SHADOW OPEN MARKET COMMITTEE

Policy Statement and Position Papers

March 11-12, 1979

SHADOW OPEN MARKET COMMITTEE

The Committee met from 1:30 p.m. to 8:00 p.m. on Sunday, March 11, 1979.

Members:

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

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

Mr. <u>H. Erich Heinemann</u>, Vice President, Morgan Stanley & Company, Inc. New York, New York

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

Dr. <u>Jerry Jordan</u>, Senior Vice President and Chief Economist, Pittsburgh National Bank, Pittsburgh, Pennsylvania

Dr. <u>Rudolph Penner</u>, American Enterprise Institute, Washington, DC

Professor <u>Robert Rasche</u>, Department of Economics, Michigan State University, East Lansing, Michigan

Professor <u>Wilson Schmidt</u>, Department of Economics, Virginia Polytechnic Institute, Blacksburg, Virginia

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

Dr. <u>Anna Schwartz</u>, National Bureau of Economic Research, New York, New York

POLICY STATEMENT

Shadow Open Market Committee

March 12, 1979

A surge of inflation in 1978 and 1979 has made the effects of excessive monetary and fiscal stimulus visible to all. Inflation reached an average of 9% in 1978 and is likely to be even higher in 1979. In the past two years, the dollar has depreciated substantially against the currencies of our trading partners. Oil price increases have added to the costs borne by consumers and producers. Although political events in Iran contributed to the most recent rise in oil prices, most of the current inflation is the result of misdirected economic policies of the Federal Reserve and the Federal Government in recent years.

Many forecasters predict that recession and rising unemployment will add to the nation's economic problems in 1979. Recessions have occurred at irregular intervals during most of our history, and no fundamental change has occurred to break the pattern. The occurrence of a recession possibly could be postponed by increasing monetary and fiscal stimulus; however, additional stimulus at this time would further raise the ultimate cost of reducing inflation. The Shadow Open Market Committee is strongly opposed to the adoption of stimulative fiscal and monetary policy to postpone a recession.

The desire to "do something" about rising inflation appears to have produced a shift towards antiinflation policy in recent months. It should be recognized that inflation this year has largely been predetermined by past policies. Increasingly restrictive steps over the coming months should be avoided, but also the temptation to reverse policies once again when the economy slows must be resisted.

The principal aim of economic policy, now and in the future, should be to establish conditions under which the U.S. and other market economies can achieve stable, noninflationary growth and rising standards of living in the 1980's. Another round of "stop and go" culminating in higher inflation and slow growth of productivity in the early 1980's is a highly probable outcome if a break with past approaches to stabilization is not made at this time.

What Has Been Done

For the fifth time in two decades, lower inflation and a smaller budget deficit are given high priority in the rhetoric about economic policy. But the words will not necessarily be matched by deeds. Announced policies are likely to increase instability in the near term, while not offering any assurance of increased stability in the early eighties.

Current economic policy has three main features:

(1) A pitiably small reduction in the proposed budget deficit for the fiscal year starting next October, to be achieved principally by allowing inflation to increase taxes. Estimates by the Congressional Budget Office show no reduction in the budget deficits for fiscal 1980.

(2) An unprincipled system of coercion masquerading as voluntary price and wage restraint. Programs of this kind confuse the symptoms of inflation with the causes of inflation, encourage strikes, involve the President and his staff in collective bargaining to the detriment of that process, impose large costs of compliance, arbitrarily restrict the incomes earned by particular groups of

workers and firms, but do nothing to slow inflation. The many attempts at formal or informal wage and price controls, here and abroad, during the past fifteen years have not produced success for any policy of this kind.

(3) Continued emphasis on the level of short-term interest rates as a measure of the degree of monetary restraint. In the past, emphasis on interest rates has caused excessive monetary growth and rising inflation during years of economic expansion, and insufficient monetary growth and recession at other times.

In 1976, 1977 and 1978, the Federal Reserve refused to permit modest, prompt increases in interest rates in response to the borrowing demands of the public and private sector. Instead, money growth and inflation rose, and the dollar fell on foreign exchange markets. Eventually, market interest rates and inflation rose to much higher levels than would have been required if a policy of gradually reducing money growth had been followed in these years.

Now the risks are in the opposite direction. If private demand for credit were to slow, a policy of controlling short-term interest rates would cause money growth to fall. The economy would be pulled into a deeper recession than is required to slow inflation.

The risks of serious recession are increased by the absence of reliable information about the nation's money supply. The interaction of inflation with interest rate ceilings, complex reserve requirements, and new regulations prevent the public and the government from knowing what is happening to actual money growth. Congress should promptly eliminate restrictions on the payment of interest on demand, time, and savings deposits as part of a program to restore the reliability of data on the monetary aggregates.

What Should Be Done?

The high priority now given to controlling inflation will have no lasting effect on inflation unless it is a part of a sustained program. Anything less than a sustained program, lasting three to five years, would be a costly, wasted effort. After fifteen years of rising inflation and many commitments by past administrations and Federal Reserve officials, skepticism is large and government credibility is small.

At our meeting last September, we urged that monetary growth be reduced as one part of a program to end inflation and restore stability within the next five years. Although excessive monetary growth continued in the fall, there is growing evidence that the annual growth rate of money has now been reduced even after adjustment for change in definitions. We believe that further reductions in the annual growth rate of the money aggregates at this time would be a mistake. Instead we urge:

One - the importance of growth in monetary aggregates is now widely recognized. Uncertainty about these growth rates can lead to major errors in the interpretation of monetary policy and to severe recession or increased inflation. Uncertainty can be minimized only if Congress removes controls on the payment of interest on demand and time deposits. Continued failure to act imposes large risks and small benefits.

Two - the growth of the monetary base should be 8% for the year ending in August 1979. This is consistent with the recommendation of this Committee at our meeting in September 1978, when we selected the monetary base, as published by the Federal Reserve Bank of St. Louis, as the most reliable measure of monetary growth currently available in this period of uncertainty about the interpretation of growth rates of monetary aggregates. The monetary base is entirely

controllable by the Federal Reserve since changes in the base are the direct result of changes in the Federal Reserve portfolio. To control the size of its securities portfolio -- which is the principal source of the monetary base -- the Federal Reserve must allow short-term interest rates to respond freely to forces in the open market.

Three - we have urged repeatedly that the Federal Reserve adopt a five-year program to end inflation by reducing the growth rate of the monetary base by 1% a year for the next five years. The need for a program of this kind has now been recognized by Chairman Miller. During the past four months, the Federal Reserve has not made any effort to announce and implement the program. The Federal Reserve can reduce the cost of ending inflation by publicly accepting a commitment to sustained, gradual, but persistent reductions in money growth.

Four - productivity has grown at an average rate of 1% for the past two years. Capital investment has lagged behind the growth of the labor force. To encourage investment and output, Congress should further reduce the growth of government spending (including off-budget items) below the recommendations of the President, and reduce real tax rates. A tax reduction bill, to reduce the real burden of taxation on households and firms should be passed early in the session to encourage investment.

Five - to reduce uncertainty in financial markets, Congress should move at once to repeal the Credit Control Act of 1969 and the International Emergency Economic Powers Act of 1977. These laws -- which, respectively, create standby authority for (1) direct government control of domestic financial markets and (2) the imposition of foreign exchange controls in peacetime -- are unnecessary. Should the Administration ever implement these authorities, the result would be counterproductive and very costly to American society.

REDEFINING THE MONETARY AGGREGATES

Statement on Monetary Aggregates

Prepared by the Shadow Open Market Committee

March 12, 1979

Monetary aggregates are now widely recognized as important indicators of exchange rates, interest rates, inflation, and economic activity. Central banks in several countries now seek to control some monetary aggregates, and even the Federal Reserve states target rates of growth for various monetary aggregates. Governments, central bankers, investors, and savers throughout the world draw inferences about the future by observing trends in monetary aggregates. While foreign central banks have employed some variant of the monetary base concept, the Federal Reserve has stated its targets exclusively in terms of the money stock concept.

The monetary base statistics have proven to be accurate and reliable over extended periods of time. However, money stock statistics periodically have been subject to major revisions after the identification of measurement errors. As long as errors in the reported statistics remained small or could be regarded as constant, no major problems of interpretation arose. Currently, errors appear to be large and variable. The possibility of a major error in monetary policy or in private decisions based on a misinterpretation of monetary aggregates as currently recorded has increased.

The Federal Reserve Bulletin for January, 1979, invited interested parties to comment on the staff's proposals to redefine the monetary aggregates so as to reduce potential errors of interpretation. Our Committee believes that the proposed changes in definition are in the right direction. However, the published proposal neither addresses the central problem nor fully adjusts the definitions for past changes in financial arrangements. Measures of the monetary aggregates can never be entirely accurate, but current errors can be reduced to more acceptable levels.

The staff of the Board of Governors proposes two principal types of change to M-1 and M-2. One removes deposits of foreign banks and official institutions from these aggregates. The other adds consumer-type transaction deposits at thrift institutions to the aggregates.

The proposal does not incorporate into the monetary aggregates the effects of substantial changes in businesses' asset management practices such as the use of overnight repurchase aggreements, overnight Euro-dollar deposits and other relatively close substitutes for bank deposits. These practices appear to have as much importance for the levels and rates of change of monetary aggregates as the items in the staff proposal. Currently, there are no comprehensive measures of these items. The Federal Reserve should promptly institute sampling procedures to assure adequate measurement.

It is regrettable that the Federal Reserve did not foresee the need to change its data collection procedures in advance of the regulatory changes it recently instituted. Future changes in regulatory practice should be coordinated with monetary policy and data collection.

The Central Problem

The central problem cannot be solved permanently by changing definitions. There is now a large and rapidly growing volume of financial assets not subject to ceiling rates on deposits, not covered by Federal Deposit Insurance programs, and in some cases not subject to reserve requirements. The private benefits from these arrangements are entirely the result of archaic regulations and controls on interest rates.

Interest rate controls on savings, time, and demand deposits encourage innovation to circumvent regulations. Differential reserve requirements for the types of liabilities issued by banks and non-bank institutions provide additional

incentives to innovate. The relatively high market rates of interest, resulting from past and currently anticipated inflation, increase the incentives for owners and issuers of financial liabilities to circumvent regulations and controls on the payment of interest. The net social cost resulting from misinformation about the growth of the aggregates is high and probably is rising.

The proper remedy is to remove these restrictions and controls. The Congress, the Federal Reserve, the Federal Home Loan Bank Board, and other regulatory agencies should act promptly to remove controls on interest rates and other incentives to socially wasteful innovation.

Statement Prepared for the Hearings on the

Conduct of Monetary Policy

Held pursuant to the Full Employment and Balanced Growth Act of 1978

U.S. House of Representatives

Committee on Banking, Finance and Urban Affairs

Washington, D.C.

February 22, 1979

Karl Brunner

University of Rochester

1. <u>The Full Employment and Balanced Growth Act of 1978</u>

I appreciate the opportunity to present my views to this Committee concerning the course of monetary policy best designed to promote the goals of the Full Employment and Balanced Growth Act of 1978. This Act establishes medium and long term goals for both inflation and unemployment. Inflation sould be lowered to 3% p.a. by 1983 and completely vanquished by 1988. Unemployment for individuals aged twenty and over need be reduced to 3% and among all persons aged sixteen and over to 4%. These unemployment levels should be realized by 1983 and subsequently maintained into the future. The Act also declares Congressional intentions addressed to capital formation, rising productivity and increasing real income per capita. Congress rejects thus the prospects of permanent stagnation advanced by assorted groups advocating a "non-growth economy". Congress also rejected the views advanced with increasing frequency that we should accept a permanent inflation and accommodate our policies to this fate.

2. <u>The Inflationary Heritage of Past Policies</u>

The apparent interest of Congress in price-stability and economic growth, at least as expressed in the Act of 1978, should stimulate concern about the performance of our economy in the 1970's. The drift in inflation and unemployment was not produced by blind fates beyond our reach. We contribute to this drift with the dominant trend in our economic policies. This fact holds most particularly for the case of inflation. The differences in the

behavior of the general price-level between the period 1960-1965 and the
1970's and similar differences in other countries or between countries are
not determined by mysterious social forces. Nor is the relative intracta-
bility of recent infltion in the USA particularly surprising. The level and
persistence of our inflation is essentially the product of our monetary policy
pursued since 1965. This policy produced a monetary growth pushing nominal
gross national product at a rate of expansion exceeding the average rate of
real growth. Economic agents in the private sector unavoidably adjusted their
price and wage setting to this nominal expansion maintained over many years by
the Federal Reserve Authorities. The sequence of abandoned attempts at an
anti-inflationary policy (1966, 1969, 1971/72, 1974/75) confirms prevalent
expectations of a persistent inflationary policy. Wage- and price-setters
show little inclination under the circumstances to adjust their behavior to a
temporary reduction in monetary growth and to the passing retardation of
nominal demand. Both our current inflation and its apparent intractability result
from the pattern of policies cultivated by our monetary authorities.

3. A General Program of Monetary Policy

The recognition of the underlying cause driving our inflation determines
the course of policy pushing the economy nearer to the goals expressed by
Congressional legislation. A stable price-level requires that the Federal
Reserve hold the growth rate of the monetary base to around 2% p.a. The
combination of this growth with the expected trend in the monetary multipliers
and monetary velocity produced by a gradual diffusion of institutional inno-
vations determines approximately a trend growth of 3% p.a. in nominal gross

national product. This implies under the circumstances a normal rate of
growth in real output of about 3% p.a. and a stable price-level. With a
different normal real growth or a different trend in multiplier and velocity
than implicitly used in the previous assessment suitable revisions in the
medium term growth rate of the monetary base yield closer approximation to
the stability of the price-level required over time. A well managed
Federal Reserve Authority with a definite commitment to its public responsi-
bility would learn from experience as the situation evolves the approximate
magnitude of the non-inflationary growth rate of the monetary base. At the
moment and on the basis of our available information it seems quite adequate
to use 2% as a benchmark for 1988 or even somewhat earlier. The probable
errors are small relative to the magnitude of the current inflation. The
path of the monetary base determined by its initial position (around 9% p.a.
in 1978) to the benchmark level set for 1986-1988 would assure an unambiguous
reduction of the rate of inflation to a small fraction of the inflation emerging
during the winter 1978/79.

4. The Implementation of the Program

The implementation of this general program requires some attention. The
non-inflationary level can be approached in many different ways. If we knew
with certainty the economy's complex dynamic structure and the patterns of
changing expectations induced by new information the move to a non-inflationary
state could be realized under optimal conditions in terms of the social costs
associated with the transition. The revisions of expectations would moreover
induce rapid changes in price-wage setting in case the new policy is

(miraculously) accepted by the public with full confidence as an expression of a determined and sustained effort. The social costs of the transition would be lowered to a minimal level under the circumstances. Unfortunately we do not possess this information and we must grope for a path in a murky fog. An immediate reduction of the growth rate of the base from 9% to 2% induces most likely a recession with losses in output and employment. The low credibility attached at this time to any sustained anti-inflationary monetary policy raises the social cost of the transition as it lengthens the time required for the adjustment in price-wage setting behavior. It should be noted however that the moderation in the growth of the base required for our proposal is substantially smaller than the retardation observed in 1920/21 or in 1936/37. It would be somewhat larger than the retardation imposed by the Fed in 1948/49 and other postwar recessions. The loss in output and employment resulting under the circumstances fosters most likely political pressures forcing a reversal of monetary policy onto a renewal of the inflationary game. I know of no way to determine a path for the monetary base which will assure us the absence of any social cost of transition or promise that we move along an optimal trajectory in terms of social cost. My best suggestion under this uncertainty shared by all of us indicates a gradual approach explicitly announced and well articulated to the public. According to this approach the Fed should announce once and for all in a manner con-veying a convincing commitment that it plans to lower the growth rate of the monetary base each year by one percentage point until we achieve a stable price-level. This policy need be announced now and initiated for 1979. The.

White House should also commit its prestige, as it is, in support of this policy and make clear that it will not tolerate any deviation from the announced path.

5. The Implementation of the Program: Changes in Procedures and
    Conceptions Governing the Fed's Policy-Making

The simple proposal involves no technical complications and difficulties. The Federal Reserve Authorities possess all the technical means for an effective execution of such a policy. It will require however somewhat of a revolution in the conception and procedure of the Federal Reserve's bureaucracy. The Federal Reserve continues to formulate and implement policy according to an old pattern. This pattern,and its consequences with respect to economic stability,has been described in detail in a study on Federal Reserve Policy Making jointly prepared for this Committee in 1964 by myself and Allan H. Meltzer. The Shadow Open Market Committee also commented repeatedly in recent years on this problem. The Fed's traditional procedure seriously impairs the control of monetary growth and the growth of the monetary base. It obstructed in the past four years the realization of Congressional intentions expressed by HC 133 (March 1975) and the recent revisions of the Federal Reserve Act. This obstruction was reenforced by the Fed's conception traditionally dominating its views of monetary events and monetary processes. The conception inherited by the Fed's bureaucracy essentially denies the relevance of monetary aggregates and blinds the Fed to the crucial role of monetary growth in the inflation process. The internal pro- cedures combined with the old conceptions explain the fact why the Fed so

miserably failed to satisfy the Congressional intentions over the past four years.

6. The Implementation of the Program: Institutional Reform of Adequate Information

The change in procedures and conception of the Fed's bureaucracy must be supplemented with two other groups of measures in order to improve our policy-making in a manner better suited to achieve Congressional goals. Some of the institutional arrangements in the US monetary system are not well designed for an effective control over monetary growth. The prevailing structure of reserve requirements and the ceiling on interest rates imposed on checking and time deposits produces under inflationary circumstances serious distortions in the measured monetary aggregates. These distortions lower the information content of the data and impair any rational assessment in policymaking. These distortions have recently been aggravated by increasing errors impounded into the traditional measures of M_1 and M_2. Institutional innovations (AFT accounts, NOW accounts, broker and money market fund checkable accounts and overnight repos) in the financial industry erode the meaning of the published data. There remain however some questions concerning the adequacy of the published date even in the absence of the evolving in-stitutional innovations. Several years ago a special Committee constituted by the Federal Reserve Authorities recommended several modifications in the assembly and preparation of data for the measurement of monetary aggregates. It seems most urgent at this time that the Federal Reserve Authorities be

advised that their responsibility defined by the Federal Reserve Act and the
Full Employment and Balanced Growth Act requires a systematic reexamination
of their measurements. Inadequate measures increase the uncertainty con-
fronting policymakers and economic agents. They also offer opportunities
for useful exploitation by the Fed's bureaucracy in order to produce sufficient
verbal smog to obstruct the movement to a non-inflationary path of the relevant
monetary magnitudes. It is important to emphasize in the present context
however that we need not suspend any relevant action until the studies of
new Committees or the enquiries made by the Fed are terminated. The Fed can
immediately initiate the necessary changes in implementation proposed by the
Shadow Open Market Committee in recent years, modify some arrangement (e.g.
reserve requirements), actively propose some other modifications (structure
of reserve requirements, interest ceilings on deposits) and <u>most particularly</u>
<u>announce a commitment to lower the growth rate of the monetary base by one</u>
<u>percentage point each year</u> in the manner indicated above. We note in passing
that the monetary base suffers at most vanishing measurement problems. It
suffers on the other hand under the Federal Reserve's systematic refusal to
recognize its central position in the money supply process.

7.   <u>The Significance of Fiscal Policy</u>

My statement concentrated thus far on monetary policy. A short comment
bearing on the role of fiscal policy need be added at this point. The direct
effect of budget and deficit on the rate of inflation is comparatively negligible.
An expansion of government expenditures on goods and services tends indeed to
raise the price-level. But such expansions contribute (directly) little to

to our inflation. A similar situation holds for the deficit. The direct effect of the deficit on the rate of inflation vanishes in comparison to the importance of the mode of its financing. The deficit exerts however an indirect effect of some importance on the inflation motor. The nature of the political process lowers the likelihood of a non-inflationary monetary policy under the circumstances of a persistent and large borrowing requirement by the Federal Government. It would thus seem advisable that fiscal policy contribute with a balanced budget to the goal addressed by Congress. The comparative irrelevance of the direct effect of budget and deficit on inflation does not imply however the irrelevance of these fiscal magnitudes in terms of our welfare. A large and increasing budget absorbs resources by the government sector. These resources are used less productively and more wastefully in this manner than in the private sector. Rising government expenditures on goods and services lower in the average real investment and real consumption and lower over time our economic welfare. Rising government expenditures in any form expand moreover the power and reach of the bureaucracy. The citizen's control over an ever expanding government sector forms a major problem for our political future beyond the threat of permanent inflation.

8. The Objections to Anti-Inflationary Monetary Policy

The program submitted in my statement is hardly uncontested. It is opposed on the grounds that the social cost of transition to a stable price-level is too high. The argument asserts in particular that the social cost of permanent inflation is small when compared to the social cost of an anti-inflationary policy. This discrepancy in social costs determines that

policy should rationally accommodate a persistent inflation built into the economy. Another objection contends that inflation involves a social process essentially independent of monetary growth. A reduction in monetary growth produces under the circumstances a permanent loss of output and employment. It is useless and harmful in this view to tame inflation by means of monetary control. Lastly, one may concede some usefulness to monetary-fiscal restraints but argue that such "general measures" be supplemented by "specific and structural" measures.

a. The Social Cost of Anti-Inflationary Policy

The case for a permanent inflation in terms of the social cost of anti-inflationary policy involves essentially an irrelevant comparison. It compares the transition to a stable price-level with a stable and fully anticipated inflation. But this comparison is hardly relevant for our purposes. It assesses an anti-inflationary policy against the standards of Never-Never-Land. Permanent inflation actually means an erratic inflation with large variations in the spread between expected and actual rate of inflation. A policy of permanent inflation induces thus substantial variations in output and unemployment. The cumulative loss of output from intermittent recessions whenever inflation abates exceeds probably the social cost of a once and for all transition. Permanent inflation imposes additional social costs beyond this cumulative output loss resulting from intermittent "stagflationary" recessions. The erratic course of permanent inflation increases the uncertainty confronting economic agents. The higher level of uncertainty shortens the horizon of investment projects, curtails the average pay-off

period, and tends thus to lower the rate of investment in human and non-human capital. These repercussions are further aggravated by our tax structure. Permanent inflation typically fosters furthermore intermittent controls over prices, wages, and interest rates. Every new wave of inflation encourages the formation of new agencies and watchdogs "supervising" prices or fosters extended powers to already existing agencies. The bureaucracy expands and the power of government increases. The resources invested in this manner by the government sector hardly affect the ongoing increase in costs and prices. They do provide however substantial incentives encouraging a wasteful and distorted use of our productive opportunities. These repercussions lower over time the trend growth of normal output.

b. Irrelevance of Monetary Policy and Monetary Growth?

The second objection against an anti-inflationary monetary policy implicitly argues that the social cost imposed by such a policy is indefinitely high. This follows from the view that inflation evolves irrespective and independently of monetary growth. This theme has become quite fashionable in wide circles. Its attraction follows to a large extent from the political message implicit in the view. It offers some further justification for massive social engineering and most particularly for the replacement of markets with political institutions. The evidence accumulated from a wide array of inflationary experiences drawn from many different historical circumstances and countries thoroughly refutes however this contention. No inflation ever emerged without an excessive monetary growth usually produced by the government. This holds for the French inflation in the middle of the 14'th century just as well

as for the Latin American inflation of the last 150 years, or the Italian,
English, Turkish, Spanish, etc. inflation of the past ten years. We find
in particular that every major or persistent acceleration of monetary growth
is followed by rising inflation. Substantial variations over time within
any given country or differences between countries at any given time in the
level of monetary growth are clearly reflected by prevailing magnitudes in
the rate of inflation. But the evidence shows more. It also reveals that
inflation disappears whenever monetary growth subsides to a level determined
by normal real growth and the trend in velocity. Recent experiences in West
Germany, Switzerland and the United Kingdom offer remarkable instructions for
our purposes. West Germany and Switzerland were more exposed to the real
shocks produced by OPEC and the failure of agricultural crops than the USA.
They still managed by a determined reduction of monetary growth below the
excessive rates reached in 1972 to lower inflation to vanishing levels.
There are many other cases from other periods and other countries which exhibit
unambiguously that a persistent and sufficient decline of monetary growth
effectively reduces the rate of inflation. Any contention that inflation
proceeds irrespective of monetary policy and independently of monetary growth
finds no support in the reality of inflation experiences.

c. A Need for Supplementary Measures?

Lastly, it is argued on occasion that general measures based on monetary
and fiscal policy cannot form the sole instruments of an anti-inflationary
policy. They need to be supplemented by "specific and structural" measures.

But this position is fundamentally untenable and contradicted by the facts summarized by the previous paragraphs. In particular, the contention that general policy measures have been unable to lower inflation is simply false. The failure observed over fourteen years in the USA is not due to price movements being disconnected in a "new world governed by new social structures" from falling monetary growth produced by unstinting efforts of our Federal Reserve bureaucracy. The facts are very different. Our monetary policy never settled on such an effort and never showed any determined attempt to reduce monetary growth to the levels required for a non-inflationary growth. One might just as well attribute the failure of a car to move because the driver confuses brake and accelerator or fumbles with the ignition to a breakdown of the car. An emphasis on supplementary measures lowers the likelihood of an effective anti-inflationary policy as it directs attention away from the basic requirement to lower monetary growth. The Federal Reserve bureaucracy essentially rejected in the past years and still rejects this very notion of monetary control for the purpose of taming inflation.

Supplementary measures are basically useless as anti-inflationary devices. "Income policies", "social contracts", "orchestrated approaches" or simple coercion all failed to contain inflation. We need not invoke ancient history and the futile exercies of Diocletion, Julian the Apostate, Jean Valois II of France, Edward III of England and others. The experiences of the postwar era are quite sufficient to reveal that such measures may modify somewhat the shorter-run path of inflation with little longer-run effect in the face of a persistently excessive monetary growth. Moreover, the measures mentioned above hardly contribute to raise the credibility of a new attempt at anti-inflationary

monetary policy. The uncertain and unreliable record of policy-makers will
not dissolve with the cultivation of irrelevant and ineffective measures.
Even under the best circumstances when they initiate a more efficient use of
our resources the effect of specific or structural measures on the rate of
inflation is minimal. It is quite illusory to cope with an 8% p.a. rate of
inflation in such terms. It should be noted however that the irrelevance of
supplementary (structural) measures with respect to inflation does not imply
their irrelevance in terms of their cumulative effect on our general welfare.
But I also wish to emphasize that some of the supplementary measures
occasionally proposed are more likely to foster price increases and a waste-
ful use of our resources.

9.   Unemployment and Growth

The Full Employment and Balanced Growth Act 1978 imposes joint goals
for inflation and unemployment. Policymakers are thus addressed to pursue
a course of action lowering both inflation and measured unemployment. This
course should also foster economic growth. Some clarification of the role of
monetary policy in this context may be useful in view of many prevalent con-
fusions. The case for an effective anti-inflationary monetary policy is
frequently dismissed as an expression of "Republican values" favoring higher
unemployment and lower inflation. This argument misrepresents unfortunately
the actual issues confronting us. The choice is not between lower unemploy-
ment and higher inflation on the one side or higher unemployment and lower
inflation on the other side. Our choice lies between a temporary increase
of unemployment in the present above its normal level in conjunction with a

return to the normal level and no inflation in the future on the one side, or, on the other side, permanent inflation with intermittent spurts of unemployment beyond its normal level augmented very likely by an increase in the normal level. It is unfortunate that we do not possess a sure way out of inflation without suffering most likely some temporary increase in unemployment. But there is really no alternative. All attempts to avoid lower monetary growth, exemplified by my proposal in a previous section, which insist on a variety of "specific or structural" measures are committed to failures. They will produce an apparently more and more intractable inflation and the final "Latin-Americanization" of this country. And most importantly, the country will move even further away from the goals declared by Congress.

A determined and generally understood sustained effort to reduce monetary growth does remove inflation. It will not raise the normal level of unemployment but neither will it lower this level significantly at this stage of our inflationary heritage. The normal level of unemployment settled probably around 6% under the current institutions. Any effort to lower this level moves our attention beyond monetary policy. Monetary policy could lower the measured unemployment rate substantially below 6% only for a short period and would unleash thereby accelerating inflation. A reduction in the normal level of unemployment must be accomplished by major changes in our social institutions, (among others: minimum wage, the modus of food stamp plan and unemployment compensation or benefits). Government policies reenforced in the USA the upwards drift in the normal (and measured) unemployment rate beyond the range due to demographic trends in our labor force. A similar pattern holds for the fall in the rate of real growth observed in the USA. The proper

approach to lower unemployment and higher real growth involves under the circumstances a systematic reassessment of a wide range of inherited government policies and regulatory procedures. This reexamination with appropriate actions should indeed be welcomed and encouraged. Our society would benefit and general welfare rise. But our political process may not produce this result and Congress may prefer to continue the prevailing arrangement. But this also means under the circumstances that one should rationally accept the consequences expressed in terms of unemployment and growth rate. In particular, these consequences offer no justification for an "expansionary" monetary and fiscal policy intended to force a lower rate of unemployment and higher rate of real growth. Monetary policy will not deliver this result. It would only yield on this course accelerating and erratic inflation with unstable output and rising level of normal unemployment. And lastly, any attempt at curing the problems of low growth and high measured unemployment with larger doses of the "specific and structural" measures which produced these problems contributes to accelerate the trend into stagnation and permanent inflation.

In the several years up to the middle of last fall, the
Federal Reserve was increasing the stock of money of the
nation inordinately. This rapid growth of money has been the
major cause of rapid and increasing inflation and reduction in
the rate of growth of money was long overdue in order for
inflation to be moderated. But instead of a reasonable moderate
monetary growth, which this Committee recommended last September,
the Federal Reserve, about November 1, instituted a sudden and
inordinate reversal of monetary policy. Since October narrowly
defined money (M1) has declined at a 2 percent annual rate, after
increasing 7.8 percent in the preceding year. Money more broadly
defined (M2) has grown at a 2 percent rate, after increasing 8.7
percent in the preceding year. The monetary base has grown at a
6 percent rate compared with 9.7 percent in the preceding year.
This sudden extremely tight monetary policy may lead us in the
future to an unnecessarily acute recession, and the longer the
present excessively restrictive policy continues the greater the
likelihood and severity of such a recession.

We recommend that the degree of restraint on monetary growth
be moderated immediately. Specifically, we advise that the growth
of that monetary aggregate consisting of currency and bank deposits
in the hands of the public (M2) be increased for the next six months
at a rate of about 6 percent a year. This would help to correct the
excessive restraint of the last four months, yet would give assurance
that the inflationary rate of expansion in the years before last
November would not be resumed. A moderation of the recent restraint
would reduce the likelihood of extreme recession, and at the same
time would be beneficial to our foreign exchange rates. It would
reduce the likelihood that we would later reverse policy to one of
inordinate ease.

MONETARY AGGREGATES
RATE OF GROWTH

	Since Oct. 1978	Year Ending Oct. 78	III 74 to III 78	III 76 to III 78	III 74 to III 76	III 72 to III 74
Federal Reserve Credit	8.5	11.3	9.3	9.9	8.7	10.1
Monetary Base	6.0	9.7	8.5	9.0	8.1	8.8
M2	2.2	8.7	9.3	9.8	8.9	8.8
M1	- 2.2	7.8	6.4	8.0	4.8	6.2

Homer Jones
March 9, 1979

TO _____ SOMC

FROM _____ Jerry L. Jordan _____ PHONE No. ___355-3101___

SUBJECT _____ ECONOMIC PROJECTIONS _____ DATE __March 5, 1979__

I. Below are two tables showing projections for 1978 as of the
September meeting last year (I) and actual results for 1978 (II).

TABLE I
(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

TABLE II
(percent changes)

Actual for 1978

	GNP	Output	Deflator	M^1	M^2	V^1	V^2
Q4/77- Q4/78	13.0	4.3	8.3	7.3	8.5	5.3	4.1
1977- 1978	11.6	4.0	7.4	7.8	8.6	3.5	2.8

Growth of real output was higher than projected in September, but lower
than the 4.9 percent change projected at the March 1978 meeting. Inflation
was higher than projected, and measured velocity grew more rapidly. These
results are very strongly influenced by the sharp increase in real output
reported for Q4/1978 and the sharp decrease reported for money growth in
Q4/1978.

II. The next two tables show the projections for 1979 as of the
September 1978 meeting (III) and for the March 1979 meeting (IV).

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

TABLE IV
(percent changes)

Projections for 1979 as of March 11 SOMC Meeting

	GNP	Output	Deflator	M^1	M^2	V^1	V^2
SPRINGYL:	7.1	-.8	7.9		5.4		1.6
Q4/78-Q4/79	10.5	2.0	8.3	7.0	8.0	3.3	2.3
(handwritten)	10.4	2.0	8.3		6.3		5.9
1978-79	11.8	3.3	8.3	6.8	8.3	4.7	3.2

The following assumptions for 1979 were put forth for the September
1978 meeting.

" The unemployment rate is expected to remain in the 5.5 to 6.5 percent
range in 1979, 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 in 1979 will be down 10 to 15
percent compared with 1978, but non-residential construction will exceed
1978. Real capital spending will still rise this 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 by smaller. Government spending in nominal terms is projected to rise
11 percent, about the same as nominal GNP."

III. The deceleration in monetary growth in late 1978 and early 1979, in com-
bination with the announcements and actions of policymakers since November,
1978 suggest that monetary growth this year will be less than in 1978. Interest
rate increases in the next six months are likely to be greater than expected
last September. However, a peak in short-term market interest rates is
expected to occur before year-end and declining market rates can be expected
in 1980.

MONEY GROWTH RATES

(% Change from Previous Year)

FROM:	TO:	M1	M2	MONETARY BASE	M1+
1971/Q1	1972/Q1	6.8	10.9	7.1	8.9
Q2	Q2	6.3	9.7	7.2	7.7
Q3	Q3	6.7	10.4	6.9	8.2
Q4	Q4	8.4	11.2	8.3	9.2
1972/Q1	1973/Q1	8.5	10.5	8.9	8.4
Q2	Q2	8.0	10.0	8.9	7.6
Q3	Q3	7.2	9.2	9.1	6.3
Q4	Q4	6.2	8.8	8.1	5.2
1973/Q1	1974/Q1	5.9	9.0	8.1	5.1
Q2	Q2	5.7	8.8	8.4	5.2
Q3	Q3	5.3	8.3	8.4	5.4
Q4	Q4	5.1	7.7	9.0	5.5
1974/Q1	1975/Q1	3.8	6.7	8.2	5.2
Q2	Q2	4.2	7.3	7.8	6.8
Q3	Q3	5.0	8.4	8.0	8.5
Q4	Q4	4.6	8.4	7.6	8.8
1975/Q1	1976/Q1	5.3	9.6	8.0	11.0
Q2	Q2	5.3	9.6	8.7	11.4
Q3	Q3	4.6	9.3	8.3	10.6
Q4	Q4	5.8	10.9	8.4	12.6
1976/Q1	1977/Q1	6.5	11.0	8.3	12.5
Q2	Q2	6.8	10.8	7.9	11.2
Q3	Q3	8.0	11.1	8.5	11.3
Q4	Q4	7.9	9.8	8.8	9.3
1977/Q1	1978/Q1	7.7	8.8	9.5	7.2
1977/Q2	1978/Q2	8.2	8.6	9.4	7.0
1977/Q3	1978/Q3	8.1	8.6	9.4	6.4
1977/Q4	1978/Q4	7.3	8.5	9.6	5.3

TWO-QUARTER COMPOUNDED ANNUAL RATES OF CHANGE

	M1	M2	MONETARY BASE	M1+
Q1/71-Q3/71	8.2	11.5	8.2	10.1
Q2/71-Q4/71	4.8	8.1	6.6	6.3
Q3/71-Q1/72	5.4	10.2	6.0	7.8
Q4/71-Q2/72	7.8	11.3	7.8	9.1
Q1/72-Q3/72	8.1	10.7	7.8	8.6
Q2/72-Q4/72	9.0	11.0	8.9	9.3
Q3/72-Q1/73	9.0	10.4	10.1	8.3
Q4/72-Q2/73	7.1	9.0	8.8	5.8
Q1/73-Q3/73	5.5	8.0	8.1	4.4
Q2/73-Q4/73	5.3	8.6	7.4	4.5
Q3/73-Q1/74	6.3	10.0	8.1	5.8
Q4/73-Q2/74	6.1	8.9	9.5	5.9
Q1/74-Q3/74	4.2	6.7	8.8	4.9
Q2/74-Q4/74	4.0	6.4	8.5	5.1
Q3/74-Q1/75	3.3	6.6	7.7	5.5
Q4/74-Q2/75	4.3	8.3	7.1	8.5
Q1/75-Q3/75	6.7	10.2	8.3	11.6
Q2/75-Q4/75	4.9	8.6	8.2	9.1
Q3/75-Q1/76	3.9	8.9	7.8	10.4
Q4/75-Q2/76	5.7	10.7	9.2	13.8
Q1/76-Q3/76	5.4	9.7	8.7	10.7
Q2/76-Q4/76	5.9	11.1	7.7	11.5
Q3/76-Q1/77	7.6	12.3	7.9	14.2
Q4/76-Q2/77	7.6	10.4	8.1	10.9
Q1/77-Q3/77	8.3	9.9	9.2	8.5
Q2/77-Q4/77	8.2	9.3	9.5	7.7
Q3/77-Q1/78	7.2	7.7	9.8	6.0
Q4/77-Q2/78	8.2	7.9	9.3	6.2
Q1/78-Q3/78	9.0	9.5	9.0	6.8
Q2/78-Q4/78	6.4	9.1	9.9	4.3

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

Beryl W. Sprinkel
Executive V.P. & Economist
Harris Trust & Savings Bank
Chicago, IL 60690

	ACTUAL	FORECAST								YEARS			
	1978:4	1979:1	1979:2	1979:3	1979:4	1980:1	1980:2	1980:3	1980:4	1977	1978	1979	1980
GROSS NATL PRODUCT	2210.8	2271.6	2319.0	2341.5	2372.9	2414.7	2483.0	2555.5	2631.9	1887.2	2106.6	2326.3	2521.3
%CH	14.7	11.5	8.6	3.9	5.5	7.2	11.8	12.2	12.5	11.0	11.6	10.4	8.4
CONSTANT DOLLAR GNP	1412.2	1422.1	1422.7	1408.4	1400.4	1398.6	1412.4	1428.3	1445.0	1332.7	1385.1	1413.4	1421.1
%CH	6.1	2.8	0.2	-4.0	-2.2	-0.5	4.0	4.6	4.8	4.9	3.9	2.0	0.5
PRICE DEFLATOR	1.5654	1.5974	1.6300	1.6625	1.6944	1.7265	1.7580	1.7892	1.8214	1.4158	1.5204	1.6461	1.7738
%CH	8.1	8.4	8.4	8.2	7.9	7.8	7.5	7.3	7.4	5.9	7.4	8.3	7.8
CONSUMPTION EXPENDITURES	1402.2	1435.1	1466.9	1495.0	1521.9	1554.0	1593.9	1636.9	1681.9	1206.5	1339.7	1479.7	1616.7
%CH	14.0	9.7	9.2	7.9	7.4	8.7	10.7	11.2	11.5	10.7	11.0	10.5	9.3
DURABLES	209.6	212.4	214.5	214.0	212.1	214.7	222.8	232.7	243.0	178.4	197.6	213.3	228.3
%CH	21.8	5.5	4.0	-0.9	-3.5	5.0	16.0	19.0	18.9	13.9	10.8	7.9	7.1
NONDURABLES	550.8	563.9	576.9	589.1	601.1	613.5	627.1	641.2	655.7	479.0	525.8	582.8	634.4
%CH	15.2	9.9	9.5	8.7	8.4	8.5	9.2	9.3	9.4	8.2	9.8	10.8	8.9
SERVICES	641.8	658.8	675.5	691.9	708.7	725.8	744.0	763.0	783.2	549.1	616.3	683.7	754.0
%CH	10.6	11.0	10.5	10.1	10.1	10.0	10.4	10.6	11.0	11.8	12.2	10.9	10.3
INVESTMENT EXPENDITURES	359.9	374.7	377.7	361.8	354.0	353.6	371.1	389.5	404.6	297.8	344.5	367.0	379.7
%CH	11.7	17.5	3.2	-15.8	-8.3	-0.5	21.3	21.4	16.4	22.6	15.7	6.5	3.4
NONRES FIXED EXPEND	235.0	242.4	248.8	253.0	255.8	256.8	259.4	264.6	271.2	190.4	222.1	250.0	263.0
%CH	13.9	13.2	11.0	6.9	4.5	1.6	4.1	8.3	10.4	15.7	16.6	12.6	5.2
PRODUCERS DUR EQUIP	151.0	155.6	159.3	161.6	162.7	162.8	164.4	168.0	173.0	126.5	144.6	159.8	167.1
%CH	12.6	12.8	9.9	5.9	2.8	0.2	4.0	9.1	12.4	17.9	14.2	10.5	4.5
BUSINESS STRUCTURES	84.0	86.8	89.5	91.4	93.1	94.0	95.0	96.6	98.2	63.9	77.5	90.2	96.0
%CH	16.2	14.0	13.0	8.8	7.6	3.9	4.3	6.9	6.8	11.5	21.3	16.4	6.4
RES FIXED EXPEND	112.5	112.3	109.5	104.8	100.2	103.3	109.4	116.5	123.6	91.9	106.8	106.7	113.2
%CH	13.5	-0.7	-9.6	-16.1	-16.4	13.0	25.8	28.6	26.7	34.8	16.2	-0.1	6.1
INVENTORY CHANGE	12.4	20.0	19.4	4.0	-2.0	-6.5	2.3	8.4	9.8	15.6	15.7	10.3	3.5
NET EXPORTS	-6.9	-2.4	1.4	3.0	3.0	4.0	5.6	7.2	10.2	-11.2	-11.8	1.3	6.7
GOVT PURCHASES	455.6	464.2	473.0	481.7	494.0	503.1	512.4	521.9	535.2	393.9	434.2	478.2	518.1
%CH	15.2	7.8	7.8	7.6	10.6	7.6	7.6	7.6	10.6	9.6	10.2	10.1	8.3
FEDERAL	163.4	165.3	167.3	169.3	174.8	177.3	179.9	182.5	188.8	145.1	154.0	169.2	182.1
%CH	26.7	4.7	4.9	4.9	13.6	5.8	6.0	5.9	14.5	11.7	6.2	9.8	7.7
MILITARY	102.1	104.0	106.0	108.0	111.9	113.8	115.8	117.8	122.3	94.3	99.5	107.5	117.4
%CH	10.4	7.7	7.9	7.8	15.2	7.0	7.2	7.1	16.2	8.6	5.6	8.0	9.3
OTHER	61.3	61.3	61.3	61.3	62.9	63.5	64.1	64.7	66.5	50.8	54.5	61.7	64.7
%CH	60.1	0.0	0.0	0.0	10.9	3.9	3.8	3.8	11.6	17.9	7.3	13.2	4.9
STATE & LOCAL	292.2	298.9	305.7	312.4	319.2	325.8	332.5	339.4	346.4	248.9	280.2	309.1	336.0
%CH	9.3	9.5	9.4	9.1	9.0	8.5	8.5	8.6	8.5	8.4	12.6	10.3	8.7

NOTE: PERCENTAGE CHANGES AT ANNUAL RATES; PRELIMINARY DATA FOR 78:4

Beryl W. Sprinkel
Executive V.P. & Economist
Harris Trust & Savings Bank, Chicago, Illinois 60690

ECONOMIC OUTLOOK

2/2/79

(BILLIONS OF DOLLARS--SEASONALLY ADJUSTED ANNUAL RATES)

	ACTUAL	FORECAST								YEARS			
	1978:4	1979:1	1979:2	1979:3	1979:4	1980:1	1980:2	1980:3	1980:4	1977	1978	1979	1980
PRETAX PROFITS*	227.0	226.0	222.0	208.6	199.2	196.5	203.9	213.5	223.9	173.9	202.5	214.0	209.3
%CH	49.2	-1.8	-6.9	-22.0	-16.8	-5.3	15.9	20.2	20.1	11.5	16.4	5.7	-2.2
TAX LIABILITY	94.4	90.2	88.6	83.2	78.9	77.8	80.7	84.5	88.5	71.8	83.9	85.2	82.9
%CH	44.0	-16.9	-6.9	-22.0	-19.3	-5.3	15.9	20.2	20.1	11.8	16.8	1.6	-2.7
AFTER TAX PROFITS	132.6	135.8	133.4	125.4	120.3	118.7	123.2	129.0	135.0	102.1	118.6	128.7	126.4
%CH	53.0	10.2	-6.9	-22.0	-15.2	-5.3	15.9	20.2	20.1	11.4	16.1	8.6	-1.8
AFT TAX PROF ADJ[1]	84.9	89.8	88.2	84.4	82.4	80.9	82.0	84.4	89.4	72.3	76.2	86.2	84.1
%CH	33.2	25.5	-7.0	-16.4	-8.9	-7.2	5.4	12.2	26.1	15.3	5.3	13.1	-2.4
PERSONAL INCOME	1786.4	1836.1	1876.1	1911.2	1942.9	1983.8	2040.8	2099.4	2162.1	1529.0	1707.3	1891.6	2071.5
%CH	13.2	11.6	9.0	7.7	6.8	8.7	12.0	12.0	12.5	10.7	11.7	10.8	9.5
TAX & NONTAX PAYMENT	275.0	270.8	277.4	282.8	288.6	296.6	308.5	318.8	331.9	226.0	256.2	279.9	314.0
%CH	19.2	-6.0	10.1	8.0	8.5	11.6	17.1	14.1	17.5	15.0	13.4	9.3	12.2
DISPOSABLE INCOME	1511.4	1565.3	1598.7	1628.4	1654.3	1687.2	1732.3	1780.6	1830.2	1303.0	1451.2	1611.7	1757.6
%CH	12.2	15.1	8.8	7.6	6.5	8.2	11.1	11.6	11.6	10.0	11.4	11.1	9.1
PERSONAL OUTLAYS	1439.2	1474.8	1508.9	1538.9	1567.2	1600.9	1642.4	1687.1	1733.8	1236.1	1374.5	1522.5	1666.1
%CH	14.1	10.3	9.6	8.2	7.6	8.9	10.8	11.3	11.5	10.7	11.2	10.8	9.4
PERSONAL SAVINGS	72.3	90.5	89.8	89.5	87.1	86.3	89.9	93.5	96.4	66.9	76.8	89.2	91.5
%CH	-18.1	145.8	-3.1	-1.4	-10.3	-3.7	17.7	16.9	13.0	-1.7	14.7	16.3	2.5
SAVING RATE(%)	4.8	5.8	5.6	5.5	5.3	5.1	5.2	5.2	5.3	5.1	5.3	5.5	5.2
EMPLOYMENT	95.616	96.041	96.201	95.944	95.859	95.859	96.342	96.997	97.675	90.543	94.381	96.011	96.718
%CH	3.8	1.8	0.7	-1.1	-0.4	0.0	2.0	2.7	2.8	3.5	4.2	1.7	0.7
LABOR FORCE	101.524	102.200	102.800	103.200	103.600	104.000	104.400	104.900	105.500	97.375	100.417	102.950	104.700
%CH	3.1	2.7	2.4	1.6	1.6	1.6	1.5	1.9	2.3	2.8	3.1	2.5	1.7
UNEMPLOYMENT RATE(%)	5.833	6.026	6.419	7.031	7.472	7.828	7.718	7.534	7.417	7.025	6.000	6.737	7.624
PRODUCTIVITY*	1.173	1.177	1.177	1.170	1.165	1.165	1.172	1.180	1.188	1.159	1.163	1.172	1.176
%CH	2.4	1.4	0.0	-2.4	-1.7	0.0	2.4	2.8	2.7	1.3	0.4	0.8	0.3
INDUSTRIAL PRODUCTION	1.495	1.507	1.499	1.458	1.432	1.426	1.449	1.477	1.506	1.371	1.450	1.474	1.465
%CH	7.0	3.2	-2.1	-10.5	-6.9	-1.7	6.6	8.0	8.1	5.6	5.8	1.6	-0.6
MONETARY BASE-(MB)	141.433	144.300	145.800	147.300	149.200	151.900	155.000	158.200	161.600	124.850	136.667	146.650	156.675
%CH	9.9	8.4	4.2	4.2	5.3	7.4	8.4	8.5	8.9	8.3	9.5	7.3	6.8
VELOCITY OF MB	15.631	15.742	15.905	15.896	15.904	15.897	16.019	16.154	16.287	15.114	15.409	15.862	16.089
%CH	4.4	2.9	4.2	-0.2	0.2	-0.2	3.1	3.4	3.3	2.4	2.0	2.9	1.4
MONEY SUPPLY-(M2)	869.967	880.000	891.000	902.000	918.500	941.700	967.700	994.400	1023.000	779.658	844.642	897.875	981.700
%CH	7.7	4.7	5.1	5.0	7.5	10.5	11.5	11.5	12.0	10.7	8.3	6.3	9.3
VELOCITY OF M2	2.541	2.581	2.603	2.596	2.583	2.564	2.566	2.570	2.573	2.420	2.493	2.591	2.568
%CH	6.6	6.5	3.3	-1.0	-1.9	-2.9	0.3	0.6	0.4	0.3	3.0	3.9	-0.9

NOTE: PROFITS FOR 78:4 ARE ESTIMATES; PRODUCTIVITY IS MEASURED AS OUTPUT PER HOUR--NONFARM BUSINESS
1) AFTER TAX PROFITS ADJUSTED TO EXCLUDE INVENTORY PROFITS AND ALLOW FOR DEPRECIATION AT REPLACEMENT COST

Beryl W. Sprinkel
Executive V.P. & Economist
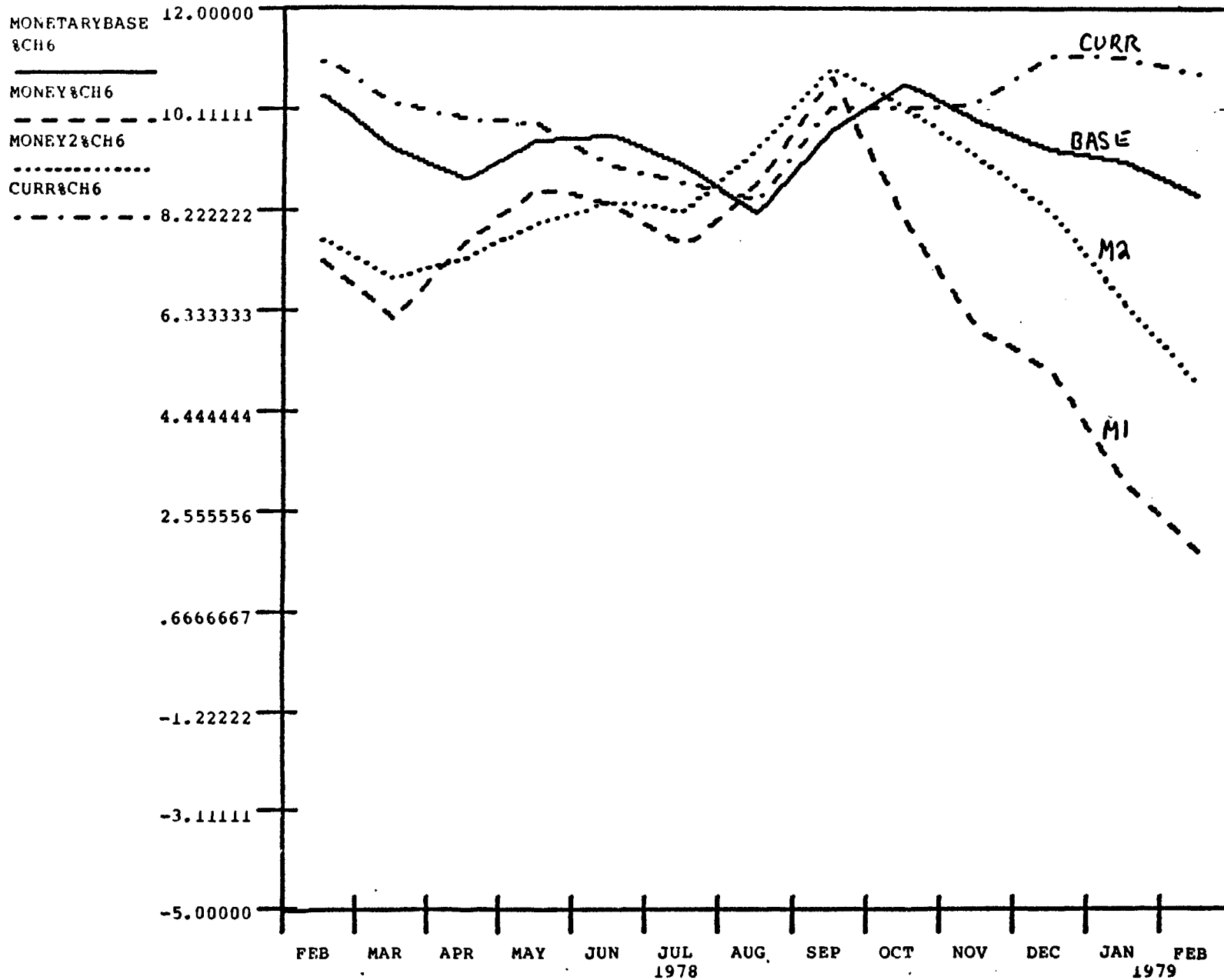Harris Trust & Savings, Chicago, Illinois 60690

2/2/79   ECONOMIC OUTLOOK

	ACTUAL	FORECAST								YEARS			
	1978:4	1979:1	1979:2	1979:3	1979:4	1980:1	1980:2	1980:3	1980:4	1977	1978	1979	1980
INTEREST RATES													
NEW ISSUE AA INDUS BONDS	9.000	9.200	10.000	10.000	9.750	9.500	9.250	9.000	9.000	7.918	8.735	9.738	9.188
NEW ISSUE AA UTIL BONDS	9.370	9.700	10.300	10.300	10.000	9.900	9.600	9.400	9.400	8.325	9.098	10.075	9.575
PRIME RATE	10.793	11.750	12.500	11.750	11.000	10.000	9.000	8.000	8.000	6.824	9.052	11.750	8.750
COMMERCIAL PAPER 4-6 MOS.	9.897	10.600	12.000	11.000	10.000	9.000	8.000	7.000	7.000	5.612	7.994	10.900	7.750
AUTO SALES 1)	11.100	10.800	10.676	10.108	9.317	9.390	9.990	10.590	11.310	11.184	11.293	10.225	10.320
DOMESTIC	9.200	9.000	8.900	8.400	7.740	7.800	8.300	8.800	9.400	9.132	9.305	8.510	8.575
IMPORTS	1.900	1.800	1.776	1.708	1.577	1.590	1.690	1.790	1.910	2.066	1.992	1.715	1.745
HOUSING STARTS 1)	2.129	1.900	1.830	1.700	1.500	1.600	1.800	1.900	1.950	1.967	2.009	1.733	1.813

1) IN MILLIONS OF UNITS--SEASONALLY ADJUSTED ANNUAL RATES

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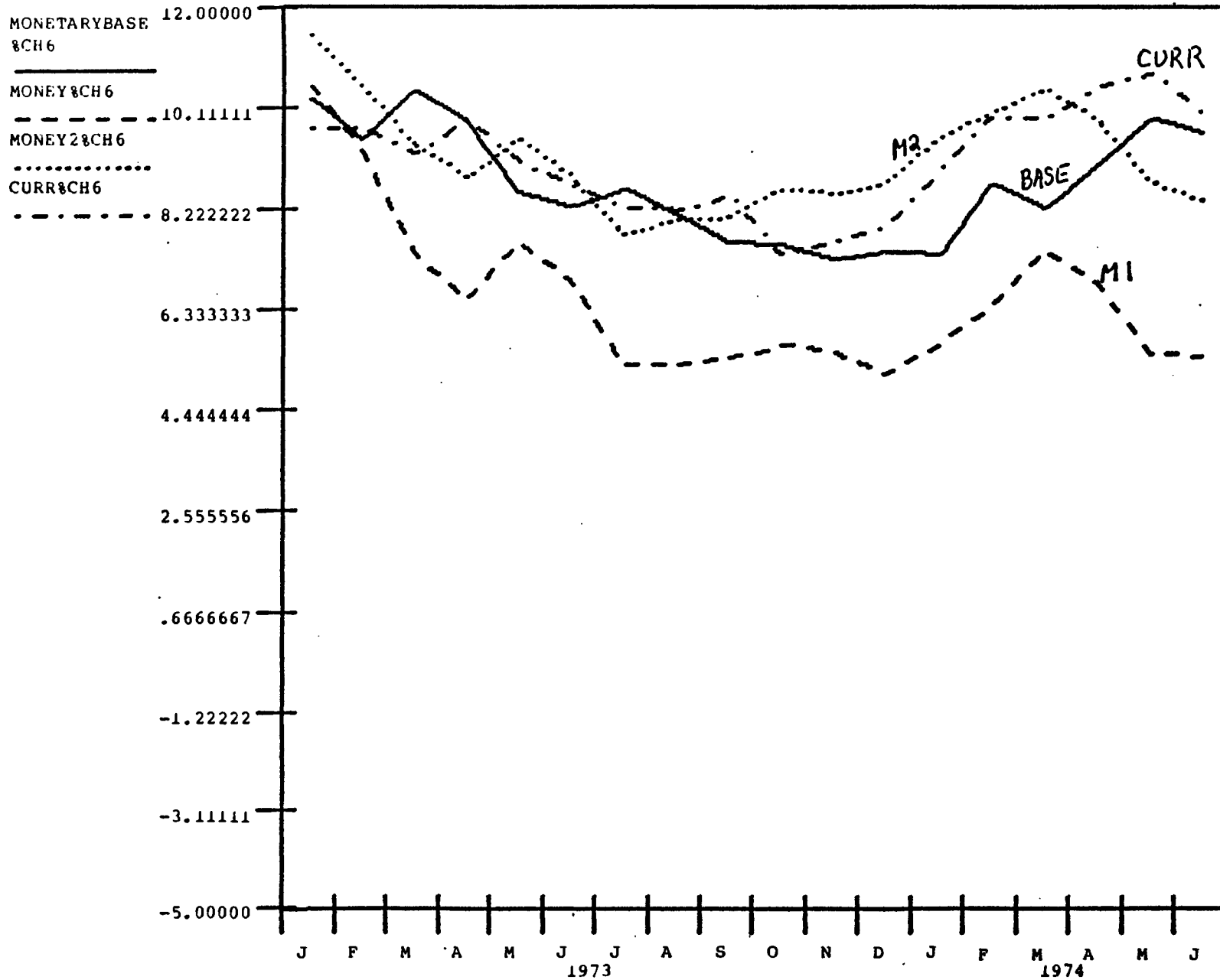
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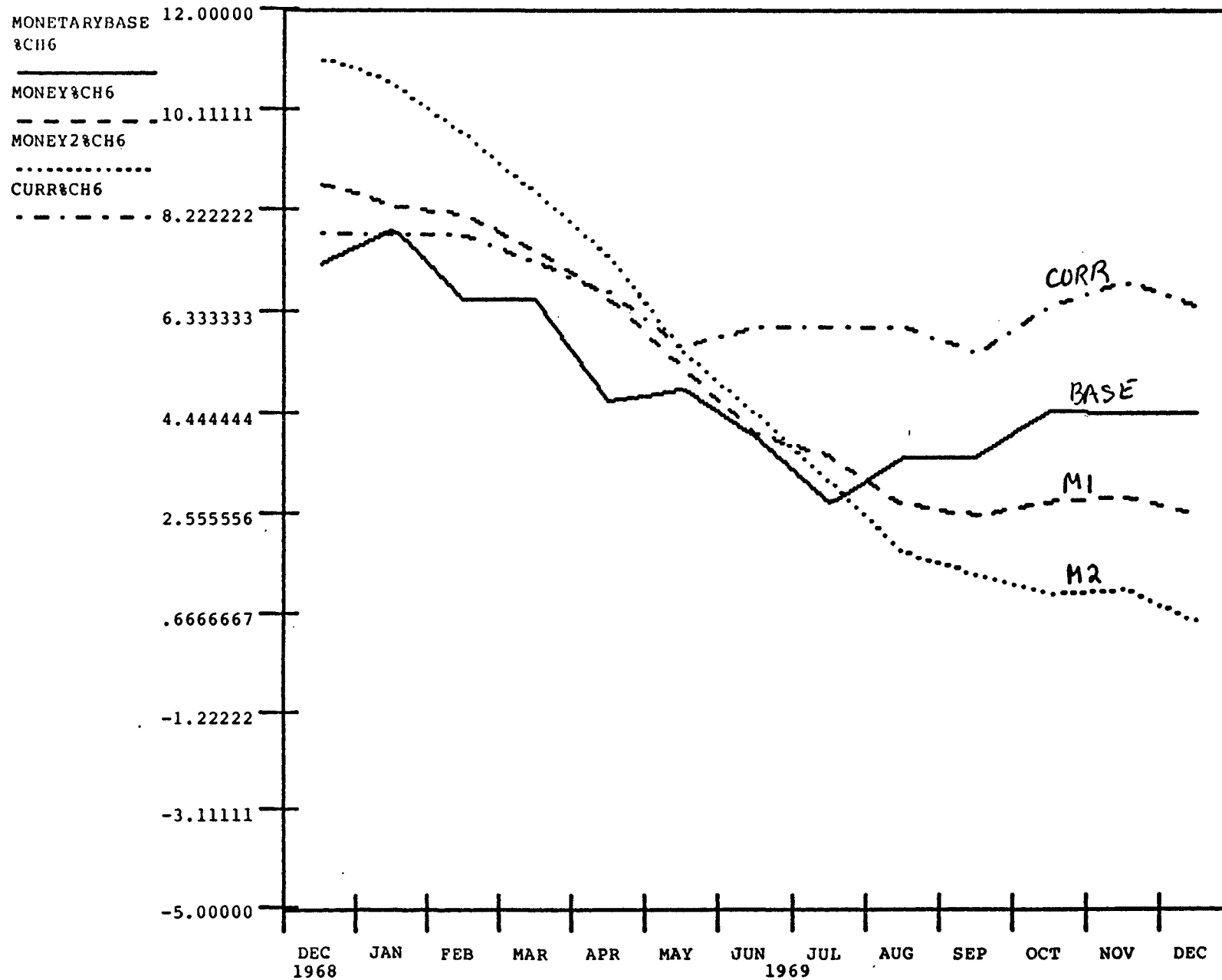
Prices of key industrial commodities have been moving up with explosive force in re-
cent weeks. The 12% annual rate of increase in the producer price index for finished
goods that was reported yesterday by the Bureau of Labor Statistics is, in fact, only
the tip of the iceberg. According to the BLS, the weekly index of sensitive spot
commodity prices averaged 271.1 (1967=100) during the four weeks ended March 6, up at
an 82.6% compound annual rate from the average of 258.85 in the four weeks ended
February 6. Since the beginning of January, this index has advanced at a 50% com-
pound annual rate. Most disturbing in this week's report were increases of 2.9% (in
one week) in livestock prices, and a 5.2% surge in metals prices (copper, lead, and
steel scrap, as well as tin and zinc).

When combined with the continuing evidence of strong demand for short-term credit,
the explosion in materials prices since the first of the year suggests to us that
some of the economic distortions that normally characterize a cyclical peak in the
economy are now starting to come into view. Total commercial paper outstanding av-
eraged $86.8-billion in the four weeks ended on March 7, up at a 42.8% seasonally
adjusted compound annual rate from the prior four-week period, and up at a 44.1%
annual rate over the past three months. In the week ended February 28, the Morgan
Stanley proxy for total short-term business credit outstanding rose $942-million, and
now stands $3.4-billion higher than at the beginning of the year. Against this
background, it is very likely that some anticipatory inventory accumulation is now
under way on the part of businessmen trying to hedge expected future price increases.
Certainly it has been profitable to borrow money at an effective cost ranging be-
tween 10% and 14% in order to buy materials whose prices have been rising at roughly
triple that rate. Furthermore, the full impact of the tightening of world oil sup-
plies due to the Iranian crisis has yet to hit the American economy.

At the same time, the monetary data rein-
force our belief that Federal Reserve poli-
cy is belatedly swinging sharply in the
direction of restraint. The annual rate
of increase in the monetary base, which
was 10% from December 1977 through October
1978, dropped to 6.5% from October through
February. Since the public's holdings of
currency have continued to rise at a 10%
annual rate in this period, growth in the
reserve base of the banking system has
been brought to a halt. The slowdown in
bank reserve growth, about which we have
commented repeatedly in recent weeks, is
in our opinion the most important influence
on the overall deceleration in monetary
expansion. Figure 1 on page 3, which de-
picts the procyclical record of Federal Re-
serve monetary policy, shows the downturn
in the underlying rate of money growth that
the central bank is now starting to imple-
ment. (The underlying rate of expansion

CONTENTS

in M-1 was 7.32% for the 12 months ended February 1979, down significantly from the peak rate of 7.99% for the 12 months ended September 1978.) Since this is a measure of M-1 (currency and most demand deposits), it is indeed distorted by the structural changes in the banking system that took place last November -- the introduction of the automatic transfer service and the shift in Treasury cash management practices. However, the more broadly defined aggregates, which are much less affected by these changes, also have slowed down.

Federal Reserve Data

(Weekly Averages of Daily Figures; in Millions of Dollars)

	Latest Week	Change From Prev. Week	Rates of Change Over 3 Months	6 Months	1 Year
Money Supply (M-1)* (1)	$356,500	$- 1,700	- 2.3%	+ 1.1%	+ 4.8%
M-1-Plus* (1)	577,400	- 1,400	- 5.3	- 1.3	+ 2.5
Money Supply Plus Comm'l Bank Time Deposits Other Than Large CDs (M-2)* (1)	876,000	- 700	+ 1.3	+ 4.7	+ 7.0
Monetary Base* (2)	144,200	+ 500	+ 6.4	+ 8.1	+ 8.3
Adjusted Federal Reserve Credit* (2)	125,400	+ 200	+ 9.1	+10.7	+ 9.8
Total Effective Bank Reserves* (1)	44,500	- 600	- 0.7	+ 3.7	+ 5.0
Member Bank Borrowing (2)	1,026	- 58	NA	NA	NA
Wednesday Figures					
Short-Term Business Credit (1) R	228,522	+ 942	N/AV	N/AV	N/AV
Total Commercial Paper Outstanding* (1)	87,903	+ 1,397	+41.4	+31.3	+31.1
Business Loans:					
All Large Banks (1) R	133,949	+ 358	N/AV	N/AV	N/AV
New York City Banks* (2)	38,451	+ 64	+ 2.2	+12.6	+12.2
Chicago Banks (2) R	13,478	- 27	N/AV	N/AV	N/AV

R = Series Revised; Figures are not comparable with those published during 1978.

*Seasonally Adjusted   NA = Not Applicable   N/AV = Not Available

Rates of change are compound annual rates. Short-term business credit includes commercial and industrial loans at large banks plus loans sold to affiliates less bankers' acceptances and commercial paper held in portfolio plus loans at large banks to finance companies and nonbank financial institutions plus nonbank commercial paper.

(1) February 28   (2) March 7

Figure 1

The Cyclical Record of Federal Reserve Policy
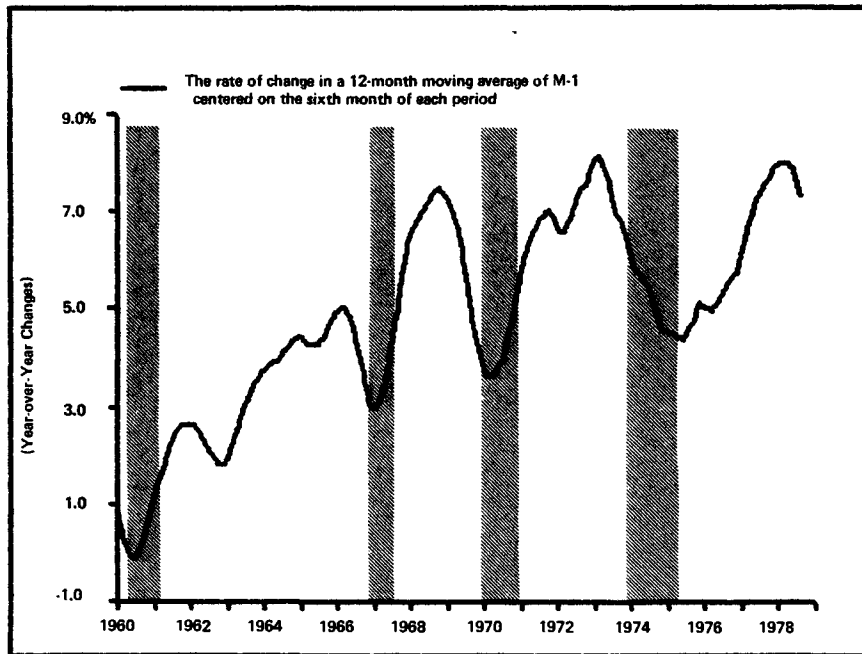
Shaded areas represent periods of recession as designated by the National Bureau of Economic Research except for the mini-recession of 1966-1967.

Sources: Chase Econometric Associates Data Base; Morgan Stanley Research

In our opinion, a confrontation is developing between an apparent surge of aggregate demand and the belated resolve of the monetary authorities to bring a clearly excessive rate of increase in total spending under control. In time, this will inevitably lead to a deceleration in the growth of final demand (GNP less the change in inventories). As businessmen perceive the shift in their sales prospects, they will begin to move to trim their inventories by cutting back production, thus initiating a contraction in aggregate economic activity. However, we are not yet at that point, and before the economy reaches its crest, pressures in the financial markets are likely to intensify. Short-term interest rates should rise above present levels, thus leading to an even sharper downward slope in the yield curve. We continue to believe that the Federal funds rate will <u>average</u> between 10.5% and 11.5% over the next three months, and in individual weeks it could easily reach levels well above that range.

A RETURN TO SELECTIVE CONTROLS?

It is very clear that the monetary authorities -- despite their repeated assertions that they wish to slow total spending in such a manner to avoid a reduction in aggregate real output -- are now becoming impatient. They are obviously, and correctly, concerned with the explosive behavior of the price level. But they seem unwilling to wait for a gradual unwinding of the excess demand that they have helped to create. In the first instance, the authorities are plainly ignoring the monetary growth targets that Mr. Miller announced just two weeks ago (see Tables 1 and 2 on page 4). The current levels of both M-1 and M-2 are far below the lower ends of the ranges

Table 1

Targets for Monetary Growth: M-1
($ Billions)

Date	M-1 (Actual)	Target #16 Upper +4.5%	Target #16 Lower +1.5%	Target #15 Upper +6.0%	Target #15 Lower +2.0%	Target #14 Upper +6.5%	Target #14 Lower +4.0%	Target #13 Upper +6.5%	Target #13 Lower +4.0%	Target #12 Upper +6.5%	Target #12 Lower +4.0%	Target #11 Upper +6.5%	Target #11 Lower +4.0%
7/77	$328.7												
8/77	330.6											$330.8	$330.8
9/77	333.1											332.6	331.9
10/77	335.4											334.4	333.0
11/77	336.5									$336.9	$336.9	336.2	334.1
12/77	338.7									338.7	338.0	338.0	335.2
1/78	341.9									340.5	339.1	339.8	336.3
2/78	342.4							$342.5	$342.5	342.3	340.2	341.6	337.4
3/78	343.2							344.4	343.6	344.2	341.4	343.3	338.5
4/78	347.9							346.2	344.8	346.0	342.5	345.1	339.6
5/78	350.7					$350.4	$350.4	348.1	345.9	347.8	343.6	346.9	340.7
6/78	352.5					352.3	351.5	349.9	347.1	349.6	344.7	348.7	341.8
7/78	354.5					354.2	352.7	351.8	348.2	351.5	345.8	350.5	342.9
8/78	357.0			$357.5	$357.5	356.1	353.9	353.6	349.3	353.3	347.0	352.3	344.0
9/78	361.1			359.3	358.1	358.0	355.0	355.5	350.5	355.1	348.1	354.1	345.1
10/78	361.6			361.1	358.7	359.9	356.2	357.3	351.6	356.9	349.2		
11/78	361.0	$361.4	$361.4	362.9	359.3	361.8	357.4	359.2	352.8	358.8	350.3		
12/78	361.5	362.7	361.8	364.7	359.9	363.7	358.5	361.1	353.9	360.6	351.5		
1/79	359.9	364.1	362.3	366.5	360.5	365.5	359.7	362.9	355.1				
2/79	358.8	365.4	362.7	368.3	361.1	367.4	360.9	364.8	356.2				
3/79		366.8	363.2	370.0	361.7	369.3	362.0	366.6	357.3				
4/79		368.1	363.6	371.8	362.3	371.2	363.2						
5/79		369.5	364.1	373.6	362.9	373.1	364.4						
6/79		370.9	364.5	375.4	363.5	375.0	365.5						
7/79		372.2	365.0	377.2	364.1								
8/79		373.6	365.4	379.0	364.7								
9/79		374.9	365.9	380.8	365.3								
10/79		376.3	366.3										
11/79		377.6	366.8										
12/79		379.0	367.2										

Target #11 was established by the Federal Open Market Committee on October 18, 1977; Target #12, on February 28, 1978; Target #13, on April 18; Target #14, on July 18; Target #15, on October 17; and Target #16, on February 6, 1979.

Sources: Federal Reserve Board; Morgan Stanley Research

Table 2

Targets for Monetary Growth: M-2
($ Billions)

Date	M-2 (Actual)	Target #16 Upper +8.0%	Target #16 Lower +5.0%	Target #15 Upper +9.0%	Target #15 Lower +6.5%	Target #14 Upper +9.0%	Target #14 Lower +6.5%	Target #13 Upper +9.0%	Target #13 Lower +6.5%	Target #12 Upper +9.0%	Target #12 Lower +6.5%	Target #11 Upper +9.0%	Target #11 Lower +6.5%
7/77	$783.9												
8/77	789.6											$789.7	$789.7
9/77	795.5											795.6	793.9
10/77	801.2											801.5	798.2
11/77	805.2									$805.3	$805.3	807.4	802.5
12/77	809.4									811.3	809.6	813.4	806.8
1/78	816.0									817.3	814.0	819.3	811.1
2/78	819.4							$819.3	$819.3	823.4	818.4	825.2	815.3
3/78	822.6							825.5	823.8	829.4	822.7	831.1	819.6
4/78	830.3							831.6	828.2	835.5	827.1	837.0	823.9
5/78	836.7					$836.5	$836.5	837.8	832.6	841.5	831.4	843.0	828.2
6/78	842.6					842.8	841.1	843.9	837.1	847.5	835.8	848.9	832.4
7/78	848.7					849.1	845.6	850.1	841.5	853.6	840.2	854.8	836.7
8/78	856.9			$857.3	$857.3	855.4	850.1	856.2	846.0	859.6	844.5	860.7	841.0
9/78	866.2			863.7	861.9	861.6	854.7	862.3	850.4	865.7	848.9	866.7	845.3
10/78	870.9			870.1	866.6	867.9	859.2	868.5	854.8	871.7	853.2		
11/78	874.3	$873.8	$873.8	876.6	871.2	874.2	863.7	874.6	859.3	877.7	857.6		
12/78	876.3	879.7	877.5	883.0	875.8	880.5	868.3	880.8	863.7	883.8	862.0		
1/79	875.4	885.5	881.1	889.4	880.5	886.7	872.8	886.9	868.2				
2/79	877.0	891.3	884.8	895.8	885.1	893.0	877.3	893.1	872.6				
3/79		897.1	888.4	902.3	889.8	899.3	881.8	899.2	877.0				
4/79		903.0	892.0	908.7	894.4	905.5	886.4						
5/79		908.8	895.7	915.1	899.0	911.8	890.9						
6/79		914.6	899.3	921.6	903.7	918.1	895.4						
7/79		920.4	903.0	928.0	908.3								
8/79		926.3	906.6	934.4	913.0								
9/79		932.1	910.2	940.9	917.6								
10/79		937.9	913.9										
11/79		943.7	917.5										
12/79		949.6	921.2										

Target #11 was established by the Federal Open Market Committee on October 18, 1977; Target #12, on February 28, 1978; Target #13, on April 18; Target #14, on July 18; Target #15, on October 17; and Target #16, on February 6, 1979.

Sources: Federal Reserve Board, Morgan Stanley Research

Figure 2

The Underlying Rate of Growth in Federal Spending Slows Down
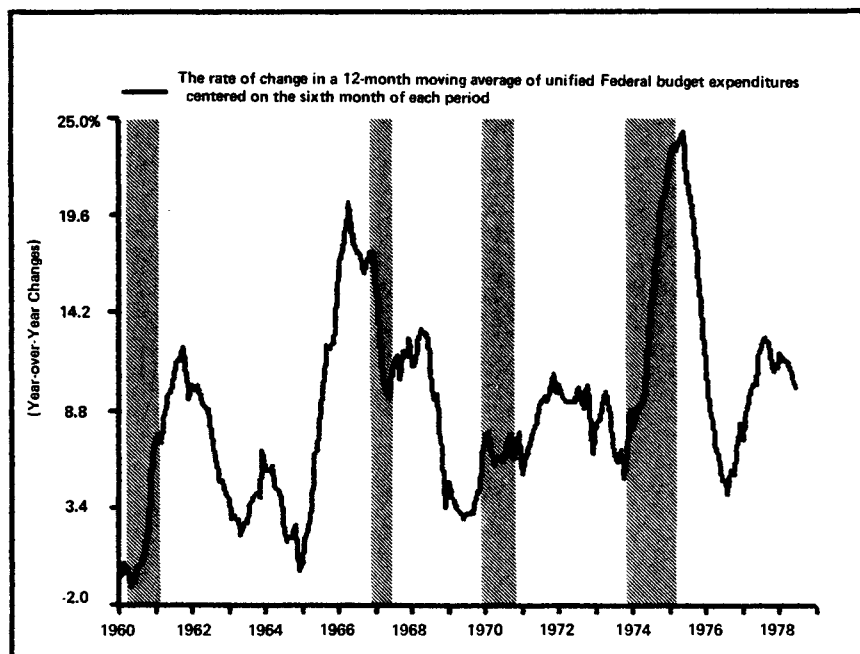
Shaded areas represent periods of recession as designated by the National Bureau of Economic Research except for the mini-recession of 1966-1967.

Sources: Chase Econometric Associates Data Base; Morgan Stanley Research

established by the Federal Open Market Committee, but this has produced no visible action to rectify the situation.

Moreover, in moving to restrict somewhat the interest that banks and thrift institutions can pay on so-called money market certificates (six-month time deposits whose interest rates are tied to the rate on six-month Treasury bills), the authorities have given a strong hint that they are prepared to use selective controls, if necessary, to cool off the economy. All types of deposit institutions have been prohibited from compounding the interest on such instruments (effective March 15), and savings and loan associations will no longer be allowed to pay 25 basis points more than the six-month bill rate. According to one calculation, these changes would reduce the effective yield on a certificate issued by a savings and loan association this week to 9.41% from 10.29%.

The change in the regulations comes at a time when the savings and loan industry, in particular, is heavily overcommitted. Future lending commitments at the end of January totaled $32.9-billion, seasonally adjusted, only slightly below the record peak of $34-billion in November 1978. With the prospect that, at minimum, the inflow of funds from deposits of this type will slow, managers of thrift institutions are likely to curtail sharply their willingness to make additional lending commitments until the present total is worked down to more manageable levels. Then, too, there is the threat that even more severe restrictions on money market certificates might be proposed in the future. Since the total of such deposits is now well in excess of $100-billion, this threat has to be taken seriously. Without debating the theoretical merits or demerits of this approach, there is little question but that in the short run it will have restrictive and destabilizing impact on the flow of funds into the housing market.

THE OUTLOOK FOR TREASURY FINANCING

A key element in the Carter Administration's economic strategy for 1979 is a policy of "fiscal restraint," a marked deceleration in the rate of growth in Federal spending, with cutbacks in social service programs more than offsetting a modest increase in defense outlays. An early result of this effort may just possibly be visible in the drop in the underlying rate of growth in Federal spending that is shown in Figure 2 on page 5. However, we are doubtful that this nascent trend will continue for long, and we are also highly skeptical that Mr. Carter will come anywhere near his goal of a Federal budget deficit of less than $30-billion in the fiscal year that ends on September 30, 1980.

The Administration, of course, has built its projections on the assumption that, to paraphrase Pierre Rinfret's famous prediction, "there ain't gonna be no recession" in 1979 or 1980. This forecast, in our view, is highly questionable; indeed, it would be surprising if a business contraction did not occur. With defense expenditures already programmed on a rising track, a contraction in real activity is likely to prove troublesome for the Administration's budget planners. Contracyclical domestic spending will in all probability be increased, as the impact of both inflation and

Table 3

Federal Financing Requirements - 1978 and Estimated 1979
($ Billions)

	Receipts	Outlays	Surplus + Deficit -	Off-Budget Surplus + Deficit -	Total Financing Required	Change in Cash Balance	Other Miscellaneous Accounts	Borrowing from the Public
1978								
January	$ 33.2	$ 36.9	$- 3.7	$- 1.2	$+ 4.9	$+ 0.2	$- 0.9	$+ 6.0
February	26.9	33.9	- 7.0	- 1.3	+ 8.3	- 5.2	- 2.0	+ 5.1
March	25.2	40.4	-15.1	- 1.2	+16.3	- 1.0	+ 5.6	+ 9.7
April	42.5	35.9	+ 6.6	- 0.6	- 6.0	+ 3.3	- 0.4	- 2.3
May	35.1	36.8	- 1.7	- 1.0	+ 2.7	- 6.4	- 3.1	- 0.6
June	47.7	38.6	+ 9.1	- 0.7	- 8.4	+14.1	+ 0.3	+ 5.4
July	29.2	36.4	- 7.2	- 0.8	+ 8.0	- 5.8	- 7.0	+ 3.2
August	35.0	39.6	- 4.5	- 1.6	+ 6.1	+ 1.0	- 2.0	+ 9.0
September	42.6	38.9	+ 3.7	- 0.8	- 2.9	+ 9.7	+ 4.0	+ 2.8
October	28.7	42.7	-13.9	- 0.8	+14.7	- 7.1	+ 1.2	+ 6.5
November	33.2	39.1	- 5.9	+ 1.4	+ 4.5	- 3.5	- 4.2	+ 5.2
December	37.5	41.4	- 3.9	- 0.7	+ 4.6	+ 2.3	+ 3.4	+ 3.5
Total	$416.8	$460.3	$-43.5	$- 9.3	$+52.8			$ 53.5
1979								
January	$ 38.4	$ 41.1	$- 2.7	$- 1.0	$+ 3.7	$+ 0.2	$+ 0.6	$+ 3.3
February	30.8	37.7	- 6.9	- 0.9	+ 7.8	- 2.2	- 0.5	+ 6.1
March	30.7	41.2	-10.5	- 1.1	+11.6	- 2.0	+ 1.2	+ 8.4
April	49.1	42.6	+ 6.5	- 0.3	- 6.2	+ 6.4	+ 1.1	- 0.9
May	31.9	39.4	- 7.5	- 0.6	+ 8.1	- 6.8	+ 1.2	+ 0.1
June	52.8	40.0	+12.8	- 0.4	-12.4	+ 7.7	- 1.4	- 3.3
July	31.7	42.3	-10.6	- 1.0	+11.6	- 7.2	- 2.8	+ 7.2
August	37.7	41.2	- 3.5	- 1.2	+ 4.7	+ 0.2	- 2.7	+ 7.6
September	44.8	40.7	+ 4.1	- 0.6	- 3.5	+ 8.8	+ 2.1	+ 3.2
October	29.8	46.2	-16.4	- 1.2	+17.6	- 4.9	+ 2.3	+10.4
November	34.6	43.0	- 8.4	- 0.1	+ 8.5	- 3.3	- 2.4	+ 7.6
December	40.0	44.0	- 4.0	- 1.1	+ 5.1	+ 3.3	+ 1.6	+ 6.8
Total	$452.3	$499.4	$-47.1	$- 9.5	$+56.6			$ 56.5

Sources: United States Treasury; Federal Reserve Board; Morgan Stanley Research Estimates

Figure 3

The Steady Downtrend of the Money Multiplier...
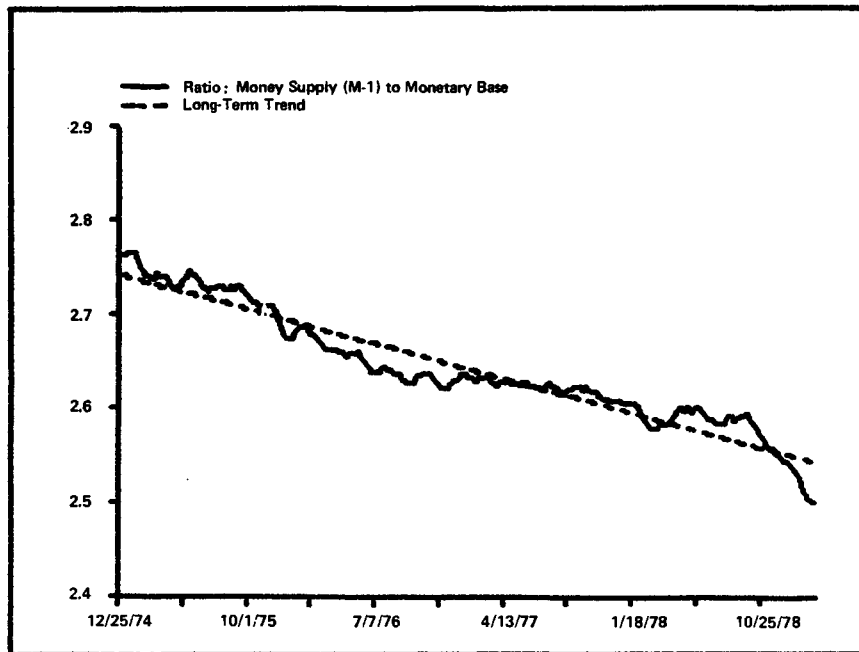
Sources: Chase Econometric Associates Data Base; Morgan Stanley Research

recession on the rate of increase in transfer payments is likely to be considerable. For instance, Social Security cost-of-living adjustments in July will add significantly to the bill for transfer payments, while lower levels of employment and income will lead to rises in unemployment benefits and spending for such programs as food stamps. In addition, if the economy weakens as we anticipate, a tax cut is likely to be proposed to take effect early in 1980.

The net result of these considerations is shown in Table 3 on page 6, which tracks our expectations for the Federal budget month-by-month during calendar year 1979. We expect that the unified budget deficit this year will be approximately $47.1-billion, and that the off-budget agencies -- chiefly the Post Office and the Federal Financing Bank -- will contribute another $9.5-billion or so to a total Federal financing requirement of $56.5-billion. Because of the uncertainties involved in forecasting monthly changes in the Treasury cash balance well into the future - to say nothing of the highly volatile "miscellaneous" accounts -- the specific monthly forecasts have to be treated with considerable caution. However, we are convinced that the overall pattern conforms closely to the most probable outlook for the Federal budget at the present time.

FEDERAL RESERVE ACTION AND MONETARY GROWTH

One of the key uncertainties at the present time concerns the relationship between the policy tools that are under the direct control of the authorities -- of which the most important is the monetary base -- and the rate of monetary expansion, and,
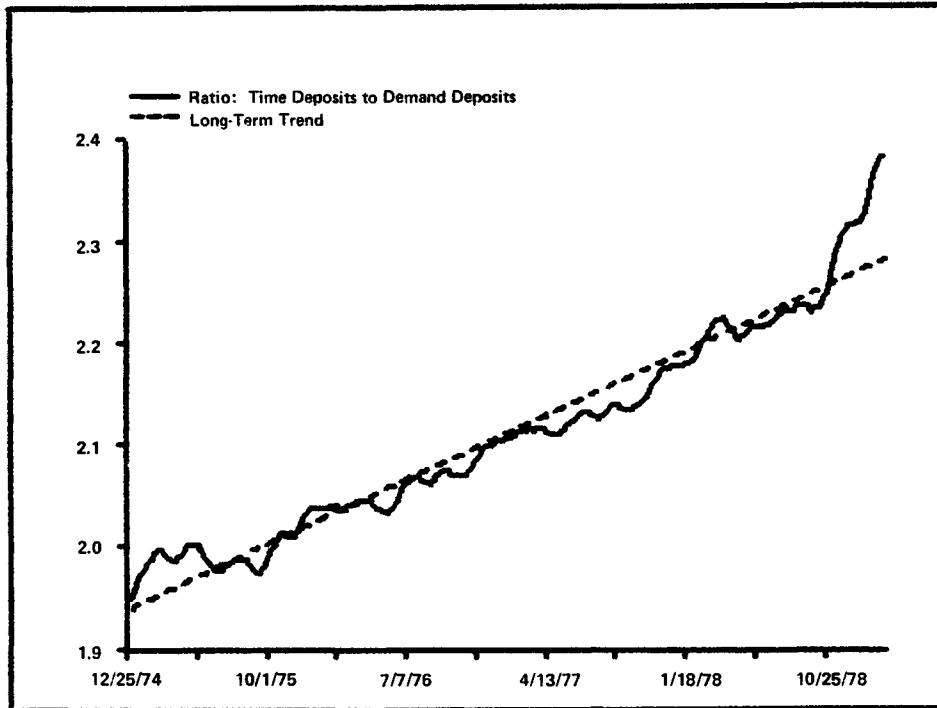
Figure 4

Can be Traced to the Rapid Rise in Public Holdings of Currency...

- Ratio: Currency to Demand Deposits
- Long-Term Trend
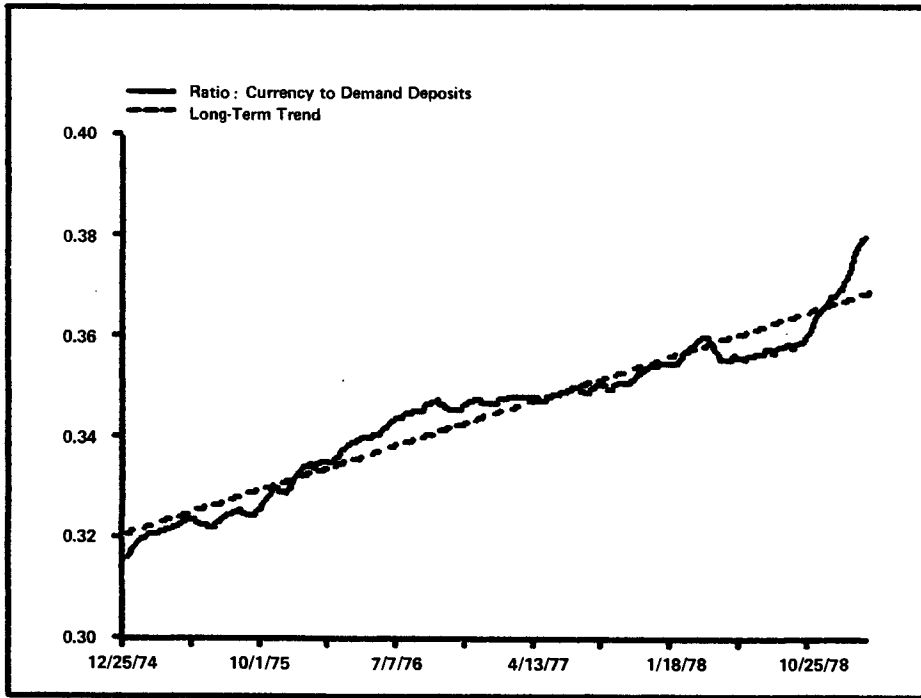
Sources: Chase Econometric Associates Data Base; Morgan Stanley Research

Figure 5

Increased Holdings of Time Deposits...

- Ratio: Time Deposits to Demand Deposits
- Long-Term Trend
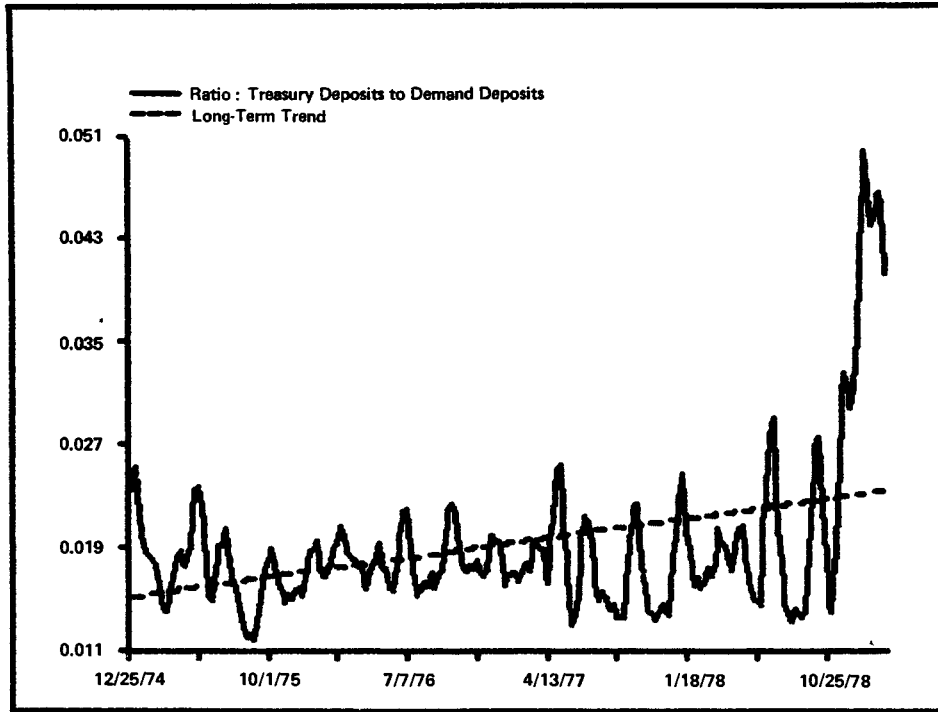
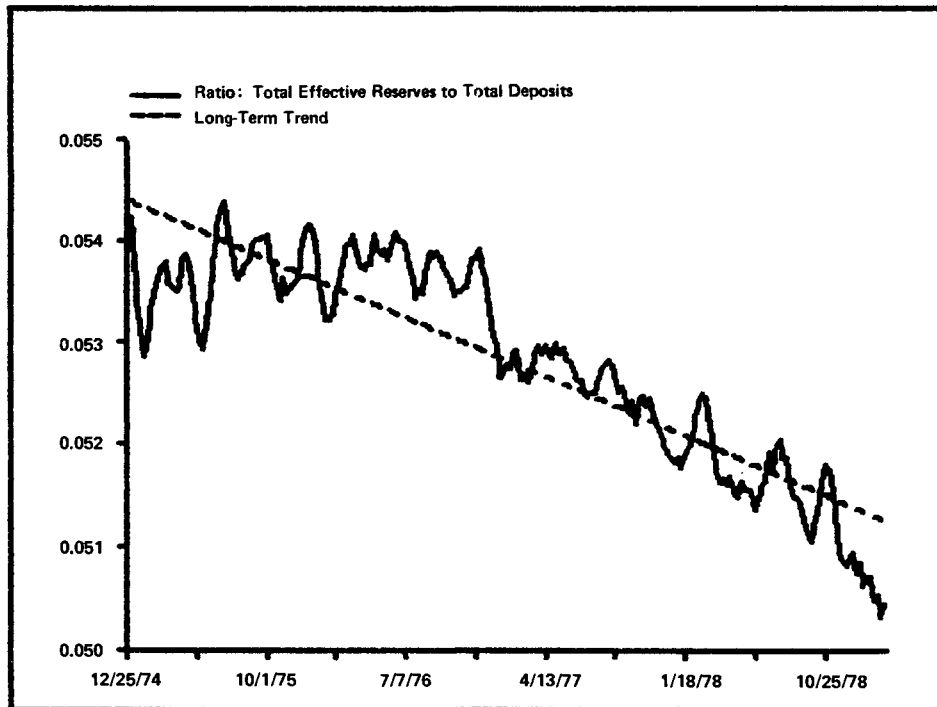Sources: Chase Econometric Associates Data Base; Morgan Stanley Research

Figure 6

And a Sharp Jump in Treasury Deposits in Private Commercial Banks...

Sources: Chase Econometric Associates Data Base; Morgan Stanley Research

Figure 7

...Partially Offset by a Drop in Effective Reserve Requirements

Sources: Chase Econometric Associates Data Base; Morgan Stanley Research

Table 4

Federal Reserve Action and Monetary Growth
($ Billions)

Date Four Weeks Ended	(1) Monetary Base	(2) Currency	(3) Total Effective Bank Reserves (1-2)	(4) Demand Deposits	(5) Total Time Deposits	(6) Treasury Deposits	(7) Total Deposits (4+5+6)	(8) Adjusted Reserve Ratio (3/7)	(9) Currency Ratio (2/4)	(10) Time Deposit Ratio (5/4)	(11) Treasury Deposit Ratio (6/4)	(12) Money Multiplier (2+4/1)
Jul 5 '78	$136.6	$92.7	$43.9	$260.6	$577.7	$ 7.2	$845.5	0.0519	0.3557	2.2167	0.0275	2.5869
12	136.6	92.9	43.8	260.9	578.8	7.6	847.2	0.0517	0.3560	2.2187	0.0289	2.5884
19	137.0	93.0	44.0	260.9	580.2	5.4	846.5	0.0520	0.3563	2.2235	0.0208	2.5837
26	137.2	93.1	44.1	261.3	581.6	4.8	847.6	0.0520	0.3563	2.2262	0.0183	2.5830
Aug 2	137.2	93.2	44.0	261.2	582.7	3.8	847.7	0.0518	0.3569	2.2310	0.0145	2.5836
9	137.4	93.4	44.0	261.5	583.8	3.6	848.9	0.0519	0.3571	2.2327	0.0136	2.5828
16	137.5	93.6	43.9	262.4	585.1	3.5	850.9	0.0516	0.3566	2.2298	0.0131	2.5892
23	137.7	93.8	43.9	262.9	586.3	3.7	852.8	0.0515	0.3569	2.2305	0.0140	2.5901
30	138.0	94.0	44.0	262.9	587.7	3.6	854.2	0.0515	0.3577	2.2358	0.0138	2.5861
Sep 6	138.3	94.3	44.0	263.6	589.2	3.6	856.3	0.0514	0.3578	2.2352	0.0135	2.5872
13	138.6	94.6	44.0	264.2	590.7	3.7	858.6	0.0512	0.3579	2.2355	0.0138	2.5892
20	138.9	94.9	44.0	265.0	592.1	4.9	861.9	0.0511	0.3580	2.2349	0.0183	2.5904
27	139.3	95.1	44.2	266.1	593.3	5.9	865.3	0.0511	0.3574	2.2293	0.0222	2.5936
Oct 4	139.7	95.3	44.4	266.2	594.2	7.1	867.5	0.0512	0.3579	2.2322	0.0268	2.5880
11	140.0	95.5	44.6	266.4	594.9	7.3	868.6	0.0513	0.3584	2.2335	0.0274	2.5838
18	140.4	95.6	44.8	266.5	595.6	5.9	868.0	0.0516	0.3587	2.2348	0.0222	2.5795
25	140.6	95.7	44.9	265.9	596.8	4.9	867.6	0.0518	0.3600	2.2446	0.0184	2.5709
Nov 1	140.8	95.9	44.9	265.7	598.6	3.7	867.9	0.0517	0.3611	2.2532	0.0139	2.5675
8	141.1	96.1	45.0	265.3	601.2	4.3	870.7	0.0517	0.3623	2.2664	0.0162	2.5614
15	141.2	96.3	44.9	264.7	604.1	4.9	873.8	0.0513	0.3638	2.2825	0.0187	2.5574
22	141.3	96.5	44.8	264.7	606.8	6.7	878.2	0.0510	0.3647	2.2929	0.0252	2.5565
29	141.5	96.6	44.9	264.3	608.8	8.6	881.7	0.0509	0.3657	2.3036	0.0323	2.5509
Dec 6	141.7	96.8	44.8	264.1	609.9	8.4	882.3	0.0508	0.3666	2.3094	0.0316	2.5480
13	141.9	97.0	44.9	264.0	610.6	7.8	882.4	0.0509	0.3674	2.3133	0.0296	2.5444
20	142.1	97.1	45.0	264.0	611.0	8.2	883.2	0.0509	0.3677	2.3144	0.0312	2.5419
27	142.2	97.3	44.9	264.0	611.2	9.3	884.5	0.0507	0.3685	2.3152	0.0352	2.5415
Jan 3 '79	142.5	97.4	45.1	264.1	611.6	11.7	887.4	0.0508	0.3690	2.3161	0.0443	2.5361
10	142.7	97.7	45.0	263.8	612.1	13.1	888.9	0.0506	0.3702	2.3207	0.0497	2.5335
17	142.9	97.9	45.0	263.4	613.2	12.2	888.8	0.0507	0.3715	2.3276	0.0462	2.5282
24	143.1	98.1	45.0	262.4	614.8	11.5	888.8	0.0507	0.3736	2.3429	0.0439	2.5190
31	143.1	98.2	44.9	261.0	616.5	11.6	889.1	0.0505	0.3764	2.3625	0.0446	2.5100
Feb 7	143.5	98.5	45.0	260.6	617.9	12.1	890.5	0.0505	0.3778	2.3711	0.0464	2.5028
14	143.4	98.6	44.8	260.3	618.9	11.8	891.0	0.0503	0.3788	2.3780	0.0452	2.5022
21	143.6	98.7	44.9	260.3	619.7	10.4	890.3	0.0505	0.3792	2.3810	0.0401	2.4995
28	143.6	98.9	44.8	259.9	620.4	8.4	888.7	0.0504	0.3803	2.3871	0.0322	2.4978

Sources: Chase Econometric Associates Data Base; Morgan Stanley Research

Table 5

Federal Reserve Action and Monetary Growth

Compound annual rates of change to the average of the four weeks ended on the dates shown in the table from the four-week average ended four weeks earlier.

Date Four Weeks Ended	Monetary Growth (M-1)	(less)	Federal Reserve Actions (Monetary Base)	(equals)	Contribution of the Money Multiplier	This is accounted for by changes in the: Adjusted Reserve Ratio	Currency Ratio	Time Deposit Ratio	Treasury Deposit Ratio
Jul 5 '78	7.36%		14.61%		- 7.25%	-4.78%	- 0.18%	-0.45%	-1.84%
12	6.17		11.88		- 5.71	-2.12	- 0.86	-0.71	-2.03
19	5.00		11.05		- 6.05	-3.27	- 1.52	-1.35	0.09
26	5.86		10.77		- 4.90	-3.38	- 0.80	-1.45	0.73
Aug 2	4.12		5.86		- 1.74	0.40	- 2.00	-1.96	1.82
9	4.41		7.37		- 2.97	-1.37	- 1.83	-1.92	2.15
16	7.80		4.85		2.95	3.26	- 0.50	-0.84	1.02
23	8.87		5.09		3.78	4.70	- 0.93	-0.56	0.57
30	9.47		8.11		1.36	3.11	- 1.21	-0.64	0.10
Sep 6	11.56		9.11		2.45	3.91	- 1.13	-0.34	0.01
13	10.92		10.92		0.01	0.32	- 0.22	-0.08	-0.01
20	12.11		11.94		0.17	2.40	- 1.36	-0.44	-0.43
27	17.06		12.70		4.36	4.00	0.63	0.93	-1.19
Oct 4	13.90		13.46		0.44	2.00	- 0.21	0.41	-1.75
11	11.43		14.49		- 3.06	-0.66	- 0.74	0.29	-1.95
18	8.64		14.72		- 6.08	-4.28	- 1.25	0.01	-0.57
25	1.36		13.62		-12.26	-6.30	- 4.37	-2.12	0.52
Nov 1	0.36		11.25		-10.89	-4.74	- 5.08	-2.85	1.78
8	- 1.60		10.20		-11.80	-2.83	- 6.15	-4.35	1.52
15	- 3.96		7.42		-11.38	2.19	- 7.88	-6.17	0.47
22	- 1.52		5.93		- 7.45	7.68	- 7.64	-6.55	-0.94
29	- 2.22		6.41		- 8.64	8.02	- 7.40	-6.75	-2.50
Dec 6	- 1.52		5.43		- 6.95	7.93	- 6.99	-5.78	-2.10
13	- 0.18		6.64		- 6.82	4.20	- 5.55	-4.02	-1.44
20	- 0.36		7.37		- 7.73	0.32	- 4.54	-2.75	-0.77
27	1.18		6.14		- 4.96	1.16	- 4.25	-1.50	-0.37
Jan 3 '79	2.18		8.58		- 6.40	-0.18	- 3.70	-0.88	-1.65
10	1.72		7.58		- 5.86	2.05	- 4.37	-0.96	-2.58
17	0.72		8.06		- 7.34	2.03	- 5.72	-1.71	-1.95
24	- 2.84		9.05		-11.89	0.39	- 7.68	-3.49	-1.11
31	- 8.13		5.13		-13.26	3.00	-10.58	-5.64	-0.04
Feb 7	- 8.21		7.54		-15.76	0.77	-10.82	-6.11	0.40
14	- 8.30		4.88		-13.18	3.24	-10.50	-6.05	0.12
21	- 5.45		4.64		-10.09	1.94	- 7.89	-4.61	0.48
28	- 1.53		4.88		- 6.40	0.75	- 5.70	-3.01	1.56

Sources: Chase Econometric Associates Data Base; Morgan Stanley Research

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hence, the movements of the overall economy. In particular, there is concern about the quantitative impact of the structural changes in the banking system that were introduced on November 1 and the reported rate of change, for example, in M-1. In Figures 3, 4, 5, 6, and 7 on pages 7, 8, and 9 and Tables 4 and 5 on pages 10 and 11, we attempt to answer this question.

The figures show clearly that the money multiplier (the ratio of M-1 to the monetary base) dropped decisively below its trendline for this business cycle last fall. This slippage was the result (1) of a significant increase in the public's holdings of currency relative to demand deposits, (2) an even sharper rise in time deposits relative to demand deopsits, and (3) a spectacular jump in the Treasury's cash balances in private commercial banks. These moves were only partially offset by a continuing, long-term drop in the level of effective reserve requirements in the banking system, reflecting the growth of time deposits relative to demand deposits.

In quantitative terms the largest contribution to the reported slowdown in the reported rate of growth of M-1 came from the Federal Reserve policy actions in reducing the rate of growth of the monetary base. Of the four other factors -- the currency ratio, the time deposit ratio, the Treasury deposit ratio, and reserve ratio -- by far the dominant influence was the increase in holdings of currency. This reflects the fact that currency growth has held steady at a high level, while the growth of demand deposits and most time deposits has slowed down in response to the sharp tightening of monetary policy by the Federal Reserve.

The interest rates regularly monitored by the Federal Reserve were as follows:

Rate	Daily Average Week Ended February 28	March 7	Change in Basis Points
Federal Funds	10.06%	10.07%	+ 1
90-Day Treasury Bills	9.45	9.41	- 4
90- to 119-Day Commercial Paper	9.96	9.96	--
90-Day CDs (Secondary Market)	10.26	10.14	- 12
90-Day Eurodollars	10.84	10.61	- 23
20-Year Governments	9.12	9.10	- 2

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March 9, 1979

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STATISTICAL APPENDIX - CAPITAL MARKET ACTIVITY

Table 1

Bond Market Volume 1971-1979*

Publicly Offered Nonconvertible Debt
($ Millions)

	1971	1972	1973	1974	1975	1976	1977	1978	1979
January	$ 1,960	$ 2,483	$ 1,130	$ 2,521	$ 3,680	$ 2,670	$ 2,964	$ 1,370	$1,891
February	2,115	1,846	602	2,071	3,759	2,323	1,371	1,212	1,862
March	3,924	1,891	1,662	2,300	3,684	3,267	2,652	2,740	
Total 1st Quarter	$ 7,999	$ 6,220	$ 3,394	$ 6,892	$11,123	$ 8,260	$ 6,987	$ 5,322	
April	$ 1,797	$ 1,876	$ 1,558	$ 2,149	$ 2,866	$ 2,713	$ 2,263	$ 2,591	
May	1,968	1,563	910	2,288	3,844	2,425	1,496	2,328	
June	1,814	1,316	1,502	1,917	4,150	3,610	2,890	1,867	
Total 2nd Quarter	$ 5,579	$ 4,755	$ 3,970	$ 6,354	$10,860	$ 8,748	$ 6,649	$ 6,786	
July	$ 1,547	$ 1,759	$ 1,200	$ 2,065	$ 3,112	$ 1,681	$ 3,053	$ 2,067	
August	1,458	1,420	937	2,018	1,287	1,746	1,825	1,471	
September	2,154	1,296	671	1,025	1,569	2,264	2,104	1,574	
Total 3rd Quarter	$ 5,159	$ 4,475	$ 2,808	$ 5,108	$ 5,968	$ 5,691	$ 6,982	$ 5,112	
October	$ 1,980	$ 1,940	$ 1,699	$ 3,565	$ 2,345	$ 2,857	$ 2,376	$ 2,363	
November	1,882	1,951	1,935	3,111	2,292	2,423	2,478	1,712	
December	1,423	1,390	2,118	2,701	2,537	2,687	1,712	1,094	
Total 4th Quarter	$ 5,285	$ 5,281	$ 5,752	$ 9,377	$ 7,174	$ 7,967	$ 6,566	$ 5,169	
Total	$24,022	$20,731	$15,924	$27,731	$35,125	$30,666	$27,184	$22,389	

*Excludes Federal, state, and local issues as well as tax-exempt pollution control financings; includes a
limited number of underwritten offers by Federal agencies

Source: Morgan Stanley & Co. Incorporated

Table 2

Public Bond Sales; 1977, 1978, and 1979
By Type of Issuer
(\$ Millions)

	Banks & Fin.	For. & Provinc.	Indus-Trials	Tele-phone	Trans-port.	Utility	Misc.	Total
1977								
January	$ 800	$ 300	$ 825	$ 50	$ 379	$ 610	--	$ 2,964
February	265	433	200	280	46	87	$ 60	1,371
March	475	125	635	755	142	420	100	2,652
Total 1st Quarter	$ 1,540	$ 858	$ 1,660	$ 1,085	$ 567	$ 1,117	$ 160	$ 6,987
Percent	22.0%	12.3%	23.8%	15.5%	8.1%	16.0%	2.3%	100.0%
April	$ 750	--	$ 580	$ 275	$ 98	$ 560	--	$ 2,263
May	561	$ 260	150	135	40	250	$ 100	1,496
June	915	800	5	370	118	682	--	2,890
Total 2nd Quarter	$ 2,226	$ 1,060	$ 735	$ 780	$ 256	$ 1,492	$ 100	$ 6,649
Percent	33.5%	15.9%	11.1%	11.7%	3.9%	22.4%	1.5%	100.0%
July	$ 1,180	$ 185	$ 860	$ 42	$ 331	$ 395	$ 60	$ 3,053
August	682	150	400	45	208	340	--	1,825
September	375	475	141	315	190	563	45	2,104
Total 3rd Quarter	$ 2,237	$ 810	$ 1,401	$ 402	$ 729	$ 1,298	$ 105	$ 6,982
Percent	32.0%	11.6%	20.1%	5.8%	10.4%	18.6%	1.5%	100.0%
October	$ 693	$ 300	$ 170	--	$ 48	$ 815	$ 350	$ 2,376
November	515	425	636	$ 282	124	496	--	2,478
December	690	300	161	35	161	340	25	1,712
Total 4th Quarter	$ 1,898	$ 1,025	$ 967	$ 317	$ 333	$ 1,615	$ 375	$ 6,566
Percent	28.9%	15.6%	14.7%	4.8%	5.1%	25.2%	5.7%	100.0%
Total 1977	$ 7,901	$ 3,753	$ 4,763	$ 2,584	$ 1,885	$ 5,558	$ 740	$27,184
Percent	29.1%	13.8%	17.5%	9.5%	6.9%	20.5%	2.7%	100.0%
1978								
January	$ 150	$ 500	$ 75	$ 300	$ 30	$ 315	--	$ 1,370
February	650	--	337	--	60	165	--	1,212
March	675	950	200	275	232	388	$ 20	2,740
Total 1st Quarter	$ 1,475	$ 1,450	$ 612	$ 575	$ 322	$ 868	$ 20	$ 5,322
Percent	27.7%	27.2%	11.5%	10.8%	6.1%	16.3%	0.4%	100.0%
April	$ 1,071	$ 550	$ 431	$ 35	$ 174	$ 330	--	$ 2,591
May	530	650	437	--	196	500	$ 15	2,328
June	351	270	258	250	148	540	50	1,867
Total 2nd Quarter	$ 1,952	$ 1,470	$ 1,126	$ 285	$ 518	$ 1,370	$ 65	$ 6,786
Percent	28.8%	21.7%	16.7%	4.2%	7.6%	20.2%	1.0%	100.0%
July	$ 785	$ 100	$ 258	$ 360	$ 39	$ 525	--	$ 2,067
August	150	125	353	450	18	375	--	1,471
September	35	325	569	185	55	405	--	1,574
Total 3rd Quarter	$ 970	$ 550	$ 1,180	$ 995	$ 112	$ 1,305	--	$ 5,112
Percent	19.0%	10.8%	23.1%	19.5%	2.2%	25.5%	--	100.0%
October	$ 363	$ 750	$ 180	$ 275	--	$ 775	$ 20	$ 2,363
November	500	250	400	400	$ 42	120	--	1,712
December	350	--	359	150	15	120	100	1,094
Total 4th Quarter	$ 1,213	$ 1,000	$ 939	$ 825	$ 57	$ 1,015	$ 120	$ 5,169
Percent	23.5%	19.3%	18.2%	16.0%	1.1%	19.6%	2.3%	100.0%
Total 1978	$ 5,610	$ 4,470	$ 3,857	$ 2,680	$ 1,009	$ 4,558	$ 205	$22,389
Percent	25.1%	20.0%	17.2%	12.0%	4.5%	20.3%	0.9%	100.0%
1979								
January	$ 500	$ 575	$ 325	$ 150	$ 21	$ 220	$ 100	$ 1,891
February	225	610	58	550	44	375	--	1,862
Total Year-to-Date	$ 725	$ 1,185	$ 383	$ 700	$ 65	$ 595	$ 100	$ 3,753
Percent	19.3%	31.6%	10.2%	18.7%	17.3%	15.9%	2.7%	100.0%

Source: Morgan Stanley & Co. Incorporated

Table 3

Public Bond Sales; 1977, 1978, and 1979
By Rating of Issuer
(S Millions)

	Moody's Rating				Unrated	
	Aaa	Aa	A	Baa	or Lower	Total
1977						
January	S 1,709	S 655	S 475	S 125	--	S 2,964
February	713	173	300	50	S 135	1,371
March	1,181	83	912	250	226	2,652
Total 1st Quarter	S 3,603	S 911	S 1,687	S 425	S 361	S 6,987
Percent	51.6%	13.0%	24.1%	6.1%	5.2%	100.0%
April	S 1,175	S 546	S 278	S 140	S 124	S 2,263
May	505	210	230	280	271	1,496
June	1,250	730	255	182	473	2,890
Total 2nd Quarter	S 2,930	S 1,486	S 763	S 602	S 868	S 6,649
Percent	44.1%	22.3%	11.5%	9.1%	13.0%	100.0%
July	S 1,550	S 629	S 400	S 50	S 424	S 3,053
August	250	371	520	190	494	1,825
September	917	481	234	60	412	2,104
Total 3rd Quarter	S 2,717	S 1,481	S 1,154	S 300	S 1,330	S 6,982
Percent	38.9%	21.2%	16.5%	4.3%	19.1%	100.0%
October	S 800	S 283	S 405	S 400	S 488	S 2,376
November	1,097	593	509	26	253	2,478
December	319	660	275	165	293	1,712
Total 4th Quarter	S 2,216	S 1,536	S 1,189	S 591	S 1,034	S 6,566
Percent	33.8%	23.4%	18.1%	9.0%	15.7%	100.0%
Total 1977	S11,466	S 5,414	S 4,793	S 1,918	S 3,593	S27,184
Percent	42.2%	19.9%	17.6%	7.1%	13.2%	100.0%
1978						
January	S 300	S 620	S 200	S 225	S 25	S 1,370
February	319	566	140	150	37	1,212
March	1,299	203	702	288	248	2,740
Total 1st Quarter	S 1,918	S 1,389	S 1,042	S 663	S 310	S 5,322
Percent	36.0%	26.1%	19.6%	12.5%	5.8%	100.0%
April	S 745	S 597	S 470	S 25	S 754	S 2,591
May	675	671	407	220	355	2,328
June	426	552	495	90	304	1,867
Total 2nd Quarter	S 1,846	S 1,820	S 1,372	S 335	S 1,413	S 6,786
Percent	27.2%	26.8%	20.2%	4.9%	20.8%	100.0%
July	S 460	S 664	S 585	S 200	S 158	S 2,067
August	693	400	175	--	203	1,471
September	375	445	419	--	335	1,574
Total 3rd Quarter	S 1,528	S 1,509	S 1,179	S 200	S 696	S 5,112
Percent	29.9%	29.5%	23.1%	3.9%	13.6%	100.0%
October	S 1,275	S 375	S 225	S 235	S 253	S 2,363
November	650	692	230	100	40	1,712
December	400	210	285	75	124	1,094
Total 4th Quarter	S 2,325	S 1,277	S 740	S 410	S 417	S 5,169
Percent	45.0%	24.7%	14.3%	7.9%	8.1%	100.0%
Total 1978	S 7,617	S 5,995	S 4,333	S 1,608	S 2,836	S22,389
Percent	34.0%	26.8%	19.4%	7.2%	12.7%	100.0%
1979						
January	S 1,071	S 530	S 125	S 140	S 25	S 1,891
February	1,059	170	475	100	58	1,862
Total Year-to-Date	S 2,130	S 700	S 600	S 240	S 83	S 3,753
Percent	56.8%	18.7%	16.0%	6.4%	2.2%	100.0%

Source: Morgan Stanley & Co. Incorporated

Table 4

Public Bond Sales; 1977, 1978, and 1979
By Maturity
($ Millions)

	Five to Ten Years	Over Ten Years	Total
1977			
January	$ 625	$ 2,339	$ 2,964
February	478	893	1,371
March	225	2,427	2,652
Total 1st Quarter	$ 1,328	$ 5,659	$ 6,987
Percent	19.0%	81.0%	100.0%
April	$ 575	$ 1,688	$ 2,263
May	360	1,136	1,496
June	890	2,000	2,890
Total 2nd Quarter	$ 1,825	$ 4,824	$ 6,649
Percent	27.4%	72.6%	100.0%
July	$ 925	$ 2,128	$ 3,053
August	150	1,675	1,825
September	300	1,804	2,104
Total 3rd Quarter	$ 1,375	$ 5,607	$ 6,982
Percent	19.7%	80.3%	100.0%
October	$ 368	$ 2,008	$ 2,376
November	515	1,963	2,478
December	50	1,662	1,712
Total 4th Quarter	$ 933	$ 5,633	$ 6,566
Percent	14.2%	85.8%	100.0%
Total 1977	$ 5,461	$21,723	$27,184
Percent	20.1%	79.9%	100.0%
1978			
January	$ 175	$ 1,195	$ 1,370
February	350	862	1,212
March	900	1,840	2,740
Total 1st Quarter	$ 1,425	$ 3,897	$ 5,322
Percent	26.8%	73.2%	100.0%
April	$ 1,070	$ 1,521	$ 2,591
May	450	1,878	2,328
June	487	1,380	1,867
Total 2nd Quarter	$ 2,007	$ 4,779	$ 6,786
Percent	29.6%	70.4%	100.0%
July	$ 560	$ 1,507	$ 2,067
August	175	1,296	1,471
September	406	1,168	1,574
Total 3rd Quarter	$ 1,141	$ 3,971	$ 5,112
Percent	22.3%	77.7%	100.0%
October	$ 550	$ 1,813	$ 2,363
November	450	1,262	1,712
December	475	619	1,094
Total 4th Quarter	$ 1,475	$ 3,694	$ 5,169
Percent	28.5%	71.5%	100.0%
Total 1978	$ 6,048	$16,341	$22,389
Percent	27.0%	73.0%	100.0%
1979			
January	$ 480	$ 1,411	$ 1,891
February	300	1,562	1,862
Total Year-to-Date	$ 780	$ 2,973	$ 3,753
Percent	20.8%	79.2%	100.0%

Source: Morgan Stanley & Co. Incorporated

Table 5

Publicly Offered Convertible Debt
1977, 1978, and 1979
($ Millions)

	Industrials	Banks & Ins.	Transportation	Misc.	Total
1977					
Total 1st Quarter	--	--	--	--	--
April	--	--	$ 50	--	$ 50
May	--	--	--	--	--
June	$ 56	--	--	--	56
Total 2nd Quarter	$ 56	--	$ 50	--	$ 106
Percent	52.8%	--	47.2%	--	100.0%
July	$ 21	--	--	--	$ 21
August	258	--	--	--	258
September	20	--	--	$ 50	70
Total 3rd Quarter	$ 299	--	--	$ 50	$ 349
Percent	85.7%	--	--	14.3%	100.0%
October	--	--	--	--	--
November	$ 15	$ 4	--	--	$ 19
December	11	--	--	--	11
Total 4th Quarter	$ 26	$ 4	--	--	$ 30
Percent	86.7%	13.3%	--	--	100.0%
Total 1977	$ 381	$ 4	$ 50	$ 50	$ 485
Percent	78.6%	0.8%	10.3%	10.3%	100.0%
1978					
Total 1st Quarter	--	--	--	--	--
April	12	$ --	--	--	$ 12
May	--	--	--	--	--
June	$ 70	50	--	--	120
Total 2nd Quarter	$ 82	$ 50	--	--	$ 132
Percent	62.1%	37.9%	--	--	100.0%
July	--	--	--	--	--
August	--	--	--	--	--
September	$ 85	--			$ 85
Total 3rd Quarter	$ 85	--	--	--	$ 85
Percent	100.0%	--	--	--	100.0%
October	$ 100	--	--	--	$ 100
November	12	$ 4	--	$ 10	26
December	6	--		--	6
Total 4th Quarter	$ 118	$ 4	--	$ 10	$ 132
Percent	89.4%	3.0%	--	7.6%	100.0%
Total 1978	$ 285	$ 54	--	$ 10	$ 349
Percent	81.7%	15.5%	--	2.9%	100.0%
1979					
January	--	--	--	--	--
February	--	--	--	--	--

Source: Morgan Stanley & Co. Incorporated

Table 6

Underwritten Public Common Stock Sales; 1977, 1978, and 1979
By Type of Issuer and Issue
(S Millions)

	Banks & Fin.	Indus-Trials	Tele-phone	Utility	Trans.	Secondary Offers	Misc.	Total
1977								
January	--	$ 13	--	$ 257	--	$ 10	$ 9	$ 289
February	$ 36	15	$ 147	182	--	9	--	389
March	5	21	--	537	--	77	7	646
Total 1st Quarter	$ 41	$ 49	$ 147	$ 976	--	$ 96	$ 15	$ 1,324
Percent	3.1%	3.7%	11.1%	73.7%	--	7.2%	1.2%	100.0%
April	$ 114	$ 93	--	$ 74	--	$ 89	--	$ 370
May	3	27	--	868	--	9	--	907
June	103	312	$ 45	192	$ 2	62	--	716
Total 2nd Quarter	$ 220	$ 432	$ 45	$ 1,134	$ 2	$ 160	--	$ 1,993
Percent	11.0%	21.7%	2.3%	56.9%	0.1%	8.0%	--	100.0%
July	--	$ 88	--	$ 228	--	$ 38	--	$ 354
August	$ 105	48	--	59	--	46	--	258
September	216	10	--	--	--	--	$ 2	228
Total 3rd Quarter	$ 321	$ 146	--	$ 287	--	$ 84	$ 2	$ 840
Percent	38.2%	17.4%	--	34.2%	--	10.0%	0.2%	100.0%
October	--	$ 31	--	$ 206	--	$ 22	--	$ 259
November	--	8	$ 718	736	--	6	--	1,468
December	--	26	--	387	--	9	--	422
Total 4th Quarter	--	$ 65	$ 718	$ 1,329	--	$ 37	--	$ 2,149
Percent	--	3.0%	33.4%	61.9%	--	1.6%	--	100.0%
Total 1977	$ 582	$ 477	$ 910	$ 3,726	$ 2	$ 592	$ 17	$ 6,306
Percent	9.2%	7.6%	14.4%	59.1%	0.0%	9.4%	0.3%	100.0%
1978								
January	--	--	--	$ 349	--	$ 71	$ 3	$ 423
February	--	--	--	147	--	--	--	147
March	$ 14	$ 28	--	521	--	1	--	564
Total 1st Quarter	$ 14	$ 28	--	$ 1,017	--	$ 72	$ 3	$ 1,134
Percent	1.2%	2.5%	--	89.7%	--	6.3%	0.3%	100.0%
April	--	$ 12	--	$ 60	$ 19	$ 39	$ 8	$ 138
May	$ 40	34	--	420	--	6	--	500
June	173	158	5	234	--	59	--	629
Total 2nd Quarter	$ 213	$ 204	$ 5	$ 714	$ 19	$ 104	$ 8	$ 1,267
Percent	16.8%	16.1%	0.4%	56.4%	1.5%	8.2%	0.6%	100.0%
July	$ 42	$ 268	$ 24	$ 28	--	$ 52	--	$ 414
August	8	139	7	217	--	144	--	515
September	83	156	--	343	--	70	--	652
Total 3rd Quarter	$ 133	$ 563	$ 31	$ 588	--	$ 266	--	$ 1,581
Percent	8.4%	35.6%	2.0%	37.2%	--	16.8%	--	100.0%
October	$ 19	$ 177	--	$ 583	--	$ 167	--	$ 946
November	--	3	--	394	$ 3	12	$ 2	414
December	5	57	--	143	--	10	--	215
Total 4th Quarter	$ 24	$ 237	--	$ 1,120	$ 3	$ 189	$ 2	$ 1,575
Percent	1.5%	15.0%	--	71.1%	0.2%	12.0%	0.1%	100.0%
Total 1978	$ 384	$ 1,032	$ 36	$ 3,439	$ 22	$ 631	$ 13	$ 5,557
Percent	6.9%	18.6%	0.6%	61.9%	0.4%	11.4%	0.2%	100.0%
1979								
January	$ 4	$ 42	--	$ 335	--	$ 13	$ 4	$ 398
February	--	102	--	434	--	10	--	546
Total Year-to-Date	$ 4	$ 144	--	$ 769	--	$ 23	$ 4	$ 944
Percent	0.4%	15.3%	--	81.5%	--	2.4%	0.4%	100.0%

Source: Morgan Stanley & Co. Incorporated

Table 7

Public Preferred Stock Sales; 1977, 1978, and 1979
By Type of Issuer
($ Millions)

	Utility	Trans. & Industrials	Telephone	Ins. & Banks	Total
1977					
January	S 95	--	--	--	S 95
February	42	S 75	--	--	117
March	270	187*	--	S 10	467
Total 1st Quarter	S 407	S 262	--	S 10	S 679
Percent	59.9%	38.6%	--	1.5%	100.0%
April	S 65	--	--	--	S 65
May	163	S 53	--	S 2*	218
June	--	200	--	25*	225
Total 2nd Quarter	S 228	S 253	--	S 27	S 508
Percent	44.9%	49.8%	--	5.3%	100.0%
July	S 22	S 100*	S 16*	--	S 138
August	50	--	--	S 100*	150
September	264	45*	--	--	309
Total 3rd Quarter	S 336	S 145	S 16	S 100	S 597
Percent	56.3%	24.2%	2.7%	16.8%	100.0%
October	S 170	--	--	S 58*	S 228
November	50	S 100*	--	75	225
December	99	37	--	--	136
Total 4th Quarter	S 319	S 137	--	S 133	S 589
Percent	54.2%	23.2%	--	22.6%	100.0%
Total 1977	S 1,290	S 797	S 16	S 270	S 2,373
Percent	54.4%	33.5%	0.7%	11.4%	100.0%
1978					
January	S 116	--	--	--	S 116
February	127	--	--	--	127
March	102	--	--	--	102
Total 1st Quarter	S 345	--	--	--	S 345
Percent	100.0%	--	--	--	100.0%
April	S 110	S 75	--	--	S 185
May	177	35	--	10	222
June	105	325*	--	57*	487
Total 2nd Quarter	S 392	S 435	--	S 67	S 894
Percent	43.8%	48.7%	--	7.5%	100.0%
July	--	S 40*	--	S 12*	S 52
August	S 91	--	--	20*	111
September	45	53*	--	--	S 98
Total 3rd Quarter	S 136	S 93	--	S 32	S 261
Percent	52.1%	35.6%	--	12.3%	100.0%
October	--	--	--	--	--
November	S 20	S 7	--	S 10	S 37
December	148*	28*	--	--	176
Total 4th Quarter	S 168	S 35	--	S 10	S 213
Percent	78.9%	16.4%	--	4.7%	100.0%
Total 1978	S 1,041	S 563	--	S 109	S 1,713
Percent	60.8%	32.9%	--	6.4%	100.0%
1979					
January	S 121	--	--	--	S 121
February	226	--	--	--	226
Total Year-to-Date	S 347	--	--	--	S 347
Percent	100.0%	--	--	--	100.0%

*Includes convertible preferred stock

Source: Morgan Stanley & Co. Incorporated

Table 8

Private Placements by Type of Issuer*; 1977, 1978, and 1979
(S Millions)

	Banks	Foreign	Industrial	Telephone	Trans-portation	Utility	Misc.	Total
1977								
January	S 51	S 363	S 1,174	S 1	--	S 57	--	S 1,646
February	147	160	476	9	--	26	--	818
March	101	161	657	17	S 63	15	--	1,014
Total 1st Quarter	S 299	S 684	S 2,307	S 27	S 63	S 98	--	S 3,478
Percent	8.6%	19.7%	66.3%	0.8%	1.8%	2.8%	--	100.0%
April	S 43	S 45	S 961	S 28	S 147	S 392	--	S 1,616
May	210	248	703	21	64	40	--	1,286
June	299	--	657	89	34	112	--	1,191
Total 2nd Quarter	S 552	S 293	S 2,321	S 138	S 245	S 544	--	S 4,093
Percent	13.5%	7.1%	56.7%	3.4%	6.0%	13.3%	--	100.0%
July	S 97	S 70	S 889	S 203	S 37	S 111	S 75	S 1,482
August	10	150	722	--	87	--	--	969
September	27	246	295	75	2	--	--	645
Total 3rd Quarter	S 134	S 466	S 1,906	S 278	S 126	S 111	S 75	S 3,096
Percent	4.3%	15.1%	61.6%	9.0%	4.0%	3.6%	2.4%	100.0%
October	S 213	S 146	S 1,039	--	S 376	S 238	--	S 2,012
November	124	375	1,591	--	18	68	--	2,176
December	341	67	1,512	S 100	71	295	S 40	2,426
Total 4th Quarter	S 678	S 588	S 4,142	S 100	S 465	S 601	S 40	S 6,614
Percent	10.3%	8.9%	62.6%	1.5%	7.0%	9.1%	0.6%	100.0%
Total 1977	S 1,663	S 2,031	S10,676	S 543	S 899	S 1,354	S 115	S17,281
Percent	9.6%	11.8%	61.8%	3.1%	5.2%	7.8%	0.7%	100.0%
1978								
January	S 42	--	S 657	S 10	S 17	S 35	--	S 761
February	153	--	402	25	35	50	S 10	675
March	101	S 70	794	--	228	94	6	1,293
Total 1st Quarter	S 296	S 70	S 1,853	S 35	S 280	S 179	S 16	S 2,729
Percent	10.8%	2.6%	67.9%	1.3%	10.3%	6.6%	0.6%	100.0%
April	S 35	S 120	S 513	S 18	S 38	S 177	--	S 901
May	175	30	840	150	121	569	--	1,885
June	109	60	333	100	258	935	--	1,795
Total 2nd Quarter	S 319	S 210	S 1,686	S 268	S 417	S 1,681	--	S 4,581
Percent	7.0%	4.6%	36.8%	5.9%	9.1%	36.7%	--	100.0%
July	S 92	S 255	S 1,320	S 15	S 44	S 69	S 115	S 1,910
August	108	125	544	19	38	344	--	1,178
September	120	60	417	--	172	36	--	805
Total 3rd Quarter	S 320	S 440	S 2,281	S 34	S 254	S 449	S 115	S 3,893
Percent	8.2%	11.3%	58.6%	0.9%	6.5%	11.5%	3.0%	100.0%
October	S 99	S 27	S 534	S 30	S 147	S 286	--	S 1,123
November	32	35	209	--	6	65	--	347
December	153	86	961	245	143	388	--	1,976
Total 4th Quarter	S 284	S 148	S 1,704	S 275	S 296	S 739	--	S 3,446
Percent	8.2%	4.3%	49.4%	8.0%	8.6%	21.4%	--	100.0%
Total 1978	S 1,219	S 868	S 7,524	S 612	S 1,247	S 3,048	S 131	S14,649
Percent	8.3%	5.9%	51.4%	4.2%	8.5%	20.8%	0.9%	100.0%
1979								
January (Revised)	S 78	S 180	S 758	S 5	S 86	S 95	--	S 1,202
February	69	4	497	2	75	142	--	789
Total Year-to-Date	S 147	S 184	S 1,255	S 7	S 161	S 237	--	S 1,991
Percent	7.4%	9.2%	63.0%	0.4%	8.1%	11.9%	--	100.0%

*Data prior to 1979 includes publicly announced private placements done on an agency basis only.

Source: Morgan Stanley & Co. Incorporated

The Exchange Rate and Inflation

by Wilson E. Schmidt

Recently, in an unpublished paper, Peter Hooper and Barbara Lowery
of the Fed staff reviewed the main papers on the question of the relation-
ship between the foreign exchange value of the dollar and the price level.
Hooper and Lowery standardized the results of all of the papers to the
Fed's multilaterally weighted index of the exchange rate covering ten
countries. We do about half of our trade with those countries and they account
for about two-thirds of world trade. They drew a consensus from the
papers that a 10% depreciation in the real effective rate, which is the
average change in the rate adjusted for changes in consumer prices here
and abroad, leads to a 1.5% to 1.75% increase in the U.S. consumer price
index within 2-3 years with about half of the impact coming in the first
year.

The real effective exchange rate fell from an index of 95.4 at the
end of 1976 to 88.5 at the end of 1977 and to 81.9 at the end of 1978.
A provisional estimate for February 1979 is 81.8. Hence, according to
the Hooper-Lowery rule of thumb, the 14.5% slide in the dollar from the
end of 1976 contributed about 1.1 to 1.3 percentage points to the annual
rate of inflation. Hence, something on the order of 1.25% percentage
points should be removed from recent inflation rates to calculate the under-
lying rate of inflation.

What about 1979? Which way will the real effective rate go? Obviously
the question is extremely difficult to answer. Let us focus on events abroad,
excluding developments in the United States which is the concern of the
committee.

Weighting the money stock growth rates of the ten countries according
to the Fed's multilateral weights, we find that the stock of money grew

at the same rate in 1977 and 1978 in the ten countries. The weighted index
of CPIs grew at a point lower in 1977, namely 6.5%, than in 1978. This
suggests that if the monetary stance of the ten countries were to remain
unchanged there would be a further decline in inflation abroad. Last
November the OECD forecast a slight decline to 5.9%. On the other hand,
in seven countries for which I have reasonably recent data, industrial
production on a multilaterally weighted basis has been growing at a rate
of 8.2% for the last three available months compared with 6.6% for the
last 12 available months, suggesting a heating up and possibly greater
inflation. Current discussion leaves little doubt about higher inflation
rates in Germany and the United Kingdom.

Looking at the forward premia and discounts of the dollar, the
foreign exchange market seems to be predicting a 3-4% fall in the effective
rate for the dollar. But at the end of last year, and the beginning of
this year, the foreign exchange market was very - probably too - pessimistic
about the dollar. Since the end of last year, the effective rate for the
dollar has risen about 1.5%. Furthermore, the forward discounts on the
dollar have, save for the guilder, been declining, indicating that
the market is revising its views. Furthermore, two recent forecasts by
commercial banks in the United States imply a rise in the rate of inflation,
using the multilateral weights, in the Big Six from 6.5% to 7.2% and 7.4%.
All things considered, chiefly because of the expansion of economic activity
abroad and the outlook for Germany and the U.K. price levels, I am inclined
to accept the view that, on a multilaterally weighted basis, inflation is
likely to increase abroad, which taken by itself is likely to strengthen
the dollar. Whether it will rise by more than the increase in the rate
of inflation abroad determines what happens to the real effective rate.
Here I am inclined to believe it will rise by more than the rate of inflation
abroad because the market probably was too pessimistic about the dollar

and seems to be gradually revising its expectations. In short, the real effective exchange rate is likely to move in a manner which will provide a modest reduction in the measured rate of U.S. inflation. Obviously, this outcome depends on events in the United States, which have not been addressed here.

A Report on Fiscal Policy for the Shadow Open Market

Committee

Rudolph G. Penner
American Enterprise Institute

A. The President's 1980 Budget

After adding substantially to outlays in the budgets of 1978 and
1979, the President has undertaken a dramatic shift of policy and
recommended 1980 outlays $12.5 billion below the level required to
provide for current entitlement programs and to maintain the real
value of other programs. Total outlays rise 0.7 percent in real terms
between 1979 and 1980 entirely because of a real increase in defense
outlays. Non-defense programs remain exactly constant in real terms
with automatic increases in entitlement programs under current law
being exactly offset by recommended real cuts in both entitlement and
non-entitlement programs.

The resultant deficit of $29 billion certainly does not imply an
economically conservative policy at this stage of the business cycle,
but when a Democratic President suggests major outlay cuts from current
policy levels in the face of an Administration forecast of an unemploy-
ment rate rising above 6.0 percent, it qualifies as something of a
political, if not an economic, revolution. Despite the conservative
rhetoric of the last election, a later section of this report will argue
that the swing toward spending constraint in the President's budget is
probably slightly more than the Congress will swallow. The $29 billion
deficit estimate also rests heavily on relatively optimistic assumptions
regarding the future course of the economy and the spendout rate for

certain entitlement programs.

The following table summarizes the President's recommendations, given his assumptions. The table includes both budget and off-budget credit activities of the government for 1979 and 1980.

Selected Budget and Off-Budget Aggregates, Fiscal 1979 and 1980

	1979		1980	
	Billions of dollars	% of GNP	Billions of dollars	% of GNP
Budget Outlays	493.4	21.6	531.6	21.2
Budget Receipts	456.0	19.9	502.6	20.1
Budget Deficit	37.4	1.6	29.0	1.2
Off-budget Deficit	12.0	0.5	12.0	0.5
Federal debt held by the public	650.9	28.4	689.9	27.5
Net change in guarantees	20.8	0.9	25.5	1.0
Outstanding guarantees	213.9	9.3	239.4	9.6

A further note on the 1979 budget - In one of those unfortunate accidents that has plagued the history of fiscal policy, the 1979 budget is turning expansionary at a very bad time. On an NIA basis, OMB expects the deficit to rise from about $20 billion in the fourth calendar quarter of 1978 to $30 billion in the first quarter of 1979. The rise is the result of the tax cut effective January 1.

After falling slightly to $28 billion in the second quarter, it is

expected to again rise to $37 billion in the third quarter and to finish the year at $39 billion, i.e., at approximately twice the level attained a year earlier. The spurt in the third quarter is in large part due to cost-of-living increases for social security while the continued high deficit in the fourth quarter appears to be the result of an assumed slowdown in economic growth in the last half of the year. (The Administration does not publish forecasts on a quarterly basis.)

Given the President's budget and economic assumptions, the NIA deficit declines rapidly in 1980 reaching $17 billion in the third quarter.

B. Political Risks to 1980 Budget

Much has been written about the conservative mood of the public and of the new Congress. Obviously, something important is going on, but there is little evidence that there will be massive budget cutting over the next year. It is, of course, as difficult to forecast the actions of Congress as it is to forecast the Dow-Jones average, but it is my guess that the Congress will be conservative in the sense that many programs are allowed to be eroded by inflation and there will be great reluctance to take on new programs or program reforms that add significantly to outlays. But, at the same time, there will not be the courage to adopt many of the President's explicit program cuts. On balance I expect the Congressional and Presidential deficits to be similar after adjustments for estimating differences.

The problem of cutting the spending side is well illustrated by the reaction to the Administration's recommended cuts in social security. The President recommended ten marginal reforms which would save $609 million 1980, but $2.9 billion by 1982. The most important reforms are directed at areas where social security benefits overlap with SSI, educational assistance, or civil service pensions. It is hard to argue that truly needy individuals would be significantly harmed by the reforms except that they would have to make applications for income-conditioned assistance. In my view, all of the recommendations are eminently rational and, at least, deserving of serious debate.

The reforms were immediately opposed by a coalition of over one hundred interest groups headed by Wilbur Cohen. Hearings by the House Select Committee on Aging will hear 9 or 10 opponents of the reforms, but only the Administration was invited to testify on their behalf.

This is an extreme case illustrating the immense power of interest groups, but variants of this story will be repeated again and again for other programs as the year progresses. However, it was previously noted that some of the President's deficit increasing proposals will also face severe difficulties.

The following table lists Presidential proposals on both sides of the ledger that appear to be headed for trouble. Because of the difficulty of predicting the actions of Congress, I do not wish to claim that the list is complete or that all proposals on the list will be rejected, but it does illustrate the difficulties that the President will

face over the next year. I should also note that some of the

proposals deserve all of the political difficulties that they will

encounter.

Politically difficult, deficit-reducing proposals

Hospital cost containment	$1.7 B.
Veteran's medical care	0.3
School lunches	0.4
Social security & railroad retirement	0.7
Agricultural price supports	0.7
National forests	0.3
Impact aid	0.2
Total	$4.3 B.

Politically difficult, deficit-increasing proposals

Real wage insurance*	$2.5 B.
Targeted fiscal assistance	0.2
International aid	0.3
National Development Bank	0.2
Total	$3.2 B.

*This ill-conceived program refuses to die and Ways and Means may go
into markup.

C.   Economic and Other Estimating Risks

The Administration's budget estimates are based on a relatively

optimistic economic forecast. On a fourth quarter over fourth quarter

basis, real GNP is expected to grow 2.2 percent during 1979 and 3.2

percent during 1980. The GNP deflator is expected to rise 7.4 percent

in 1979 and 6.4 percent in 1980. If real growth is lower than forecast,

the deficit will be increased. If inflation is higher, the positive

impact on receipts will be greater than the positive impact on indexed

outlay programs and the deficit will therefore be reduced.

Many forecasters foresee a recession toward the end of 1979. For example, the Congressional Budget Office expects negative real growth in the last two quarters of 1979 followed by a mild economic recovery during 1980. Their fourth quarter over fourth quarter real growth rate is about 1 percent for 1979 and 4 percent for 1980. They also expect somewhat higher inflation rates than in the Administration forecast with the GNP deflator rising 8 percent during 1979 and about 7 1/2 percent in 1980. On the receipts side of the budget, CBO's lower growth rate and higher inflation rate offset each other, and their receipts estimate, given Administration policy, is only slightly lower then the Administration's. CBO's outlay estimate is, however, considerably higher than the Administration's. In addition to the outlay impact of lower real growth and higher inflation, the CBO believes that the Administration has converted the famous "shortfall" into a "longfall" and that for a given set of economic assumptions, outlays will be almost $4 billion higher than predicted by the Administration.

CBO's adjustments, given Presidential policy, are as follows:

Administration receipts estimate	$502.6
Differing economic assumptions	-3.2
CBO receipts	499.4
Administration outlay estimate	$531.6
Differing economic assumptions	+4.6
Other estimating differences	+3.8
CBO outlays	540.0
CBO deficit	$ 40.6

The CBO also adjusts the Administration's 1979 deficit estimate, but raises it only from $37.4 to $40.5 billion, assuming the policy stance in the Second Budget Resolution.

The CBO does not make estimates for off-budget items but it predicts lower interest rates than are predicted by the Administration. One might expect this to lower off-budget financing, but the effect is unlikely to be very large. Therefore, even if one accepts the CBO economic scenario, I do not believe it necessary to alter the administration estimate of off-budget activity (although that activity can be quite volatile for reasons unrelated to changes in the economic aggregates.) Combining off-budget estimates of $12 billion in both 1979 and 1980 with CBO on-budget deficits of $40.5 and $40.6 billion yields almost identical total deficit figures of $52.5 billion in 1979 and $52.6 billion in 1980.

The Iranian Factor - Both the Administration and the CBO completed their forecasts before the extent of the turmoil in Iran was fully recognized. The consequent impact on world oil supplies will have a negative impact on both the U.S. economy and on the budget deficit, but it is far too early to say how much of a negative impact. The nature of the impact will depend on the extent to which Iranian oil production is restored (if at all) by the end of 1979; on the supply response of other producing countries; and on the U.S. policy response. (Will the Fed. finance any "price shock"? Will we use a non-market response such as gas rationing?) The array of plausible scenarios is enormous, but it is hard to imagine any that cause a recession as severe as that of 1974-75.

However, a 15 percent world price increase above the levels already-scheduled by OPEC is easy to imagine, and depending on a multitude of other variables, that could be sufficient to extend a two quarter recession into a three-quarter recession. (It would cost the U.S. nearly $7 billion over the following year.) But the difference between this scenario and the CBO scenario is likely to be very much less than the difference between the CBO and administration scenarios with respect to its impact on the 1980 budget. My guess is that the impact on the deficit of a 15 percent world oil increase is very likely to be less than $5 billion. It must be emphasized that I do not wish to imply that this is the most likely scenario. The example is used only to outline the quantitative impact of one plausible series of events.

The tax cut factor - All of the above assumes that policies are not changed in response to a recession. The Congress may be conservative enough to avoid the spending binges provoked by the 1974-75 recession and the Carter "stimulus" package of 1977, but there will be intense pressures for a major tax cut. Those pressures result from a number of different forces. First, 1980 is an election year. Second, there is a growing consensus that there should be some relief from the burden that inflation is imposing on the taxation of capital and it is hard to give capital relief without providing cuts for individuals. Third, growing money incomes and social security tax increases will push 1980 and 1981 total tax burdens to unprecedented peacetime levels. The following table shows the ratio of total Federal receipts to GNP for selected years. This is far from a perfect measure of tax burdens, but it is all that is provided in the budget.

Ratio of Federal Receipts to GNP, Selected Years

Fiscal Year	Ratio in percent
1960	18.6
1965	17.8
1970	20.2*
1975	19.3
1978	19.7
1979 estimate	19.9
1980 estimate	20.1
1981 estimate	20.9

*Impacted by Vietnam surtax. The highest ratio since WWII, 20.8 percent, was reached in 1969.

The difference between 1978's 19.7 percent and 1980's 20.1 percent may not seem like much, but at 1980 levels of GNP it amounts to a $10 billion tax increase which grows to a $28 billion increase by 1981.

Consequently, some sort of major tax action seems likely before the 1980 election. It probably would not take effect until 1981, but in the face of a recession it could possibly apply retroactively to 1980 even if it is not passed before the end of 1979. However, it need not have a big impact on fiscal 1980 receipts. Nevertheless something of the order of $5 to $10 billion cannot be totally ruled out.

DEPARTMENT OF ECONOMICS · MARSHALL HALL   EAST LANSING · MICHIGAN · 48824

April 16, 1979

TO: Karl Brunner, Al Burger, Erich Heinemann, Allan Meltzer

FROM: Bob Rasche and Jim Johannes

SUBJECT: Money Multiplier Forecast Errors

We now have data for two months of our forecast period, and some indication of
how March will come in based on the weekly data. It appears that after our
adjustments for the ATS that our forecasts for the M_1 multiplier are very
precise for the whole three month period. The observed forecast errors are in
the third digit to the right of the decimal.

The M_2 multiplier forecasts, on the other hand, appear to have an almost constant
error of the magnitude of .045, something less than one percent. We have
investigated this error for January and February, and have discovered that it
is accounted for by offsetting errors in the t_1 and t_2 components. Our forecasts
for t_1, after adjustment for ATS's, overestimate the observed t_1, while our
forecasts for t_2, again after adjustment for ATS's, underestimate the observed
t_2. The sum of the forecasts for the two components is almost exactly equal
to the sum of the observed values (January: forecast = 2.3072, actual = 2.2941;
February: forecast = 2.4385, actual = 2.4328; all n.s.a.). Hence the common
denominator of the two multipliers is forecast almost perfectly, while the numerator
of the M_2 multiplier is overestimated. We feel that there is reason to believe
that the errors may be in the reported figures. In all the ATS confusion, it is
easy to overlook the fact that the sample for the weekly reporting banks was
changed effective January 1, 1979. The large CD series represents large negotiable
CD's at the old sample of weekly reporting banks. Therefore the series has to be
continued on an estimated basis, since neither the old weekly reporting series nor
the new weekly reporting series are subsets of the other. If the splice has not
been made correctly, then the t_1 ratio will be consistently overestimated by our
model, but the error in the sum of t_1 plus t_2 should fluctuate around zero,
exactly as we have observed for three months. We are indebted to Carl Gambs of
the Kansas City Fed for calling this change to our attention. Just another
ingredient in an already messy situation.

Regardless, we feel that the forecasts have correctly laid out the recent trends
in the multipliers, and support the proposition that multipliers such as these,
regardless of the definition of monetary aggregate that is settled on, can be
forecast over some intermediate horizon with a great deal of precision. When the
March data are available, we hope to construct a new set of forecasts, based on
an updated sample, to determine if our current forecast for the remainder of the
year should be modified.

MEANS OF FINANCING OF U.S. BUDGET
DEFICIT 1976-78
(BILLIONS OF DOLLARS)

	1976	1977	1978
Total Financing Required (Unified Budget Plus Off-Budget Agencies)	59.138	61.431	48.242
I. Net Change in Privately Held Debt	49.569 (.84)	19.390 (.32)	20.530 (.43)
II. Change in Net Source Base	6.462 (.11)	11.396 (.19)	12.162 (.26)
III. Change in Foreign Transaction Accounts	7.023 (.12)	29.381 (.48)	24.710 (.51)
IV. Other Sources[1]	-3.916 (-.07)	1.264 (.02)	-9.760 (-.20)

[1] Include Changes in Treasury Cash Balances (-), Change in Federal Reserve Float(-), Interest Accurals (+), Excess of Misc: F.R. Liability Accounts or Misc. Asset Accounts (+), Change in Misc. Treasury Accounts (+), Change in Deposit Funds (+).

[2] Jan.-Nov.