

Statement of  
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Director  
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before the  
Subcommittee on Economic Goals and  
**Intergovernmental** Policy  
Joint Economic Committee  
The Congress of the United States

September 13, 1984

There should be no  
**release** of this statement  
before its delivery,  
scheduled for 10:00 a.m.,  
September 13, 1984.

Mr. Chairman, it is a **pleasure** to be here today to discuss the views of the **Congressional** Budget Office (CBO) on the **outlook** for interest rates, the deficit, and the economy.

## INTEREST RATES AND THE ECONOMIC AND BUDGET OUTLOOK

CBO's current forecast, which is summarized in Table 1 and discussed in detail in our recent report on The Economic and Budget Outlook: An Update, is for slower but still **substantial** economic growth through next year. Inflation is expected to be moderately higher next year compared with this year, and unemployment moderately lower.

In the CBO forecast, both short-term and **long-term** interest rates **decline** gradually between now and the end of 1985. These declines are not very large, however: the average 1985 level of the three-month Treasury bill rate is 9.7 percent in the forecast, **only** about seven-tenths of a percentage point below current levels. Longer-term rates represented by **Moody's** AAA-rated corporate bond yield are projected to average a bit less than 12.5 percent during 1985, down only slightly from current levels. In other words, CBO does not anticipate that either nominal rates or real rates (nominal rates adjusted for inflation) **will** decline dramatically from their current levels.

Both nominal and real interest rates are extraordinarily high compared to historical experience. As shown in Figure 1, interest rates in the 1980s have been far above their levels earlier in the postwar period. Although

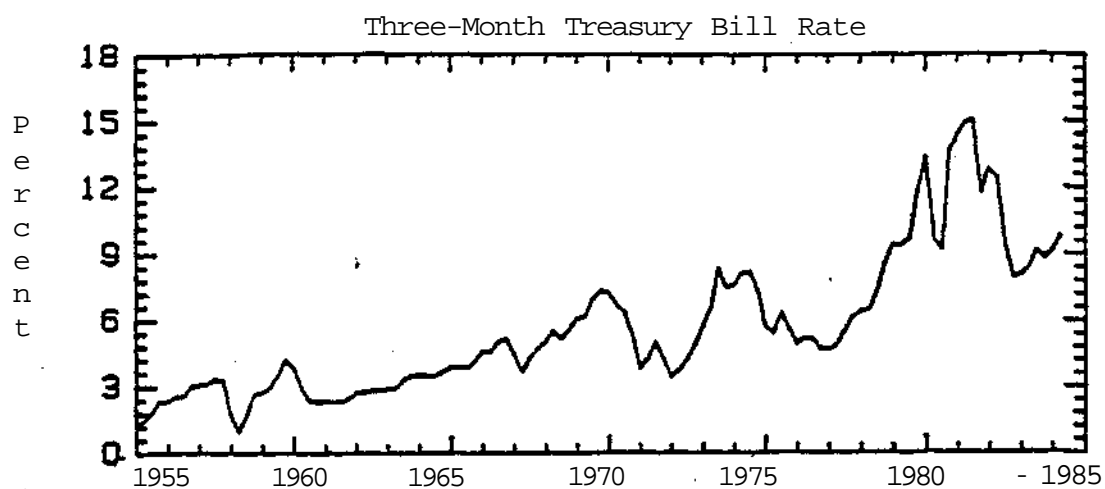
TABLE 1. THE CBO FORECAST FOR 1984 AND 1985

	Actual		Forecast	
	1982	1983	1984	1985
Fourth Quarter to Fourth Quarter (percent change)				
Nominal GNP	2.7	10.4	10.9	8.2
Real GNP	-1.5	6.3	6.6	2.8
GNP Implicit Price Deflator	4.3	3.8	4.1	5.3
Consumer Price Index, Urban Consumers	4.5	3.3	4.5	5.2
Calendar Year Average (percent)				
Civilian Unemployment Rate	9.7	9.6	7.3	6.7
3-Month Treasury Bill Rate	10.6	8.6	10.0	9.7
Corporate Bond Rate, Moody's AAA	13.8	12.0	13.1	12.3

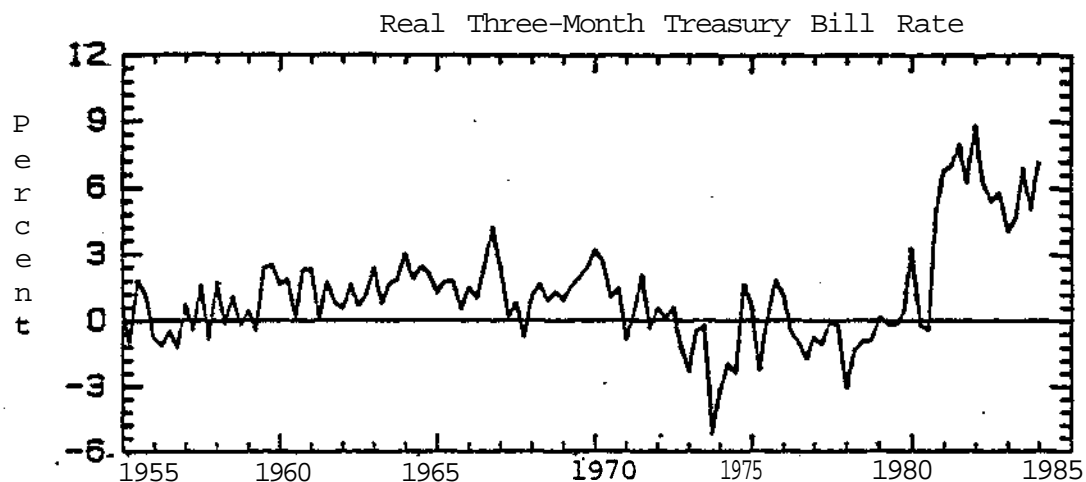
TABLE 2. UPDATED CBO BASELINE BUDGET PROJECTIONS  
(By **fiscal** year)

	1983 Actual	1984 Base	<u>Projections</u>				
			1985	1986	1987	1988	1989
<u>In Billions of Dollars</u>							
Revenues	601	673	<b>751</b>	811	881	965	1,042
Outlays	796	<b>845</b>	929	1,006	1,097	1,203	1,305
Unified Budget Deficit	195	172	178	195	216	238	263
Total Deficit	208	183	191	209	231	254	278
<u>As a Percent of GNP</u>							
Revenues	18.6	<b>18.7</b>	19.1	<b>19.1</b>	19.2	19.4	<b>19.4</b>
Outlays	<b>24.7</b>	23.5	23.7	23.7	23.9	24.2	24.3
Unified Budget Deficit	6.1	4.8	4.5	4.6	4.7	4.8	4.9
<b>Off-Budget</b> Deficit	<b>0.4</b>	0.3	0.3	0.3	0.3	0.3	0.3
Total Deficit	<b>6.4</b>	5.1	4.9	4.9	5.0	5.1	5.2

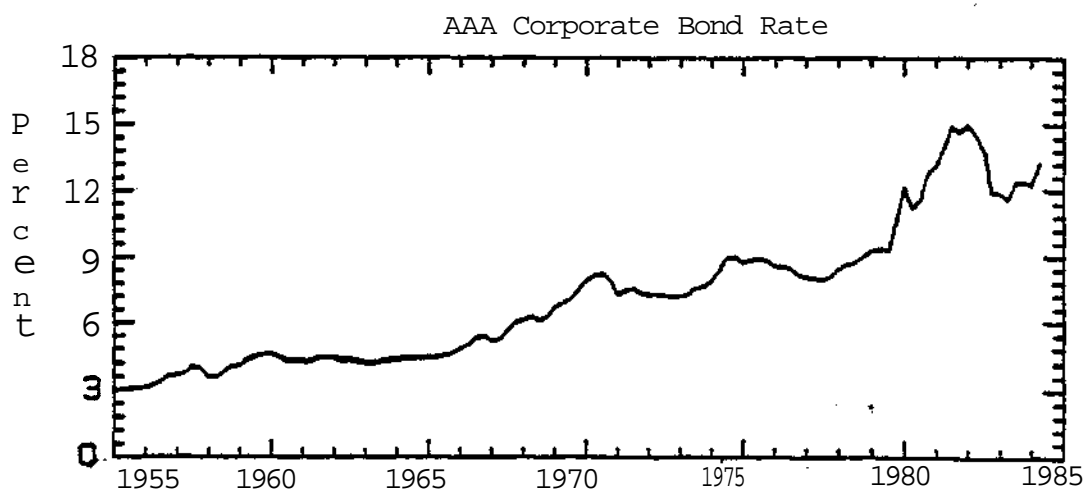
FIGURE 1. SELECTED INTEREST-RATE MEASURES, 1955-1984



SOURCE: Federal Reserve Board



SOURCE: Congressional Budget Office



SOURCE: Moody's Investors' Service

nominal interest rates have recently been well below **levels** reached in the early 1980s, **real** Treasury bill rates—nominal rates less the rate of inflation—have declined less significantly. 1/

Few analysts believe that they know all the reasons why rates are so high; nor do they agree on the relative importance of the reasons that have been identified. Some evidence indicates that inflationary fears play a role in keeping rates high, because many financial market participants **still** lack confidence that the double-digit inflation rates of the 1970s are, in fact, behind us. Some observers also argue that **volatility** in interest and money-growth rates has pushed interest rates up by increasing uncertainty. Many find still another factor in deregulation of financial markets. There is probably at least a grain of truth in all these explanations. Moreover, there may well be even other factors that no one has identified yet.

Most economists, though not all, assign an important **role** to the federal deficit in keeping real interest rates high. Federal credit requirements now amount to 5 percent of GNP, and when added to the strong borrowing of the private sector they imply an extraordinary total demand for credit. To an important extent that demand is being financed by

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1/ Many economists believe that real interest rates, or interest rates less expected inflation, are a more **relevant** measure of the true cost of borrowing than nominal rates. While the expected inflation rate is unobserved, it can be approximated by inflation as actually experienced in calculating real short-term interest rates. That is not the case for expected inflation several years in the future, and so no estimates of **real** long-term rates are given in Figure 1.

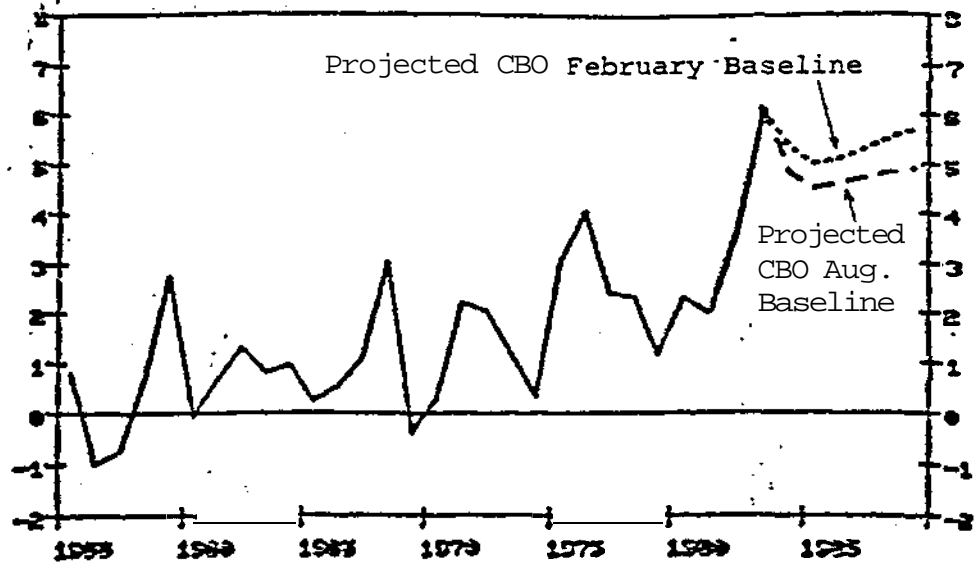
net inflows from international capital markets, which, in turn, are attracted in large measure by the fact that interest rates are higher here than in other major countries.

The expectation that budget deficits will continue at the unprecedented peacetime level of roughly 4 percent to 5 percent of GNP, unless significant changes are made in current policies, is undoubtedly playing a role in holding long-term rates well above short rates. For most of the past two years, the differential between long and short rates has been **exceptionally** large. Moreover, the **differential** has not followed a downward trend during the recovery, in contrast to the usual pattern during such periods. One way to explain this is to note that long rates reflect expectations of future short-term interest rates and inflation rates. Large expected deficits could well be raising expected short rates above current **levels** if financial-market participants expect a credit crunch later in the recovery. The same result **could** also occur if large **deficits** are expected to pressure the Federal Reserve into monetizing the deficit and causing higher inflation.

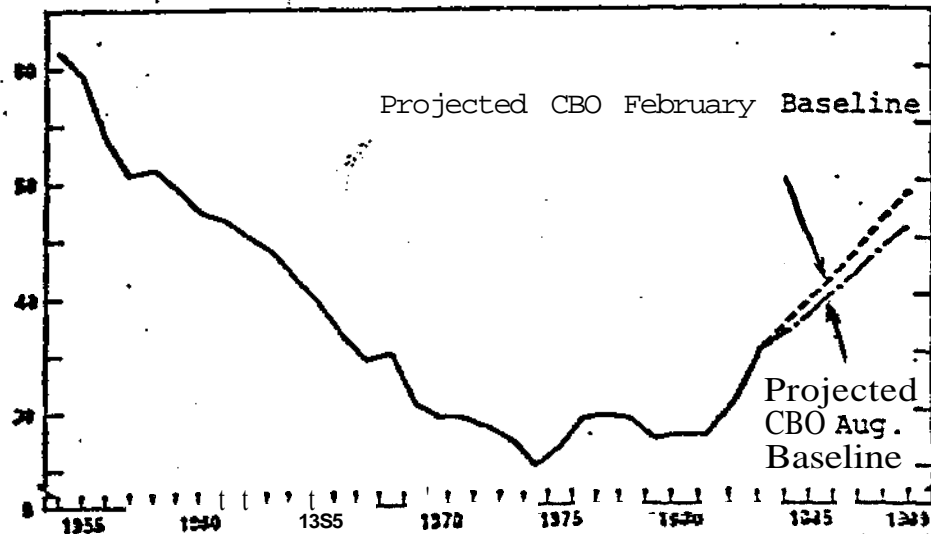
**CBO's** budget projections show that the Deficit Reduction Act of 1984, passed this summer, has nearly stabilized the deficit for the next **several** years at just less than 5 percent of GNP (Table 2 and Figure 2). But it maintains the deficit at such a high **level** that the ratio of the stock of federal debt to GNP is projected to continue to rise (as shown in Figure 2, second panel). This prospect is extremely worrisome. Many analysts believe that the stock of debt relative to GNP, rather than the deficit per se, works

FIGURE 2. SELECTED FISCAL MEASURES, 1955-1980 AND PROJECTIONS  
FOR 1984-1989 (FISCAL YEARS)

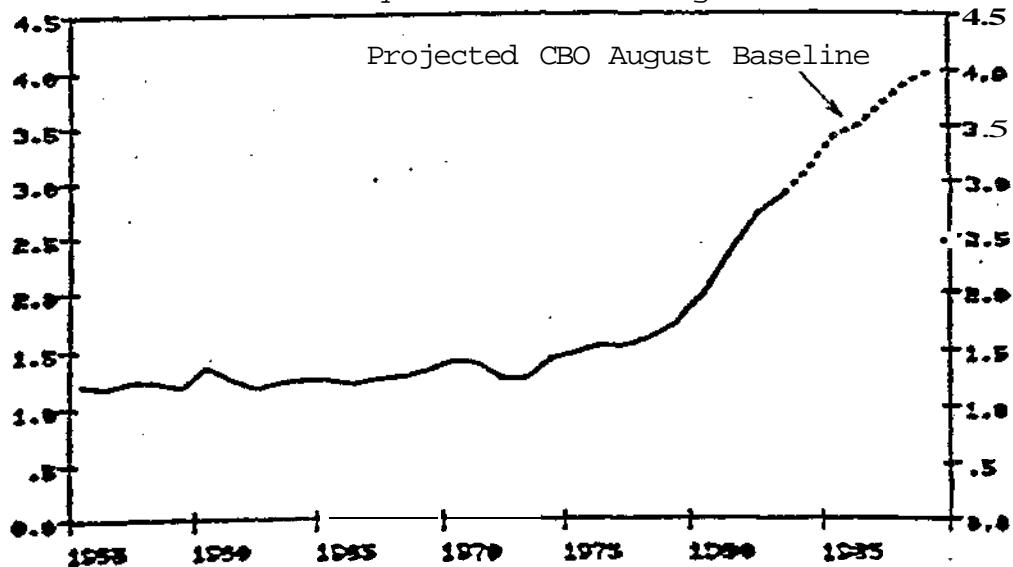
Federal Deficit as a Percentage of GNP



Federal Debt Held by Public as Percentage of GNP



Federal Net Interest Payments as Percentage of GNP



SOURCE: Congressional Budget Office.



most directly to affect the level of interest rates, and through them the level of private investment. The continuing increases in the debt/GNP ratio that are implied by current policy therefore threaten us with persistent upward pressures on interest rates, and the danger that federal borrowing will crowd private investment out of the financial markets. Quite apart from that, the rapid growth in debt means rapid growth in budget outlays for interest payments in the future even if interest rates stay the same. CBO projections, which assume interest rates near current levels for the next several years, show a rise in interest costs as a percent of GNP from 3.1 percent in 1984 to 4.0 percent in 1989, compared to an average level of 1.6 percent during the 1970s. This makes controlling deficits and stopping the growth in federal debt harder and harder as time goes on. So while the deficit-reducing legislation passed during the summer of 1984 has been a valuable step, much remains to be done.

### The Role of Monetary Policy

Monetary policy has had to contend with some extremely difficult challenges since the trough of the recession. Its goal has been to provide enough liquidity to allow a strong recovery, but not so much as to convert that recovery into an inflationary boom. In doing this, it has had to contend with a flood of government debt into the market place; indeed the stock of Federal debt in the hands of private investors has recently been growing at an annual rate of between 15 and 20 percent.

Domestically, monetary policy has also been confronted with threats to the solvency of several major banks, the largest being Continental Illinois. At the same time, **policy** has had to remain concerned about the international implications **of** its policies, **especially** as they pertain to the viability of the LDC debt.

So far these challenges have been met **remarkably** well. The current recovery is the second most vigorous in post-war history and there are still no signs of accelerating inflation. The **M-1** and **M-2** monetary aggregates are well within their target ranges. Further, over the last two years, interest rates have been much more **stable--though** at extremely high levels **--than** than they were in the previous three years.

Monetary policy works with a **considerable** time **lag**, however, and the successes of the immediate past do not necessarily prove the wisdom of the current monetary stance. Some observers, pointing to the lack of any evidence of **accelerating** inflation and to the depressed prices of gold and certain other commodities, believe that the Federal Reserve **could** afford to be more expansionary. Others cite increased capacity utilization and the gradual tightening of labor markets over the last year to support their view that there is a real danger of future **inflation**.

**CBO's** forecast lies between these extremes. We **believe** that a policy that keeps money growth during 1984 and 1985 near the centers of the target ranges announced by Chairman Volcker on July 25 is likely to result in a relatively **slight** increase in **inflation** and a moderation in growth. Those

wishing to judge the appropriateness of current monetary **policy** should decide whether this forecast seems reasonable, and what risks there would be in **significantly** faster or slower monetary growth.

### Evidence on Interest-Rate Impacts of Deficits

Few empirical studies have uncovered a clear causal link between deficits and interest rates, and this has led some observers to question whether current concerns about the deficit outlook are warranted. Most of the studies, however, that have been published to ~~date--both~~ those that find no relationship as **well** as those that ~~do--base~~ their **conclusions** on tenuous evidence. Three CBO staff economists recently undertook a careful review of many of these studies (I have attached their report for the record). They found that many of the statistical results, whether supporting or belying a **relationship** between deficits and rates, could be reversed by making minor changes in the specification of the statistical relationships tested. In other words, few of the conclusions are reliable, and the overall inference should be that the data are inconclusive.

One can easily imagine why many of these studies may have failed to come to grips with the deficit/interest-rate question. Many of them tested **relatively simple** hypotheses embodied in **single** equations, while a correct but considerably more complicated approach would have to take explicit account of nonfederal credit demands as **well as** many other factors.

Moreover, many economists have attempted to associate **deficits** directly with the level of interest rates. As I noted earlier, however, interest rate levels may be determined by the stock of debt among other factors. Under this hypothesis, the deficit, which determines changes in the stock of debt, would be associated with changes in the level of interest **rates**--a very different relationship.

Even if there were compelling statistical studies showing that past deficits have had little adverse impact on interest rates or on the economy, one would have good reason to doubt their relevance to **today's** situation. As I have already pointed out, not since World War II have current and projected structural deficits been as large as they are now relative to GNP, and never before has the outlook been for steady increases in the federal debt relative to GNP during a period in which GNP growth is projected to exceed the long-run, full-employment growth rate.

#### THE EFFECTS OF HIGH RATES ON THE OUTLOOK

One would expect that the effects of **today's** high **real** interest rates would result in depressed levels of spending in such interest-sensitive domestic sectors as **housing**, nonresidential construction, **producers'** durable equipment, and consumer durables. In fact, the evidence is mixed. Two of these **sectors**--**housing** and nonresidential **structures**--**account** for a smaller share of GNP than at comparable stages of earlier recoveries, but the other

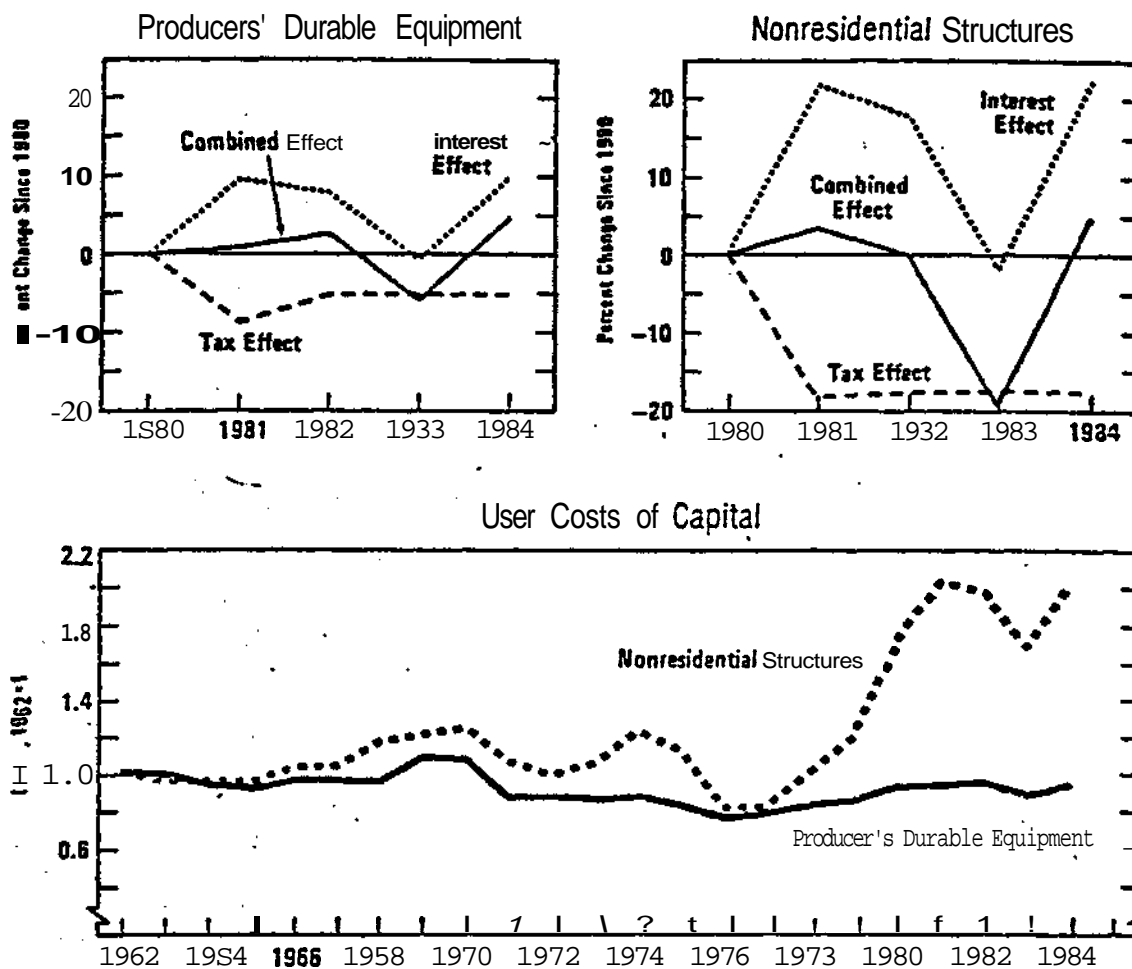
sectors do not. Moreover, all except nonresidential construction have grown more rapidly since the recession trough than during earlier recoveries.

How did this happen in the face of high interest rates? One factor that helped shield investment from high rates was the investment-stimulating effect of the Economic Recovery Tax Act of 1981, much of which survived the moderating provisions of the 1982 revenue-raising legislation. CBO has calculated the combined effects of changes in interest rates and in tax provisions on the overall cost of business fixed investment. The results, shown in Figure 3, suggest that the tax cut offset most, though not all, of the effects of increases in interest rates during 1981 and 1982, and helped give a real push to investment when rates fell in late 1982. Both the rise in interest rates and the tax reductions have had **proportionately** greater effects on nonresidential structures than on **producers'** durable equipment, which are shorter-lived capital goods. A more detailed discussion of these results is contained in a CBO study that I am also attaching for inclusion in the record.

Investment could **also** have been stimulated by the strength of the recovery, which may have overcome the **effects** of high rates by **convincing** firms that they needed to expand or **modernize** capacity to meet growing demands for their products. Several other factors specific to equipment investment have helped to account for this particular sector being the strongest component of investment. The relative prices of business equipment have been declining, in part because much of this capital

Figure . 3.

## Sources of Change in User Costs of Capital



SOURCE: Congressional Budget Office.

NOTE: Changes in the user cost of capital shown above are the result of changes in interest rates and federal tax laws. Values for 1984 were computed on the basis of the first two quarters. The tax life for structures in 1984 was assumed to be 15 rather than 18 years because most structures put in place in 1984 are expected to qualify for the shorter tax life permitted by law.

is imported and has benefited from rising **dollar** exchange rates. Equipment spending has also been strengthened by a push to **modernize** with computers and other products of the wave of electronic innovations of recent years.

Two other factors also help explain the strength of investment. One is the pent-up demands for both business capital and housing that accumulated during the recession; another is the introduction of adjustable-rate mortgages with rates **well** below those on conventional loans. In any case, the **result** has been to **limit** any crowding out of private investment during the economic upswing.

The ability to borrow in international capital markets has certainly mitigated to some degree the crowding out of domestic investment, although this simply means that crowding out has been transferred to our trading sector. U.S. interest rates have risen above those in other countries, **helping** to attract a heavy inflow of foreign savings. The demand for dollars to use in buying U.S. assets has bid up dollar exchange rates, which in turn have raised the prices of U.S. goods relative to foreign goods. Spending patterns have shifted accordingly, leaving those sectors of the U.S. economy that are involved in international trade in a depressed state. **Moreover**, the capital borrowed from abroad imposes direct long-run costs on the economy in that a growing proportion of our future national output will have to be devoted to paying interest and dividends to **foreign** residents.

Increases in U.S. interest rates have imposed **particularly** significant costs on debt-burdened Third World countries by increasing the amount of

interest they owe to foreign lenders. Recent estimates suggest that aggregate **Third-World** interest obligations increase by \$3 billion to \$5 billion for every percentage-point rise in **U.S.** rates. At the same time, however, the rising **dollar** exchange rates that accompany rises in U.S. interest rates encourage these countries' exports to the United **States**, on which they depend heavily for foreign exchange with which to pay their debts. Rapid economic expansion in this country has added further to the demand for their products. Nevertheless, high interest rates divert foreign exchange into interest payments, and have forced many countries to limit their imports from the United States, thus adding to U.S. trade problems.

## CONCLUSION

The economic outlook for 1984 and **1985** is bright despite high interest rates and despite several risks that are being exacerbated by large budget deficits. The most important risks in the outlook include:

- o Higher inflation, which **could** result from a sharp decline in dollar exchange rates, among other factors;
- o Sudden reductions in foreign inflows of capital, which could occur if **foreigners'** portfolios became saturated with U.S. financial assets; and
- o **Financial** instabilities associated with high **and volatile** interest rates, which could be made more serious by the **sizable** problem-**loan** portfolios of some major financial institutions.

CBO does not expect these risks to materialize during the forecast period. Nevertheless, it is important to place a high priority on reducing



federal deficits if only to curb the extraordinary growth in the cost of servicing the debt. Rising interest costs play a major role in making future budget prospects appear so bleak. If the deficit **could** be reduced to the point where the **debt-to-GNP** ratio began to **decline**, debt servicing costs would fall **substantially—even** if interest rates remained constant. What is now a major part of the budget problem could then be converted into a major part of the solution to our difficulties. In addition, if a **falling** debt-to-GNP ratio were to **result** in falling interest rates, it would have a further beneficial and compounding **effect--making** the budget problem even more tractable, and improving the potential for economic growth.