which new production techniques are adopted, thereby slowing productivity growth. This has the obvious effect of reducing potential growth and hence the standard of living relative to what it might be. A cessation of foreign savings would also lead to a fall in the dollar and to an increase in interest rates and inflation.

So far, the behavior of foreign savings has confounded forecasters throughout the recovery. Predicting when the inflow of foreign savings will cease, like predicting when an under-inflated tire will become damaged, is virtually impossible. This is what makes the deficit so insidious and so dangerous.

This Economic Commentary examines some potential problems that could be caused by large persistent deficits. It begins by identifying conditions that could lead to runaway debt. The real cost of deficits—a primary element of these conditions—is described in some detail.

Recent projections by the administration and by Congress suggest that while large deficits will persist, there is no evidence they are explosive. Nevertheless, the projected deficits will lead to a continued imbalance between domestic credit demands and private savings. The implications of this imbalance are discussed in the final section of this article.

The Potential of Runaway Debt

In some respects, the federal debt situation is like debt in personal finance. Early in adult life people typically build up debt for a sustained period as they purchase their first homes, furniture, appliances, and cars. During this stage, the change in a family’s outstanding debt—debt service—and the other is created by current overspending—the primary deficit.1

A day doesn’t pass without some public discussion of the federal deficit. Advocates of immediate deficit cutting use terms like ‘explosive’ and ‘unstable’ to describe the debt burden, suggesting imminent catastrophe. Others describe this as hysteria, pointing to the current performance of the economy as evidence that nothing serious is wrong. Neither view is quite right.

The deficit problem could more properly be characterized as an insidious danger, much like a slow leak in a car tire. A tire with inadequate air pressure wears much faster, but worse, it eventually becomes permanently damaged and potentially dangerous. Unfortunately, one cannot always tell whether or not a tire is damaged by looking at it from the outside. This makes it difficult to assess how soon a low tire will become dangerous; hence it’s always prudent to treat the problem as urgent. One doesn’t wait until an accident occurs to acquire insurance.

Similarly, the case for urgent action on the deficit is to insure against the risk that government debt requirements will stifle private investment that is necessary for a healthy, growing economy. The current state of the economy, like the outside of the tire, doesn’t reveal the problem. The unfortunate consequence of deficits will manifest themselves in the future. The insidious danger of large persistent deficits is that they are likely to reduce the growth of output and to reduce our standard of living.

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1. Although debt service is sometimes defined to include repayment of principal, it is assumed here that principal due is refinanced.

2. However, unlike the individual whose earning potential will ultimately end, government income (its revenue and grow industry) is as long as the economy will allow. Most estimates of potential growth of the economy exceed 2.5 percent annual rates. Population growth alone generally assumes growth in advanced economies over long periods.
increasing productivity will account for additional gains. This seemingly endless potential for growth in an economy with inflation is 5 percent. Ignoring tax effects, an increase in base money. The revenue from government debt is related to the business cycle. The OMB and CBO projections are based on macroeconomic models, and on rules of thumb, may offer some indication about whether or not the deficit is on an explosive track. While the CBO projections seem to suggest that the deficit is on an explosive track, and the OMB projections are based on cycle-free assumptions on historical trends. It notes that from 1961 to 1969, the economy grew 4.6 percent. But this performance was based on a long-term trend on record — was also accompanied by accelerating inflation. Many analysts are skeptical that non-inflationary economic growth can endure for long. If a cyclical slowdown occurs in the next three years, it would be quite probable that the primary deficit would not jump sharply, reflecting the additional spending on automatic stabilization programs and reduced revenues.

Table 1. Net Real Interest Rate on Government Debt and Real Economic Growth Projections, Percent

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<thead>
<tr>
<th>Year</th>
<th>CBO</th>
<th>OMB</th>
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<tbody>
<tr>
<td>1985</td>
<td>1.5</td>
<td>12.9</td>
</tr>
<tr>
<td>1986</td>
<td>0.7</td>
<td>3.2</td>
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<td>1987</td>
<td>1.1</td>
<td>3.3</td>
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<tr>
<td>1988</td>
<td>1.2</td>
<td>3.4</td>
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<tr>
<td>1989</td>
<td>1.1</td>
<td>3.4</td>
</tr>
<tr>
<td>1990</td>
<td>1.2</td>
<td>3.4</td>
</tr>
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NOTE: The net real interest rate is estimated by the ratio of net interest payments (adjusted for Federal Reserve note effects) to the debt at the beginning of the year. The real growth rate is estimated by subtracting inflation. Until this year, tax rates were adjusted for inflation, but in 1990, tax rates were adjusted for inflation. The OMB and CBO projections are based on cycle-free assumptions. The real growth rate of GNP is in a calendar year basis, all other figures are on fiscal year basis. SOURCES: Congressional Budget Office; and Office of Management and Budget.

The OMB deficit projections are more optimistic relative to the CBO's more critical outlook. The OMB assumes that current laws and policies would remain unchanged, the OMB and CBO assumptions agreed that Congress would pass the Reagan administration's current budget proposals. Neither projection indicates that the debt will become runaway. However, together they indicate that there is an immediate threat to raise the real interest rate and reduce the probability of such an event. As chart 1 illustrates, the CBO projections seem to suggest that the deficit is on an explosive track. The OMB projections are cycle-free, but not inflation-neutral. Real GNP. This assumes a substantially faster growth in productivity than prevailed in the 1970s. Although neither of the projections provides evidence of explosive deficits, both seem precarious dependent on optimistic recession-free outlooks. Such outlooks imply that future deficits would be almost exclusively structural — that is, unrelated to the business cycle. The OMB deficits on its treasurization assumption on historical trends. It notes that from 1961 to 1969, the economy grew 4.6 percent. But this performance was based on a long-term trend on record — was also accompanied by accelerating inflation. Many analysts are skeptical that non-inflationary economic growth can endure for long. If a cyclical slowdown occurs in the next three years, it would be quite probable that the primary deficit would not jump sharply, reflecting the additional spending on automatic stabilization programs and reduced revenues.