Statement of
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before the
Joint Economic Committee
Congress of the United States

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There should be no release of this statement until its delivery, scheduled for 10:00 a.m. (EST) Thursday, February 28, 1985.

Mr. Chairman, I am pleased to testify today before this Committee on the outlook for the economy and on fiscal policy. Thus far in this recovery the performance of the economy has exceeded expectations. Last year, the rate of economic growth was 6.9 percent, the highest since 1951. The inflation rate was down to about 4 percent in both 1983 and 1984, the lowest rate in a decade.

The budget deficit, however, remains a serious problem. Despite the vigor of the recovery, the deficit-to-GNP ratio in fiscal year 1984 was, at 5.2 percent, the second highest in our postwar history, clearly illustrating the extreme imbalance in our fiscal policies. If budget policies are not changed, record budget deficits are likely for the remainder of this decade. Current law implies a steadily rising total deficit reaching $300 billion by 1990, assuming average historical rates of economic growth. The deficit-to-GNP ratio, while projected to remain constant, is near 5½ percent. This does, however, represent an improvement over last February's projection of a steadily rising deficit-to-GNP ratio. The improvement results from the enactment of the "down payment" on the deficit during calendar year 1984.

The high deficits imply rapid growth of the outstanding debt. In turn, this rapidly growing debt implies a steadily growing interest burden that is itself a major component of our budget problem. More important, current fiscal policy suggests that the living standards of future generations of Americans will be gradually lowered compared with what they could be if fiscal policy were more prudent. CBO's projections assume that the

economy will continue to expand in the face of a steadily growing debt burden. In fact, in the very short run, the growing deficit may even add slightly to the rate of expansion. The combination of growing deficits and relative economic prosperity is without precedent in peacetime history, however, and CBO's relatively optimistic economic projections must be put forward with considerable uncertainty.

RECENT ECONOMIC DEVELOPMENTS

Real GNP grew at a rapid 5.9 percent rate between the last quarters of 1983 and 1984, only slightly less than in the first year of recovery, and the unemployment rate declined to 7.2 percent by the fourth quarter of the year. Despite the sharp drop in unemployment, the inflation rate averaged about 4 percent during 1984, little changed from the moderate pace achieved in the previous year. Economic growth was led by rapid growth in consumer spending and a surge in business investment spending, both of which continued to benefit from the tax cuts enacted earlier. The lagging trade sector, however, remained a serious drag on the economy.

Economic growth was particularly strong in the first half of 1984, then slowed sharply at mid-year, and returned to a more sustainable pace in the last quarter. Interest rates declined and inflation remained moderate at the end of 1984. At year-end, business firms also had some success in reducing excess inventories. Thus, conditions now appear to be set for continued economic expansion with little increase in inflationary pressure.

THE CBO ECONOMIC PROJECTIONS

CBO's baseline economic projections are composed of two parts: a two-year forecast, conditional on specific policy assumptions; and medium-term projections, which show a smooth growth trend derived from average historical experience.

The Short-Run Economic Forecast

As in the past, CBO's economic forecast for the next two years incorporates an assumption of unchanged federal budget policies. In regard to monetary policy, the forecast assumes that the growth in the money aggregate Ml will be 5.5 percent from the end of 1984 to the end of 1985—the midpoint of the target range recently announced by Federal Reserve Chairman Volcker--and 5.0 percent in 1986. In addition to these policy assumptions, the price of imported oil is projected to average about $1.50 per barrel below last year's price and the value of the dollar in international exchange markets is assumed to decline moderately from current levels, so that its average value this calendar year will be about the same as last year.

Based on these assumptions, real growth is now forecast to be about 3½ percent over the four quarters of 1985 and slightly less during 1986. The unemployment rate is projected to decline gradually to 6.9 percent in 1986. Inflation is expected to rise only fractionally from about 4.0 percent last year to 4.6 percent by 1986. The three-month Treasury Bill rate in calendar

year 1985 is about one percentage point below last year and rises only slightly in 1986.

The Medium-Term Projections

In its medium-term projections, CBO assumes that from the fourth quarter of 1982 (the recession trough) to the fourth quarter of 1990, the growth of GNP and of labor productivity will match the average growth rate in the eight-year periods following earlier postwar recessions. As a result, real GNP growth averages about 3.4 percent a year in the 1987-1990 period, and productivity growth in the nonfarm business sector averages about 2.2 percent. With these growth rates, the unemployment rate declines slowly to 6.2 percent in calendar year 1990. Inflation, as measured by the GNP deflator, averages 4.2 percent in the 1987-1990 period while the three-month Treasury bill rate averages 8.2 percent, or 4.0 percent after adjustment for inflation (see Table 1 and Figure 1).

Uncertainties in the Economic Outlook

The economy's performance could easily turn out to be much better or worse than CBO's projections indicate. At present, the major uncertainties in the short run are related to oil prices, exchange rates, and interest rates. Some analysts expect that oil prices will decline more sharply than projected by CBO, a development that could have beneficial effects on both inflation and real growth. On the negative side, the economy may be

vulnerable to a drop in capital inflows from abroad. While CBO does not forecast such an occurrence, a sharp drop in capital inflows would lead to a decline in the dollar, a rise in domestic inflation, and increased pressure on interest rates. Other risks relate to the financial stress being experienced in agriculture and other sectors. CBO assumes that these problems will be

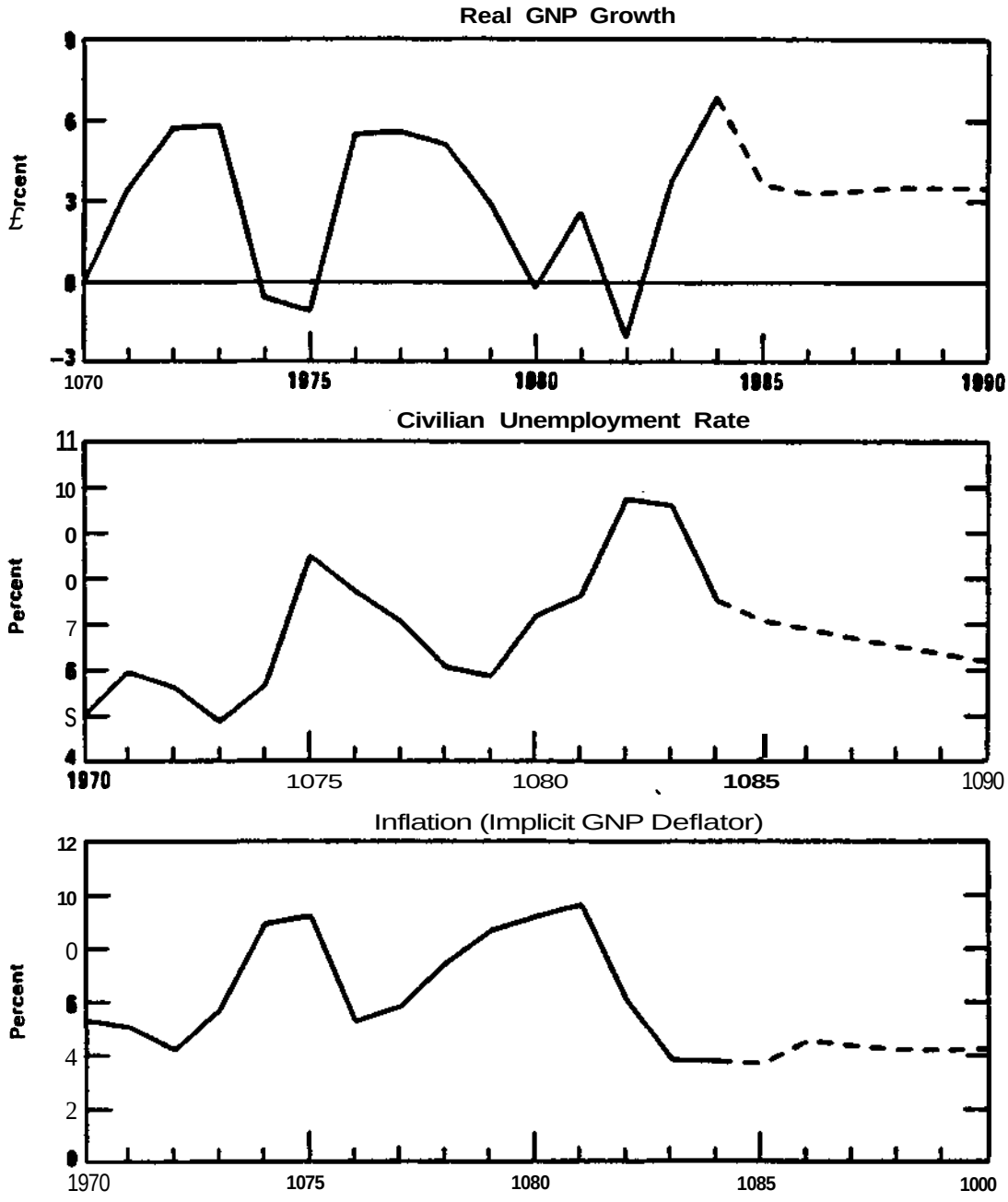
TABLE 1. CBO'S MEDIUM-TERM ECONOMIC PROJECTIONS FOR CALENDAR YEARS 1987-1990

	Actual	Forecast [a]		Projection			
	1984	1985	1986	1987	1988	1989	1990
GNP (billions of current dollars)	3664	3927	4238	4567	4921	5301	5711
Nominal GNP Growth Rate (percent change, year over year)	10.9	7.3	7.9	7.8	7.7	7.7	7.7
Real GNP (percent change, year over year)	6.9	3.5	3.2	3.3	3.4	3.4	3.4
GNP Implicit Price Deflator (percent change, year over year)	3.8	3.6	4.6	4.4	4.2	4.2	4.2
CPI-U (percent change, year over year)	4.3	3.7	4.5	4.2	4.2	4.2	4.2
Civilian Unemployment Rate (percent, annual average)	7.5	7.1	6.9	6.7	6.6	6.4	6.2
Three-Month Treasury Bill Rate (percent, annual average)	9.5	8.3	8.7	8.2	8.2	8.2	8.2

a. Does not reflect revised GNP estimates for 1984.

FIGURE 1.

MAJOR ECONOMIC ASSUMPTIONS



SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis; U.S. Department of Labor, Bureau of Labor Statistics; Congressional Budget Office.

confined to the sectors directly affected and will not spread in any significant way to the rest of the economy.

Although the baseline projection for the out-years does not explicitly incorporate a recession or an inflationary shock of any kind, it also does not imply that such events will not occur. Because the timing of such events is impossible to forecast so far in advance, our projections simply smooth out real growth and inflation rates over the period.

COMPARISON OF CBO AND ADMINISTRATION ECONOMIC ASSUMPTIONS

The near-term economic forecasts by the Administration and CBO are quite similar, though the Administration is somewhat more optimistic about economic growth. Both forecasts indicate that the expansion is likely to continue at a healthy rate at least through 1986 -without a major acceleration of inflation.

Unlike the CBO baseline forecast, which assumes a continuation of current law, the Administration's forecast assumes the implementation of its proposed deficit reductions over three years, and therefore the forecasts are not directly comparable. (These budget proposals are analyzed in a recent CBO report entitled An Analysis of the President's Budgetary Proposals for Fiscal Year 1986.) In the Administration's medium-term economic projections, growth rates of productivity and real output exceed the postwar averages assumed by CBO. The Administration's projection of real growth is, however, well within the bounds of historical experience. As

TABLE 2. COMPARISON OF ADMINISTRATION AND CBO ECONOMIC ASSUMPTIONS, 1985-1990 (By calendar year)

	1985	1986	1987	1988	1989	1990
Nominal GNP (in billions of dollars)						
Administration	3948	4285	4642	5017	5399	5780
CBO	3927	4238	4567	4921	5301	5711
Difference	21	47	75	96	98	69
Real GNP (percent change, year over year)						
Administration	3.9	4.0	4.0	4.0	3.9	3.6
CBO	3.5	3.2	3.3	3.4	3.4	3.4
Difference	0.4	0.8	0.7	0.6	0.5	0.2
Consumer Price Index (percent change, year over year) a/						
Administration	4.1	4.3	4.2	3.9	3.6	3.3
CBO	3.8	4.5	4.2	4.2	4.2	4.2
Difference	0.3	-0.2	0	-0.3	-0.6	-0.9
3-Month Treasury Bill Rate (percent)						
Administration	8.1	7.9	7.2	5.9	5.1	5.0
CBO	8.3	8.7	8.2	8.2	8.2	8.2
Difference	-0.2	-0.8	-1.0	-2.3	-3.1	-3.2
Civilian Unemployment Rate (percent)						
Administration b/	7.0	6.9	6.6	6.3	6.1	5.8
CBO	7.1	6.9	6.7	6.6	6.4	6.2
Difference	-0.1	0	-0.1	-0.3	-0.3	-0.4

SOURCE: Congressional Budget Office.

a. Urban wage earners and clerical workers.

b. The Administration's projection is for the total labor force including armed forces residing in the United States, while CBO's is for the civilian labor force excluding armed forces. In recent years, the former has tended to be 0.1 to 0.2 percentage points below the rate for the civilian labor force.

shown in Table 2, economic growth in the Administration's projection is less than 4 percent, which is significantly below that experienced in the strongest postwar expansion (1961-1969). The Administration also assumes a larger decline in the unemployment rate than does CBO, and a slowing of inflation. The major difference, however, is the decline in real and nominal interest rates in the Administration's projection. Some decline in interest rates appears to be consistent with the proposed measures for deficit reduction.

THE BUDGET OUTLOOK

Given baseline economic assumptions and no change in the budget policies now in place, CBO estimates that the total federal deficit--including off-budget spending--will rise from $215 billion in 1985 to over $300 billion by 1990 (see Table 3). Except for the current fiscal year, the projected total deficits for the 1986-1989 period are very close to those calculated in our August report. The 1985 total deficit estimate, however, has been raised by $24 billion--from $191 billion to $215 billion--largely because of lower anticipated revenues and a one-time increase of $13 billion in spending for purchases of federally guaranteed notes issued by local public housing authorities.

Under current law and budget policies, projected total deficits are stabilized at around 5.4 percent of GNP through 1990--in contrast to our projections of a year ago, when the deficit was rising as a percentage of

TABLE 3. BASELINE BUDGET PROJECTIONS (By fiscal year)

	1984 Actual	1985 Base	Projections 1986	1987	1988	1989	1990
			In Billions of Dollars				
Baseline with Budget Resolution Defense Authority a/							
Revenues	666	735	788	855	934	1,005	1,088
Total Outlays b/	852	950	1,008	1,095	1,191	1,284	1,390
Total Deficit b/	185	215	220	240	257	280	302
Debt Held by the Public	1,313	1,526	1,745	1,984	2,240	2,519	2,820
Baseline with No Real Growth in Defense c/							
Revenues	666	735	788	855	934	1,005	1,088
Total Outlays b/	852	950	1,002	1,075	1,150	1,218	1,292
Total Deficit b/	185	215	213	219	216	213	204
Debt Held by the Public	1,313	1,526	1,739	1,957	2,172	2,384	2,587
			As a Percent of GNP				
Baseline with Budget Resolution for Defense a/							
Revenues	18.6	19.1	19.0	19.1	19.3	19.3	19.4
Total Outlays b/	23.8	24.6	24.2	24.4	24.7	24.7	24.8
Total Deficit b/	5.2	5.6	5.3	5.4	5.3	5.4	5.4
Debt Held by the Public	36.7	39.6	42.0	44.3	46.4	48.4	50.3
Baseline with No Real Growth in Defense c/							
Revenues	18.6	19.1	19.0	19.1	19.3	19.3	19.4
Total Outlays b/	23.8	24.6	24.1	24.0	23.8	23.4	23.0
Total Deficit b/	5.2	5.6	5.1	4.9	4.5	4.1	3.6
Debt Held by the Public	36.7	39.6	41.8	43.7	45.0	45.8	46.1
Reference: GNP (in billions of dollars)	3,581	3,855	4,158	4,483	4,830	5,204	5,606

SOURCE: Congressional Budget Office.

a. Defense budget authority for 1986 and 1987 is assumed to be the amounts specified in the most recent Congressional budget resolution. Defense budget authority for 1988-1990 is an extrapolation of the budget resolution prepared for the staffs of the House and Senate Budget Committees. Outlays are estimated consistently with the assumed budget authority using CBO technical estimating methods.

b. Includes off-budget spending, primarily by the Federal Financing Bank.

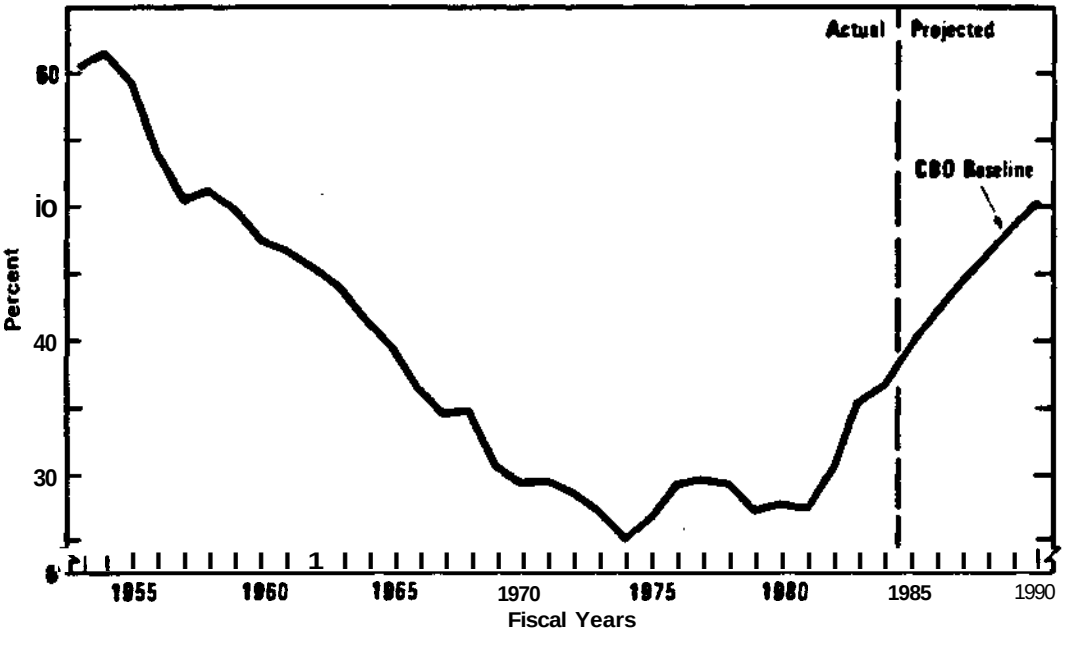
c. Defense budget authority for 1986 through 1990 is the amount that would provide no real growth under CBO economic assumptions.

GNP. This improvement results from policy changes in the Deficit Reduction Act and other measures.

With current policies, these deficit projections imply that federal debt held by the public would grow from $1.3 trillion at the end of fiscal year 1984 to $2.8 trillion by the end of 1990, an accumulation that outpaces the growth in the economy by a wide margin. The debt held by the public would grow from under 30 percent of GNP during the 1970s to 50 percent by 1990 (see Figure 2).

I would like to emphasize that our projections are not meant to be forecasts of future budget outcomes, but merely what would happen to the budget if current laws and policies were continued unchanged. In that sense, they provide a useful benchmark or baseline against which proposed policy changes can be measured. In preparing our baseline projections, it is necessary to adopt a number of conventions or assumptions as to what constitutes current budgetary policies. In some cases, the choice of assumptions can have a substantial effect on the projections. For example, for defense spending we use an extrapolation of the most recent Congressional budget resolution as the best approximation of current policy. An alternative approach would be to assume no real growth in defense budget authority, essentially the same assumption as that used for nondefense discretionary spending programs. The effect of this alternative assumption is to hold the budget deficit at about the present level for the next several years. As shown in Table 3, under a zero real-growth assumption for

FIGURE 2.
FEDERAL DEBT HELD BY THE PUBLIC AS A PERCENTAGE OF GNP



SOURCE: Congressional Budget Office.

defense spending, the baseline deficit in 1990 is projected at $204 billion. This amount is almost $100 billion lower than the deficit projected under an extrapolation of defense spending implied by last year's budget resolution.

Finally, in terms of the budgetary outlook, I must underscore the sensitivity of the specific numbers to the actual state of the economy. If the economy performs better than projected, deficits will be less than projected. But the opposite also holds: a weaker economy implies a bleaker budgetary picture.

We have provided two alternative sets of economic assumptions that are very likely to bracket the range of possibilities. 1/ In one set of assumptions, the economy duplicates the extraordinary growth performance of the 1960s. Even in this scenario, under current policy, the budget remains far from balanced. The implied 1990 deficit is about $130 billion or about 2 percent of the GNP--a ratio exceeded only once in the 1960s. In the other set of economic assumptions, we assume a severe recession in 1987 and as a result the 1990 deficit soars to about $430 billion or nearly 9 percent of a much lower GNP.

THE ECONOMIC EFFECTS OF DEFICITS

What are the economic effects of the deficits implied by the CBO projections? Economists cannot answer this question precisely. It seems unlikely that deficits would have a sudden destructive impact on the economy. In fact, under some circumstances, temporary deficits--even large ones--can have beneficial effects on the economy. But persistant large deficits, such as those that would be realized with current policies, are almost certain to have detrimental effects on the growth of the economy in the long run.

In the remainder of my testimony, I will discuss five aspects of the deficits: their size in relation to historical savings trends; deficits and international capital flows; the costs associated with financing such deficits;

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1. See The Economic and Budget Outlook: Fiscal Years 1986-1990. pp. 44-46.

the impact of the buildup in government debt on the living standards of future generations; and the short-run effects of corrective measures.

Savings and Deficits

The unique nature of the recent experience with deficits, and the potential for damaging productive investment, can be seen by looking at historical magnitudes of flows of savings and investment. Since 1950, net private savings in the U.S. economy have averaged about 7.2 percent of GNP. State and local governments registered an additional small surplus that averaged 0.4 percent of GNP during this period, while net foreign investment was negligible. Federal deficits absorbed about 1.1 percent of GNP, on a national income accounts basis, leaving total private and public saving available for net domestic investment equal to about 6.5 percent of GNP (see Table 4).

Thus far in the 1980s, the federal sector deficit has averaged 3.9 percent of GNP despite the fact that net private savings was only 6.0 percent, well below the historical average. The financing of these large budget deficits was made possible by above average savings by the state and local sector (1.3 percent of GNP) and an increase in net foreign investment. Private investment also was weak (4.1 percent of GNP), largely as a result of the recession.

While it is difficult to forecast future savings flows, it is clear that the federal government will stake a major claim to these funds during the

TABLE 4. NET SAVINGS AND INVESTMENT FLOWS AS PERCENTS OF GNP (NIPA Basis)

Period	(1) Net Private Domestic Savings	(2) State and Local Surplus	(3) Federal Deficit	(4) Net Domestic Savings Available for Domestic investment: (1)+(2)-(3)	(5) Net Private Domestic Investment	(6) Net Domestic Savings Shortfalls (5)-(4) = Net Foreign Investment
1950-1959	7.2	-0.2	-0.1	7.1	7.1	-0.1
1960-1969	7.8	0	0.3	7.5	7.0	-0.5
1970-1979	7.2	0.8	1.8	6.2	6.4	-0.1
1980-1984 a/	6.0	1.3	3.9	3.4	4.1	0.7
Average						
1950-1984	7.2	0.4	1.1	6.5	6.4	-0.1
1985-1990 b/	7.2	1.4	4.6 c/	4.0	6.4	2.4

SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis; Congressional Budget Office.

a. BEA estimates are used for 1984 state and local surplus and 1984 federal deficit.

b. Only the federal deficit is a CBO projection. Net private domestic savings and net private domestic investment shares of GNP are assumed for illustrative purposes to be at their averages of the 1970s, while the state and local surplus is assumed to maintain its high estimated share of GNP in 1984. Columns 4 and 6 are calculated from the other figures.

Details may not appear consistent with totals because of rounding.

c. The NIPA federal deficit projection is based on unified budget deficit projections from The Economic and Budget Outlook: Fiscal Years 1985-1990, CBO, February 1985.

next several years if budget policies are not changed. CBO's baseline budget projection for the 1985-1990 period indicates that the federal deficit-to-GNP ratio will average over 4½ percent of GNP, on the same national income accounts basis. Thus, the share of net domestic savings absorbed by deficits would be many times higher than the average of the past. Moreover, funds available for domestic investment would be well below average, if savings behavior follows historical trends. Even if net private savings were restored to its historical average of 7.2 percent and state and local surpluses were to near their record high, domestic savings available for investment would be only about 4 percent of GNP, given the budget deficits. Therefore, if investment spending merely matched its historical average—6.4 percent of GNP--the shortfall of domestic saving would be about 2* percent of GNP. This large gap between domestic savings and investment could be filled only by (1) reducing federal budget deficits, (2) raising domestic savings sharply above U.S. experience, or (3) attracting inflows of foreign capital of record proportions. Otherwise, investment spending is bound to suffer.

While the behavior of savings rates is not well understood, experience in the United States indicates that this large shortfall is not likely to be filled by increased private domestic saving. Instead, if budget policies are not changed, total domestic savings are likely to remain scarce relative to planned investment. The competition for funds would be intense, leading to high real-interest rates, because interest rates are the mechanism for allocating scarce funds to alternative uses. In its baseline economic

projections, CBO assumes that large capital inflows are maintained and that growth in domestic investment remains strong. For this to happen, investors must be willing to see their holding of dollar-denominated assets rise rapidly.

The Deficit and International Capital Flows

Net capital inflows have already become very large, amounting to 2.5 percent of GNP in 1984, a postwar record. Foreigners have been lending more to the United States, but equally important, U.S. residents have been lending and investing less abroad. The result has been a soaring dollar. It is up about 20 percent since January 1984, and on average, nearly double its value at its low point in 1980.

The strength of the dollar, which continues to surprise economists, has had some good results: higher availability of capital means that interest rates are not as high as they would otherwise be, and lower costs for imported goods have helped to achieve the significant reductions of inflation in recent years. But there have also been severe costs. Some sectors of the economy have suffered losses of profits and employment--for example, farming and other industries for which exports are important, as well as many industries that directly compete with imports. The direct counterpart of the record net capital inflow is a record merchandise trade deficit, which reached 3.4 percent of GNP last year.

In CBO's view, a significant portion of the massive capital inflows is linked to the federal deficit. When there are few impediments to

international capital flows, relatively small changes in interest rates can move large amounts of capital from one country to another. Therefore, the deficit, which increases domestic demands for credit and thus increases interest rates, can be financed to a large extent in the international capital market rather than in the domestic market alone. Economists also point to other reasons for the changes in capital flows:

- Investors may be attracted to the relative political stability of the United States; and

- Real rates of return on investment in the United States have been raised by the tax reforms of the ERTA, and possibly by the regulatory reforms undertaken in recent years.

The stability of current capital inflows, whatever their source, cannot be relied on indefinitely. Investment prospects may improve abroad. Foreigners who acquire U.S. assets could eventually face the risk of unfavorable changes in the return on their dollar holdings--for example, a fall in the value of the dollar or capital loss as a result of rising interest rates. At some point, which cannot be determined in advance, the net capital inflow must slow or stop. At that point, the prop that has supported the dollar will be removed. CBO has assumed in its projections that dollar accumulation by foreigners will continue at least through 1990, but the risk of an earlier end must be recognized.

What would happen if foreigners decide to acquire fewer dollar assets? First, the dollar would fall. Since the strength of the dollar is an important part of the attractiveness of holding dollar assets, a fall in the dollar would

presumably further reduce capital inflows. Second, lower credit supplies on the domestic market would raise interest rates in the United States. Third, the falling exchange rate would add to inflation--a big change from the current situation, in which the rising dollar is holding down inflation. Fourth, one pleasant result would be that those industries that have been most severely hurt by the rising dollar would get relief.

Outlays for Interest on the Debt

As indicated earlier, if budget policies are not changed, the outstanding federal debt will rise dramatically. Federal spending for interest payments would also rise sharply. How fast interest payments will rise depends on the rate of growth of the outstanding debt and the level of interest rates. In CBO's baseline, net interest costs are the fastest growing category of spending, rising from $111 billion in fiscal year 1984 to $234 billion in fiscal year 1990. One consequence of the rapid rise in interest costs is that it would limit resources available for other spending programs, given a constant deficit-to-GNP ratio.

If deficits were to become sufficiently high in the long run or interest rates were to rise significantly, interest costs might rise so rapidly that it would no longer be politically feasible to offset their growth by raising taxes or cutting programs. At that point, there is a danger that the deficit and the associated debt outstanding would explode relative to GNP. Under these circumstances, there would be a strong temptation to finance government by creating money rather than by further borrowing. The result would be, of

course, highly inflationary. Fortunately, under current policies, the projected growth of non-interest spending, relative to the growth in receipts, is sufficiently low to offset the growth in interest costs and to stabilize the deficit/GNP ratio at somewhat more than 5 percent of GNP.

Long-Run Effects of Deficits

One consequence of persistent large deficits about which there seems to be little disagreement is their adverse effect on future generations. If deficits were financed entirely through domestic savings, rising federal debt would begin supplanting more and more private debt and equity in the portfolios of private investors. Slower growth of the private capital stock would result in lower productivity than would occur with smaller deficits, and the income of future generations would be lower. If the deficits were partly financed by inflows of foreign savings, those inflows would imply a growing debt owed to foreigners. While investment could be maintained at higher levels than would be possible without the inflows, U.S. residents would enjoy a shrinking proportion of the production generated here because of rising interest and dividend payments abroad.

Thus, while reducing deficits may be painful for our generation, failure to reduce them will affect future generations. Of course, to what extent one chooses to benefit the current generation at the expense of future ones call for a value judgment rather than an economic one.

Short-Run Considerations

Although a vast majority of the economics profession argues that deficits should be cut, some economists worry that large and abrupt spending cuts or tax increases might weaken the economy in the short run. Most options now being considered, however, would phase in deficit-reduction measures, thus ameliorating any shocks to the economy. But without such cuts federal fiscal policy will become even more expansionary at a time when the economy may be approaching high rates of capacity utilization.

The potential adverse economic impact of deficit reduction measures would also be limited by the following factors:

- A reduction in budget deficits could reduce foreign capital inflows and thus put downward pressure on the dollar in international exchange markets. If the dollar declined, the U.S. net export position would improve over time, thereby at least partially offsetting the contractionary effects of deficit-reduction measures on domestic demand. There is a small chance that more prudent fiscal policy would so enhance the confidence of foreign investors in the United States that capital inflows would rise and the dollar would appreciate further. Under these circumstances, the enhanced savings inflow could reduce interest rates dramatically.

- With a given monetary policy, the curtailment of the Treasury's borrowing needs would reduce upward pressure on interest rates and stimulate interest-sensitive domestic expenditures. According to some economic theories, the reduced pressures on interest rates would quickly offset the contractionary effects of deficit-reduction measures.

- The financial community has expressed so much concern over the high deficits that any effort to correct them should have a salutary effect on investors' confidence in the long-run health of the economy, and thereby stimulate long-term investment.

In theory, monetary policy could largely offset short-run effects of deficit-reduction measures, at least on nominal GNP. Indeed, if falling deficits showed clear signs of reducing the velocity of money, a somewhat faster rate of money growth may be appropriate. But such fine tuning is fraught with difficulties. There is also a risk of overcompensation and the inflation that goes with it.

Thus, while there is a chance that a large and abrupt change in budgetary policies would temporarily have an adverse effect on the economy, that effect could be ameliorated by a number of factors, including phasing in the program changes, monetary policy, or an exchange-rate decline. Moreover, because of its long-run consequences, the deficit situation must be dealt with, and the sooner the better. Indeed, postponing action on the deficit may entail costs beyond the direct costs of higher interest outlays on the budget. For example, delay may have serious consequences for business investment even in the short run. Businesses and individuals have to plan knowing that there is growing pressure to reduce deficits, but without knowing what specifically will be done. The uncertainty of this situation could cause firms to postpone investment or to make inefficient decisions, with adverse consequences both for individuals and for the economy.