SHADOW OPEN MARKET COMMITTEE

Policy Statement and Position Papers

September 10-11, 1978

1. SOMC Members – September 10, 1978
2. Shadow Open Market Committee Policy Statement, September 11, 1977
3. Position Papers

    Economic Projections – Jerry L. Jordan, Pittsbufgh National Bank

    Economic Prospects Through 1979 – Robert Genetski, Harris Bank

    The Dilemma of U.S. Monetary Policy and the "Commitment" to Permanent Inflation – Karl Brunner, University of Rochester

    Fiscal Policy – Rudolph G. Penner, American Enterprise Institute

    Worksheets – Robert Rasche, Michigan State University

SHADOW OPEN MARKET COMMITTEE

The Committee met from 1:30 p.m. to 8:00 p.m. on Sunday, September 10, 1978.

Members:

Professor Karl Brunner, Director of the Center for Research in Government Policy and Business, Graduate School of Management, University of Rochester, Rochester, New York

Professor Allan H. Meltzer, Graduate School of Industrial Administration, Carnegie-Mellon University, Pittsburgh, Pennsylvania

Mr. H. Erich Heinemann, Vice President, Morgan Stanley & Company, Inc. New York, New York

Dr. Homer Jones, Retired Senior Vice President and Director of Research, Federal Reserve Bank of St. Louis, St. Louis, Missouri

Dr. Jerry Jordan, Senior Vice President and Chief Economist, Pittsburgh National Bank, Pittsburgh, Pennsylvania

Dr. Rudolph Penner, American Enterprise Institute, Washington, DC

Professor Robert Rasche, Department of Economics, Michigan State University, East Lansing, Michigan

Professor Wilson Schmidt, Department of Economics, Virginia Polytechnic Institute, Blacksburg, Virginia

Dr. Beryl Sprinkel, Executive Vice President and Economist, Harris Trust and Savings Bank, Chicago, Illinois

Dr. Anna Schwartz, National Bureau of Economic Research, New York, New York

POLICY STATEMENT

Shadow Open Market Committee

September 11, 1978

The government's economic policy has produced the results we predicted. Inflation has risen from 4 3/4% in 1976 to between 7% and 8% this year. The increase in the rate of inflation is now reflected in higher interest rates, a sinking dollar and increased demands by labor for compensatory wage increases. Long-term interest rates are near the highest levels in a century.

Neither the Administration nor the Federal Reserve has developed a policy capable of slowing the rate of inflation. The Administration proposes or adopts one stopgap after another. None of their programs or proposals to limit price or wage increases has more than a temporary effect on the measured rate of inflation. The Federal Reserve continues to chase interest rates to higher levels by rapidly creating money. The Federal Reserve and the Administration confuse public discussion by misinterpreting the rise in interest rates as evidence of restrictive monetary policy and by opposing policies to reduce monetary growth. Figure 1 records the results of Federal Reserve monetary policy since 1960.

Measures to "defend the dollar" by selling gold, drawing on IMF balances, using swap arrangements, or encouraging foreign borrowing by domestic banks at best, buy time. But time that has been bought has been squandered. The Administration and the Federal Reserve have not developed any effective policy to lower the rate of inflation permanently and to prevent further acceleration.

We are drifting without a program or a goal. One month, the Administration wants tax reduction to stimulate spending; the next month, increases in spending in fiscal 1980 are to be held to the lowest level in decades. One month, the U.S. is a tugboat pulling the rest of the world onto the seas of higher growth; the next month, there is talk of "defending the dollar" and restricting imports from the economies we intended to stimulate. One month, the Federal Reserve announces a target rate of growth of money; the next month, the target is exceeded and ignored.

The experience of the past several years should remove any remaining belief that the government can fine tune the economy. The risk of recession has increased and the threat to economic freedom has grown. Inflation has risen and the long-term growth rate has fallen.

The Past Five Years

The Shadow Open Market Committee first met in the fall of 1973. We were concerned then by the lack of consistent direction in government policy, the resort to controls, the high growth rate of money and the failure of government to develop a long-range program to reduce instability and inflation. Now, five years later, we find again the same high growth rate of money, a renewed drift toward controls, a much larger budget deficit and higher inflation.

At our first meeting and many subsequent meetings, we warned that inflation would not be reduced if we continued to follow stop and go policies. We predicted as early as 1975 that continued large federal deficits financed by debt would "crowd out" private spending and reduce the rate of investment and the growth of real income. In the fall of 1975, we recognized that economic capacity had been reduced by the oil price rise and challenged the then standard view that the economy was in a deep depression comparable to the depressions of the thirties. We argued then that the standard measurement of the output gap -- the gap between actual and potential output -- was misleading and that policies that relied on published measures of idle capacity would produce excessive stimulus and higher inflation. In March 1977, we warned against the return to fine tuning, predicted that the increase in money growth would bring increased inflation in

1978 and 1979, and pointed out, again, that there would be no large increase in investment spending if the government budget deficit averaged $50-billion or more in 1977 and 1978 as then seemed likely. Our recommendations for monetary policy are shown in Figure 2.

Our predictions regrettably have come true. Investment has remained relatively low. Policies to stimulate consumption did not produce an investment boom. The government was not able to increase output first and slow inflation later. The economy, as we predicted, has come close to economic capacity with a large budget deficit, a rising rate of inflation and slow growth of productivity.

The Next Five Years

The policy of gradualism in reducing the growth rate of money in 1974 and 1975 brought the increase in consumer prices down from about 11% in 1974 to an average of 5 3/4% in 1976. The economy recovered. The dollar exchange rate remained stable. If we had avoided the burst of government spending and excessive money growth in the last two years, we would have continued to receive the sustained benefits that could have been achieved only if government policies had been stabilizing. The monetary expansion of the past year and a half renewed excessive stimulus. These policies have continued too long to be abruptly halted.

We propose four steps to end inflation and restore stability within the next five years.

One, the rate of monetary expansion in the past year has been 7.75%. We urge that the rate be reduced to an annual rate of 6% over the next year. The stock of M-1 -- currency and demand deposits -- will average $376-billion in the third quarter of 1979 if the 6% growth rate is attained.

Two, we recommend reduction in the average rate of monetary expansion by 1% a year until a noninflationary rate of monetary expansion is achieved. The Federal Reserve should publicly commit monetary policy to this stabilizing long-term course in order to fulfill its legal responsibilities under the Federal Reserve Reform Act of 1977. Abandoning interest rate targets and controlling the monetary base -- currency and bank reserves -- is the single most important step the Federal Reserve must take to meet those responsibilities. This change in Federal Reserve procedure should be adopted forthwith.

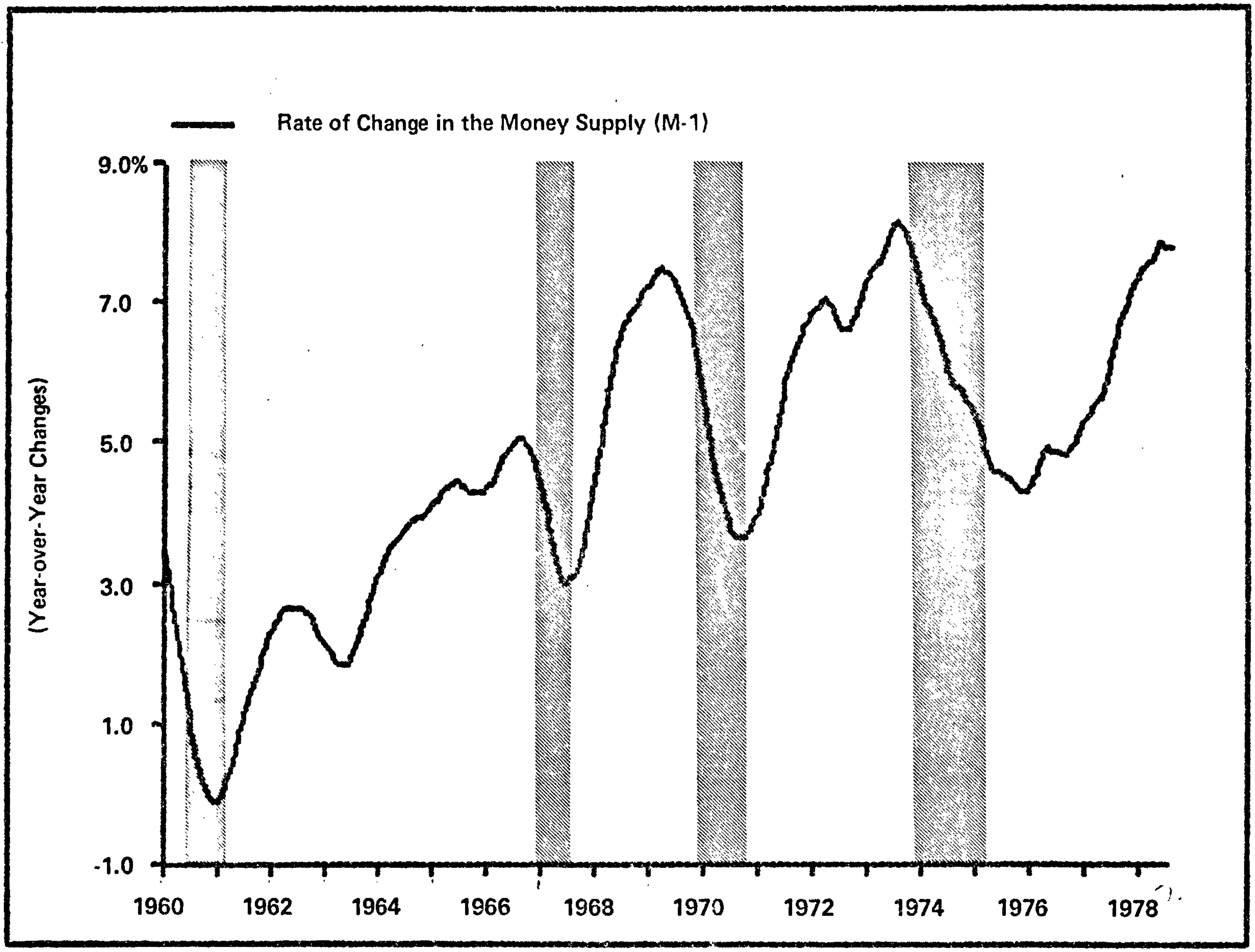
The Federal Reserve proposes to permit transfers between consumer-type time and demand deposits on November 1. If the change occurs, the reported short-term growth of M-1 will fall. This fall should <u>not</u> be interpreted as part of the reduction in M-1 growth that we recommend and should not be an excuse for acceleration of the growth rate of the monetary base. No misinterpretation will result if the Federal Reserve shifts its procedure to control the monetary base.

<u>Three</u>, the Congress should implement the Administration's pledge to reduce the growth of government spending below the growth of private spending during the next three fiscal years. Growth of government spending should be reduced enough to produce a steadily declining absolute deficit.

<u>Four</u>, to encourage investment and output, the Administration and the Congress should reduce all tax rates, individual and corporate, to offset the full effect of inflation on all taxpayers. Real taxes in future years should be no higher than they would have been if there were no inflation.

Figure 1

The Record of Federal Reserve Monetary Policy



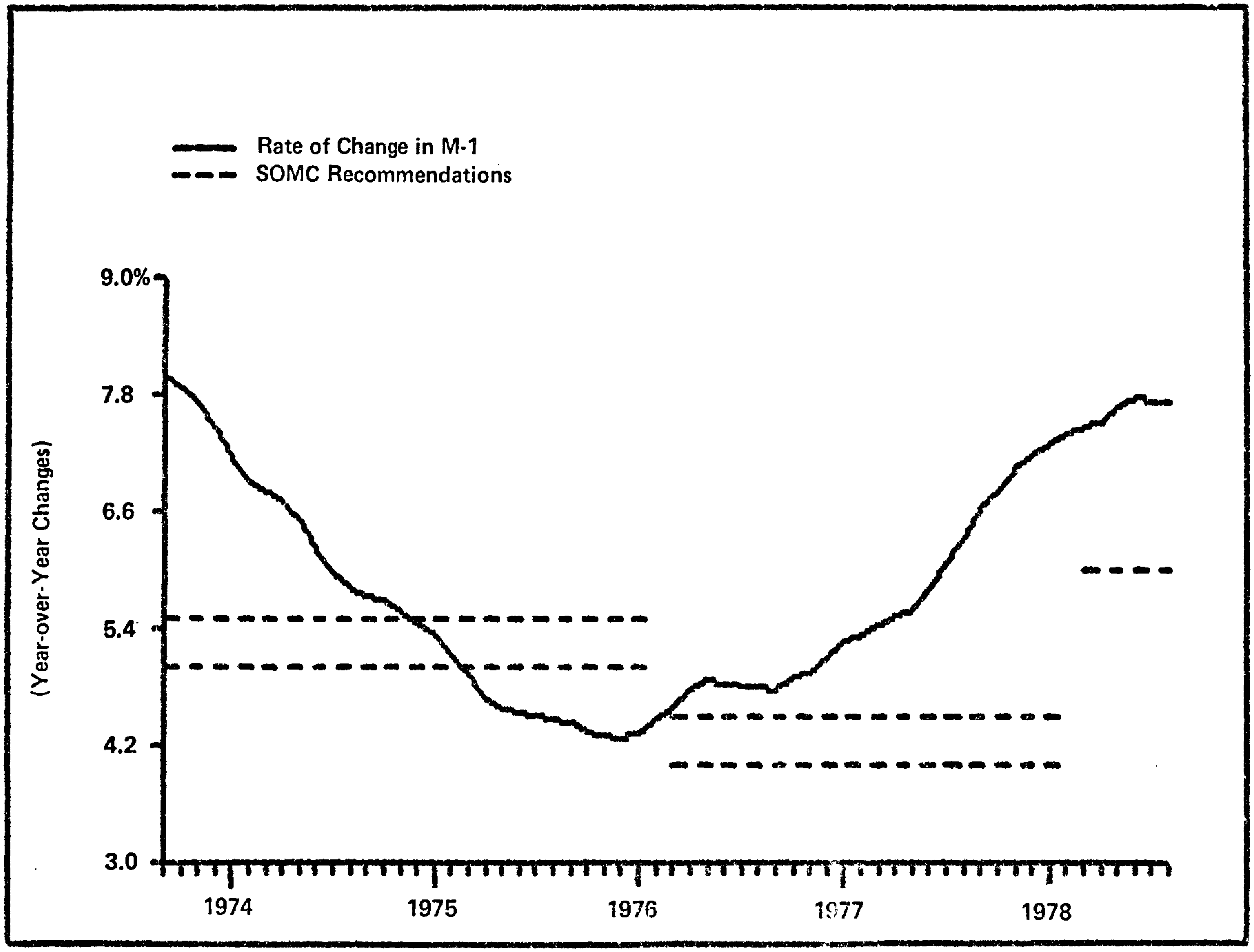
Shaded areas represent periods of recession as designated by the National Bureau of Economic Research except for the mini-recession of 1966-1967.

Sources: Chase Econometric Associates Data Base; Morgan Stanley Research

Figure 2

Targets for the Money Supply

The 'Underlying' Rate of Growth in M-1 and the Recommendations of the Shadow Open Market Committee



Sources: Chase Econometric Associates Data Base; Morgan Stanley Research

PITTSBURGH NATIONAL BANK

TO Shadow Open Market Committee

FROM Jerry L. Jordan PHONE No.

SUBJECT ECONOMIC PROJECTIONS DATE Sept. 1, 1978

I. Below are two tables showing summary projections for 1978 as presented in March this year (I) and as now appears likely (II).

TABLE I
(percent changes)

Projections for 1978 as of March 78 SOMC Meeting

	GNP	Output	Deflator	M^1	M^2	V^1	V^2
Q4/77-Q4/78	11.7	4.9	6.5	7.0	9.0	4.4	2.5
1977-1978	11.6	5.1	6.2	7.4	9.0	3.9	2.4

TABLE II
(percent changes)

Projections for 1978 as of September 78 SOMC Meeting

	GNP	Output	Deflator	M^1	M^2	V^1	V^2
Q4/77-Q4/78	12.1	4.1	7.7	7.6	8.1	4.2	3.8
1977-1978	11.4	4.0	7.2	7.7	8.4	3.5	2.8

Growth of both M^1 and GNP are going to be higher than projected at the March meeting, even though the growth of M^1 projected at that time was considered to be undesirably high. Growth of M^2 will be somewhat less, but V^2 will be quite a bit greater. Growth of V^1 will be close to the estimate at quite a high rate for this stage of the economic expansion, as was assumed at the March meeting.

Inflation is going to be much greater than has been projected in March, although the rates yet to be reported for Q3 and Q4/1978 are likely to be close to the rate that had been projected for the full year.

At the March meeting, the levels of economically efficient potential real output under four alternative assumptions were discussed. The lowest level projected for Q4/78 was \$1409 billion and the highest level was \$1439 billion. It now appears the level of real output at year-end will be at the lower figure, or about \$1410 billion. The question of whether real output in 1979 is likely to grow at a more rapid rate than the long-run trend rate can still be usefully discussed within the context of the analysis of the loss of real economic capacity that occurred in the past few years.

II. Projections for 1979 are shown in Table III. Again it must be emphasized that the growth rates shown, especially for the money stock, are assumptions about what will occur, and are not recommendations about desired trends.

TABLE III
(percent changes)

	Projections for 1979						
	GNP	Output	Deflator	M^1	M^2	V^1	V^2
Q4/78-Q4/79	10-12	2-3	8-9	8.0	9.0	3.0	2.0
1978-79	11.6	3.4	8.0	7.9	8.8	3.5	2.6

The unemployment rate is expected to remain in the 5.5 to 6.5 percent range in the next year, and the growth of employment, as well as the labor force, are likely to be slower than in 1978.

Both short- and long-term market interest rates are expected to rise, at least through mid-1979. The rise of high quality corporate bond yields will be about one-half percentage point while yields on short-term market securities will rise by 75 to 100 basis points.

Residential construction activity next year will be down 10 to 15 percent compared with 1978, but non-residential construction will exceed this year. Real capital spending will still rise next year, but by a smaller amount than in 1978. Automobile sales can be expected to decline about 10 percent for the full year, with a somewhat larger decline occurring in foreign cars and a smaller decline in sales of domestically built cars.

Export volume will continue to rise in 1979 and will be accompanied by a smaller increase in import volume so the trade deficit is expected to be smaller. Government spending in nominal terms is projected to rise 11 percent, about the same as nominal GNP.

III. Monetary policy has become more firmly wedged between the rock and the hard place. Growth of M1 has averaged between 7.5 and 8 percent during the past two years. Unfortunately, it appears that a third year of money growth in this historically high range is likely, and a "trend" of inflation of around 8 percent will be established. The ease with which the "acceptable" rate of inflation rose from 2 percent in the early 1960's, to 4 percent in the late 1960's, and to 6 percent in the mid-1970's, suggests that policy-makers may conclude that it is easier to live with an 8 percent continuing inflation than it would be to reduce it.

Institutional changes in the banking system -- especially the prospects of "automatic transfer accounts" on November 1, 1978 -- are likely to present problems for the monetary authorities in interpreting short-run movements in the monetary aggregates. Typically, the FOMC has decided to emphasize "money market conditions" during such periods. That usually means they accomodate credit demands by providing sufficient reserves to "moderate tendencies for interest rates to rise". The SOMC may wish to consider recommending that the Fed make full disclosure of the data it is collecting, and will be collecting, such as on NOW accounts, share drafts, automatic transfer accounts, and others.

TWO-QUARTER COMPOUNDED ANNUAL RATES OF CHANGE

	M1	M2	MONETARY BASE
Q1/71-Q3/71	8.2	11.5	8.1
Q2/71-Q4/71	4.8	8.1	6.6
Q3/71-Q1/72	5.4	10.2	6.1
Q4/71-Q2/72	7.8	11.3	7.8
Q1/72-Q3/72	8.1	10.7	7.7
Q2/72-Q4/72	9.0	11.0	9.0
Q3/72-Q1/73	9.0	10.4	10.2
Q4/72-Q2/73	7.1	9.0	8.8
Q1/73-Q3/73	5.5	8.0	8.1
Q2/73-Q4/73	5.3	8.6	7.4
Q3/73-Q1/74	6.3	10.0	8.2
Q4/73-Q2/74	6.1	8.9	9.5
Q1/74-Q3/74	4.2	6.7	8.8
Q2/74-Q4/74	4.0	6.4	8.6
Q3/74-Q1/75	3.3	6.6	7.6
Q4/74-Q2/75	4.2	8.2	7.0
Q1/75-Q3/75	6.3	10.0	8.2
Q2/75-Q4/75	4.5	8.4	8.0
Q3/75-Q1/76	3.7	8.9	8.1
Q4/75-Q2/76	5.9	10.7	9.5
Q1/76-Q3/76	5.4	9.6	8.5
Q2/76-Q4/76	5.6	11.1	7.5
Q3/76-Q1/77	7.3	12.3	7.9
Q4/76-Q2/77	7.7	10.3	8.1
Q1/77-Q3/77	8.3	9.8	9.1
Q2/77-Q4/77	8.0	9.3	9.6
Q3/77-Q1/78	6.7	7.8	9.8
Q4/77-Q2/78	7.8	7.8	9.3

MONEY GROWTH RATES
(% Change from Previous Year)

FROM:	TO.	M1	M2	MONETARY BASE
1971/Q1	1972/Q1	6.8	10.9	7.1
Q2	Q2	6.3	9.7	7.2
Q3	Q3	6.7	10.4	6.9
Q4	Q4	8.4	11.2	8.4
1972/Q1	1973/Q1	8.5	10.5	8.9
Q2	Q2	8.0	10.0	8.9
Q3	Q3	7.2	9.2	9.1
Q4	Q4	6.2	8.8	8.1
1973/Q1	1974/Q1	5.9	9.0	8.1
Q2	Q2	5.7	8.8	8.4
Q3	Q3	5.3	8.3	8.5
Q4	Q4	5.1	7.7	9.0
1974/Q1	1975/Q1	3.8	6.7	8.2
Q2	Q2	4.1	7.3	7.8
Q3	Q3	4.8	8.3	7.9
Q4	Q4	4.3	8.3	7.5
1975/Q1	1976/Q1	5.0	9.5	8.2
Q2	Q2	5.2	9.5	8.7
Q3	Q3	4.5	9.3	8.3
Q4	Q4	5.7	10.9	8.5
1976/Q1	1977/Q1	6.3	10.9	8.2
Q2	Q2	6.6	10.7	7.8
Q3	Q3	7.8	11.0	8.5
Q4	Q4	7.9	9.8	8.9
1977/Q1	1978/Q1	7.5	8.8	9.5
1977/Q2	1978/Q2	7.9	8.6	9.5

BANK

Harris Economic Research Office Service

May 5, 1978

ECONOMIC PROSPECTS THROUGH 1979

After a difficult winter, business activity is once again rising rapidly at the start of the second quarter. However, much of the recent strength in the economy reflects a rebound from adverse weather and coal-induced cutbacks rather than fundamental strength. The economy suffers from low productivity gains and rising inflation brought about by extensive government regulation and highly expansive monetary and fiscal policies. These policies have created an unstable economic environment which is highly vulnerable to recession.

It has now become painfully obvious to many policymakers that at some point in the current cycle monetary and fiscal restraint will have to be applied in an effort to contain rising inflation. The precise timing of such restraint is difficult to forecast with any high degree of confidence. At one extreme, the restraint may have already begun in the sense that monetary growth, which has slowed since last October, may continue to moderate in the months immediately ahead. In this case, a recession would begin later this year. At the other extreme, there may be no effective restraint until after the 1980 election in which case inflation will rise close to the double digit range by 1980 creating the potential for a major downturn in the early eighties.

While the precise timing of a policy move remains unknown, the present forecast is based on the assumption that effective monetary restraint is applied late this year (after the Congressional elections) when public furor over the inflation rate becomes intense. As a result of this restraint, the economy is seen entering a recession in the spring of 1979.

Inflation - A Case for Monetary Restraint

There have been two notable developments since the beginning of the year which make a recession in 1979 more likely. The first of these is the boost in the underlying inflation rate. On a year-to-year basis, both consumer and wholesale prices are up 6½%. However, in the first three months of this year, both indices were rising in the vicinity of 8-9% annual rates, and in April wholesale prices jumped 16% at an annual rate. More significant in the eyes of some policymakers is the sharp rise in wages. The year-to-year increase in average hourly earnings reached 8% in March compared to 7% in the twelve months ending in March, 1977. Moreover, in the past three months, average hourly earnings rose 9.2% at an annual rate.

By virtually any measure, inflation is accelerating. The Administration view that stimulative monetary and fiscal policies would not lead to higher inflation because of excess capacity is being proved wrong. In the past few months, both the public and policymakers have become more concerned about rising inflation and this raises the odds that some effective action will be taken to slow monetary growth.

Chairman Miller - Another Case for Monetary Restraint

The most pleasant surprise on the monetary front has been the policy pronouncements and the actions of the new Chairman of the Federal Reserve, G. William Miller. He has verbally come down as hard as possible against inflation and for a policy of monetary and fiscal restraint. In addition to the words, there have been some signs of action. The federal funds rate has been moved from 6 3/4% in early April to 7¼% by early May in an effort to contain a rapid rise in bank reserves and hence, money. As a result of these moves, the growth in the raw ingredients of money (federal reserve credit and the monetary base) has slowed moderately since January. In addition, the growth in the narrowly defined money supply, M_1, was under 6% at an annual rate in the six months ending in April.

Putting the Squeeze on the Economy - When?

A squeeze on the economy in terms of a significant tightening in the money supply could come at any time. The recent upward move in inflation rates is providing some pressure for an immediate move toward tighter money. However, there are some reasons to believe that the squeeze could be put off until the fourth quarter. First, from a political perspective, both Congress and the Administration would find it extremely undesirable for unemployment to be moving higher prior to the elections this fall. As a result, Congressional pressure to increase the money supply in the upcoming months will be intense. Second, from a technical perspective, the Federal Reserve may be reluctant to continue to raise interest rates to the heights that may be necessary to contain monetary expansion. With each upward move in rates, the Federal Reserve will be subject to unrelenting criticism that it is contributing to both inflation and recession.

While there is no way to know for certain how long the Federal Reserve can withstand such criticism, the current forecast assumes that a further slowdown in monetary growth is still some months away. Once the Congressional elections are over, some increase in the unemployment rate will be more acceptable as a trade-off for containing inflation.

Interest Rates to Move Higher

Interest rates are expected to move higher throughout the balance of this year even with the relatively large increase in money anticipated for the second and third quarters. By year-end and early 1979, when monetary restraint is applied, short-term rates are expected to move sharply higher with the 4-to-6 month commercial paper rate rising to 9% by the first quarter of 1979. As a result of political jawboning, the prime rate is forecast to peak in the vicinity of 9%. Once the recession begins, short-term rates are expected to decline rapidly. Long-term rates follow the same general pattern as short rates, but the magnitude of change is much smaller.

Predicting the timing of a business cycle is crucial for forecasting interest rate developments. If tighter money were to develop over the next six months (instead of near year-end as the forecast assumes) interest rates would go up very rapidly in coming months and then would decline later this year. Since there is no way to know for certain when monetary growth will slow, the precise timing of interest rate changes cannot be forecast with a high degree of confidence.

Fiscal Policy

A net tax cut of close to $25 billion is assumed to take place in the first quarter of 1979. Only a third of the revenue-raising reform elements recommended by President Carter are assumed to be passed while individuals and business receive approximately $27½ billion in tax relief. Since social security contributions are scheduled to increase taxes by $9½ billion and inflation will raise personal tax receipts by moving individuals into higher tax brackets, the true reduction in taxes is much lower than the $25 billion figure. The growth in the federal deficit as the economy slows early next year will put further upward pressure on financial markets and help to prevent a larger tax reduction.

Corporate Profits

Corporate profits are expected to move sharply higher in the present quarter following a steep decline during the first quarter. However, from this point on profits are expected to trend downward with the sharpest declines occurring when the economy turns down next year. The anticipated cut in corporate profit taxes in the first quarter of 1979 helps to modify the decline in after-tax profits. In the past, when real output has been in the vicinity that is projected, profit performance has been extremely volatile. Hence, although it is fairly certain that a decline in economic activity will be accompanied by a sharp drop in profits, the magnitude of the profit decline is highly uncertain.

SUMMARY

The prospects concerning future economic developments are changing rapidly. Inflation remains strong and may be reaching the point where policies of restraint will be applied. Given the vulnerability of the economy in the fourth year of an economic expansion, a recession appears to be a likely development. In light of political pressures, the recession is forecast to occur in 1979 and is tentatively assumed to be relatively mild. Although inflationary pressures should start to recede by the end of the next year as a result of the recession, it is doubtful that policymakers will be willing to incur the costs that are necessary to significantly lower inflation in future years.

Robert Genetski
Vice President and Economist

5/2/78

ECONOMIC OUTLOOK
(BILLIONS OF DOLLARS--SEASONALLY ADJUSTED ANNUAL RATES)

	ACTUAL		FORECAST							YEARS			
	1977:4	1978:1	1978:2	1978:3	1978:4	1979:1	1979:2	1979:3	1979:4	1976	1977	1978	1979
GROSS NATL PRODUCT	1961.8	1992.9	2057.5	2109.4	2159.6	2203.4	2230.1	2252.7	2303.8	1706.4	1889.6	2079.8	2247.5
%CH	9.9	6.5	13.6	10.5	9.9	8.4	4.9	4.1	9.4	11.6	10.7	10.1	8.1
CONSTANT DOLLAR GNP	1360.2	1358.3	1378.2	1387.7	1394.9	1397.4	1390.0	1381.6	1391.8	1274.7	1337.3	1379.8	1390.2
%CH	3.9	-0.6	6.0	2.8	2.1	0.7	-2.1	-2.4	3.0	6.0	4.9	3.2	0.8
PRICE DEFLATOR	1.4423	1.4673	1.4929	1.5200	1.5482	1.5768	1.6044	1.6305	1.6553	1.3386	1.4127	1.5071	1.6167
%CH	5.9	7.1	7.2	7.5	7.6	7.6	7.2	6.7	6.2	5.3	5.5	6.7	7.3
CONSUMPTION EXPENDITURES	1259.5	1284.0	1321.0	1354.0	1387.0	1418.2	1443.5	1464.4	1494.1	1093.9	1211.2	1336.5	1455.1
%CH	14.0	8.0	12.0	10.4	10.1	9.3	7.3	5.9	8.4	11.6	10.7	10.3	8.9
DURABLES	186.0	184.0	193.5	199.7	204.9	208.6	208.8	207.4	210.0	158.9	179.8	195.5	208.7
%CH	20.3	-4.2	22.3	13.4	10.8	7.4	0.4	-2.7	5.1	19.6	13.2	8.7	6.7
NONDURABLES	499.9	505.8	517.0	528.1	539.7	551.2	561.9	571.2	582.3	442.8	480.7	522.6	566.6
%CH	15.9	4.8	9.2	8.9	9.1	8.8	8.0	6.6	8.0	8.2	8.6	8.7	8.4
SERVICES	573.7	594.3	610.5	626.2	642.4	658.4	672.8	685.8	701.8	492.3	550.8	618.4	679.7
%CH	10.5	15.2	11.4	10.7	10.8	10.3	9.0	8.0	9.7	12.3	11.9	12.3	9.9
INVESTMENT EXPENDITURES	306.7	314.4	326.8	330.0	330.6	329.0	320.4	311.1	321.2	243.3	294.3	325.5	320.4
%CH	4.1	10.4	16.7	4.0	0.7	-1.9	-10.1	-11.1	13.6	28.7	20.9	10.6	-1.5
NONRES FIXED EXPEND	193.5	197.7	204.6	210.0	214.5	217.9	220.1	221.1	222.0	161.9	185.1	206.7	220.3
%CH	13.4	9.0	14.7	11.0	8.9	6.5	4.1	1.8	1.6	8.6	14.3	11.7	6.6
PRODUCERS DUR EQUIP	129.0	132.6	136.2	139.1	141.0	143.0	143.7	143.7	144.0	106.1	123.6	137.2	143.6
%CH	13.8	11.6	11.3	8.8	5.6	5.8	2.0	0.0	0.8	10.2	16.5	11.0	4.6
BUSINESS STRUCTURES	64.5	65.1	68.4	70.9	73.5	74.9	76.4	77.4	78.0	55.9	61.5	69.5	76.7
%CH	12.7	3.8	21.9	15.4	15.5	7.8	8.3	5.3	3.1	5.7	10.1	13.0	10.4
RES FIXED EXPEND	99.7	100.2	102.0	99.5	97.0	93.0	93.5	95.0	97.0	68.0	91.0	99.7	94.6
%CH	35.0	2.0	7.4	-9.4	-9.7	-15.5	2.2	6.6	8.7	32.3	33.7	9.5	-5.1
INVENTORY CHANGE	13.5	16.5	20.2	20.5	19.1	18.1	6.8	-5.0	2.2	13.3	18.1	19.1	5.5
NET EXPORTS	-18.2	-22.6	-18.0	-13.6	-10.0	-3.0	-2.0	0.0	-1.1	7.8	-10.9	-16.1	-1.5
GOVT PURCHASES	413.8	417.1	427.8	438.9	452.0	459.2	468.1	477.1	489.6	361.4	395.0	433.9	473.5
%CH	13.5	3.2	10.7	10.8	12.5	6.5	8.0	7.9	10.9	6.6	9.3	9.8	9.1
FEDERAL	153.8	153.1	157.0	161.3	169.0	170.7	174.0	177.3	184.0	130.1	145.4	160.1	176.5
%CH	16.3	-1.8	10.6	11.4	20.5	4.1	8.0	7.8	16.0	5.5	11.8	10.1	10.2
MILITARY	98.5	99.2	100.0	100.8	104.0	106.2	108.5	110.7	115.0	86.8	94.3	101.0	110.1
%CH	12.7	2.9	3.3	3.2	13.3	8.7	8.9	8.4	16.5	3.4	8.7	7.1	9.0
OTHER	55.2	53.8	57.0	60.5	65.0	64.5	65.5	66.6	69.0	43.3	51.2	59.1	66.4
%CH	22.2	-9.8	26.0	26.9	33.2	-3.0	6.3	6.9	15.2	10.0	18.0	15.5	12.4
STATE & LOCAL	260.0	264.1	270.8	277.6	283.0	288.5	294.1	299.8	305.6	231.2	249.6	273.9	297.0
%CH	11.7	6.5	10.5	10.4	8.0	8.0	8.0	8.0	8.0	7.2	8.0	9.7	8.4

NOTE PERCENTAGE CHANGES AT ANNUAL RATES; PRELIMINARY DATA FOR 78:1

HARRIS BANK

HEROS
Harris Economic Research Office Service

August 22, 1978

Economic Forecast - Revised Second Quarter Numbers

One month after it issues preliminary quarterly GNP numbers, the Department of Commerce releases revised figures. Some of our customers have requested to see these revised numbers as well as the implications they have for our forecast. The attached tables show our previous economic forecast (dated July 28, 1978) with the latest revised GNP numbers for the second quarter. The forecast is the same as that released last month in the sense that, where applicable, the percent changes for each item are the same as they were at that time. The only difference is that the percent changes are now applied to updated second quarter numbers. This has the effect of changing many of the annual figures by a small amount.

Since there is no essential difference between this forecast and the one of July 28, it is suggested that these numbers be attached to the HEROS write-up entitled ECONOMIC PROSPECTS THROUGH 1979 which was mailed approximately a month ago.

Robert J. Genetski
Vice President and Economist
(312) 461-5001

8/21/78

ECONOMIC OUTLOOK
(BILLIONS OF DOLLARS--SEASONALLY ADJUSTED ANNUAL RATES)

	ACTUAL			FORECAST						YEARS			
	1977:4	1978:1	1978:2	1978:3	1978:4	1979:1	1979:2	1979:3	1979:4	1976	1977	1978	1979
GROSS NATL PRODUCT	1958.1	1992.0	2083.2	2138.3	2193.3	2247.8	2295.1	2326.0	2351.8	1700.1	1887.2	2101.7	2305.2
%CH	8.9	7.1	19.6	11.0	10.7	10.3	8.7	5.5	4.5	11.2	11.0	11.4	9.7
CONSTANT DOLLAR GNP	1354.5	1354.2	1380.5	1391.2	1400.2	1407.3	1409.5	1401.1	1389.8	1271.0	1332.7	1381.5	1401.9
%CH	3.2	-0.1	8.0	3.1	2.6	2.0	0.6	-2.4	-3.2	5.7	4.9	3.7	1.5
PRICE DEFLATOR	1.4456	1.4710	1.5090	1.5369	1.5664	1.5972	1.6283	1.6601	1.6922	1.3375	1.4158	1.5208	1.6445
%CH	5.5	7.2	10.7	7.6	7.9	8.1	8.0	8.1	7.9	5.2	5.9	7.4	8.1
CONSUMPTION EXPENDITURES	1255.2	1276.7	1324.9	1357.9	1392.9	1428.5	1461.9	1488.5	1514.3	1090.3	1206.5	1338.1	1473.3
%CH	14.1	7.0	16.0	10.3	10.7	10.6	9.7	7.5	7.1	11.1	10.7	10.9	10.1
DURABLES	187.2	183.5	198.0	203.2	208.6	213.2	216.2	215.9	214.5	156.6	178.4	198.3	214.9
%CH	24.0	-7.7	35.6	11.0	11.1	8.9	5.8	-0.6	-2.6	18.1	13.9	11.2	8.4
NONDURABLES	496.9	501.4	519.8	531.4	543.9	556.7	569.5	581.7	593.9	442.6	479.0	524.1	575.5
%CH	15.1	3.7	15.5	9.3	9.7	9.8	9.5	8.9	8.6	8.2	8.2	9.4	9.8
SERVICES	571.1	591.8	607.1	623.3	640.4	658.6	676.2	690.9	705.9	491.0	549.1	615.7	682.9
%CH	10.1	15.3	10.7	11.1	11.5	11.8	11.1	9.0	9.0	12.2	11.8	12.1	10.9
INVESTMENT EXPENDITURES	313.5	322.7	344.0	349.9	354.6	359.4	360.6	355.1	341.1	243.0	297.8	342.8	354.1
%CH	5.0	12.3	29.1	7.0	5.5	5.5	1.4	-6.0	-14.8	27.3	22.6	15.1	3.3
NONRES FIXED EXPEND	200.3	205.6	219.8	226.1	232.3	238.3	243.7	246.5	248.4	164.6	190.4	220.9	244.2
%CH	14.8	11.0	30.6	11.9	11.4	10.7	9.3	4.7	3.2	9.6	15.7	16.0	10.5
PRODUCERS DUR EQUIP	132.8	137.1	143.7	147.8	151.7	155.3	158.3	160.2	161.4	107.3	126.5	145.1	158.8
%CH	15.5	13.6	20.7	12.0	10.8	9.9	8.0	4.9	3.1	11.3	17.9	14.7	9.5
BUSINESS STRUCTURES	67.4	68.5	76.1	78.3	80.6	83.0	85.3	86.3	87.0	57.3	63.9	75.9	85.4
%CH	12.8	6.7	52.3	11.8	12.6	12.2	11.9	4.4	3.4	6.5	11.5	18.8	12.5
RES FIXED EXPEND	100.2	100.3	105.3	107.7	107.5	105.5	103.5	103.5	105.5	68.2	91.9	105.2	104.5
%CH	27.5	0.4	21.5	9.5	-0.7	-7.3	-7.4	0.0	8.0	32.5	34.8	14.5	-0.7
INVENTORY CHANGE	13.1	16.7	18.9	16.1	14.8	15.6	13.5	5.1	-12.8	10.2	15.6	16.6	5.4
NET EXPORTS	-23.2	-24.1	-10.2	-8.3	-6.3	-1.3	1.7	1.6	3.7	7.5	-11.2	-12.2	1.4
GOVT PURCHASES	412.5	416.7	424.5	438.6	451.9	461.1	470.8	480.5	492.4	359.5	393.9	432.9	476.2
%CH	13.7	4.1	7.7	14.0	12.7	8.4	8.7	8.5	10.3	6.2	9.6	9.9	10.0
FEDERAL	152.2	151.5	147.2	155.5	163.3	166.9	170.9	174.8	180.6	129.8	145.1	154.4	173.3
%CH	15.5	-1.8	-10.9	24.6	21.6	9.1	9.9	9.4	13.9	5.5	11.7	6.4	12.3
MILITARY	97.1	97.9	98.6	99.8	103.2	104.9	106.6	108.3	112.2	86.8	94.3	99.9	108.0
%CH	11.9	3.3	2.9	4.9	14.3	6.7	6.6	6.5	15.2	3.7	8.6	5.9	8.1
OTHER	55.1	53.6	48.6	55.7	60.1	62.0	64.3	66.5	68.4	43.1	50.8	54.5	65.3
%CH	22.3	-10.5	-32.4	72.7	35.6	13.3	15.7	14.4	11.9	9.5	17.9	7.3	19.9
STATE & LOCAL	260.3	265.2	277.3	283.1	288.6	294.2	299.9	305.7	311.8	229.6	248.9	278.6	302.9
%CH	12.6	7.7	19.5	8.6	8.0	8.0	8.0	8.9	8.2	6.6	8.4	11.9	8.7

NOTE: PERCENTAGE CHANGES AT ANNUAL RATES

8/21/78

ECONOMIC OUTLOOK
(BILLIONS OF DOLLARS--SEASONALLY ADJUSTED ANNUAL RATES)

	ACTUAL			FORECAST						YEARS			
	1977:4	1978:1	1978:2	1978:3	1978:4	1979:1	1979:2	1979:3	1979:4	1976	1977	1978	1979
PRETAX PROFITS	178.3	172.1	201.6	200.0	200.0	195.7	194.0	188.6	182.8	155.9	173.9	193.4	190.3
%CH	1.8	-13.2	88.3	-3.1	0.0	-8.4	-3.3	-10.8	-11.7	29.5	11.5	11.2	-1.6
TAX LIABILITY	73.9	70.0	84.2	81.7	81.7	75.6	75.0	72.9	70.7	64.3	71.8	79.4	73.5
%CH	6.2	-19.5	109.3	-11.4	0.0	-26.6	-3.3	-10.8	-11.7	29.0	11.8	10.5	-7.4
AFTER TAX PROFITS	104.4	102.1	117.3	118.3	118.3	120.1	119.0	115.7	112.2	91.7	102.1	114.0	116.7
%CH	-1.5	-8.5	74.2	3.4	0.0	6.1	-3.3	-10.8	-11.7	30.0	11.4	11.6	2.4
AFT TAX PROF ADJ 1)	74.3	62.6	75.3	77.7	78.0	79.5	77.9	74.0	69.4	62.8	72.3	73.4	75.2
%CH	-32.9	-49.6	109.4	13.4	1.6	7.7	-7.4	-18.8	-22.8	36.2	15.3	1.5	2.4
PERSONAL INCOME	1593.0	1628.9	1682.2	1727.6	1777.6	1817.6	1855.6	1880.6	1900.6	1380.9	1529.0	1704.1	1863.6
%CH	13.4	9.3	13.7	11.2	12.1	9.3	8.6	5.5	4.3	10.0	10.7	11.5	9.4
TAX & NONTAX PAYMENT	233.3	237.3	248.9	260.2	270.4	267.3	273.7	276.8	280.0	196.5	226.0	254.2	274.4
%CH	16.4	7.0	21.0	19.4	16.7	-4.5	9.9	4.6	4.7	16.4	15.0	12.5	8.0
DISPOSABLE INCOME	1359.6	1391.6	1433.3	1467.4	1507.2	1550.3	1581.9	1603.8	1620.6	1184.3	1303.0	1449.9	1589.2
%CH	12.9	9.8	12.5	9.8	11.3	11.9	8.4	5.7	4.3	9.0	10.0	11.3	9.6
PERSONAL OUTLAYS	1285.9	1309.2	1358.7	1394.1	1430.2	1466.3	1500.6	1528.2	1554.8	1116.3	1236.1	1373.1	1522.4
%CH	13.9	7.4	16.0	10.8	10.8	10.5	9.7	7.6	7.1	11.3	10.7	11.1	10.2
PERSONAL SAVINGS	73.7	82.4	74.6	73.2	77.0	84.1	81.4	75.7	65.9	68.1	66.9	76.8	[illegible]
%CH	-3.2	56.3	-32.8	-7.1	22.1	42.3	-12.2	-25.2	-42.6	-18.6	-1.7	14.8	-0.1
SAVING RATE(%)	5.4	5.9	5.2	5.0	5.1	5.4	5.1	4.7	4.1	5.8	5.1	5.3	4.8
EMPLOYMENT	92.069	93.050	94.244	95.000	95.700	96.400	97.000	97.246	97.000	87.481	90.554	94.498	96.912
%CH	5.6	4.3	5.2	3.2	3.0	3.0	2.5	1.0	-1.0	3.2	3.5	4.4	2.6
LABOR FORCE	98.622	99.205	100.206	101.000	101.700	102.400	103.100	103.600	104.100	94.767	97.389	100.528	103.300
%CH	4.4	2.4	4.1	3.2	2.8	2.8	2.8	2.0	1.9	2.4	2.8	3.2	2.8
UNEMPLOYMENT RATE(%)	6.633	6.200	5.933	5.941	5.900	5.859	5.917	6.133	6.820	7.683	7.025	5.993	6.182
PRODUCTIVITY*	1.164	1.154	1.156	1.159	1.163	1.166	1.167	1.162	1.156	1.140	1.156	1.158	1.163
%CH	1.0	-3.4	0.7	1.0	1.4	1.0	0.3	-1.7	-2.0	3.5	1.5	0.1	0.4
INDUSTRIAL PRODUCTION	1.393	1.396	1.439	1.457	1.467	1.473	1.469	1.442	1.409	1.298	1.371	1.440	1.448
%CH	2.5	1.0	12.8	5.1	2.8	1.6	-1.1	-7.2	-8.9	10.1	5.6	5.0	0.6
MONEY SUPPLY-(M1)	335.600	340.300	348.400	356.000	363.000	368.000	370.000	370.000	372.000	304.283	326.108	351.925	370.000
%CH	7.7	5.7	9.9	9.0	8.1	5.6	2.2	0.0	2.2	5.1	7.2	7.9	5.1
VELOCITY OF M1	5.835	5.854	5.979	6.006	6.042	6.108	6.203	6.287	6.322	5.587	5.786	5.970	6.230
%CH	1.1	1.3	8.9	1.8	2.4	4.4	6.4	5.5	2.3	5.8	3.6	3.2	4.3
MONEY SUPPLY-(M2)	804.300	818.200	835.100	858.500	879.400	895.700	905.000	909.500	919.800	703.775	778.467	847.900	907.250
%CH	8.4	7.1	8.5	11.7	10.1	7.6	4.2	2.0	4.2	9.8	10.6	8.9	7.0
VELOCITY OF M2	2.435	2.435	2.495	2.491	[illegible]	2.510	2.536	2.557	2.560	2.415	2.424	2.478	2.541
%CH	0.4	0.0	10.2	-0.6	0.6	2.5	4.3	3.4	0.3	1.3	0.3	2.3	2.5

NOTE: PROFITS FOR 78:2 ARE PRELIMINARY; PRODUCTIVITY IS MEASURED AS OUTPUT PER HOUR--NONFARM BUSINESS
1) AFTER TAX PROFITS ADJUSTED TO EXCLUDE INVENTORY PROFIT AND ALLOW FOR DEPRECIATION AT REPLACEMENT COST

M1
3.4

8/21/78

ECONOMIC OUTLOOK

	ACTUAL			FORECAST						YEARS			
	1977:4	1978:1	1978:2	1978:3	1978:4	1979:1	1979:2	1979:3	1979:4	1976	1977	1978	1979
INTEREST RATES													
NEW ISSUE AA INDUS BONDS	8.040	8.480	8.730	9.100	9.300	9.600	10.000	10.000	9.800	8.250	7.918	8.902	9.850
PRIME RATE	7.673	7.977	8.300	9.200	9.500	10.000	10.500	10.000	9.000	6.841	6.824	8.744	9.875
COMMERCIAL PAPER 4-6 MOS.	6.593	6.797	7.200	8.300	8.700	9.300	10.000	9.000	8.000	5.345	5.612	7.749	9.075
AUTO SALES 1)	10.984	10.815	12.039	11.943	12.042	11.700	11.460	10.800	10.000	10.114	11.185	11.710	10.990
DOMESTIC	8.978	8.748	9.972	9.794	9.874	9.600	9.400	8.900	8.200	8.612	9.119	9.597	9.025
IMPORTS	2.006	2.067	2.067	2.149	2.168	2.100	2.060	1.900	1.800	1.502	2.066	2.113	1.965
HOUSING STARTS 1)	2.146	1.721	2.114	2.049	1.820	1.804	1.734	1.692	1.729	1.533	1.967	1.926	1.740

1) I[redacted]OF UNITS--SEASONALLY ADJUSTED ANNUAL RATES

THE DILEMMA OF U.S. MONETARY POLICY AND THE "COMMITMENT" TO PERMANENT INFLATION

Karl Brunner
University of Rochester and Universität Bern

Lecture presented at a luncheon
sponsored by the Swiss National Bank

Bern, June 16, 1978

THE DILEMMA OF U.S. MONETARY POLICY

Karl Brunner

I. Some Background

The Federal Reserve System enjoyed over many decades a remarkable esteem. The media reflected without probing questions the views offered by the "proper authorities". Textbooks in "Money and Banking" uncritically accepted the official interpretations of monetary events or of "policies" pursued. These golden days of the Federal Reserve System vanished with its 50th anniversary in 1964. The monumental work on the History of the US Monetary System published in 1963 by Milton Friedman and Anna Schwartz described in substantial detail the tragic failure of the Federal Reserve during the Great Depression. The Banking and Currency Committee of the US House of Representatives published moreover shortly afterwards an extensive and critical examination of Federal Reserve policy-making. This examination demonstrated the systematic misinterpretation of monetary events in the councils of the Federal Reserve. This misinterpretation was essentially caused by a money market conception centered on free reserves and short-term interest rates guiding the formulation and implementation of monetary policy over many decades.

The public debate unleashed by the scholarly critique produced some hesitant changes in the Federal Reserve's procedures. The free reserve doctrine gradually disappeared by the end of the 1960's. It was replaced by a money market conception emphasizing the role of an unstable money demand operating within a Keynesian perspective. There also emerged over a period of ten years major changes in the rhetoric and the general language used to express "policies". The format of the directive addressed by the Federal Open Market Committee (FOMC) to the account manager at the Federal

Reserve Bank of New York experienced intermittend adjustments. The crucial procedures used by the FOMC and the "account manager" in order to implement policies remained however substantially unchanged. The account manager continued to adjust open market operations according to the position of the Federal funds rate relative to a target range prescribed by the FOMC. A decline of the Federal funds rate below the target range encourages open market sales and increases beyond the range foster purchases. The target range operates in this manner similar to a control band in a feedback system. This pattern assures systematic accommodation of money market pressures. Variations in these pressures are converted into monetary accelerations or decelerations. The basic policy pattern of the 1930's or 1950's thus persists into the 1970's. It was enunciated, justified and elaborated with a different language, conveying the impression of a major shift in policy-making.

II. Congress and the Federal Reserve

The public debate initiated by the work published in 1963 and 1964 attracted within a few years occasional attention by some members of Congress and some Congressional Committee. The Joint Economic Committee recommended in 1968 that monetary growth be maintained between 2 % and 6 % per annum. The recommendation reflected the Committee's concern about the Federal Reserve's perfomance between 1965 and 1968. But Congressional interest waned rapidly and the recommendation receded to a shadow of political irrelevance.

The large variation of inflation suffered over the first half of the 1970's and the recession suffered in the winter of 1974/75 motivated the most significant incursion by Congress into monetary affairs since 1932. House Concurrent Resolution 133 was explicitly addressed in March 1975 to the Federal Reserve Authorities. The Resolution instructed the Federal Reserve to develop longer-range targets of monetary growth compatible with a stable price-level.

It recognized that lower inflation was the most effective means to reduce interest rates. It finally provided that the Federal Reserve publicly announce targets for monetary growth applicable to the subsequent four quarters. This information must be submitted at quarterly Hearings on monetary policy before Congressional Committees in the House of Representatives and the Senate. The legal status of the Resolution was eventually changed in the fall of 1977. Its intent was incorporated into the Federal Reserve Act.

III. The Response of the Federal Reserve

The Federal Reserve initially opposed the Resolution and negotiated behind the scenes for changes in the formulation. After Congress accepted the Resolution the Federal Reserve adjusted quickly to the new circumstances. The first Hearings were held at the end of April 1975 and followed each other in quarterly succession. On each occasion the Federal Reserve presented a target zone for planned monetary growth of M1 and M2. The target zones presented in each quarter for the following four quarters were moreover based on the average volume of the money stock actually observed in the previous quarter. This procedure assures that all errors made in the past are carried forward and unavoidably affect the level of the future target zones. Members of the FOMC seemed to interpret moreover the procedure in a variety of ways. The Shadow Open Market Committee cautioned since 1976 repeatedly against this procedure and warned about the potential drift built into monetary growth. The quarterly revision of the target zone offers opportunities to evade the sense of the Congressional Resolution. The Shadow Open Market Committee emphasized that the procedure evolved by the Federal Reserve Authorities in response to the Congressional Resolution was essentially restricted to the formulation and adjustments of monetary targets. The implementation guiding the execution of policy remained centered on money market conditions and was never adjusted to the requirement of monetary control. The Shadow Open Market Committee offered on several occasions specific proposals for an effective translation of monetary targets into appropriate actions by the account manager.

IV. The Discrepancy between Words and Action

The persistence of the traditional implementation implies that the actions of the account manager are poorly related to the policy goals announced to Congress and public. The actions are based on instructions from the FOMC couched in terms of a target range for the Federal funds rate. The problems associated with this traditional procedure could thus be expected to continue. They result from a singularly volatile and unreliable connection between the control band on the Federal funds rate governing open market operations and the longer-range monetary growth targets. This approach to policy-making is demonstrably faulty and unsuccessful. "Keynesian" and "monetarist" members of a panel evaluating the role of Congessional Supervision of monetary policy at last December's annual meeting of the American Economic Association concluded that the substance of Federal Reserve policy-making hardly changed at all over recent years. The correlation between rhetoric and substance persists at a low level. Comparatively low rates of interest and a low demand for credit from the private sector produced in the context of traditional implementation a moderate rate of monetary growth during the early recovery phase following the last recession. The monetary control intended by Congress and publicly announced by the Federal Reserve seemed to work. But the year 1975 offered no real test of Federal Reserve performance.

A gradual change in underlying conditions increasingly tested the Federal Reserve during 1976 and particularly during 1977. The announced policies still cultivated an anti-inflationary tone. There was hardly a Hearing at which the Federal Reserve Authorities did not lower an upper or lower boundary of the target zone for M1 and

M2. Since the initiation of Congressional supervision the target zones confining monetary growth were gradually lowered. "Policy" clearly conveyed throughout this period the Federal Reserve's determined anti-inflationary concern. This impression was reenforced by Chairman Burns with numerous and excellent speeches.

Unfortunately, "policy" was not reflected by the actual behavior of monetary growth. The tabulation

Period	Growth of M1 in Percentages p.a.
I/1976 - III/1976	5.4
II/1976 - IV/1976	5.6
III/1976 - I/1977	7.3
IV/1976 - II/1977	7.7
I/1977 - III/1977	8.3
II/1977 - IV/1977	7.8
III/1977 - I/1978	6.2

of relevant data reveals a remarkable increase of monetary growth beginning in early 1976. The growth rates actually achieved in 1977 substantially exceeded the target zone. In contrast to the official line of "policy" signalling a continued committment to an anti-inflationary track the monetary acceleration actually observed indicates the very opposite.

It is important to understand the full responsability of the Federal Reserve Authorities for this development. Some financial analysts adduced some tortured explanations for this excessive monetary growth. The decline of the dollar, liquidity traps and other exotic events were made responsible. But all these explanations possess no basis and are moreover simply irrelevant with respect to our issue. Three proximate determinants pushed monetary growth over the past one and a half years: An acceleration of the monetary base supplemented by increasing contributions emanating from movements of the public's currency and time deposit ratio (i.e. the public's desired holdings of currency and time deposits relative to demand deposits). The movements of the monetary base are completely controlled by the Central Bank. The currency ratio and the time deposit ratio exhibit on the other hand systematic patterns which could be exploited for suitable adjustments in the monetary base in order to approximate the desired rate of monetary growth. The Federal Reserve's implicit refusal to develop and institute effective procedures of monetary control assures the likelihood of "uncontrollable" monetary acceleration.

V. The Dilemma of Current Monetary Policy

The Federal Reserve's tacit abondonment of an anti-inflationary policy produced some visible consequences. Inflation reached a low value of 4.7 % p.a. in the last quarter of 1976 (expressed by the GNP deflator). A monetary growth maintained along the lower boundary of the official target zone would have slightly reduced the rate of inflation over the period 1976/77. The very opposite happened under the impetus of a new monetary acceleration. A new surge of inflation appeared in the USA pushing the expected rate of inflation for 1978 (relative to 1977) to around 7.5 %. And, of course, the price of US-dollars fell on foreign exchange markets suffering under renewed uncertainties about the course of US financial policies.

The inheritance determined by the Federal Reserve's behavior over the past two years confronts our policy-makers with an unfortunate dilemma. They may continue the course initiated in 1976 and maintain a monetary growth of around 8 % p.a. over the next one and a half years. Or they may accept the monetary deceleration observed during the past winter and use this opportunity to reaffirm the official committment to an anti-inflationary line.

What are the consequences of these two scenarios? Under the first option the rate of inflation drifts to higher levels and settles in 1979 eventually around 8 % p.a. Real growth would move around 3.5 % - 4 % p.a. between the summer of 1978 and the end of 1979 and thus approximate the growth rate of full output. The likelihood of a recession within the next one and a half years would remain quite low under the circumstances. But interest rates tend to rise and the prime rate would reach a level of about 9.5 % (or more) by late summer of 1979. The Presidential Campaign opens thus under the first scenario with the political liability of high rates of inflation and high levels of interest rates.

The second scenario produces a monetary growth of about 5 % p.a. This pattern continues the trend initiated last winter. But the deceleration observed early this winter is not sufficiently significant per se to affect inflation and real growth this year. An expansionary course emerging beyond the first quarter would overwhelm the minor effect of a single quarter's retardation. The second scenario introduces however a persistent decline of monetary growth. A retardation of output in the second half of 1978 appears unavoidable under the circumstances. A recession is quite unlikely, but real growth may be expected to remain very low for several quarters reaching into 1979. The rate of inflation on the other hand would fall this year very little, if at all. Inflation and interest rates may gradually respond during 1979. A persistent monetary growth of about 5 % p.a. lowers eventually the inflation rate from 7 % - 7.5 % p.a. in 1978 to around 5 % p.a. in 1980. Real growth would rise gradually in 1979 under the second scenario and move towards the 5 % level. Lastly, market rates of interest eventually fall by 1980 at least two percentage points below the level established along the first scenario.

The second option, expressed by an immediate return of actual monetary growth to the official target zone, offers President Carter probably a better basis for his reelection campaign. Still, an approximation to the first scenario appears more probable. I may be wrong and I hope that I will be wrong. Fortunately (or unfortunately) this issue is easily settled by the time I return to Switzerland next year.

Somebody may suggest that my assessment seems already refuted by recent Federal Reserve actions initiated earlier in the second quarter of 1978. The media conveyed to the world in April and May that the Federal Reserve has shifted to a substantially restrictive stance. But this message involved the traditional misinterpretation of monetary events. Short-term interest rates rose rapidly beyond the middle of April. Banks raised in early May the prime rate, and the Federal Reserve Banks boosted the discount rate. What should be noted however is the rapid increase by about 11 % p.a. in the monetary base from the middle of March to early May. We also note the remarkable acceleration of monetary growth from late March to the first week of May. Market pressures pushed interest rates to higher levels and the Federal Reserve Banks adjusted the discount rate in the usual manner in order to maintain some balance with the market rates. The acceleration of the base reveals moreover the Federal Reserve's attempt to moderate the rise in interest rates with suitably enlarged injections of base money. An examination of the situation which evolved in April/May actually indicates therefore just the opposite of a move to a more restrictive policy. The provisional data for the second quarter resemble so far more closely the pattern associated with the first scenario.

Other considerations reenforce the conjecture favoring the first scenario. The Carter Administration exhibits a pronounced disposition towards "Mondalean economists". Many advisers, staff members and members of the Cabinet apparently prefer a "pressure cooker" approach to macro-policy. The economy should proceed according to this view under full steam with the necessary dosage of expansionary fiscal and monetary policies. Any spillover of demand pressures to prices must be contained with the aid of "voluntary restraint" in price-wage setting. Some vague allusions ("or else") usually refer to the eventual threat of coercive measures involving the government's police power.

The various groups associated with the Carter Administration's macro-policy determinedly argue moreover at every passing decline of the quarterly growth rate in output the need for immediate monetary-fiscal expansion. They argue in particular that the economy could never expand on its own. Persistent economic growth requires in their view intermittend boosts from an expanding budget supported by an accelerated monetary growth. We also hear at this stage that another expansionary boost need be applied this year.

The Carter Administration's anti-inflation program offers little solace for our anxieties. It is a mixture of rhetorical exercises shifting responsibility to business or labor supplemented with symbolic gestures about the budget. The program never referred to monetary policy and offers little hope that the growth of government expenditures can be contained or the deficit substantially lowered over the next years. Even more disturbing is Chairman Miller's statement that he prefers to use other methods than monetary policy to curb inflation. The context made sufficiently clear that "other methods" involve some more or less "coercively voluntary" price-wage restraints. Chairman Miller expresses himself volubly and usefully on matters bearing on the budget, fiscal policy and the effect of inflation on interest rates. He remains in contrast remarkably quiet in all matters concerning monetary policy. The Chairman of the Federal Reserve Board appears reticent to commit himself in affairs involving his direct responsibility. Lastly, the Administration is imbued with an attitude that anti-inflationary policies should never lead to (temporarily) lower employment and output. This attitude removes the only effective instruments of anti-inflationary policies from the "admissible range" of political action. It unavoidably fosters a permanent drift to higher inflation.

The pattern of conceptions and attitudes surveyed above lowers the likelihood of the second scenario in my judgment and renders the first scenario more probable. But such assessments could of course be wrong and we could experience a shift to the second option during

June and the third quarter. But this move would accelerate the increase in short-term rates of interest over the next four months. It also induces a substantial retardation of economic activity with an increase of the unemployment rate towards the 7 % level. On all these counts we could reasonably expect therefore a major political assault on the Federal Reserve in the media, from the Carter Administration and particularly also from Congress. The record of past behavior, and especially the abortion of repeated anti-inflationary attempts in the past 12 years, suggests that the Federal Reserve Authorities would most probably abandon by next winter the newest endeavor at anti-inflationary policies. The reversal into renewed monetary acceleration could be safely expected to initiate, as in 1967, 1972, 1976, another and probably larger surge of inflation than previously experienced.

VI. The Drift into Permanent Inflation

In 1969 I published an article advancing the thesis of a rapid drift into a state of permanent inflation in the Latin American tradition. The events evolving over the seventies strengthen my conjecture. The Carter Administration reveals no signs beyond rhetorical exercises to implement any meaningful and effective anti-inflationary policy. Monetary policy will most probably drift over the next years along an erratic course producing an average rate of inflation in the range of 6 % to 9 % p.a. This development will be accompanied with varying styles and procedures modifying private wage-price setting by political actions. Other countries face under the circumstances an unfortunate choice. They may adjust to the "financial leadership" offered by the United States and suffer the inflationary consequences. They may on the other hand explore alternative policies and experience volatile exchange rates superimposed on a long-run drift reflecting their deviation from the "leader's" financial style. In any event we will continue to live in a troubled and uncertain world suffering from the policies of permanent inflation pursued in the United States.

Fiscal Policy

A Report Prepared for the Shadow Open Market Committee

The deficit outlook for both fiscal 1978 and 1979 is now slightly less pessimistic than I indicated in my last report to this committee.

A. Fiscal 1978

Outlays- Last March, I estimated final 1978 outlays at $455-456 billion. Since that time, outlays have been redefined to include refunds of the earned income credit and receipts estimates have been raised accordingly. Consequently, my estimate was equivalent to $456-457 billion given the new definition. I purposely chose an outlay figure higher than the $454.4 billion which would subsequently appear in the OMB, March 1978 estimates because of my judgment that OMB had finally overestimated the outlay "shortfall." The fact that it now appears that outlays will come in about $450 billion indicates that the shortfall problem remains with us. Given the numerous procedural changes undertaken by OMB to eliminate the problem, I must confess to total puzzlement.

The severity of the shortfall problem is indicated by the fact that between January and July, the official outlay estimates had to be lowered by $10.8 billion or by 2.3 percent. Now, I am suggesting another 0.5 percent reduction for a total error of 2.8 percent. There were no significant budget policy changes over the period and adjustments in the economic forecasts of inflation and unemployment should have largely offset each other.

Needless to say, errors of this magnitude, after appropriations actions are virtually completed, make it extremely difficult to operate a rational fiscal policy.

Receipts- In contrast to OMB's outlay estimates, Treasury's receipts estimates (adjusted for definitional changes) have been miraculously accurate. The forecasts made at various times were: January, $401.3 billion; March $401.4 billion; and July $401.2 billion. It now appears as though the actual number will be very close to the July estimate.

Deficit- The implied deficit is:

Outlays	$450	billion
Receipts	401	billion
Deficit	$ 49	billion

B. Fiscal 1979

Outlays- Appropriations actions are not yet completed for fiscal 1979, and the Second Budget Resolution is waiting to go to conference. However, the outlook for 1979 outlays is considerably brighter than it was last March. Part of the change is due to the shortfall discussed above. It is expected to carry forward into 1979. In addition, the Congress is showing very little interest in certain expensive Carter spending initiatives such as the urban program and welfare reform. (Welfare reform had very little impact on 1979 outlays but the Administration's optimistic cost estimates suggested that the reforms would increase outlays by $13 billion by fiscal 1983.) There are also across-the-board cuts in the House version of the Labor-HEW and the HUD appropriations bills.

While it is too early to say that the public mood which brought us Proposition 13 is having a profound impact on Congressional behavior, it has at least altered the tone of the debate. Whether or not it will alter the substance of the debate may depend on what members of Congress heard at home during the Labor Day weekend.

I do not, however, expect any dramatic change in the outlook for 1979 outlays. I would suggest using a figure of $490 billion for 1979. Note that while I have lowered my estimate for outlays by $5 billion since our last meeting, my estimate for the <u>rate of increase</u> of spending between 1978 and 1979 has actually gone up slightly from 8.7 to 8.9 percent.

It is conceivable that outlays will be a bit lower than $490 billion. I believe that the outcome of the debate on the re-authorization of CETA and on the President's proposal for fiscal assistance to cities will be a good indicator of whether there is, in fact, a new mood in the Congress. If CETA, Title VI (public service employment) is cut back and if countercyclical revenue sharing is extended as a substitute for the President's more expensive fiscal assistance program, there will, at least, be a hint that the Proposition 13 phenomenon is having a real impact. There will be little effect on 1979 outlays, but the implications could be more dramatic for 1980.

Receipts- In July, the Administration estimated 1979 receipts at $448.2 billion. This figure assumed a $20 billion tax cut for calendar 1979. The House has passed a $16 billion cut and the Senate Finance Committee will be starting to mark up a tax bill around September 10. It is generally believed that the Senate will provide a larger tax cut than that in the House Bill, but the situation is sufficiently unstable that anything could happen.

I am inclined to adopt the Administration's receipts estimate on the basis of the following assumptions:

1. The eventual tax cut will be between $16 and $20 billion;
2. A worsening inflation outlook does not quite offset a worsening real growth outlook and money GNP will therefore be slightly lower in calendar 1979 than the $2,330 billion assumed by the Administration in July;
3. Although the 1979 money GNP is assumed to be lower, GNP revisions suggest that the current share of corporate profits in money GNP is somewhat higher than believed earlier and it seems reasonable to raise the profit share forecast for 1979. A higher profit share, of course, means that revenues will be higher for any given money GNP.

In summary, I assume that the revenue increasing impact of the first and last assumptions offset the revenue reducing impact of the second assumption. Needless to say, considerable political and economic uncertainty surround the receipts forecast.

Deficit- The outlay and receipts estimates made above imply a 1979 deficit of:

Outlays	$490	billion
Receipts	448	billion
Deficit	$ 42	billion

C. The Longer Run

The July, Mid-Session Review of the 1979 Budget estimated that an extension of current policies plus Presidential recommendations, already announced, implied outlay levels of $549.4 billion in 1980 and $591.3 billion in 1981. The 1981 figure was $15.2 billion higher than had been estimated in January -- only six months earlier. These projections clearly frightened the Administration, and in a most unusual footnote for a budget document they said, "The Administration regards the current estimates of 1980 outlays -- and the deficit that results -- as unacceptably high. The President's budget for 1980 will, therefore, reflect a fiscal program that will lead to substantially lower outlay levels. Reductions in 1980 spending will also reduce the current estimates of 1981 spending."

Various press reports suggested that the Administration was using a planning ceiling of $537-538 billion for 1980. With a current policy estimate of $549.4 billion this implied a truly Draconian budget by the standards of the recent past. Indeed, it was fair to say that OMB was working on the most

Republican budget of the last 30 years.

But the $549.4 billion current policy estimate for 1980 was based on a 1979 outlay estimate of $496.6 billion. Although it is now reasonable to assume a 1979 outlay level of $490 billion there is no indication that the Administration has made a comparable reduction in its planning ceiling for 1980. The implied rate of increase in outlays for 1980 has gone from 8.8 percent to 9.7 percent. More important, the reduction from current policy plus Presidential initiatives has gone from over 2 percent to about one percent. This may seem like a tiny change, but it is immensely important politically in terms of the number of special interest groups that will be antagonized by cuts in their programs. It must be remembered that, for all practical purposes, cuts have to be concentrated on that 25 percent of the budget that is defined as being "relatively controllable."

In attempting to achieve their goal the Administration will be hurt by the worsening inflation and real growth outlook and by the Congressional rejection of their health price controls. On the other hand, they will be aided by the lack of Congressional action on welfare reform and urban initiatives. It is far too early to say how this will all come out. While it appears as though the 1980 Budget will be stringent, it is only safe to say that it will not be as stringent as it appeared last July nor as stringent as the Administration and the special interest groups will claim next January.

TO: Members of the Shadow Open Market Committee

FROM: Bob Rasche

Attached are copies of my worksheets on the sources of financing of the Federal Government deficit for the first five months of 1978. To save you the task of going through the detailed numbers, I have constructed the following summary:

			(to date)	(to date)
Total Financing Required	FY 1977	CY 1977	FY 1978	CY 1978
(millions)	53,720	61,431	56,246	26,164
Borrowing from private capital markets	23,450 (.44)	19,390 (.32)	19,771 (.35)	10,894 (.42)
Monetization (Change in Net Source Base)	5,260 (.10)	11,396 (.19)	5,852 (.10)	3,995 (.15)
Borrowing from foreign official institutions	20,274 (.38)	29,381 (.48)	20,583 (.37)	8,141 (.31)
Other sources of financing	4,736 (.09)	1,264 (.02)	10,040 (.18)	3,134 (.12)

I would interpret this summary as indicating little change since the beginning of the year from the patterns that we saw established in 1977. Foreign Official institutions continue to be a major, if not the major source of funding for the continuing large deficits. The data for June, July and August are not yet available, but judging from the newspaper reports over the summer, it would seem that at least the Japanese have been a major contributor during this period. It seems likely that when the fiscal year comes to an end, these institutions will have contributed at least the 40-50 percent of the financing requirements that they did last year. If my notes and memory serve me correctly, this is a higher rate than we anticipated last March.

The behavior of the Fed is also running essentially unchanged from the past several years. It appears that it is difficult, if not impossible for the Fed to reduce the expansion of the net source base below say a range of 10-20 percent of the total financing requirements of the Federal Government, given their concerns about resisting upward pressure on short-term interest rates. If we take this as a very rough forecasting rule of the minimum expansion of the net source base (they have managed to get below ten percent once in the past 6 years, to eight percent in calendar 1975), combined with the long-term projections of the federal deficit such as those constructed by the Congressional Budget Office, the results for monetary expansion over the next few years are not at all optimistic.

	FY 78	FY 79	FY 80	FY 81	FY 82
Federal Budget Deficit Projections[1]	61.25	67.0	61.0	49.0	39.0
Off-budget agency deficit[2]	7.5	7.5	7.5	7.5	7.5
Total	68.75	74.5	68.5	56.5	46.5
Change in Base at .10 monetization:	6.9	7.5	6.9	5.7	4.6
% change from 9/30/77	(5.7)	(5.9)	(5.1)	(4.0)	(3.1)
Change in Base at .20 monetization	13.8	15.0	13.8	11.4	9.2
% change from 9/30/77	(11.4)	(11.1)	(9.2)	(7.0)	(5.3)

[1]Congressional Budget Office; Five Year Budget Projections: Fiscal Years 1979-83, December 1977, pp. xii.

[2]My arbitrary assumption based on deficits in last several fiscal years.

15894 .12
3995 .11
3141 .31
313

(1)

			1	2	3	4
			JAN	FEB	MARCH	APRIL
		UNIFIED BUDGET DEFICIT (+) OR SUR (-)	3717	6992	15125	-6618
PLUS		OFF BUDGET AGENCY DEF (+) OR SUR (-)	1174	1293	1164	569
EQUALS		TOTAL FINANCING REQUIRED	4891	8285	16289	-6049
		SOURCES OF FINANCING				
(+)	I	NET CHANGE IN PRIVATELY HELD DEBT	8617	1894	-1180	-609
		BORROWINGS FROM PUBLIC	6027	5108	9656	-2263
LESS		Δ F.R. HOLDINGS OF GOV'T SEC.	-5815	1446	3127	1923
LESS		Δ F.R. HOLDINGS OF AGENCY ISSUES	-451	-22	211	-129
LESS		Δ FOR OFFICIAL HOLDINGS OF MKT & NMKT	1744	-1147	885	-1759
LESS		Δ FOR OFFICIAL HOLDINGS REPORTED BY BKS	1932	2937	6613	-1689
(+)	II	CHANGE IN NET SOURCE BASE	-11054	7750	2848	-275
		Δ MEMBER BANK DEPOSITS	-7569	6746	1853	421
PLUS		Δ CURRENCY IN CIRCULATION	-2992	550	1023	722
LESS		Δ MEMBER BANK BORROWINGS	493	-454	28	1418
(-)	III	CHANGE IN TREASURY CASH BALANCE	-3907	2523	-2074	402
		Δ TT & L ACCTS	-3907	2523	-2074	402
PLUS		Δ OTHER DEPOSITORIES	—	—	—	—
(+)	IV	CHANGE IN FOR. TRANSACTION ACCTS	3716	1752	7649	-2991
		Δ FOR DEPOSITS @ F.R.	43	23	-93	129
PLUS		Δ FOR OFFICIAL HOLDINGS OF MKT & NMKT	1744	-1147	885	-1759
PLUS		Δ FOR OFFICIAL HOLDINGS REPORTED BY BKS	1932	2937	6613	-1689
LESS		Δ U.S. GOLD STOCK	—	—	—	—
LESS		Δ S.D.R. HOLDINGS	1	42	22	-24
LESS		Δ GOLD TRANCHE DRAWING RIGHTS	2	12	-272	-298
LESS		Δ LOANS TO I.M.F.	—	7	6	-6
(-)	V	CHANGE IN F.R. FLOAT	273	-584	-767	285
(+)	VI	INTEREST ACCRUALS	481	-2567	911	1826
		Δ ACCRUED INTEREST PAYABLE	481	-2567	911	1826
LESS		CONVERSION OF GOV'T ACCTS TO ACCRUAL	—	—	—	—
			56	4	3	0

			JAN	FEB	MARCH	APRIL
(+)	VII	EXCESS OF F.R. LIAB OVER ASSETS	958	691	-1230	-189
		Δ OTHER DEPOSITS @ F.R.	-316	-173	42	-56
PLUS		Δ OTHER F.R. LIAB & CAP ACCTS	817	-176	-73	220
LESS		Δ OTHER F.R. LOANS	-	-	-	-
LESS		Δ ACCEPTANCES	-954	-	770	-480
LESS		Δ OTHER F.R. ASSETS	497	-1040	429	833
(+)	VIII	MISC TREASURY ACCTS	-1488	559	4468	-3002
		Δ TREASURY CASH	-5	1	5	-17
LESS		INCREMENT ON GOLD	-	-	-	-
PLUS		Δ MISC LIAB ACCTS	-289	-323	3254	602
LESS		Δ OTHER CASH & MON. ASSETS	70	-141	236	800
LESS		SEIGNIORAGE	-27	-24	-35	-32
LESS		NET GAIN/LOSS FROM U.S. CUR. VAL ADJ	-2	-35	-29	32
LESS		Δ TREASURY CURRENCY OUTSTANDING	49	16	45	41
LESS		Δ MISC ASSET ACCOUNTS	1104	-697	-1426	2746
LESS		NET GAIN/LOSS FROM IMF LOAN VAL ADJ	-	-	-	-
(+)	IX	DEPOSIT FUNDS	-23	141	-15	-122
		ALLOCATIONS OF SDRs	1	27	23	-24
PLUS		Δ OTHER DEPOSIT FUNDS	-24	114	-38	-98

(2)

	Initials	Date
Prepared By		
Approved By		

	5	6	7	8	9	10	11	12	
	MAY	JUNE	JULY	AUGUST	SEPT	OCT	NOV	DEC	
1	1709	-9055	7230						1
2	1039	654							2
3									3
4	2748	-8401							4
5									5
6									6
7	2172								7
8	-555	5401							8
9	-674	7320							9
10	-143	605							10
11	-746								11
12	-1164								12
13									13
14	4726	-1424							14
15	1814	-2005							15
16	2329	842							16
17	-583	261							17
18									18
19	-776								19
20	-776								20
21	–								21
22									22
23	-1985								23
24	-27	-166							24
25	-746								25
26	-1164								26
27	–	-12							27
28	91	45							28
29	-39	-90							29
30	-4	11							30
31									31
32	1402	-891							32
33									33
34									34
35									35
36	-1908	851							36
37	-1908	851							37
38	–	–							38
39									39
40									40
41	3								41

	Initials	Date
Prepared By		
Approved By		

5	6	7	8	9	10	11	12
MAY	JUNE	JULY	AUG.	SEPT	OCT	NOV.	DEC.
722	-544						
-24	113						
155	-42						
-	-						
-116	747						
-575	-132						
-419							
-11	5						
—	—						
-2704	-200						
-897	325						
-30	-35						
20	-57						
44	68						
-1433	120						
—	—						
69	-335						
-14	45						
83	-380						