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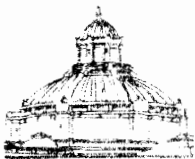
Issue Brief

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**GRAMM-RUDMAN-HOLLINGS: POTENTIAL ECONOMIC EFFECTS
OF MEETING DEFICIT TARGETS**

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CONTENTS

SUMMARY

ISSUE DEFINITION

BACKGROUND AND ANALYSIS

Economic Effects of Deficit Reduction

Monetary Stimulus: A Way to Avoid Recession?

FOR ADDITIONAL READING

GRAMM-RUDMAN-HOLLINGS: POTENTIAL ECONOMIC EFFECTS
OF MEETING DEFICIT TARGETS

SUMMARY

The 99th Congress passed the Gramm-Rudman-Hollings Act (G-R-H) in an effort to confront the continuing, large Federal budget deficits. Large Federal budget deficits are widely believed to raise real interest rates and to shift the allocation of output towards consumption and away from investment. As a result, many are concerned that long-run productivity growth may suffer. G-R-H specified a target path for future deficits leading to a balanced Federal budget by 1991.

Reducing the budget deficit, however, could have deleterious short-run economic effects. Whether achieved by reducing outlays or raising taxes, fiscal contraction will tend to slow economic growth and to raise unemployment, in the short run. Reducing outlays has an immediate, direct, effect on the level of economic activity. Increasing taxes slows economic growth indirectly, by reducing the amount of income consumers and businesses have to spend. Furthermore, it should be noted that spending cuts are generally believed to slow economic growth by more than an equivalent increase in taxes.

Although fiscal contraction is expected to slow economic growth, some of this decline might be offset by at least one policy option. Monetary stimulus could be used to minimize the loss of economic growth expected to accompany fiscal contraction. A stimulative monetary policy which reduces interest rates would tend to boost economic growth in the short run.

The problem of coordinating fiscal contraction and monetary expansion is potentially great. The economic effects of monetary expansion take place with a time lag that is likely to be substantially longer than in the case of the G-R-H fiscal contraction. While a fiscal contraction has fairly immediate economic consequences, the full effects of monetary expansion may not be felt for up to two years. By that time, the slowdown resulting from the fiscal contraction may very well have reversed itself. Thus, timing is critical; otherwise there is a chance that monetary stimulus will be destabilizing by having more of an effect on the inflation rate than on real growth.

ISSUE DEFINITION

Although some doubt that the deficit targets set by Gramm-Rudman-Hollings (G-R-H) will be met, most observers agree that degree of fiscal tightening is in the offing. Whether by increasing taxes or reducing outlays, such a fiscal contraction could slow economic growth in the short run. Depending upon the magnitude of such a fiscal contraction, the economy could be thrown into recession. A stimulative monetary policy has the potential of offsetting the economic effects of deficit reduction. What options are available which might help minimize the potential economic disruption of the process of deficit reduction?

BACKGROUND AND ANALYSIS

Economic Effects of Deficit Reduction

G-R-H calls for a \$36 billion reduction in the Federal budget deficit each fiscal year until the budget is balanced in 1991. Whether or not this objective is met may be subject to debate. But, deficit reduction, whether achieved by cutting outlays or raising taxes, is expected to slow economic growth and increase unemployment, in the short run.

If the deficit is cut by reducing expenditures, then there is an immediate reduction in the demand for output. This immediate drop in demand leads to a drop in incomes and hence a decline in consumption spending. If the deficit is cut by raising taxes, then there is no immediate effect. But, the increase in taxes cuts disposable incomes and, as a result, consumption falls. As a consequence of the difference in the way the two approaches work, a reduction in outlays should have a more immediate depressing effect on economic growth than would a tax increase of equivalent proportions.

Deficit reduction has an additional consequence. It reduces the Federal Government's demand for credit. This tends to push down market interest rates and begins a sequence which will eventually counter the initial depressing effects of deficit reduction. Lower interest rates directly stimulate private sector spending on those goods which are typically debt financed. Consumer spending for houses, autos, and other durable goods could be expected to pick up. Business spending for plant and equipment, property, and inventories would also likely pick up.

A second, indirect, effect of interest rates could also tend to boost aggregate demand. Relatively lower interest rates in the United States make dollar-denominated securities less attractive to investors compared to securities based in other currencies. This leads to a reduced demand for dollars in foreign exchange markets and tends to push down the exchange value of the dollar. The reduced value of the dollar increases the price of imported goods and services and reduces the price of exports. As a result, imports will tend to fall and exports will tend to rise. Both events would contribute to short-run economic growth.

Initially, then, a fiscal contraction would be expected to slow economic growth. Because of the decline in interest rates, however,

private spending will eventually pick up. Thus, any economic slowdown would likely be temporary, but there is the potential for a significant rise in unemployment.

Monetary Stimulus: A Way to Avoid Recession?

In theory, a monetary expansion can provide an offset to the contractionary effects of deficit reduction. The Federal Reserve can stimulate growth of the money stock by accelerating the rate at which it supplies reserves to the banking system. Faster money growth can be expected to boost growth in aggregate demand, at least in the short run.

Faster money growth, however, only affects the real economy after a time lag. This time lag is likely to be considerable. Simulations with the Data Resources, Inc. econometric model of the U.S. economy suggest that the full economic effects of a monetary expansion may not be felt for up to two years.

If fiscal contraction and monetary expansion were simultaneously pursued, the economic effects of monetary expansion might occur too late to offset the recessionary consequences of deficit reduction. It is entirely possible that by the time the full economic effects of a monetary stimulus were felt, that the economy would already have rebounded from the fiscal contraction. In that case, monetary stimulus might simply tend to raise the inflation rate rather than the real economic growth rate.

In practice, the problem of coordinating monetary expansion in such a way as to offset the potential recessionary consequences of deficit reduction are substantial. To take full advantage of a monetary expansion may require that the Federal Reserve anticipate the timing and magnitude of any forthcoming fiscal contraction. But, there remains, even in the wake of G-R-H, uncertainty regarding how much deficit reduction is in the cards.

These problems need not be considered prohibitive, however. With or without precision timing and accurate foresight, monetary expansion still has the potential of dampening the short-run effects of deficit reduction. Further, the policy coordination problems highlighted here should in no way be construed as an argument for or against budget deficit reduction.

FOR ADDITIONAL READING

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