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Budget deficits, inflation risk, and asset prices

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Abstract

Kitchen examines how US budget deficit news affects asset prices and concludes that news of lower deficits reduces the inflation risk premium. This paper constructs narrative histories of several deficit-reduction laws to identify when markets learned that deficits would fall. It then estimates a multi-factor model that allows the inflation risk premium to vary following news of deficit-reductions. The results indicate that there is a large and statistically significant drop in the factor price associated with inflation following news that budget deficits would decline. © 2002 Elsevier Science Ltd. All rights reserved.

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1. Introduction

Do budget deficits reduce capital formation and net claims on the rest of the world? Keynesian models imply that they do, Ricardian models indicate that they do not, and models of debt monetization yield mixed results (see Haliassos and Tobin, 1990). Empirical evidence on these questions has also been inconclusive (see Shaviro, 1997).

Kitchen (1996) and Elmendorf (1996), in valuable articles, investigate whether deficits matter by examining how deficit news affects asset prices. Kitchen measures deficit news using multi-year projections from the Office of Management and Budget. Elmendorf represents new information about deficits using news articles preceding passage of the Gramm–Rudman–Hollings law of 1985 and the Budget Enforcement

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Act of 1990. Both report that unexpected increases in the deficit raise interest rates and appreciate the dollar. Kitchen also finds that positive deficit innovations increase the price of gold. Kitchen (1996, p. 251) interprets these results across financial markets as implying that news of deficit-reductions would "lead to reduced uncertainty about the future path of inflation, and that lower inflation uncertainty would result in…a lower inflation risk premium…". He states that his evidence supports the claim that passage of the Omnibus Budget Reconciliation Act of 1993 lowered long-term interest rates.

Federal Reserve Board Chairman Alan Greenspan presents a similar interpretation of the relationship between budget deficits and real interest rates.[1] He claims that the enormous budget deficits of the early 1980s contributed to a long-term expected inflation rate of 7% or more.[2] Following passage of Gramm–Rudman–Hollings in 1985 he states that the growing confidence that the budget deficit will decline contributed to a large decline in the inflation premium in long-term interest rates.[3] During deliberations on the Budget Enforcement Act of 1990, he said the agreement would produce a credible, enforceable reduction in the budget deficit and lower interest rates.[4] Following passage of the Omnibus Budget Reconciliation Act of 1993, Greenspan (1994, p. 303) states:

> Fiscal and monetary policy…have contributed to the decline in inflation expectations in recent years. The actions taken last year to reduce the federal budget deficit have been instrumental in this regard…. Concerns that the deficit is out of control have diminished. In the extreme, explosive growth of the federal debt makes an eventual resort to the printing press and inflationary finance difficult to resist. By shrinking any perceived risk of this outcome, the deficit-reduction package apparently had a salutary effect on long-term inflationary expectations.

While Kitchen (1996) and Greenspan (1994) have argued that news of lower deficits reduced the inflation risk premium and long-term interest rates, many would challenge this claim. Haliassos and Tobin (1990), summarizing theoretical research, discuss how Keynesian, Ricardian, and debt monetization models yield conflicting conclusions concerning whether and how deficits affect asset prices. Seater (1993), reviewing empirical evidence, reports that most results are inconsistent with the hypothesis that government debt and interest rates are positively correlated. Shaviro (1997), surveying recent research, argues that fiscal policymakers need assign little weight to fears of producing inflation.

One way to investigate whether deficit news does affect the inflation risk premium and thus long-term interest rates is to measure this factor price directly. Ross (1976)

[1] A narrative analysis detailing the perspectives of Greenspan and other economists, forecasters, and investors on the relationship between budget deficits and inflation is available at: http://www.gmu.edu/departments/economics/working/directory.html.

[2] *New York Times* September 12, 1983, p. D1.

[3] *Washington Post* March 9, 1986, p. K1.

[4] *Washington Post* October 4, 1990, p. A12.

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