CHAPTER 1

Economic Policy for the 1980s

THE YEAR JUST ENDED was an especially significant one for the economy and for economic policymaking. When future *Reports* are written, we hope that 1981 will be described as the watershed year in which the more than decade-old rising trend of inflation was finally arrested. This development should contribute to more rapidly rising standards of living, more productive patterns of investment and saving, and a strengthened U.S. position in the world economy.

At the same time that inflation was moderating, a far-reaching set of economic policies was being developed to provide a framework for growth and stability in the years ahead, reversing more than a decade of declining productivity growth and wide swings in economic activity.

The speed with which the economy adjusts to the Administration's policies will be largely determined by the extent to which individuals, at home and at work, believe the Administration will maintain, unchanged, its basic approach to personal and business taxation, Federal spending and regulation, and monetary policy. When public expectations fully adjust to this commitment, a necessary condition for both reduced inflation and higher growth will be fully established. In short, as this *Report* attempts to demonstrate, what some people have referred to as "monetarism" and "supply-side economics" should be seen as two sides of the same coin—compatible and necessary measures to both reduce inflation and increase economic growth.

THE LEGACY OF "STAGFLATION"

Over the last 15 years the U.S. economy has experienced progressively higher rates of inflation and unemployment, a combination of conditions commonly called "stagflation." This development was associated with a substantial increase in the Federal Government's role in the economy. Federal spending and tax revenues absorbed an increasing share of national output, Federal regulations were extended to a much broader scope of economic activity, and the rate of money growth increased substantially. Table 1-1 contrasts economic conditions during the 1960-65 period (the last business cycle prior to the

Vietnam war), the 1974–79 period (the most recent extended business cycle), and 1980.

TABLE 1–1.—*Major economic conditions and the Federal role, 1960–80*

[Percent; annual average, except as noted]

Item	1960–1965	1974–1979	1980
Economic conditions:			
Productivity increase	2.6	0.7	-0.2
Unemployment rate	5.5	6.8	7.1
Inflation	1.6	7.5	9.0
Interest rate	4.4	8.7	11.9
The Federal role:			
Spending share of GNP	18.8	21.7	22.9
Revenue share of GNP	18.6	19.7	20.6
Regulation increase	7.6	13.9	12.3
Money supply increase	3.0	6.6	7.3

Note.—For this table, the following are used:
Productivity—Output per hour, private nonfarm business, all employees.
Unemployment rate—unemployment as percent of civilian labor force, persons 16 years of age and over.
Inflation—Change in implicit price deflator for gross national product (GNP).
Interest rate—Corporate Aaa bond yield.
Spending share—Federal expenditures, national income and product accounts (NIPA), as percent of GNP.
Tax share—Federal receipts (NIPA) as percent of GNP.
Regulation—Number of pages in the *Federal Register*.
Money supply—M1 (fourth quarter to fourth quarter).

Sources: Department of Commerce (Bureau of Economic Analysis), Department of Labor (Bureau of Labor Statistics), Board of Governors of the Federal Reserve System, Office of the Federal Register, and Moody's Investors Service.

As this table illustrates, economic conditions worsened between the early 1960s and the late 1970s, and deteriorated sharply during the recession year 1980. Part of the decline in U.S. economic performance was clearly attributable to developments not affected by Federal economic policy, such as the oil price increases of the 1970s. Such developments, however, explain only a small part of the decline in overall U.S. economic performance.

A full explanation of stagflation in the United States and other countries has yet to be developed. An important lesson of this period, however, is that there is no long-term tradeoff between unemployment and inflation. The increasing role of the Federal Government in the economy—whether that role was to aid the poor and aged, to protect consumers and the environment, or to stabilize the economy—contributed to our declining economic performance. Most of the increase in Federal spending over the past 15 years has been in the form of transfer payments, which tend to reduce employment of the poor and of older workers. A combination of increases in some tax rates and inflation raised marginal tax rates on real wages and capital income. The rapid growth in regulatory activity—however measured—has significantly increased production costs. The Federal Government bears the most direct responsibility for the increases in inflation and interest rates, which were due to excessive expansion of the money supply. In short, Federal economic policies bear the major responsibility for the legacy of stagflation.

THE PRESIDENT'S PROGRAM FOR ECONOMIC RECOVERY

For the economy, the most important event of 1981 was the dramatic change in Federal policy. On February 18 the President announced a long-term program designed to increase economic growth and to reduce inflation. The key elements of the proposed program were:

- cutting the rate of growth in Federal spending;
- reducing personal income tax rates and creating jobs by accelerating depreciation for business investment in plant and equipment;
- instituting a far-reaching program of regulatory relief; and
- in cooperation with the Federal Reserve, making a new commitment to a monetary policy that will restore a stable currency and healthy financial markets.

Over the year, with the support of the Congress and the Federal Reserve System, most of this program was approved and implemented. The Federal Government's budget underwent its most significant reorientation since the mid-1960s. The rate of increase in total Federal outlays declined from 17.5 percent in fiscal 1980 to 14.0 percent in fiscal 1981 and to an anticipated 10.4 percent in fiscal 1982. The composition of Federal spending was also substantially changed. Real defense spending was accelerated, real spending for the major transfer programs for the poor and aged was maintained, and most of the spending reductions were made in other domestic programs.

The Congress approved the major features of the President's tax proposal while adding a number of other provisions. The long-term increase in Federal regulation was significantly slowed, as suggested by a 27 percent decline in the number of pages in the *Federal Register*, and the Federal Reserve reduced the rate of money growth to 4.9 percent during 1981. As finally implemented, the change in Federal economic policies was more substantial than during any recent Administration. The new policies comprise an innovative approach to reducing the rate of inflation while providing incentives to achieve sustained and vigorous economic growth. While such a development would be somewhat unusual in light of historical experience, we believe that a consistent policy of monetary restraint, combined with the Administration's spending and tax policies, and reinforced by continuing regulatory relief, will provide the policy framework for both reduced inflation and increased economic growth.

A SUMMARY OF ECONOMIC CONDITIONS

General economic conditions during 1981 reflected the transitory effects of the necessary changes in Federal economic policies. The major elements of the Administration's economic policy are designed to increase long-term economic growth and to reduce inflation. Uniformly favorable near-term effects were not expected.

The primary redirection of economic policy that affected economic conditions during the year was the reduction in the growth of the money supply relative to the record high rate of growth in late 1980. This monetary restraint reduced inflation and short-term interest rates but also influenced the decline in economic activity in late 1981.

Beginning in late 1979, substantial variability in money growth rates was associated with unusually large swings in interest rates. By the end of 1980, as a result of an unprecedented degree of monetary stimulus, interest rates had risen to new peaks. In December 1980 the Federal funds rate reached more than 20 percent, the prime rate was 21½ percent, and 3-month Treasury bills had doubled in yield from their midyear lows. Long-term interest rates had risen by as much as 3 full percentage points from their midyear lows.

The rise in interest rates that began in late 1979 gradually produced an ever-widening circle of weakness centering on the most interest-sensitive industries, notably homebuilding and motor vehicles. Falling demand for housing and autos gradually affected an increasing number of other sectors, ranging from forest products to steel and rubber to appliances and home furnishings. The high interest rates also contributed to a squeeze on farm incomes—already under pressure from weaker farm prices—and weakness in industries and services closely tied to the farm sector.

Excessive monetary expansion in the latter half of 1980 helped to drive interest rates to record highs. Rates were kept at those levels for the next 6 months or so by a variety of factors, including the transitory impact of the shift to monetary restraint. Rates then fell because of the monetary restraint that characterized Federal Reserve policy during most of 1981. The high interest rates were an important factor in precipitating the downturn in the final quarter of 1981, when real output fell at an annual rate of 5.2 percent.

In short, the conflict between continued expectations of rising inflation, based on the history of the last 15 years, and the more recent monetary restraint explains many recent problems. Continued monetary restraint and a reduction of the within-year variability of money growth, however, are necessary both to reduce inflation and provide the basis for sustained economic growth.

PROSPECTS FOR RECOVERY

The series of tax cuts enacted in 1981 provides the foundation for increased employment, spending, saving, and business investment. Inflation and short-term interest rates are now substantially lower than they were at the beginning of 1981. At the time this *Report* was prepared, it appeared that the recession which started in August—as determined by the National Bureau of Economic Research—will be over by the second quarter of 1982. This would make it about average in length for a post-World War II downturn. Output and employment are expected to increase slightly in the second quarter and at a brisk pace through the rest of the year, when growth in output is expected to be in excess of a 5 percent annual rate. Inflation is likely to continue to decline and to average about 7 percent for the year, with further reductions in 1983 and beyond.

The outlook for 1983 and subsequent years is based on continuation of the Administration's spending, tax, and regulatory policies, continued monetary restraint, and broader public recognition that the Administration is committed to each of these key elements of its program. Prospective budget deficits are a consequence of the difference in the timing of the spending and tax policy actions, and of the impact on nominal gross national product growth of continued monetary restraint. Although the prospective deficits are undesirably high, they are not expected to jeopardize the economic recovery program.

Concerns have been expressed that the Federal Reserve's targets for money growth are not compatible with the vigorous upturn in economic activity envisioned later in 1982. Any such upturn, it is feared, will lead to a renewed upswing in interest rates and thus choke off recovery. We believe that such fears, while understandable on the basis of recent history and policies, are unjustified in light of current policies and the Administration's determination to carry them through.

Interest rates, after more than a decade of rising inflation, contain sizable premiums to compensate lenders for the anticipated loss in value of future repayments of principal. It is our estimate, however, that such premiums will decline over the course of 1982 and beyond. Such a decline would occur while "real" (inflation-adjusted) interest rates remain high as a result of private and public sector credit demands even as private saving flows increase. In other words, the market rate of interest is likely to continue on a downward trend, even though short-run fluctuations around the trend can be expected.

A critical element in this outlook is the assumption that inflationary expectations will, in fact, continue to recede. If they recede at a relatively fast rate, market rates of interest will decline significantly, wage demands will continue to moderate, and the pro-inflationary biases that have developed throughout the economy over the past decade will quickly disappear. Thus, the greater the degree of cooperation between the Administration, the Congress, and the Federal Reserve in continuing to support a consistent, credible anti-inflation policy, as embodied in the Administration's program, the more rapidly will real growth and employment increase.

ORGANIZATION OF THIS REPORT

This *Report* presents the economic basis for the key elements of the President's economic program. Chapter 2 develops a general framework for the economic role of the Federal Government consistent with the principles of the President's program. Chapter 3 develops a framework for a stable, noninflationary monetary policy. Chapters 4 and 5 analyze the major effects of Administration policies on Federal spending, taxes, and deficits. Chapter 6 summarizes the major features of the program for regulatory reform, while Chapter 7 summarizes the international implications of the Administration's economic policies for monetary conditions, trade, and international organizations. Finally, Chapter 8 reviews economic conditions in 1981 and the outlook for the near future in somewhat more detail than in this opening chapter.

We hope that this *Report* will help both the public and our fellow economists to understand the basis, the importance, and the effects of the dramatic changes in Federal economic policy initiated by the President in 1981.