CHAPTER 1

From Recession to Recovery and Growth

THE MAJOR ECONOMIC ACHIEVEMENT OF 1982 was a dramatic reduction of inflation to its lowest rate in a decade. The 4.6 percent increase in the gross national product (GNP) implicit price deflator between the fourth quarters of 1981 and 1982 was less than half the 10.2 percent rate of increase between the fourth quarters of 1979 and 1980. This decline in inflation has moderated the earlier widespread fears that inflation would accelerate. While some of this improvement in inflation was transitory, reflecting such special factors as the appreciation of the exchange value of the dollar, the largest share was almost certainly due to a decline in the underlying rate of inflation. The reduced rate of inflation is a major step toward the Administration's goals of full employment, healthy economic growth, and price stability.

The progress made in reducing inflation, however, was accompanied by a painful slowdown of the economy. Beginning in July 1981, the Nation suffered the second of two back-to-back recessions that brought the unemployment rate to 10.8 percent in December 1982. At that time, approximately 5 million more people were unemployed than in January 1980, when the first of the two recessions began.

The increase in long-term unemployment poses a particularly severe problem. In January 1980, about 550,000 people had been unemployed for more than 6 months. In December 1982 there were more than four times as many. Long-term unemployment is particularly serious in that it causes substantial financial hardship and is associated with a loss of job skills that may reduce future income significantly.

Some temporary decline in real economic activity was probably unavoidable in the process of reversing the upward trend of inflation. The United States entered the 1980s with a high rate of inflation and with widespread public expectations that the rate would remain high, and perhaps increase. As high inflation persisted, it became embedded in the plans and contracts of firms and workers, and lowering it involved a painful process. The decline of real GNP since early 1981

was in large part the price the United States paid for failing to control inflation in the late 1970s.

LEGACIES OF THE 1970s

In the 1960s, many economists believed that the Federal Government could keep unemployment down permanently by accepting a higher rate of inflation. Steady rises in productivity and living standards were taken for granted. During the 1970s these views proved to be incorrect. By the closing years of the 1970s, both the unemployment rate and the inflation rate were higher than they had been in the 1960s, and the rate of productivity growth was lower.

Why did unemployment, productivity growth, and inflation all worsen in the 1970s? These developments occurred in part because of factors outside the government's control, such as changes in the size and composition of the work force and rising world energy prices. But the economy also suffered from long-standing government policies that exacerbated inflation and distorted the incentives to work, save, and invest.

RISING UNEMPLOYMENT

Total employment grew rapidly in the 1970s but so did the rate of unemployment. The civilian labor force participation rate rose from 60.4 percent of the population in 1970 to 63.8 percent in 1980. The unemployment rate averaged 5.4 percent in the first half of the 1970s, greater than the 4.8 percent average of the 1960s. The recession of 1975 took the unemployment rate to a monthly high of 9.0 percent. Unemployment then declined to a monthly low of 5.6 percent in 1979, only to begin rising again to a peak of 7.8 percent in July 1980.

In addition to cyclical fluctuations in the economy, a number of structural factors contributed to the rise in the unemployment rate over the decade. These included the changing demographic structure of the labor force, the increased number of workers dislocated by changes in technology and international competitiveness, and the work registration requirements in a number of government welfare programs.

A more detailed analysis of unemployment and the labor market consequences of macroeconomic policy is presented in Chapter 2.

DECLINING PRODUCTIVITY GROWTH

From 1960 to 1970, real output per hour in the private sector rose at an annual rate of 3.0 percent; from 1970 to 1980 it rose at a rate of only 1.4 percent. Labor productivity growth would probably have

slowed somewhat in the 1970s regardless of the policies adopted. The sharp increases in the price of oil caused by supply disruptions in 1974 and 1979 reduced productivity growth as firms substituted capital and labor for energy. Furthermore, as the post-World War II baby-boom generation entered the labor force and the percentage of working-age women seeking employment rose, the proportion of less experienced workers increased, further depressing productivity.

The slowdown in productivity growth was, however, exacerbated by a decline in rates of capital formation. Net investment in fixed business capital fell from 3.5 percent of GNP in the 1960s to 3.0 percent in the 1970s, and the rate of growth of capital per worker fell even more sharply, from 3.2 percent per year in the 1960s to only 1.3 percent in the 1970s. The interaction of the tax system with inflation played an important role in reducing the rate of capital formation.

Another cause of slow productivity growth was an increase in government regulation. In some sectors of the economy, Federal regulations directly reduced labor productivity; in others, they diverted capital investment away from the improvement of productivity into the satisfaction of regulatory requirements. Some of these regulations served useful purposes, but some imposed economic costs that exceeded their economic benefits.

The tax changes proposed by the Administration and enacted by the Congress in 1981 and 1982 were designed to lead to faster growth and higher productivity by stimulating saving, investment, and individual effort. In addition, the Administration's policy of reducing government regulation is intended to enhance the efficiency of individual markets and thereby increase total production.

RISING INFLATION

Of all the economic problems that this Administration inherited when it came to office in 1981, the most urgent was the problem of rising prices. Double-digit inflation had created serious economic distortions. An equally serious concern was that the trend rate of inflation was rising over time.

From 1960 to 1970, the GNP deflator rose at an average rate of 3.0 percent per year. Between 1970 and 1973, the average rate of inflation by this measure was 5.3 percent. Then, aggravated by the sharp jump in world oil prices and other special factors, inflation reached 10.2 percent during 1974, but by 1976 it was down to 4.7 percent. In the next 4 years, which included the second oil price shock in 1979, inflation increased continually until it reached 10.2 percent again in 1980.

Over short periods of time a variety of factors influence the rate of inflation. One important factor in the 1970s was supply-determined changes in commodity prices resulting from fluctuations in harvests and disruptions in the supply of foreign oil. Another important factor was the increasing level of expected inflation. Once the expectation of continuing inflation has become firmly entrenched, prices and wages may continue to rise even in the face of declining demand, and the cost of reducing inflation may increase.

These factors, however, only affect the rate of inflation for a limited time. The popular axiom that attributes inflation to "too much money chasing too few goods" reflects a basic truth: it is difficult to imagine a sustained inflation that is not supported by excessive money growth. Over long periods of time, an additional percentage point in the rate of growth of the money stock will tend to produce an additional percentage point of growth of nominal GNP, that is, GNP measured at current prices. If the rate of real GNP growth does not change, the entire increase in nominal GNP growth will take the form of increased inflation. Although the relations between money growth, nominal GNP growth, and inflation are considerably more variable over shorter periods than they are in the long run, the impact of money growth on nominal income and inflation remains powerful even in the short run.

THE RECESSION

The substantial decline in the rate of growth of the M1 measure of money that occurred between the end of 1980 and the end of 1981 was a principal contributor to the decline in nominal income growth in 1982, a decline compounded by a marked change in the velocity of money. Part of the slowdown in nominal GNP growth took the form of lower inflation, and part of it took the form of a decline in real economic activity.

The adverse short-run effect of a slowdown in nominal GNP on real economic activity is a basic feature of our economy that reflects the stickiness of wages and prices in most markets. If prices and wages were perfectly flexible, reduced nominal GNP growth would translate immediately and painlessly into reduced inflation. However, not all wages and prices are flexible. When expectations of future inflation are deeply embedded, prices and wages may continue to rise for some time despite excess supplies of goods and labor. A change in inflationary expectations, together with the direct pressures exerted by excess supplies, eventually causes prices and wages to adjust to new market-clearing levels. But until that occurs a slowdown in nomi-

nal GNP growth is reflected in a slowing of real growth as well as in a slowing of inflation.

The severity of the recession in 1982 reflected a combination of circumstances which caused a very sharp decline in nominal GNP growth between 1981 and 1982. Between the fourth quarter of 1980 and the fourth quarter of 1981, nominal GNP grew at a rate of 9.6 percent; in contrast, nominal GNP rose only 3.3 percent last year. About one-third of the 6.3 percentage point drop in nominal GNP growth between 1981 and 1982 was reflected in a 1.9 percentage point decline in the real GNP growth rate—from an increase of 0.7 percent in 1981 to a decline of 1.2 percent in 1982. The reduction in inflation accounted for the remaining two-thirds of the drop in nominal GNP.

Although some slowdown in nominal GNP growth and in inflation in 1982 was a predictable effect of tighter monetary policies, the very sharp decline actually experienced did not reflect a decrease in the growth of the monetary aggregates. Rather the exceptional severity of the slowdown in nominal GNP growth can be traced to a combination of factors that led to an unusually sharp decline in the velocity of money, that is, in the ratio of GNP to the money stock.

THE DECLINE IN VELOCITY

The 1982 decline in the velocity of money—as measured by the velocity of either the M1 or M2 monetary aggregates—was historically atypical. Between 1961 and 1981, M1 velocity rose at an average annual rate of 3.2 percent, while the velocity of M2 remained essentially constant, rising at an average annual rate of 0.2 percent. In contrast, in 1982 the velocity of M1 fell 4.9 percent and M2 velocity fell 6.0 percent on a fourth quarter to fourth quarter basis. By either measure, the growth of nominal GNP was well below the rate that would have prevailed if the M1 or M2 measures of velocity had grown at their average historic rates. These velocity declines were the largest since 1959, the earliest year for which the Federal Reserve has published data on the monetary aggregates under the definitions currently in use.

If these velocity shifts had not occurred, the rise in nominal GNP in 1982 would have been between 10 and 12 percent. While it is uncertain how this hypothetical change would have been distributed between real activity and inflation, it is likely that real GNP would have increased enough to have ended the recession sometime before the final quarter of 1982.

Although the cause of the large velocity shift that occurred in 1982 is not fully understood, it is likely that major changes in asset demands of individuals and businesses played an important role. More

precisely, an increase in the demand for M1 or M2 at any income level decreases the corresponding velocity of money. Such shifts may occur because of regulatory changes that provide new financial opportunities—like the introduction of nationwide interest-bearing negotiable order of withdrawal (NOW) accounts—or because of changes in asset preferences—like the increased demand for money market mutual funds instead of long-term securities.

The uncertain cause of the recent decline in velocity is characteristic of the problems that the Federal Reserve has encountered in applying the new monetary control procedures that it adopted in October 1979. Changes in banking regulations and the development of new financial instruments by the private sector have compelled the Federal Reserve to make frequent revisions to the definitions of the monetary aggregates and reassessments of their economic impacts. In 1980 a complete revision of the definitions of the monetary aggregates was introduced. In the next year, a "shift adjusted" M1-B was defined in an effort to adjust for shifts from savings deposits to NOW accounts. Most recently, in 1982 and early 1983, definitional changes in M1 and M2 were required to deal with the advent of the new money market deposit account—which was added to M2—and the new super NOW account—which was added to M1.

The Federal Reserve was aware throughout 1981 and 1982 that the relationship between the monetary aggregates and economic activity was in a state of flux, and that future velocity trends were uncertain. While sustained but unanticipated shifts in velocity growth can be identified in hindsight, it is nearly impossible to know at the time they occur whether unusual quarter-to-quarter changes in velocity will continue or reverse themselves. The presumption, on the basis of past experience, is that most velocity changes are temporary. Thus, increasing the rate of money growth in response to temporary declines in velocity runs the risk of providing excessive liquidity and increasing inflation, while a failure to recognize a continuing shift in liquidity preference or velocity runs the risk of providing inadequate liquidity and reducing real GNP. Given the circumstances of 1982, the somewhat greater growth in the monetary aggregates than initially intended by the Federal Reserve appeared to be an appropriate way to balance those risks.

ECONOMIC RECOVERY

The Administration believes that the American economy will soon recover from the recession that began in July 1981. The forecast presented in Chapter 6 projects that economic recovery will begin in 1983, marking the start of a long period of sustained growth with low

inflation. More specifically, the Administration forecasts that real GNP will rise 3.1 percent from the fourth quarter of 1982 to the fourth quarter of 1983, and that nominal GNP will rise 8.8 percent. Realization of the economic forecast and steady noninflationary growth in subsequent years will depend upon the implementation of appropriate monetary and fiscal policies.

IMPLEMENTING A STABLE MONETARY POLICY

The Administration has repeatedly indicated that the fundamental guiding principle of monetary policy in an inflationary economy should be a gradual reduction in the rate of growth of the money stock until the rate is consistent with price stability. This principle is consistent with the general approach enunciated in recent years by the independent Federal Reserve.

The basic challenge for monetary policy at present is to balance the principle of stable money growth with the need to take account of changing asset preferences that may alter the velocity of money. While maintaining the approach of setting specified target ranges for money growth, the Federal Reserve will also need to use its judgment to adjust money growth rates and the corresponding targets to reflect lasting changes in asset demands.

The extent to which a policy of predetermined money growth rates is appropriate depends on the stability and predictability of the velocity of money. Strictly speaking, inflexible monetary growth rates are appropriate only if the trend in income velocity is constant or has purely random disturbances. The advisability of a strict policy rule depends on the degree of predictability of velocity disturbances. The more predictable velocity disturbances are, the more they can be offset by countervailing shifts in the money stock. The less predictable they are, the more likely it is that any attempt at countervailing shifts in the money stock will add to the overall volatility of nominal GNP.

The task of making appropriate adjustments to the monetary targets is enormously difficult. An excessive increase in the money stock will cause a period of increased inflation while an insufficient increase in the money stock will not provide adequate liquidity for the needs of an expanding economy. Eventually such deviations are self-correcting, but only after a period of accelerating inflation or weak economic performance.

One possible way to avoid such periods is to use the observed behavior of nominal GNP to guide a gradual recalibration of the monetary growth targets, recognizing that there are uncertain lags between money stock changes and the resulting changes in nominal GNP. Basing the recalibration of monetary targets on nominal GNP is con-

sistent with the basic principle of pursuing a stable monetary policy. Indeed, it is the relatively stable long-run relationship between the monetary aggregates and nominal GNP that justifies the Federal Reserve's policy of setting targets for the growth of M1 and M2. This implies that caution in revising these targets is appropriate. The principle of targeting money growth rates is not an end in itself but only a means of achieving control of nominal GNP.

Disadvantages of Interest Rate Targeting

From World War II until the mid-1970s the Federal Reserve, like most central banks, conducted monetary policy by focusing on interest rates and money market conditions. Over the 1970s, increasing emphasis was given to targeting monetary aggregates. More recently, under new procedures first adopted in October 1979, the Federal Reserve has given greater emphasis to keeping the growth of the monetary aggregates within pre-announced target ranges, even though it was recognized that this could result in greater variations in interest rates.

Since 1979 both long-term and short-term interest rates have proven more variable than in the past. Many critics attribute this change to the increased emphasis on monetary targets and the level of bank reserves as the operational basis for monetary policy. Although some have argued that the Federal Reserve should drop monetary targeting in favor of targeting interest rates, the Administration believes strongly that targeting interest rates, either nominal or real, would prove to be a serious error.

The *nominal* rate of interest is a very unreliable indicator of the thrust of monetary policy. The financial variable important to borrowers and lenders is not the *nominal* interest rate but a *real* interest rate determined by subtracting the rate of inflation from the nominal interest rate. Borrowers and lenders take into account the fact that the dollars repaid when a loan matures do not have the same purchasing power as the dollars originally borrowed. When inflation is expected, lenders insist that the nominal rate of interest include a premium to compensate them for the declining purchasing power of the dollar, and borrowers are willing to pay such a premium.

Although the real interest rate is more closely linked to borrowing and lending decisions than the nominal interest rate, the real interest rate is also not an appropriate target for monetary policy. There are several basic reasons for rejecting the policy of real interest rate targeting.

First, real interest rate targeting might well lead to an inflationary monetary policy. Any given real interest rate is compatible with a wide range of inflation rates. For example, a real interest rate of 2 percent could occur with a 5 percent nominal rate and a 3 percent

inflation rate, or with a 12 percent nominal rate and a 10 percent inflation rate. Thus, achieving a real interest rate target would provide no assurance of price stability.

Second, the real interest rate that governs economic behavior is the difference between the nominal interest rate and the *expected* rate of inflation. Since expectations of inflation are not observable, the monetary authorities cannot as a practical matter measure or target the expected real interest rate.

A third reason why real interest rate targeting is not feasible is that the relevant interest rate is not merely the real rate but the real net-of-tax interest rate. Because net-of-tax rates of interest vary among individuals and businesses in different tax positions, there is no way for the monetary authorities to determine the relevant average real net-of-tax interest rate in financial markets. Compounding the problem further, different rates of inflation can result in very different net-of-tax real interest rates corresponding to the same pretax real interest rate, even for a particular taxpayer. For example, a taxpayer with a marginal tax rate of 40 percent earns a real net-of-tax return of 1 percent if he receives a nominal rate of 10 percent and there is 5 percent inflation; that same taxpayer earns a real net-of-tax return of −2 percent if he receives the same real return of 5 percent but there is zero inflation. Similarly, the real interest rate and the real net-of-tax interest rate can easily move in opposite directions when the inflation rate changes.

There is a final and even more fundamental reason for rejecting real interest rate targeting. Even if the expected real interest rate were measurable, there would remain the virtually impossible task of determining what level of that interest rate is actually compatible with noninflationary growth. The problem of identifying the equilibrium interest rate is made even more difficult by the interaction of tax rules and inflation.

Monetary Rules and Discretion

There is no simple solution to the problem of guiding monetary policy in a time of rapid institutional change. Interest rate targeting, as shown above, is not a desirable approach. Instead, the monetary authorities should be guided by the principle of keeping money growth within a prespecified target range while adjusting those targets when a careful consideration of the evidence indicates that sustained shifts in asset demands have occurred.

The combination of monetary rules and discretion must be applied with great care and judgment. The observance of rules must not become a doctrinaire attachment to arbitrary standards, and the exercise of discretion must not degenerate into unprincipled fine tuning. Instead, the monetary rules must be understood as a way of achiev-

ing an appropriate long-run path for the economy. The exercise of discretion in recalibrating monetary targets must be subject to the discipline that such revisions are ultimately compatible with the desired long-run path of nominal GNP. With rules and discretion balanced in this way, monetary policy can support a sound recovery that leads to sustained and noninflationary growth.

THE BUDGET DEFICIT

The Federal budget deficit has become a major problem for the American economy. Without the savings proposed by the Administration in its budget plan for the years 1984 through 1988, the United States is forecasted to experience a series of deficits that would consume more than 6 percent of GNP in each of the next 6 years. Although budget deficits have been a nearly constant feature of our Nation's economic life for the past two decades, the prospective budget deficits that would result if no legislative actions were taken to reduce them would be far larger than those previously experienced in the postwar period. The economic effects of such deficits are beyond our previous experience.

The fiscal 1983 deficit is partially a result of the recession. Any recession reduces tax collections and increases outlays for unemployment benefits, retirement benefits, and certain other activities. A reasonable approximation is that the change in economic output associated with a percentage point change in the unemployment rate would raise the fiscal 1983 deficit by about $25 billion. The Administration forecasts that the unemployment rate for fiscal 1983 will average 10.7 percent. If the unemployment rate were 6.5 percent instead, the budget deficit would be about half the $208 billion now forecast for fiscal 1983. The cyclical component represents a similarly large share of the fiscal 1984 deficit.

Economic recovery and growth in the years ahead will reduce the cyclical component of the deficit. The Administration's forecast projects a decline in the unemployment rate by 4 percentage points between fiscal 1983 and fiscal 1988, leaving only a negligible cyclical component in the fiscal 1988 budget. Unless the Administration's proposals are enacted, a current services budget deficit of $300 billion is forecasted to materialize.

To see the origin of these large deficits, it is useful to compare the components of the 1988 current services budget with the same components for 1970. Between those years, taxes decline very slightly as a percentage of GNP, from 19.9 percent in 1970 to 18.9 percent in 1988. The defense share of GNP remains unchanged at 8.1 percent of GNP in both years. By contrast, nondefense activities excluding interest rise from 10.6 percent of GNP in 1970 to 13.6 percent in

1988, an increase of about one-fourth. In addition, the accumulation of previous deficits raise the net interest component of the budget deficit from 1.5 percent of GNP to 3.4 percent of GNP.

Deficits and Long-Term Growth

A succession of large budget deficits is likely to reduce substantially the rate of capital formation. The government's borrowing to finance such deficits would compete directly with borrowing by private businesses and households. With a limited amount of savings available for borrowing, high budget deficits would cause interest rates to rise until private demand for funds was reduced to the amount that remained after the government's borrowing needs were satisfied.

The magnitude of the potential crowding out of private investment is immense. During the past two decades, the net saving of households and businesses totaled only about 7 percent of GNP. Prospective deficits of more than 6 percent of GNP would represent virtually all of current net saving. Even though existing saving would be augmented by borrowing from abroad and by some increase in the private saving rate, the reduced rate of capital formation would be very substantial.

A lower rate of capital formation would have adverse consequences because the accumulation of capital is a key determinant of future increases in productivity and economic growth and therefore of higher real wages and standards of living. Further reductions in the rate of capital formation would be particularly unfortunate because, as Chapter 4 discusses in detail, the U.S. rate of capital formation has been undesirably low for several decades. In the years since 1960, net private investment has averaged only 6 percent of GNP, significantly less than the rate in most major industrial countries. Moreover, since half of this 6 percent has gone into housing, only about 3 percent of GNP has been available for productivity-increasing investments in plant and equipment. Deficits of the level implied by the current services budget could reduce the rate of net investment in plant and equipment enough to preclude any increase in the amount of capital per worker. If this occurred, the process of increasing capital intensity would cease to contribute to rising productivity and real wages.

Deficits and the Recovery

The adverse effects of large budget deficits are not limited to the distant future. The deficits that would occur without the budget actions proposed by the Administration could seriously affect the degree to which various economic sectors share in the benefits of recovery from the current recession. The crowding out of private investment which would accompany large deficits could depress the level of output in the construction industries, the steel industry, the

machinery and equipment industries, and industries that produce other durable goods.

In addition, large budget deficits raise the exchange value of the dollar relative to foreign currencies by attracting foreign capital to the United States. This weakens the competitive position of U.S. exports in the world economy and hurts those domestic industries that compete with imports from abroad. The nature and magnitude of this effect are discussed in Chapter 3 of this *Report.*

A "lopsided" recovery in which some sectors remained relatively depressed might prove more fragile than a recovery which was broadly based. An increase in economic activity limited to some sectors and regions might result in greater upward pressure on prices and wages at any given level of total output and employment than would be the case if there were balanced expansion among industries. In addition, an unbalanced recovery would produce more inflation and less real growth, regardless of the rate of expansion of nominal GNP.

The prospect of large budget deficits in the second half of this decade may also have an adverse effect on the prospects for recovery in 1983. If the financial markets respond to expected future deficits by keeping real long-term interest rates higher in 1983 than they would otherwise be, the level of spending in 1983 on interest-sensitive purchases may remain depressed. Clear evidence of the willingness of the Administration and the Congress to reduce Federal budget deficits substantially in the second half of the 1980s can play an important part in ensuring a healthy and balanced economic recovery in the more immediate future.