CHAPTER 1

Economic Policy for Growth and Stability

AS THE PRESIDENT BEGINS HIS SECOND TERM, it is time to take stock—to review the inherited conditions, policy actions, and unforeseen events that shaped the first term and established the initial conditions for the second term. Taking stock will help to define the job to be done over the next 4 years, the fundamental nature of which is to develop economic policy for growth and stability.

Looking back 4 years, it is not difficult to see why continuing emphasis on growth and stability is appropriate. Policy formulation in January 1981 was conditioned by these facts: labor productivity in the nonfarm business sector in 1980 was 2.2 percent below its 1978 level; the total unemployment rate had risen to 7.4 percent from a low of 5.5 percent in mid-1979; the 12-month inflation rate as measured by the consumer price index (CPI) was 11.7 percent, compared with only 4.8 percent in 1976; and the 13-week Treasury bill rate was 15.0 percent, up from a 1976 average of 5.0 percent.

These summary statistics understate the nature of the economic problem facing the Administration in January 1981. The economy was unsteady, only a few months into a recovery from the short, sharp recession in the first half of 1980. Both renewed recession and continued volatile inflation seemed possible. Throughout U.S. history, bouts of inflation had been regarded as temporary departures from price stability, but by 1980—after 15 years of inflation at varying rates—rising prices were coming to be regarded as normal. So also were the instabilities of output, employment, and government policy associated with inflation. In this uncertain environment, the Administration was faced with the task of introducing fundamental changes in the direction of economic policy.

It is not surprising that the economy's response to major changes in monetary and fiscal policy was not smooth. The recession that began in August 1981 occurred after only 12 months of incomplete recovery from the 1980 recession. Although the peak-to-trough decline over the 1981–82 recession was not unusually large relative to previous recessions, unemployment and excess manufacturing capacity in late 1982 reached the highest rates in the postwar period.

But the economic recovery in 1983–84 was sparkling. Employment and output gains were large, and they were achieved in an environment of stable to declining inflation. Productivity growth had resumed. Gross business fixed investment rose especially rapidly, and in real terms reached the highest share of gross national product (GNP) in the postwar period. At the end of 1984 the unemployment rate was 7.1 percent, the 12-month CPI inflation rate was 4.0 percent, and the 3-month Treasury bill rate was 8.1 percent. Numerous other indicators signaled a resumption of economic growth and vitality within an environment of greater economic stability and growing confidence on the part of most Americans.

Economic performance over the past 4 years may be best understood within this framework: The period began with a difficult set of inherited economic conditions. In 1981 the Administration and the Congress enacted major changes in the direction of fiscal policy, and the Federal Reserve System maintained a policy of substantial monetary restraint. The economy underwent a transitional period of adjustment shaped by the inherited conditions and the policy changes. Finally, the economy began to follow a course of renewed growth and stability.

This framework, although useful, is in many ways too orderly. Over the past 4 years special problems and surprises appeared. The 1981–82 recession was of greater severity and duration than had been foreseen. The international debt crisis required rapid response. Interest rates remained surprisingly high and were often volatile. The U.S. dollar continued to amaze most observers by its almost continuous appreciation against foreign currencies. The current account deficit in the balance of payments became very large by historical standards. Finally, the Federal budget deficit turned out to be much larger than had been anticipated.

At the beginning of 1985 certain conditions—especially the budget deficit and the possibility of future monetary instability—remain as sources of uncertainty to private decisionmakers and as challenges to policymakers. The task ahead is to ensure that present policy problems are solved satisfactorily, so that 1981–84 will indeed be properly viewed as a transitional period followed by an era of substantially improved economic performance. But if the policy agenda cannot be completed and does not fulfill the promise of the gains achieved, history's interpretation of the past 4 years will be different. This period will then be properly regarded as simply another volatile episode in which gains from improved policies were later lost as the Nation was unable to finish the task of changing the direction of economic policy.

The first third of this chapter is devoted to a review of the performance of the economy under the Administration's first-term programs. Policy principles for growth and stability are explored in the middle third of the chapter, and the economic outlook for 1985–90 is discussed in the final third.

THE ECONOMIC RECOVERY PROGRAM

The President took office determined to redirect economic policy. On February 18, 1981, the Administration submitted its program to the Congress in a document entitled, "America's New Beginning: A Program For Economic Recovery." Quoting from that document, the key elements of the program were:

1. A budget reform plan to cut the rate of growth in Federal spending.
2. A series of proposals to reduce personal income tax rates by 10 percent a year over three years and to create jobs by accelerating depreciation for business investment in plant and equipment.
3. A far-reaching program of regulatory relief.
4. And, in cooperation with the Federal Reserve Board, a new commitment to a monetary policy that will restore a stable currency and healthy financial markets.

The fundamental goals of the program were restoration of economic growth and stability. Reduction of governmental obstacles to production and improved incentives for work, saving, and investment were essential. So also was restoration of price stability. Overall, the policy direction has been guided by a clear and consistent set of principles, of which the most important have been reliance on markets and the maintenance of a long-run policy orientation.

THE BACKGROUND OF POOR ECONOMIC PERFORMANCE

Numerous forces destructive to productivity and output growth were at work in the late 1970s. Measuring from one business cycle peak to another, productivity gains in the nonfarm business sector trailed off from the postwar average of 2.4 percent annual growth between 1948 and 1973 to 0.6 percent between 1973 and 1980. Real GNP growth declined from 3.8 to 2.7 percent per year over the same two periods. In real terms the take-home pay of workers was eroded by the slow productivity growth, by a reduction in average hours worked per week, and by rising tax burdens as inflation pushed most workers into higher tax brackets.

In early 1981, Americans still remembered the recessions of 1969–70, 1973–75, and 1980. However unwelcome this record, it was not unusual in the light of U.S. history. It was unusual, however, that the

economic recovery in the second half of 1980 seemed to have so little promise of being long sustained, primarily because the inflation rate was so high.

It is important to note, however, that more than 14 million new jobs were created between the recession trough in March 1975 and the next business cycle peak in 1980. Because employment grew more rapidly than the working-age population, the fraction of the population employed increased. In the 1970s the U.S. economy continued to be a marvelous job-creating machine.

But during the late 1970s, the inflation that accompanied the employment gains showed that economic policy was on an unsustainable course. After 1976 the inflation rate rose every year, with the annual CPI increase peaking at 13.3 percent in 1979 before falling to a still high 12.4 percent in 1980. Reflecting this inflation, between mid-1976 and mid-1980 the foreign exchange value of the dollar fell by about 20 percent on a trade-weighted basis.

Rising inflation was the most important determinant of rising interest rates in the late 1970s. Despite sharp increases in nominal interest rates, the real, or inflation-adjusted rate of interest rose relatively little. Holders of long-term bonds were especially harmed. Inflation eroded the purchasing power of annual interest payments on outstanding bonds, and rising interest rates reduced bond prices, leaving bondholders with capital losses. It has been estimated that the typical holder of long-term U.S. Government bonds suffered losses, in real terms, of about 7 percent in 1977, 9½ percent in 1978, 13 percent in 1979, and 14½ percent in 1980.

Given this experience, it is not surprising that investors became increasingly wary. Bonds—previously a safe and conservative investment—had become risky and speculative. Asset demands shifted away from productive capital in the United States toward investment in foreign assets and various speculative real and financial assets, such as precious metals.

THE BACKGROUND OF UNSUSTAINABLE ECONOMIC POLICIES

In the 1970s the interaction of economic events and economic policy created a growing uncertainty about the future, which was manifested most clearly in rising and increasingly volatile interest rates and a falling dollar on the foreign exchange market. Money growth, as measured by the M1 definition, was 5.0 percent in 1975 before beginning a sustained rise. In 1976 the rate was 6.1 percent; in 1977, 8.1 percent; in 1978, 8.2 percent; and in 1979, 7.5 percent. In the latter 3 years money growth exceeded the Federal Reserve's announced growth targets, contributing to market concern over monetary policy.

Rising interest rates after 1976 did not signal tight monetary policy. As actual and expected inflation rose, interest rates were bid up by rising credit demands. The stance of the Federal Reserve became more restrictive in November 1978, but money growth and inflation remained high. In October 1979 the Federal Reserve, in an effort to keep monetary growth within its targets, announced a dramatic policy shift toward greater relative emphasis on controlling the provision of reserves to the banking system and less on controlling interest rates. Unfortunately, after this change in operating procedures, both short-run money growth and interest rates became more volatile, adding to market uncertainties about monetary policy.

Fiscal policy, as reflected by the Federal deficit in the national income and product accounts, on the surface appeared on track in the late 1970s. The deficit fell from 3.1 percent of GNP in calendar year 1976 to 0.7 percent of GNP in 1979, mostly because inflation swelled tax receipts. However, with the short recession in 1980 the deficit rose to 2.3 percent of GNP in that year. Total Federal receipts as a fraction of GNP increased continuously throughout this period, eventually reaching an all-time high of 21.1 percent in 1981. Personal income tax receipts grew by 77.2 percent between 1976 and 1980, compared with nominal GNP growth of 53.2 percent, as inflation pushed individuals into higher tax brackets.

Federal regulatory policy was a source of difficulty. Three manifestations of a general reliance on regulation instead of market forces to solve economic problems deserve special attention.

First, in the late 1970s the Federal Government attempted to rely on wage and price guidelines to control inflation, despite the lack of success with guidelines in the 1960s and the disruptive failure of comprehensive wage and price controls in the early 1970s. In late 1978 voluntary standards for pay and price increases were announced. In March 1980 a credit control program was introduced that contributed to an increase in the unemployment rate from 6.2 percent to 7.7 percent between March and July 1980. Moreover, during 1980 the GNP price deflator continued to rise at a rate in excess of 10 percent, a rate somewhat above the 8.2 percent rate throughout the four quarters of 1979.

Second, specific controls on oil and gas prices, production, and distribution created significant distortions in the markets for petroleum and petroleum products. Following both the 1973–74 and 1979–80 increases in world oil prices, the effects of price controls and their accompanying allocation regulations were severe. Widespread shortages of gasoline and other products and numerous changes and exceptions to the regulations made business planning more difficult.

Finally, throughout the 1970s inefficient regulatory approaches to environmental, health, and safety problems raised production costs and created considerable uncertainty as rules and regulations shifted and changed. One outcome of these policies was a substantial increase in the cost of new business investment with a corresponding reduction in the expected rate of return, reducing business fixed investment and productivity growth.

FISCAL POLICY 1981–84

The cornerstone of the Administration's tax policy, the Economic Recovery Tax Act (ERTA), was signed into law in August 1981. This Act legislated sweeping changes in both the individual and corporation income tax systems.

This Act provided for an across-the-board reduction in individual income tax rates amounting to 23 percent at the end of 3 years, and an immediate cut in the top bracket rate from 70 to 50 percent. The new law also established that, beginning in 1985, the tax brackets, exemption amounts, and the zero-bracket amount would be indexed annually for inflation. This change ensured that inflation would not erode the ERTA tax reductions by pushing individuals into higher tax brackets.

Reduced marginal tax rates were designed to increase incentives for supplying labor and acquiring training and education. There was a shift in emphasis away from using the tax system to redistribute income and toward the creation of national income through economic growth.

Responding to a widely held concern that the pace of capital formation had been insufficient, ERTA allowed accelerated depreciation of new capital assets and a system of expanded investment tax credits. Both of these provisions decreased the effective tax burden on new investment, and thus provided an incentive for increased capital formation. To encourage saving, ERTA extended the individual retirement account program to individuals covered by employer-sponsored retirement plans and increased the maximum annual contribution from $1,500 to $2,000.

The Tax Equity and Fiscal Responsibility Act of 1982 modified some of the effective tax reductions granted to businesses under ERTA. One of the objectives was to reduce the tax benefits of the investment tax credit and the accelerated cost recovery system so that they would not be more generous than an immediate writeoff. Although this Act repealed further accelerations of depreciation allowances scheduled for 1985 and 1986, the ERTA depreciation schedules for 1981–84 were left basically intact. The 1982 Act also contained provisions relating to "Safe Harbor Leasing," compliance, in-

surance, excise taxes, and other matters. The revenue provisions of the Social Security Amendments of 1983 apply predominantly to years after 1984, and therefore had little revenue impact before that time. The Deficit Reduction Act of 1984 contained numerous tax code changes, most of which were individually small and designed to make existing tax laws more effective.

The 1981–84 changes in tax law reduced receipts as a share of GNP to the range that had existed over most of the 1970s—from 21.1 percent in 1981 to an estimated 19.2 percent in 1984. Without these changes, Federal receipts would have risen further—to an estimated 22.0 percent of GNP in 1984 *given* actual 1984 economic conditions. However, in the absence of tax law changes, GNP growth during the recovery would probably have been lower.

The changing composition of Federal expenditure since 1980 clearly reflects the objectives of the Administration. As a share of GNP, defense purchases grew from 5.0 percent in 1980 to 6.0 percent in 1984, while total spending less defense purchases and net interest payments declined from 15.9 percent in 1980 to 14.8 percent in 1984. However, total Federal expenditure increased from 22.9 percent of GNP in 1980 to 24.0 percent in 1984. The Federal deficit rose from 2.3 percent of GNP in 1980 to 4.8 percent in 1984.

MONETARY POLICY 1981–84

There were three major phases to monetary policy over the 1981–84 period. In the first phase, extending to mid-1982, the Federal Reserve's main concern was to restore credibility in the markets by pursuing a restrictive monetary policy designed to reduce inflation. Although the 1980 credit control program was a contributing factor, monetary policy procedures introduced in October 1979 quite generally yielded *both* volatile interest rates and volatile money growth. Moreover, as the recession developed, the average rate of money growth in 1981 and the first half of 1982 was substantially lower than it had been over the previous several years. Money growth did not decline gradually and predictably as advocated by the Administration.

The second monetary policy phase began in the late summer of 1982. Prompted by the international debt crisis and accumulating evidence that the recession would be deeper and more protracted than had been expected, the Federal Reserve abandoned the short-run operating procedures introduced in October 1979 and turned to procedures that were similar to those pursued before 1979.

Interest rates fell sharply as money growth accelerated starting in August 1982. The Federal Reserve permitted money growth to remain high as deregulation allowed depository institutions to introduce new types of deposit accounts in December 1982 and January

1983, temporarily clouding the interpretation of the monetary aggregates data. However, as the economy revived in the winter and spring of 1983, both the Federal Reserve and the Administration became more concerned about the continuing high rate of money growth.

The third phase of monetary policy began in the late spring of 1983. Controlling money growth again became an important objective of Federal Reserve policy, and money-market interest rates were permitted to rise. From the middle of 1983 through mid-1984, money growth was substantially below the rate from mid-1982 to mid-1983. In the second half of 1984 money growth declined even further.

REVIEW OF 1981–84 ECONOMIC PERFORMANCE

Shortly after this Administration took office it was faced with a recession. At the end of 1981 and into early 1982, however, there were reasons to believe that the recession would not be particularly deep. In 1982 the *initially* reported data showed that in the first quarter real final sales grew at a 1.9 percent annual rate—the data now show a decline of 1.0 percent—and that in the second quarter real GNP rose at a 1.7 percent rate—the data now show a decline of 0.8 percent. However, later in the year incoming data indicated that the economy was weaker than had been thought.

Late 1982 was a very uncomfortable time for economic policymakers. Although the classic signs of recovery were accumulating, many observers remained pessimistic. By the end of 1982 the recession had run its course, however. The unemployment rate peaked at 10.6 percent in November and December. By early 1983, the probable resumption of economic growth was signaled by a number of indicators including the beginning of strong growth in real final sales that, from data now available, rose at a 5.5 percent annual rate in the fourth quarter of the year. With final sales rising while total output was about flat, there was a substantial reduction of inventory stocks, which helped to provide the conditions for a resumption of output growth.

It appears that monetary conditions on both the demand and supply sides contributed to the depth of the recession. Money demand—measured by the quantity of money held relative to GNP—rose to an unusual degree, probably reflecting both the reduced cost of holding money balances as market interest rates fell and the spread of interest-bearing negotiable order of withdrawal (NOW) accounts nationwide. Uncertainty attributable to volatile economic and financial conditions may also have raised the demand for money. In addition, from early 1981 through mid-1982 the Federal Reserve per-

mitted substantially lower M1 money growth than had prevailed over the previous several years. This contributed downward pressure on the economy as well.

Fiscal policy may have provided some support to aggregate demand as the ERTA tax cuts gradually took effect and national defense purchases grew, but the stimulus was probably small. The ERTA investment incentives cushioned the decline in business fixed investment, but high real interest rates tended to depress housing construction, inventory investment, and expenditure on consumer durables. High real rates of interest were also important to the strengthening of the dollar and consequent decline of net exports.

The 1981–82 recession was a painful experience for many. The unemployment and bankruptcy rates were high. The protracted recession was an unexpected and unwanted part of the economy's transition to lower inflation. The severity of the recession should serve to emphasize the importance of avoiding the economic conditions that created it.

THE 1983–84 RECOVERY

The recovery in employment and output has been brisk. Even with the slowdown in real GNP growth in the second half of 1984, the present recovery through the first eight quarters is still the strongest since the Korean war. By the end of 1984 the unemployment rate had declined by 3.5 percentage points, and industrial production had risen by more than 23 percent from the recession trough. Table 1–1 provides comparative data on postwar expansions.

TABLE 1–1.—*Real GNP growth over first eight quarters of business cycle recoveries*

[Percent]

Business cycle trough quarter	Average annual growth over		
	First four quarters	Second four quarters	First eight quarters
Present recovery:			
1982 IV	6.3	5.6	6.0
Previous postwar recoveries:			
1949 IV	13.3	5.9	9.6
1954 II	7.4	2.6	5.0
1958 II	8.4	1.7	5.0
1961 I	7.0	3.3	5.1
1970 IV	4.7	7.0	5.8
1975 I	6.7	4.4	5.5
1980 III	4.0	−3.0	.4
Average of five recoveries [1]	6.8	3.8	5.3
Average of seven recoveries	7.4	3.1	5.2

[1] Excludes 1949 and 1980.

Note.—Business cycle troughs are as determined by the National Bureau of Economic Research.

Source: Department of Commerce, Bureau of Economic Analysis, except as noted.

Some of the major characteristics of the present expansion are revealed in Table 1-2, which reports the percentage point contributions of various demand components to the total increase in real GNP and compares them with a "typical" expansion. The typical expansion is defined as the average of postwar expansions excluding those beginning in the fourth quarter of 1949 and the third quarter of 1980; the former was distorted by the Korean war and the latter lasted only four quarters.

TABLE 1-2.—*Sector contribution to real GNP growth: typical and current recovery*

Item	Annual rate over first eight quarters	
	Typical recovery [1]	Current recovery [2]
REAL GNP GROWTH (percent change)	5.3	6.0
Sector contribution to GNP growth (percentage points):		
Personal consumption expenditures	3.2	3.3
Durable goods	.9	1.2
Nonresidential fixed investment	.6	1.8
Producers' durable equipment	.5	1.5
Structures	.1	.3
Residential investment	.5	.6
Change in business inventories	.7	1.3
Net exports of goods and services	−.1	−1.3
Exports	.4	.3
Imports [3]	.4	1.6
Government purchases of goods and services	.3	.3
Federal	−.1	.1
Federal excluding CCC purchases	−.1	.4
State and local	.4	.2
Final sales:		
Total [4]	4.6	4.7
Excluding CCC purchases [5]	4.6	4.9
To domestic purchasers [6]	4.6	6.0
Domestic excluding CCC purchases [7]	4.6	6.2

[1] Average of recoveries following business cycle troughs in 1954 II, 1958 II, 1961 I, 1970 IV, and 1975 I.
[2] Calculated from 1982 IV business cycle trough to 1984 IV; data for 1984 IV are preliminary.
[3] Negative contribution to GNP growth.
[4] GNP less change in business inventories.
[5] CCC purchases removed because inversely related to change in business inventories with dollar for dollar offset for payment-in-kind programs.
[6] Final sales less net exports of goods and services.
[7] Final sales less net exports of goods and services and CCC purchases.

Note.—Business cycle troughs are as determined by the National Bureau of Economic Research.
Detail may not add to totals due to rounding.

Source: Department of Commerce, Bureau of Economic Analysis, except as noted.

Consumption and Residential Investment

Throughout the present expansion, both total consumption expenditure and its durables consumption component have increased at quite typical rates. Real disposable income grew at a 5.5 percent rate over the first eight quarters, somewhat above the typical rate of 4.6 percent. The personal saving rate has been somewhat below the 1947-80 average of 6.6 percent. Residential investment was about on track in comparison with the typical recovery.

Business Fixed Investment

Over the first eight quarters of the expansion, gross business fixed investment contributed 1.8 percentage points of real GNP growth, about three times the typical contribution. The strength of investment has been concentrated in durable equipment; structures investment has grown at a more typical rate. The rapid growth of investment from the recession trough has taken the share of real GNP devoted to real gross business fixed investment to 12.5 percent in 1984. By the fourth quarter of 1984 this share had climbed to 12.9 percent. Net business fixed investment as a share of GNP has not set a new high as has gross investment, partly because recent investment has been strong in relatively short-lived components.

A number of conditions have increased the prospective rate of return on new investment, and have thereby been responsible for the investment boom. The ERTA tax incentives and lower inflation have been important. The vigorous recovery has absorbed a significant amount of excess capacity. Prices of investment goods have been unusually well-contained; in fact, the deflator for nonresidential investment in the fourth quarter of 1984 was slightly below its level 2 years earlier. To a considerable extent, this development reflects the strong dollar and the competition from foreign producers of capital goods.

The effects on rates of return in the nonfinancial corporate sector operating through the cost side can be summarized by examining the unit costs of production. Cost increases have been moderate. Unit costs rose at an annual rate of only 0.2 percent over the first seven quarters of the recovery. A 3.4 percent rate of increase of hourly compensation combined with 2.7 percent labor productivity growth resulted in a rise of unit labor costs of about 0.7 percent, while other unit costs dropped at a 1.0 percent rate. The increase in hourly compensation was the lowest of any recovery since the data became available in 1958.

Inventory Investment

Given the large role of inventories in the 1981–82 recession, it is not surprising that a snapback of inventory investment has been a major contributor to the current expansion, especially in its first year. Despite the growth of inventory investment, inventory-sales ratios in late 1984 were still low by historical standards, suggesting that the economy has not developed any serious inventory imbalances.

Net Exports

The decline in the net export balance is one of the striking features of the present expansion. Exports have grown in typical fashion, but imports have grown very rapidly.

It is a mistake to believe that GNP would necessarily have grown more rapidly if imports had grown less rapidly; lower imports would probably not have been entirely replaced by U.S. production of competing goods. The decline in the net export balance was closely related to the appreciation of the dollar, which was caused by efforts to move capital into the United States to take advantage of the attractive investment climate. There would have been a variety of repercussions if the U.S. investment climate had been less attractive and if the dollar had not appreciated so much. With less dollar appreciation the inflation rate would not have declined as much; more of the growth in nominal GNP would have reflected inflation and less would have reflected growth in real output. Although net exports would have been higher, interest-sensitive spending including business investment would have been lower.

Government Purchases of Goods and Services

Government purchases in the national income and product accounts are not the same as government outlays; purchases exclude the transfers component of outlays and reflect certain other differences in concepts from those used in reporting government budgets. As can be seen in Table 1-2, government purchases of goods and services in the present expansion have a contribution to GNP growth that is quite typical of previous expansions. Excluding purchases of the Commodity Credit Corporation (CCC), the Federal Government contribution has been larger than typical.

THE 1981-84 LABOR MARKET

Following declines during the recession, employment increased by 3.6 percent over the first year of the recovery and by 3.1 percent over the second year; both of these increases were well above the average rate for postwar recoveries. During both the recession and the recovery, money wage increases moderated substantially. Virtually all measures of labor compensation were rising at around 9 percent in 1980, but in 1983 and 1984 most of these measures were rising only about half as rapidly. The hourly earnings index, for example, rose by 9.3 percent in 1980 but by only 3.3 percent in 1984, the lowest increase since 1965.

Union wages began decelerating before nonunion wages and the deceleration of union wages has been greater than that for nonunion wages. This development may reflect cyclical pressures on certain industries and also longer run market forces tending to reduce the gap between union and nonunion wages.

Some recent union wage settlements have involved an actual reduction in wages or fringes, a relaxation of work rules, or wage

freezes. Concessions have occurred in previous recessions, but the scale of recent concessions is unprecedented.

It is possible to pinpoint some forces that have led to these new bargaining patterns. Industries face increased competition from foreign and domestic producers. Imports have increased dramatically in the apparel, textiles, and footwear industries. Concession bargaining has dominated wage settlements in construction over the past year as the market position of firms employing nonunion workers has grown. Older trucking and airline firms have faced new competitors as deregulation reduced barriers to entry.

Despite the dramatic deceleration in money wages starting in 1982, rising productivity has permitted real wages to rise without eroding business profits. Other forces that reduced total take-home pay in the seventies were reversed as well. Real hourly compensation has increased since 1981, hours per week have risen, and average tax rates have fallen.

INFLATION AND INTEREST RATES

Between 1981 and 1984 the inflation rate declined more rapidly than even most optimists had expected. Inflation, as measured by the GNP deflator, declined from about 9.0 percent in 1981, to 4.3 percent in 1982, 3.8 percent in 1983, and 3.5 percent in 1984. Anticipated inflation, as recorded in a regular survey, was above actual inflation in every quarter except the first and third quarters of 1981.

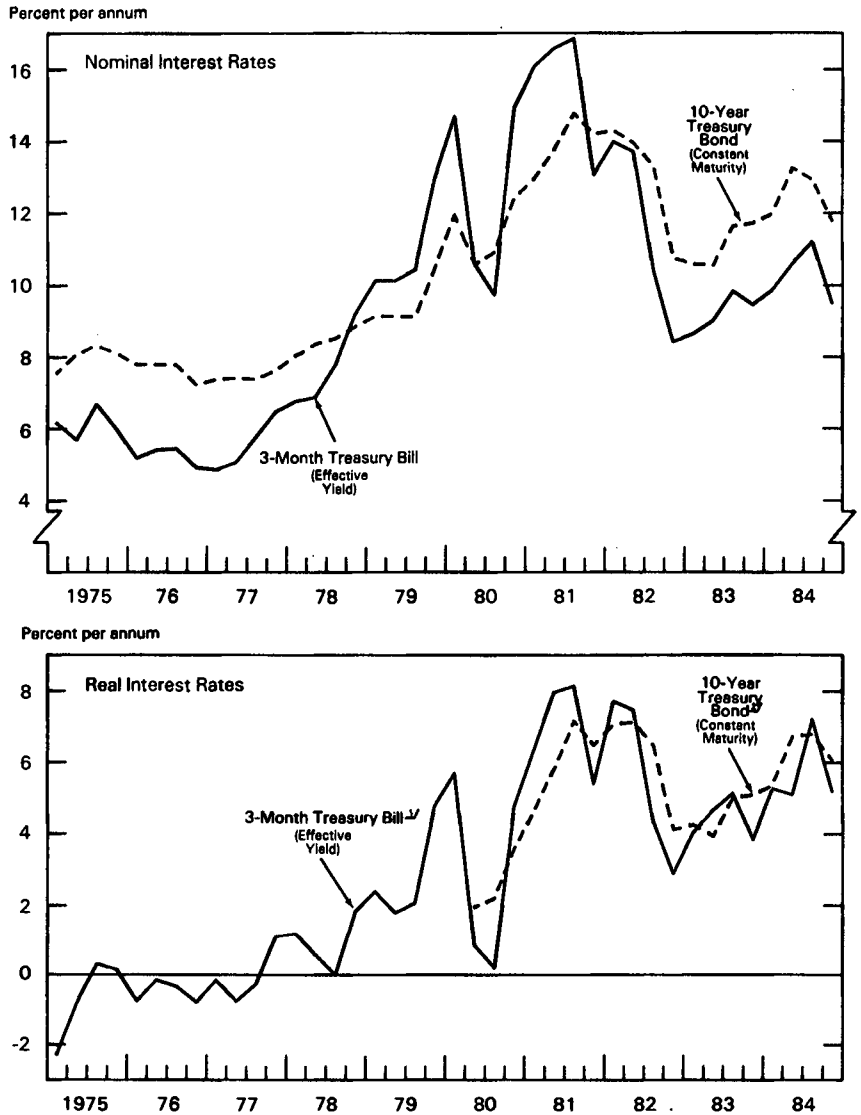
Although it is common for inflation to fall somewhat during the early stages of business cycle recoveries, few observers anticipated that the inflation rate would remain so low during a recovery as rapid as that experienced in 1983–84. The inflation rate rose slightly in the second half of 1983 and early 1984, but there was no apparent tendency for the rate to rise further. Indeed, over the course of 1984 the inflation rate declined somewhat. However, inflation is still higher than desirable, and it is worth noting that the services component of the CPI in 1984 showed some signs of slightly rising inflation.

Chart 1–1 provides a perspective on interest rate behavior after the mid-1970s. Nominal interest rates were extremely volatile in the early 1980s, and on average remained unusually and surprisingly high. Rates finally fell significantly in the summer of 1982 and thereafter remained below their 1981 peaks. By the fourth quarter of 1982, short and long real rates were about 3 and 4 percent, respectively, based on survey information reporting short-term anticipated inflation of about 5.5 percent and long-term anticipated inflation of about 6.5 percent.

From the end of 1982 to mid-1984 short and long nominal interest rates rose by almost 3 percentage points; short and long real rates

Chart 1-1

Nominal and Real Interest Rates



[1] Nominal yield less anticipated rate of inflation (as meesured by change in GNP implicit price deflator) over period to maturity from National Bureau of Economic Research/American Statistical Association *Economic Outlook Survey*.

[2] Nominal yield less anticipated rate of inflation (as measured by change in consumer price index) over period to maturity from *Decision-Makers' Poll* by Richard B. Hoey.

Sources: Department of the Treasury, Board of Governors of the Federal Reserve System, American Statistical Association, National Bureau of Economic Research, and Richard B. Hoey.

rose roughly 4 and 3 percentage points, respectively. But by the end of 1984 nominal rates had fallen about halfway back to their 1982–83 lows. Inflation anticipations seem to have declined still further in late 1984.

By historical standards, the persistently high level of real interest rates over the past few years is one of the most unusual features of the period. The initial increase seems associated with the change in monetary policy in October 1979. Since 1981 the continuing high level of real interest rates has been linked by many observers to the large Federal budget deficit. The ensuing controversy concerned the magnitude rather than the direction of the effect of the deficit on real interest rates. A number of studies have found the effect to be quite small, although some studies using different methods have found significant effects. In any event, as the economic recovery proceeded, neither the monetary explanation nor the budget deficit explanation of high real rates of interest was satisfactory as both explanations were inconsistent with the strength of investment during the recovery.

It appears that the high level of real interest rates is in large part attributable to the major change in business depreciation allowances for tax purposes enacted in 1981, which raised the real after-tax internal rate of return on new business investment. With a higher rate of return on new investment, it is worthwhile for businesses with little cash but good investment opportunities to borrow at higher interest rates to finance investment. It is also profitable for businesses with good cash flow to invest in real assets—business plant and equipment—rather than in financial assets or investments abroad. The substantial increase in the prospective rate of return on business investment has therefore pulled up the real rate of interest in the financial markets. If returns to investment had been lower, both investment and the real rate of interest in the financial markets would probably have been lower.

It is difficult to sort out the relative magnitudes of the effects on real interest rates of monetary restriction, large budget deficits, and high real rates of return on new business investment. It seems likely, however, that over the 1981–84 period as a whole, and certainly over the recovery years of 1983 and 1984, the effect flowing from a higher rate of return on new business investment has dominated. The evidence for that proposition is the coexistence of a high real rate of interest and great strength of business investment. If the monetary or budget deficit effects had dominated, then high interest rates for these reasons would have overwhelmed the new incentives to invest, making business investment relatively weak instead of relatively strong.

EXCHANGE RATES, INTERNATIONAL TRADE, AND CAPITAL FLOWS

Economic policy has had important consequences for U.S. international trade, international financial flows, and the value of the dollar. After 1980, demand in international markets for dollar-denominated assets increased markedly, lifting the dollar's average 1984 value in terms of a weighted measure of other major currencies almost 60 percent above the dollar's 1980 average value. The dollar's impressive and continuing strength is consistent with high real rates of return on U.S. investment relative to returns abroad and lower U.S. inflation relative to inflation abroad.

As a result, the U.S. current account balance shifted from a small surplus of $1.9 billion in 1980 to an estimated deficit of $103.8 billion, or about 2.8 percent of GNP in 1984. Of the various components of the current account, an increase in the merchandise trade deficit made the largest contribution to the swing in the current account balance. These international economic developments are discussed in more detail in Chapter 3.

SPECIAL PROBLEMS

A number of special problems appeared over the past 4 years; perhaps the most serious were the near defaults on international debts, the strains in agriculture, and the instabilities of U.S. financial institutions. This third problem was partly the result of the first two. A discussion of the international debt problem is contained in Chapter 3; a brief discussion of the other two areas follows.

Agriculture

Over the 1970s, global economic growth, a depreciating dollar, changes in Soviet import policy, and several crop failures around the world all contributed to more than a fivefold increase in U.S. agricultural exports. These conditions together with inflation dramatically raised farm incomes and, with expectations of inflation and low real interest rates, set in motion huge investments to expand the productive capacity of U.S. farming and agribusiness. Total U.S. farm debt rose from $49 billion to $155 billion during the 1970s and the average price of farmland grew more than threefold. By the end of the 1970s, American agriculture had become a very capital-intensive, export-dependent sector of the U.S. economy, and the industry was much more sensitive to interest rates and exchange rates than it had been.

After 1981 the global recession depressed world agricultural trade, and the rising dollar made it increasingly difficult for U.S. agriculture to compete in world markets. The problem was exacerbated by the

Agriculture and Food Act of 1981, which established rigid price supports that tended to price U.S. commodities out of the world market.

The combined effect of these changes reduced the aggregate value of U.S. farm exports by 16.7 percent between 1981 and 1983. As a result of price support activities in the face of weak export demand and bumper crops in 1981 and 1982, burdensome inventories accumulated in the Commodity Credit Corporation and Farmer Owned Reserve. In January 1983 the Administration announced the payment-in-kind program to work off surplus inventories by inducing farmers to reduce their planted acreage. In the 1980s U.S. agricultural policies have in effect supported world market prices for the benefit of other exporting countries, which have been able to expand their farm exports. Farming and agribusiness in the United States have been left with substantial excess capacity as U.S. farm exports have become less competitive on world markets.

Adjustments within the agricultural sector and in U.S. farm policies have been difficult given the rapidity with which market conditions changed in the early 1980s. Farmers who had borrowed too much and paid too much for land in the late 1970s found themselves in difficulty. Because farmland prices have fallen between 1981 and 1984—by 7 percent on average nationally and by as much as 28 percent for some States—some highly leveraged farmers now find their loan principal larger than the market value of their land. As a result, the rate of farm failures has risen significantly. The failure rate of rural banks and agribusiness firms has also increased.

Despite record high income transfers to farmers through price and income support programs, at the end of 1983 American agriculture found itself with the lowest real net income in five decades. Returns can be expected to improve over time through a combination of improving market conditions and a reduction of excess capacity. Change in agriculture policies can also help by restoring the growth of agricultural exports.

Financial Institutions

The prolonged period of rising interest rates in the late 1970s, culminating in sustained high levels in the early 1980s, has been a key cause of the weakness of many depository institutions in recent years. For thrift institutions the problem arose principally from borrowing on a short-term basis to make longer term loans. As rates rose, the thrifts had to pay higher rates immediately to retain deposits, but they could only earn the higher yields as their longer term assets gradually matured and the funds were invested in higher yielding assets. For commercial banks the main problem has been losses from loan defaults or near defaults, especially on international loans, energy development loans, and agricultural loans.

The seriousness of the current difficulties should not be underestimated. From 1950 to 1979, 184 banks failed—an average of 6 per year. Between 1980 and 1984, 189 banks failed—an average of 38 per year. As for the savings and loan industry, from 1981 through 1984 the number of institutions insured by the Federal Savings and Loan Insurance Corporation fell by about 20 percent, largely because of mergers of weakened institutions with stronger ones.

In mid-1984 one of the Nation's largest banks had to be rescued by a multibillion dollar package arranged by the Federal regulatory agencies. A few weeks later, one of the Nation's largest savings and loan associations ran into trouble. Never before in the postwar period had the largest class of depository institutions suffered deposit "runs" requiring support from the Federal regulatory agencies.

Longstanding policy mechanisms have been used to deal with these problems. With only a few exceptions, runs on financial institutions have been avoided because public confidence in the financial system has been maintained through deposit insurance and the activities of the Federal regulatory agencies. The Federal Reserve has provided appropriate assistance through its discount window, and the regulatory agencies have closed weak institutions or arranged orderly mergers with stronger ones. Beyond these traditional measures, the Garn-St Germain Depository Institutions Act of 1982 has allowed the Federal Deposit Insurance Corporation and the Federal Savings and Loan Insurance Corporation to purchase net worth certificates from qualified institutions to maintain their regulatory net worth positions high enough for them to continue operating.

With continuing economic growth, declining inflation and interest rates, and time for adjustment, depository institutions are strengthening their financial positions. Structural problems in the industry are being addressed. The Garn-St Germain Act granted thrifts new powers to diversify their portfolios away from long-term, fixed-rate mortgages. In 1984 the Federal regulatory agencies began to take steps to require banks to raise more capital as a precaution against future difficulties, and the Administration and Federal regulatory agencies began a study to reassess Federal deposit insurance. Despite recent progress, however, many depository institutions do not as yet have the resources to deal with a sustained period of higher interest rates or the loan defaults that might occur if the United States and world economies were to weaken significantly.

The Common Element

It is worth reflecting on the fact that the 1970s rise and the 1980s fall of inflation are elements common to these special problems. Many decisions made during the late 1970s, based on the expectation of continuing inflation, turned sour in the early 1980s as inflation

fell. This pattern has recurred often throughout U.S. history. The specifics differ from one episode to another, but a feature common to all of them is that loans made to finance projects based on the assumption of continuing high inflation tend to go bad when inflation comes down.

POLICIES FOR SUSTAINED ECONOMIC GROWTH

What policies will best avoid the traumas of low growth, recession, and inflation? The subject of long-run economic growth is taken up first; issues concerning output and employment stability around the growth trend and those concerning price stability are discussed in the next section.

Almost every government spending program, every provision in the tax law, and every regulation has some effect on growth. Most of the effects are individually small, but their sum total is not. The purpose of this section is not to provide a detailed examination of all the effects of government on growth—an impossible task—but rather to sketch a framework for analyzing those effects. Some of the policy issues are illustrated through specific examples. Chapter 2 contains a general analysis of the costs of government expenditure and the effects of the tax system on economic efficiency.

GROWTH AS A GOAL

Growth of real GNP has long been a national policy goal. Clearly, although the welfare of a society depends very importantly on the size of its real GNP, economic welfare is not measured solely by the quantity of goods and services produced; a single-minded devotion to more output is entirely inappropriate.

A substantial part of the growth in the potential output of goods and services has historically been taken not in the form of greater actual output but in increased leisure. People work shorter hours and take longer vacations than their forebears. They stay in school longer and enjoy earlier retirement. They invest in themselves and accumulate knowledge in ways that do not show up as entries in statistical tables. These changes are as much a part of the economic growth process as is the growth of real GNP measured in the national income and product accounts.

Moreover, even with respect to the goods and services component of economic welfare, the goal is consumption and not simply production. Saving and investment are important parts of the growth process, but greater current saving and investment for a given level of GNP generally mean less current consumption. At least in the ab-

sence of borrowing, current consumption must be forgone to achieve higher future output and consumption.

Throughout U.S. history, choices between work and leisure and between present consumption and future consumption were determined almost entirely within a relatively unconstrained market economy. Over the past 50 years, however, these decisions have increasingly been influenced by government. Government itself has saved or dissaved, and has determined the extent to which its own expenditures are oriented toward consumption or investment. Taxes, subsidies, and regulations have affected substantially the choices made by individuals and firms. In general, government policies have tilted individual decisions toward more leisure and less work, and toward more consumption and less saving.

Few government policies were explicitly intended to reduce work or saving and investment, but policies introduced for other reasons have often had these effects. With growing recognition of the importance of economic growth, all government policies need to be reexamined to determine whether their original aims are still valid or can be met through revised policies that have less negative impact on growth.

Some of the most difficult policy issues arise from the need to reconcile economic growth and economic security for individuals. The growth process creates risks for individuals; growth requires that both labor and capital resources be continuously reallocated to their most efficient uses. Entrepreneurs take risks and are often rewarded. Over time the economy as a whole benefits as new industries replace old established industries and production is shifted from one region or nation to another. In this process some people lose jobs and some firms go bankrupt, changes that are often wrenching for those involved.

Individuals absorb many risks themselves, through their occupational choices, savings, insurance, and other mechanisms. But over the years the United States and other industrial countries have sought to soften the shock to individuals resulting from the growth process. Some of these policies, however, come at the cost of reduced growth.

Careful attention to incentive issues is central to understanding the relation between growth and security. Although compensating individuals for losses suffered through no fault of their own often seems fair and just, such government policies inevitably affect choices of occupations and activities. People will be more likely to engage in activities for which the probability of loss is rather high and prospective returns low if they know that unfortunate outcomes will bring compensation from government. Long-continuing compensation may pre-

vent resources from moving out of declining industries to growing ones. Public policy must weigh the value of compensating individuals for unfortunate outcomes after the fact against the incentive created for people to assume risky positions before the fact and to remain in uneconomic occupations and industries. It is simply not possible to have a systematic public policy of compensation without creating adverse incentive effects. Government policymakers have often underappreciated the importance of the disincentives sometimes inadvertently built into policy.

PRODUCTIVITY

Productivity is at the core of the growth process. By increasing output per hour worked, it is possible to enjoy both more consumption and more leisure. Despite its importance, productivity growth is incompletely understood at a quantitative level. Qualitatively, however, it is clear that both formal schooling and on-the-job training are important sources of increases in productivity, as are capital formation and technical change.

Historically, productivity increases have involved the long-term improvement of labor skills, increases in the capital available to each worker, and the reallocation of resources from lower valued to higher valued uses. The process of "capital deepening"—increasing the capital per worker—involves not only an increase in the quantity of capital but also an improved character or quality of capital. To be used efficiently, more sophisticated and complicated capital must be maintained and operated by a more highly skilled labor force; the type of capital that can be used productively in the United States, with its highly skilled labor force, is quite different from the type of capital that can be used productively in developing nations. To maximize economic growth, investment in human skills and physical capital must proceed in appropriate proportions.

Productivity is influenced by technical change. Invention and innovation improve both skills in the labor force and features of the capital with which the labor force works. The scientific aspect of technical change is obviously important, but so also is the success with which an economy moves laboratory discoveries into the production process.

Numerous public policies influence economic growth through their effects on saving, investment, and the degree to which innovators may be encouraged through patent and copyright protection. The latter is but one example within the broad topic of the definition and limitation of property rights and their effects on the creation and use of resources. Budgetary allocations to subsidize education and research are obviously relevant, as are tax policies that affect the oper-

ating costs of scientific, educational, and research institutions and the incentive for private individuals to make charitable gifts to them. The vigorously competitive and open environment in the United States has proven especially fertile to scientific and educational endeavors.

The productivity of the economy is related to the efficiency with which it allocates its resources. The United States has been particularly successful in permitting and encouraging resources to move to their highest valued uses. The Nation has seen enormous reallocations of resources; out of agriculture and into other industries; from the Northeast to the South and West; from older manufacturing industries into newer high-technology industries. Labor is highly mobile. Young people frequently move from one job to another and from one region to another, searching out their most productive and personally satisfying employments. Unfortunately, the efficiency with which government itself uses resources has often been neglected; some government expenditures appear in the national income and product accounts as output but are in fact largely waste.

A major issue concerns the government role in allocating resources. Government subsidies and regulatory constraints affect the allocation of resources in many parts of the economy. Some of these policies are constructive but others waste resources, distort the mix of production, and reduce incentives to allocate resources to their most efficient uses. The use of tariffs and quotas to protect domestic industries from foreign competition, and thereby to prevent or slow the transfer of resources out of the affected industries, has been controversial from the earliest days under the Constitution.

THE DETERMINANTS OF TOTAL GNP GROWTH

Fluctuations in the growth of GNP over periods of 5 or 10 years have been mostly attributable to changes in productivity growth, with the important exception of the Great Depression, when a large and long-maintained increase in unemployment depressed output. However, determinants of total output growth other than productivity are affected by public policy and so deserve a brief discussion.

Partitioning the growth of total real GNP into components reflecting the growth of output per hour worked and the growth of total labor hours provides a convenient analytical framework. The growth of total hours worked can be further partitioned into population growth, changes in the fraction of the working-age population that is in the labor force (the participation rate), changes in the percent of the labor force employed (the employment rate), and changes in average hours worked per employed member of the labor force.

Table 1-3 provides information structured according to this framework. To avoid complications arising from business cycle fluctua-

tions, the entries in the first two columns are calculated from one business cycle peak to another. The third column reports data from the 1981 cycle peak through 1984, and the fourth column reflects the Administration's projections for 1984–90.

TABLE 1–3.—*Accounting for growth in real GNP, 1948–90*

[Average annual percent change]

Item	1948 IV to 1981 III	1973 IV to 1981 III	1981 III to 1984 IV[1]	1984 IV to 1990 IV
GROWTH IN:				
(1) Civilian noninstitutional population aged 16 and over	1.5	1.8	1.2	.9
(2) PLUS: Civilian labor force participation rate	.2	.5	.4	.6
(3) EQUALS: Civilian labor force	1.8	2.4	1.6	1.6
(4) PLUS: Civilian employment rate	−.1	−.4	.1	.3
(5) EQUALS: Civilian employment	1.7	2.0	1.6	1.8
(6) PLUS: NFB Employment as a share of civilian employment	.1	.2	−.2	.6
(7) EQUALS: NFB employment	1.8	2.1	1.5	2.4
(8) PLUS: Average weekly hours (NFB)	−.4	−.6	.1	−.2
(9) EQUALS: Hours of all persons (NFB)	1.4	1.5	1.6	2.2
(10) PLUS: NFB output per hour (productivity)	2.0	.7	1.9	2.0
(11) EQUALS: NFB Output	3.4	2.2	3.5	4.2
(12) LESS: NFB output as a share of real GNP	−.1	−.2	.7	.3
(13) EQUALS: Real GNP	3.5	2.4	2.7	3.9

[1] Data for 1984 IV are preliminary.

Note.—NFB refers to nonfarm business sector.
Based on seasonally adjusted data.
Detail may not add to totals due to rounding.

Sources: Department of Commerce (Bureau of the Census and Bureau of Economic Analysis), Department of Labor (Bureau of Labor Statistics), and Council of Economic Advisers.

Population Growth

The first row of Table 1–3 reports Bureau of the Census estimates of population growth over the periods indicated, together with the Census projection for 1984–90. Growth in the working-age population, of course, is an important determinant of the size of the labor force. As can be seen from the first and last columns of the table, population growth in the second half of the 1980s is projected at 0.9 percent per year compared with 1.5 percent per year over the 1948–81 period.

The Participation Rate

The participation rate, the fraction of the working-age population in the labor force, is determined by a variety of factors. Retirement decisions determine the labor force participation of older workers and decisions concerning the length of schooling determine the participation of young people. Over the past 15 years women have entered the labor force in large numbers, reflecting changes in attitudes toward work and home. Finally, some people despair of finding jobs and so cease their job search; these "discouraged workers" would

like jobs but, because they have ceased job search, are not counted in the labor force.

As shown in Table 1-3, the participation rate grew by 0.5 percent per year between 1973 and 1981 as large numbers of women entered the labor force. The projected 0.6 percent growth rate for 1984 to 1990 reflects both a projected continuation of rising female labor force participation and the movement of the baby-boom generation into older age groups that traditionally have a higher participation rate.

A wide variety of important and controversial public policy issues involve the participation rate. One is whether public policy should encourage, discourage, or remain neutral with respect to the choice of retirement age. Another concerns the effects of public policy on the decisions of young people to remain in school; while longer schooling keeps a person out of the labor force, thereby reducing the participation rate, it also improves labor skills, raising productivity growth.

Of special relevance to the debate over tax reform is the fact that lower marginal tax rates can be expected to increase labor force participation, especially of married women. There is substantial evidence that the labor force participation of these people is particularly sensitive to their after-tax wage rates.

Together, the growth of population and the growth of participation determine the growth of the labor force. Thus, row 3 in Table 1-3 is the sum of rows 1 and 2. The 1984-90 projection of 1.6 percent per year growth in the civilian labor force is slightly below the 1948-81 average of 1.8 percent and well below the 2.4 percent rate from 1973 to 1981.

The Employment Rate

The employment rate is the percent of the labor force employed, or 100 percent minus the unemployment rate. Numerous public policies affect the average employment rate over time. Income maintenance programs, including the unemployment insurance system, are known to be important. The higher the level of unemployment benefits compared with after-tax earnings available from employment, and the longer such benefits can be received, the lower the incentive to accept employment. This effect is offset to some degree by business taxes on firms to support the unemployment insurance system; these taxes are based in part on a firm's experience in laying off workers and so provide an incentive for firms to maintain employment stability. More complete experience-rating in assessing taxes on firms might lower the average unemployment rate, while maintaining the present insurance function for those who become involuntarily unemployed.

Lower average employment for reasons of job search does not necessarily mean lower national output. If longer periods of job search lead to more productive matching of employees and employers, then the net loss in output from higher average unemployment may be offset by greater productivity when people are employed. Public policy might be based on the view that there is no *prima facie* case that individuals tend to make wrong decisions with regard to job search. If this view is accepted, income maintenance programs should not provide incentives for unduly prolonging job search.

Another public policy that affects the average unemployment rate is the minimum wage—its level and coverage. It is not profitable for business firms to hire people whose productivity is below their wage, and in highly competitive markets businesses will not be able to hire such people. In the absence of a minimum wage, some of these low-skilled people would be voluntarily employed and would have an opportunity to enhance their job skills. The Administration's proposal to permit a youth employment opportunity wage in the summertime reflects these considerations.

Row 4 in Table 1–3 shows the growth in the employment rate for various past periods together with the Administration's projection for 1984–90. The increase in unemployment between 1973 and 1981 was sufficient to lower the employment rate by an average of 0.4 percent (*not* percentage point) per year. Under the Administration's economic projections, 1984–90 will see an increase averaging 0.3 percent per year. Rows 3 and 4 sum to row 5, the rate of growth of the number of people in civilian employment. The 1984–90 projection of 1.8 percent per year is slightly above the 1948–81 average of 1.7 percent per year.

(A technical note: To study productivity, information on the hours of work rather than just the number of people working is required. Reasonably accurate data on total hours worked are not available for the entire economy, but are available for the nonfarm business sector. Row 6 reports annual growth in nonfarm business employment as a share of total civilian employment. Row 7 reports annual employment growth in the nonfarm business economy. The 2.4 percent per year growth rate over the 1984–90 period is higher than that for the whole economy because the farm and government sectors are expected to grow relatively slowly.)

Average Hours Worked

As can be seen from row 8 in Table 1–3, average hours worked have declined at 0.4 percent over the postwar period, and the decline is projected to continue to 1990 at a 0.2 percent rate. Average hours can change for reasons other than the obvious ones such as longer vacations. For example, an influx of young workers, who often hold

part-time jobs, will reduce average hours for all workers taken together. Policy issues that arise in this context concern such matters as legislated premiums for overtime work and rules governing taxes on firms for unemployment and workers' compensation funds. These taxes, depending on their design, may encourage or discourage firms from hiring part-time employees.

Productivity

General considerations relating to productivity have already been discussed. Row 10 in Table 1–3 shows that the estimate of productivity change over the postwar period and the projection for 1984–90 are identical at 2.0 percent per year growth. In contrast, productivity growth averaged only 0.7 percent per year from 1973 to 1981.

Productivity growth estimates in row 10 apply to the nonfarm business economy. Row 12 shows the rate of change of the ratio of nonfarm business output to real GNP; that ratio is projected to rise over 1984–90 as the farm and government sectors experience relatively low growth. Row 13 shows the rate of growth of total real GNP; the Administration's projection is for average growth of 3.9 percent per year for 1984–90.

THE IMPORTANCE OF PRICE STABILITY TO ECONOMIC GROWTH

The contribution of price stability to economic growth is important if behavior based on economic incentives is to direct resources reliably to their most efficient uses. In periods of general inflation, price signals are often distorted. High inflation is also usually more variable and less predictable than low inflation, which makes it more difficult to compare the profitability of a project investigated carefully last month with an alternative project investigated carefully this month, and to separate transitory and inconsequential changes in individual prices from fundamental changes. Inflation also tends to bias decisions toward short-run payoffs and consumption. Contractual income from some long-term investments is eroded by long-continuing inflation, while other investments yield great rewards because they happen to benefit from inflation. For all these reasons, inflation often causes allocative inefficiencies that in the aggregate reduce economic growth.

THE OUTLOOK FOR ECONOMIC GROWTH

Prospects for a long-term revival of economic growth in the United States are excellent. Growth in employment should continue. Productivity performance has already improved; as indicated by the 1.9 percent growth rate between the business cycle peak in the third quarter of 1981 and the fourth quarter of 1984. This 13-quarter period encompasses *both* the 1981–82 recession and the 1983–84 recovery, so

the higher productivity growth is not simply a feature of the recovery phase of the business cycle. By way of comparison, over the 13-quarter period following the cycle peak in the fourth quarter of 1973, productivity rose at an average rate of 1.4 percent per year.

Productivity performance higher than the 1984–90 projection is clearly possible. Reasons for optimism include the acquisition of skills by the baby-boom generation that entered the labor force in the 1970s, the high rate of business investment, a lower and more stable inflation rate, and a phasing out of some inefficient government programs and regulations. But there is also ample reason to be cautious. Federal expenditure as a share of GNP is now higher than in the 1970s, many potential regulatory reforms have yet to be made, and continuing progress on the budget deficit is necessary.

POLICIES FOR EMPLOYMENT AND PRICE LEVEL STABILITY

The Great Depression clearly demonstrated the paramount importance of stabilizing employment at a high level. The previous section on economic growth contained a brief discussion of how changes in public policy might contribute to a higher average level of employment than experienced over the past decade. The subject of this section is stability around the average level.

Macroeconomic policies to increase employment are often advocated on the grounds that they will increase long-term growth. It is certainly better, other things being equal, to reduce unemployment sooner rather than later, but unless the long-run average rate of unemployment can be continuously lowered, or productivity growth increased, a quick reduction of unemployment will have little effect on the long-run rate of growth. Indeed, some policies to reduce unemployment quickly may have adverse effects on long-run growth. For example, a public employment program might reduce short-run unemployment but at the same time reduce long-run productivity growth through the inefficiencies of such programs. Some argue that such a tradeoff is worthwhile, but certainly there should be no automatic assumption that every policy to reduce unemployment will increase long-term growth.

Even if feasible, it would not necessarily be desirable to eliminate all fluctuations in employment. Agricultural output and employment are inherently seasonal. Some unemployment is frictional: People quit their jobs and take time to look for better ones; firms discharge employees, who must then search for new jobs.

Because some unemployment is voluntary and desirable, and some unavoidable, it is difficult to assess the general significance of fluctuations in employment. Clearly, unemployment associated with reces-

sions leads to great distress for many. Avoiding such unemployment by avoiding the conditions that cause recessions is a major goal of public policy.

As with employment and output, seasonal fluctuations in prices are normal. But the distinction between stability of the general price level and stability of individual prices is most important. Stability of the general price level is fully consistent with constantly changing individual prices. These fluctuations in individual prices serve to reallocate the economy's resources as market demand and supply conditions change. Direct control of individual prices is not an appropriate strategy for stabilizing the general price level in a market economy because of the distortions and inefficiencies caused by such controls.

The most important part of the goal of price stability is not constancy of the general price level but predictability. Many feel cheated by unanticipated changes in the price level. Citizens who acted cautiously and conservatively by placing funds in traditionally safe investments, such as bonds and ordinary life insurance, find the real value of their savings eroded by unanticipated inflation. Conversely, unanticipated inflation may reward those who place their savings in risky and speculative investments or who assume heavy long-term debts at a fixed rate of interest.

Because unanticipated inflation upsets normal investment calculations, it tends to amplify fluctuations in output and employment and to misallocate resources across different sectors of the economy. Problems in the agricultural and financial sectors caused by the 1970s inflation and 1980s disinflation were discussed earlier in this chapter. The boom and bust cycle in economic activity has almost always been associated with instability in the general price level.

As a purely economic matter, there is little advantage to a fully predictable rate of inflation of zero as compared with a fully predictable moderate rate of inflation, once the economy has fully adjusted. But the converse proposition is also true; inflation of, say, 5 percent per year has no economic advantage compared to complete price stability. Moreover, accepting some inflation has the great disadvantage of promoting distrust of the government's commitment to maintain control over inflation. As a political matter, an inflation target other than zero is not entirely credible. If 5 percent inflation is acceptable, most would say, why not 6 percent, or 8 percent, or 10 percent inflation?

This question arises not only from doubts raised by historical experience but also because there may be short-run gains from pursuing inflationary policies. The initial effects of such policies include temporary increases in output and employment; the costly inflation comes later. Public reaction to inflation and insistence that inflation-

ary policies be changed may be one of the reasons why in the United States, and across the world, higher inflation has generally been less stable and less predictable. To avoid these instabilities the short-run inflationary bias must be resisted by building in a firm commitment to noninflationary policies. Reducing inflation and in time achieving full price stability—zero inflation—is a major goal of this Administration.

MONETARY POLICY

Long-continuing inflation is fundamentally a monetary phenomenon. Other things being equal, creating more money creates a higher general level of prices. As is the case with other economic relationships, the one between money growth and inflation is not precise. This is responsible for the prevalence of nonmonetary theories of inflation. These nonmonetary theories have a ring of plausibility to them, and they have often led to government policies to combat inflation that are totally ineffective, or worse, positively harmful.

Many observers attributed the rise in inflation in 1973 and again in 1979 to the two oil price shocks. That view is fundamentally incorrect, although it is certainly true that the oil price shocks did provide further upward boosts to inflation in environments that were already marked by substantial inflationary pressures. The pattern of rising inflation was established before both of the oil price shocks. These shocks would have had much less impact on inflation had they occurred in an environment of market confidence in underlying price stability.

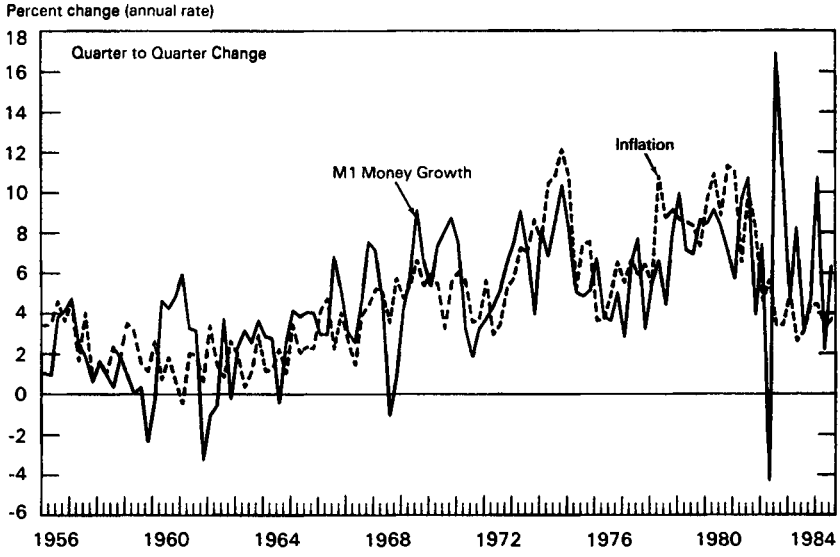
Chart 1–2 demonstrates both the looseness of the short-run relation between money growth and inflation and the strength of the underlying long-run relation. Based on studies indicating that the average lag between money growth and inflation has been about eight quarters, the top panel of the chart relates the inflation rate in a given quarter to the rate of growth of money (M1 definition) eight quarters earlier. Panel B of the chart relates the 2-year moving average rate of inflation to the 2-year moving average rate of money growth eight quarters earlier. More complex specifications yield somewhat closer relationships between money growth and inflation, but the basic proposition stands: quarter-by-quarter inflation is only loosely related to money growth, while inflation over longer intervals is more closely related to money growth.

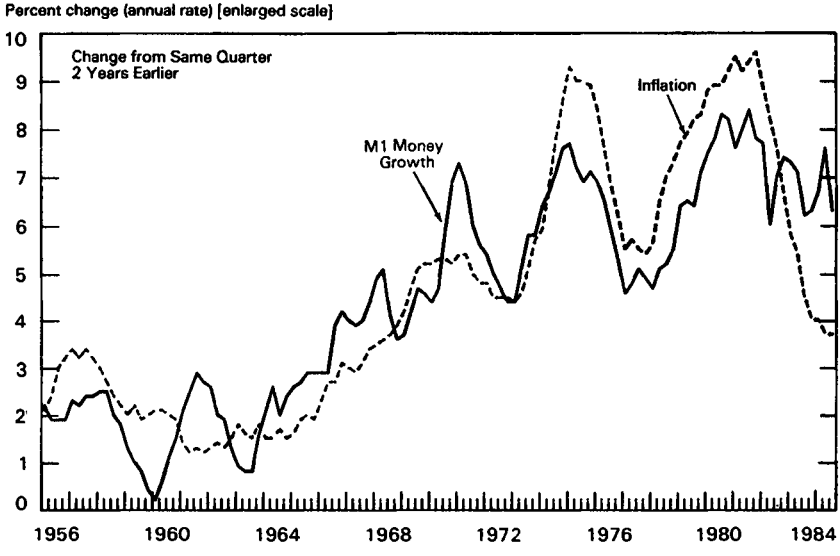
There are good economic reasons for the rather loose short-run relation between money and prices. Expectations can be extremely important: the effect of a change in the money stock on demand and supply conditions in markets, and therefore on prices, depends on whether the money stock change is viewed as temporary and subject

Chart 1-2

Money Growth and Inflation

Money Growth Lagged 8 Quarters





Note.—Inflation measured by change in GNP implicit price deflator. Based on seasonally adjusted data.

Sources: Department of Commerce and Board of Governors of the Federal Reserve System.

to reversal, or the beginning of a new trend. Over the longer run, such effects are of much less relative importance as incorrect expectations are adjusted in the light of subsequent experience.

The short-run inflation rate can also be affected by numerous nonmonetary conditions. But these conditions are ordinarily temporary and self-reversing, or at least not repetitive and cumulative. For example, a bad harvest might raise food prices and the general price level one year, but these effects are reversed when normal harvests resume.

Over the long run, inflation can be affected by economic growth. Because the economy uses money to transact the sale of goods and services, for a given rate of money growth, higher real GNP growth will yield a lower inflation rate. Historically, though, from one decade to another average real GNP growth in the United States has rarely varied by more than a few percentage points and can, therefore, account for only a small part of the variation in inflation.

Monetary policy is frequently judged by the behavior of interest rates rather than by the behavior of money growth. Central banks, including the Federal Reserve, have generally pursued monetary policy objectives through close control over interest rates in the short run. The tendency for central banks to follow this approach is reinforced by the fact that interest rate information is continuously available and most directly affects the behavior of market participants.

Data on the money stock, on the other hand, are available with a lag. More importantly, the aggregate money stock is relevant to individuals and firms only insofar as it has implications for economic conditions that directly affect them. Businesses, for example, are concerned with the prices of the goods they buy and sell, the wage rates they pay, and the interest rates they pay or receive. Although the aggregate money stock is of great relevance for variables of this kind, it is easily overlooked as an abstraction when compared with interest rates, which have great visibility and immediacy.

For these reasons, and others, policymakers and market participants have most often viewed monetary policy primarily in terms of control of, or influence over, interest rates. This view may lead to dangerous misinterpretations. Sometimes, rising interest rates reflect a restrictive monetary policy as the monetary authority reduces the supply of money in the short run. At other times, rising interest rates reflect a rising demand for funds in the private market with a steady or even increasing rate of money growth. The course of the economy is likely to be quite different when interest rates rise temporarily because of falling money growth, compared with its course when rates rise from growing private credit market demands.

Changes in inflation expectations have been particularly important over the past 20 years. After the fact, it became obvious that rising interest rates in the late 1960s reflected growing fears of inflation. Lenders increasingly insisted on higher interest rates to protect themselves from rising inflation, and borrowers were willing to pay these higher interest rates because they anticipated repaying loans in depreciated dollars. In 1967–68, 1972–73, and 1977–78, rising interest rates were accompanied by high money growth; monetary policy was inflationary rather than restrictive.

When inflation expectations fall, interest rates also fall. If money growth remains well controlled, declining interest rates reflect not an easier monetary policy but the success of disciplined monetary policy in reducing both actual and expected inflation. Under these conditions, if the central bank resists downward pressure on interest rates by reducing money growth, the outcome may be a recession.

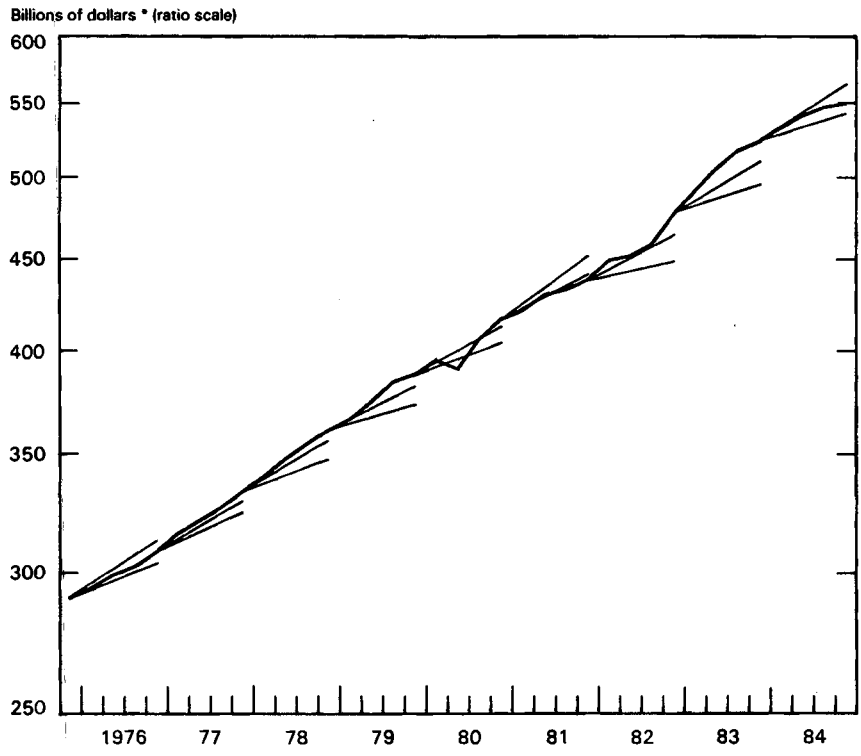
Over the past two decades, professional and public understanding of the importance of controlling money growth, and of the dangers of focusing on interest rates, has grown. In January 1970 the Federal Reserve's main policymaking body, the Federal Open Market Committee, adopted a money growth target for the first time. In 1975 the Congress passed Joint Congressional Resolution 133 requiring the Federal Reserve to adopt and announce 1-year money growth targets. In October 1979 the Federal Reserve changed its policy procedures with the intent of controlling money growth more precisely.

Chart 1–3 shows the M1 measure of the money stock over the period 1975–84. The announced target ranges for the four quarters of each year are also shown. (Not shown are other announced target ranges that in some cases modified or superseded the ranges shown in the chart.) Because M1 has been redefined, the target growth ranges in the chart have been adjusted to reflect the difference between M1 as now reported and as originally reported in February or March of the following year. However, differences between actual and targeted money growth shown in the chart are the same as the differences reported originally.

In the late 1970s money growth exceeded the announced target for 3 years in a row. These overruns were a consequence of the Federal Reserve's policy of maintaining a narrow short-run target range for the federal funds rate—a key interest rate in the money markets—and of failure to adjust the federal funds range up rapidly enough in the face of the upward pressures on interest rates that characterized the 1977–79 period. Although targeting the federal funds rate, or interest rates in general, has been advocated as a device to cushion interest rate pressures arising from temporary disturbances in the credit markets, the late–1970s experience, which is not unique, demon-

Chart 1-4

M1 Money Stock and Federal Reserve Target Ranges



* Averages of daily figures, seasonally adjusted.

Note.—Targets are fourth quarter to fourth quarter wedges as described in the text.

Sources: Federal Reserve and Council of Economic Advisers.

strates that this policy runs the risk of permitting excessive money growth and thereby contributing to inflation.

After the business cycle peak in July 1981, interest rates were generally declining. At that time the policy of cushioning downward interest rate pressures led to a decline in money growth. At the end of 1981 the money stock was below the target range announced at the beginning of the year.

The variability of money growth has led some observers to conclude that it is not technically possible for the Federal Reserve to control money growth accurately. That conclusion is incorrect; adjustments in the way reserve requirement regulations are written and in the way Federal Reserve open market operations are conducted

could achieve much more accurate money stock control. The real issues are different; they concern the effects on interest rates and the economy of adhering more closely to a money growth target. Although these matters are controversial, the position taken here is that adhering more closely to moderate money growth targets would increase rather than decrease the stability of interest rates and employment, and contribute very substantially to restoring and then maintaining price stability.

An additional feature of Chart 1-3 deserves mention. The Federal Reserve has defined the target growth range each year on a base equal to the actual level of the money stock in the fourth quarter of the previous year. For several years in a row in the late 1970s, above-target money growth one year was built into the next year's target. In 1981 below-target money growth was built into the target for 1982. If the base were the midpoint of a year's fourth-quarter target range, then differences between the actual money stock and the midpoint would not be built into the money growth target for the next year. "Base drift" would not occur.

In addition to M1, the Federal Reserve has announced targets for broader definitions of the money stock, M2 and M3, and usually for a bank credit or total credit measure as well. However, the evidence suggests that of the available monetary aggregates and credit measures, M1 is the most closely and reliably related to economic activity and inflation. The M1 target might best be regarded as primary and the others as supplemental.

Despite the fact that short-run changes in money growth have often inadvertently been poorly timed with respect to unpredictable fluctuations in the economy, monetary policy has been considered by many to be a valuable policy tool to stabilize output and employment. Activist use of monetary policy to stabilize employment, however, tended to be inflationary over the 1965–80 period. The reason is that higher money growth for a time must be offset by lower money growth at some other time. Otherwise, the average rate of money growth over time will rise, as will the long-run rate of inflation. Central banks, including the Federal Reserve, have usually found it much easier to increase the rate of money growth than to achieve the offsetting decrease at some later time.

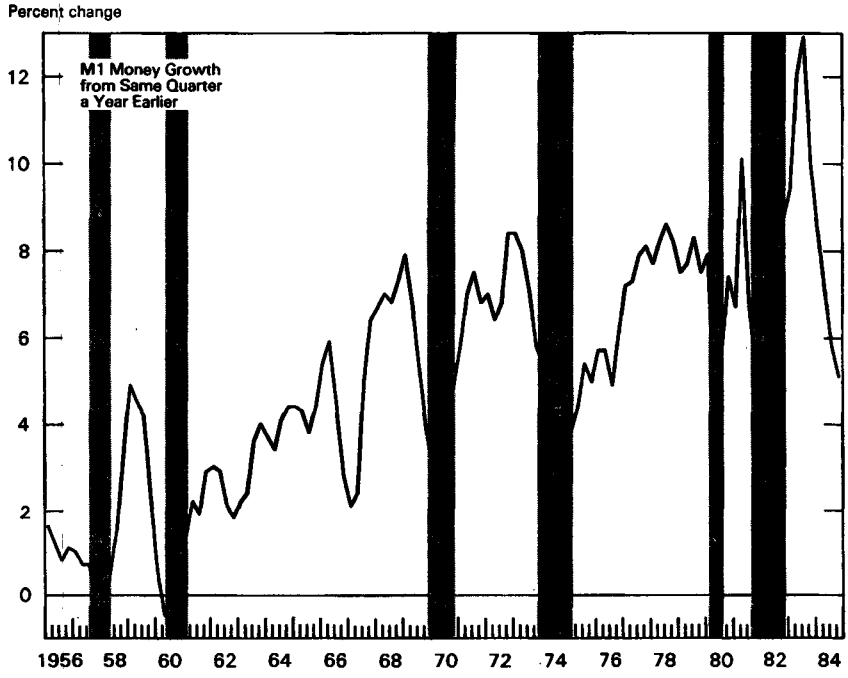
The discussion so far has concentrated on the relation of money growth to inflation. Fluctuations in money growth are also related to fluctuations in employment and output, although the reasons for this relation are less well understood.

It appears that *changes* in money growth, rather than the rate of growth itself, are correlated with the business cycle. Since 1907—the first year for which monthly money stock data are available—there

has never been a recession when money growth was rising. Historically, money growth has usually declined before the beginning of a recession, and the lower rate of money growth has most often extended into the recession. Less often, money growth has declined about the time a recession begins, and the lower growth has extended into the recession. Money growth has typically stabilized, or risen, before a recession has ended and a recovery begun. Chart 1-4, showing money growth from the same quarter a year earlier and shaded areas to indicate recessions, illustrates these relationships.

Chart 1-3

Money Growth and the Business Cycle



Note.—Shaded areas indicate recessions (peak to trough) as defined by the National Bureau of Economic Research.

Source: Board of Governors of the Federal Reserve System (except as noted).

Fluctuations in money growth have been related in part to the emphasis on interest rates in the conduct of monetary policy. When the economy is unexpectedly weak, and before economists' forecasts adjust to a changing business outlook, credit demands and interest rates tend to decline. If the monetary authority cushions the decline, then money growth falls. Under these circumstances, the decline in money growth is not appropriate; money growth should be maintained and interest rates permitted to fall more rapidly to provide support for a weakening economy. Similarly, if interest rates are held down in the face of unexpected strength in the economy, money growth may rise, contributing to the development of inflation. Steady money growth tends to act as an automatic stabilizer: interest rates rise automatically when the economy strengthens and fall when the economy weakens.

Once it has become clear that inflationary or recessionary pressures are developing, the monetary authority usually adjusts interest rates fairly aggressively, and money growth changes. But because of the lag in the effects of policy, a changed rate of money growth does not act quickly to slow inflation or to resist developing unemployment.

The importance of avoiding outbreaks of inflation in order to avoid subsequent recession is well illustrated by events since 1965. Rising rates of money growth in 1967–68, 1972–73, and 1977–78 were followed in each case by lower rates of money growth and recessions. If periods of lower money growth had not followed the periods of higher money growth, then the *average* rate of money growth and the average rate of inflation would have been higher than they actually were.

It has been emphasized that the relationships between money growth and inflation and between changes in money growth and the business cycle are not precise. To the extent that changes in these relationships can be reliably forecast, there may be reason to depart from previously announced money growth targets. From the evidence now available, the sharply higher money growth from mid-1982 to mid-1983 is a prime example of a case in which money growth far in excess of the target range did not re-ignite inflation. The case for monetary targeting, however, is not overthrown by this one episode in which abandoning targets worked well, especially given that M1 growth was below target as the recession developed in 1981. There is no reason to believe that the regularities exhibited in the charts in this section, regularities that also characterize U.S. experience before World War II and the experience of other countries, have broken down.

The fact that monetary regularities are not precise makes clear that there are unavoidable risks. What the record suggests is that more stable money growth will manage the risks better and reduce the chance that monetary policy will itself be a source of disturbance to the economy.

The present task is to complete the agenda of restoring full price stability. The Nation has just gone through a difficult period of adjustment to lower inflation—indeed, the adjustment is still incomplete. It is important that gains achieved in reducing inflation not be lost. Success will require permitting enough money growth to allow vigorous economic expansion, while at the same time maintaining downward pressure on the inflation rate to build confidence in the achievement of long-run price stability. To achieve these goals, the Administration supports a policy of gradually reducing the average rate of money growth over time and of stabilizing short-run money growth to the maximum extent possible.

FISCAL POLICY

Over the postwar period, until relatively recently, most economists were optimistic that fiscal policy, through a combination of automatic stabilizers and discretionary adjustments, could be used to dampen business cycle fluctuations. The automatic stabilizers have worked reasonably well to reduce the variability of disposable personal income, but discretionary policy adjustments have often been ill timed.

When the economy weakens, tax receipts fall and certain expenditures, such as those for unemployment benefits, rise. These automatic stabilizers do not require congressional action. Moreover, they do not upset private planning because their characteristics are known to private decisionmakers in advance.

The Bureau of Economic Analysis (BEA) has provided estimates of the cyclically adjusted Federal budget deficit on a national income and product accounts basis. Although any such estimates are subject to certain conceptual and estimation difficulties, BEA estimates provide a rough sense of the quantitative importance of the automatic stabilizers. For example, from the cycle peak in the third quarter of 1981 to the cycle trough in the fourth quarter of 1982, the total budget deficit rose by $147.5 billion; BEA estimates that $65.8 billion of the increase was attributable to the automatic stabilizers.

Beyond issues of forecast accuracy and policy lags, there is increasing doubt about the effectiveness of discretionary fiscal policy even if it could be changed in a timely fashion. Fiscal policy does not appear to have the large impacts on aggregate economic activity through demand side effects that were once thought to exist. Because con-

sumption behavior depends on households' average income, changes in individual income taxes for countercyclical purposes seem to have especially small effects. If taxpayers expect income tax changes to be temporary—and changes for countercyclical stabilization should be interpreted in a temporary context because recessions and booms are not permanent—then the tax changes are likely to have relatively little effect on consumption behavior.

Temporary changes in transfer payments seem to have little value for stabilization purposes, for the same reason that temporary tax changes have little value. The evidence suggests, however, that temporary changes in government purchases of goods and services may have somewhat greater, though still relatively small, effects on total GNP in the short run.

A problem with increasing government purchases for countercyclical purposes is that such increases run directly counter to the long-run goal of constraining government expenditure to reduce waste and promote growth. It often proves difficult to reverse spending increases—even those adopted initially as temporary. Proposals to increase expenditure for any purpose—including countercyclical stabilization—should be examined very carefully, for reasons discussed in Chapter 2 of this *Report*.

Finally, activist fiscal policy—whether on the spending or the tax side—can be upsetting to private decisionmaking. Changes in jobs, place of residence, and business investment in plant and equipment are based on long-term expectations and plans; frequent changes in government tax and spending policy make efficient decisions more difficult. Fiscal policy adjustments are often unpredictable, and this uncertainty complicates both business and consumer planning. Indeed, because business cycle fluctuations themselves have proven so difficult to forecast, government responses to business fluctuations are necessarily difficult to forecast. To avoid these problems, the purpose of fiscal policy changes should be long-run reform to improve efficiency and equity while establishing a stable and predictable fiscal framework.

THE OUTLOOK FOR 1985-90

Americans have every reason to look forward to continuing economic expansion. The base has been established: Inflation is down, interest rates are down, employment and output growth has been strong, productivity growth is up, and domestic business investment is strong. The major item of unfinished business is the establishment of long-run fiscal equilibrium, which requires a much lower budget deficit and assurance that the government expenditure share of GNP

does not continue to increase. Economic expansion will not be perfectly steady, as the past few quarters have illustrated once again, but the prospects for continuing growth are excellent.

Some observers, however, are already discussing the prospect for a new recession beginning in late 1985 or 1986. Policy mistakes can yield such a result, but there is no reason why such mistakes need occur. Activist policy, always subject to misreading of the data and forecast errors, is not required to avoid recession. What is required are sustainable, predictable, and noninflationary monetary and fiscal policies. If policy is not itself a source of disturbance, there is no reason to believe that a recession, when one finally occurs, need be anything other than a mild and temporary interruption of sustained economic expansion.

Many of those who predict another recession starting this year or next seem to do so from the view that a business expansion has a natural life, after which the economy will inevitably turn down. This view is probably wrong. If business expansions die of old age, the probability that a recession will begin rises as the expansion ages. In fact, the evidence suggests that the probability of the onset of a recession is only weakly related to the age of the expansion.

The economic process that has led to the termination of most expansions seems quite different from old age. Recessions, and especially the more recent recessions, have been associated with prior outbreaks of inflation. Imbalances arise during periods of rising inflation that make continuing expansion difficult or impossible. Public policy responses to rising inflation add downward pressure on output and employment. The business cycle peaks in December 1969, November 1973, January 1980, and July 1981 are all quite clearly related to prior outbreaks of inflation and subsequent declines in the rate of money growth.

MONETARY AND FISCAL POLICY ASSUMPTIONS

In July 1984, in its Midyear Report to Congress, the Federal Reserve announced a tentative M1 growth target range for 1985 of 4 to 7 percent. The Federal Reserve also announced tentative targets for M2 and M3, and an "associated range" for the growth of nonfinancial debt.

By reducing the upper side of the M1 range from 8 percent for 1984 to 7 percent for 1985, the Federal Reserve makes clear its intention to avoid excessive money growth. Bringing down the rate of money growth over time is essential to restoring full price stability. Also, the reduction in the width of the target range from 4 percentage points in 1984 to 3 percentage points in 1985 gives the market a clearer definition of monetary policy objectives.

An issue is the base upon which the 1985 M1 growth target is to be calculated. Historically, the money growth targets for a given year have been calculated from a base equal to the average level of the money stock in the fourth quarter of the previous year. This practice has permitted base drift, as discussed in connection with Chart 1-3, and also leads to revisions in the target path with every revision of the M1 data for the fourth quarter of the year. Of course, the target growth ranges could be adjusted to offset base drift and data revisions, but the problem with such an approach is that the announced ranges might vary from one year to the next in a way that would confuse the public. The money growth target is a statement of policy that should not be blurred by the vagaries of short-run money growth.

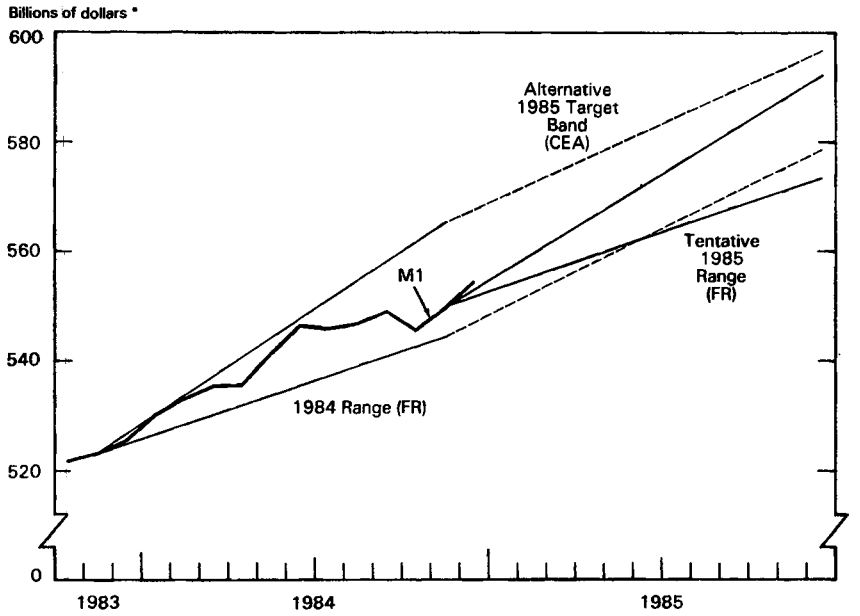
A second issue raised by the Federal Reserve's traditional method of defining the base for the money growth targets is that on occasion, as in early 1982, the money stock has started off a new year substantially above or below the announced target range, raising uncertainties in the financial markets as to whether and how quickly the Federal Reserve might bring M1 back into its range. Both of these issues could be resolved satisfactorily by defining the fourth quarter base as the midpoint of that year's target range rather than as the actual fourth quarter level of the money stock. The Federal Reserve's tentative 1985 target range of 4 to 7 percent growth of M1 could then be restated as a band around a central target of 5½ percent growth—a rate halfway between 4 and 7 percent growth. Under this interpretation, the target for 1985 would be to keep M1 within the dashed band shown in Chart 1-5 instead of within the wedge defined by the solid lines in the chart.

Growth of M1 within the dashed band of Chart 1-5 is expected to be consistent with the Administration's economic assumptions. In the postwar period the income velocity of M1—the ratio of nominal GNP to M1—has historically increased at an average rate of about 3 percent per year, although with substantial variability around that average. Abstracting from the variability by averaging over 2 years, the Administration expects nominal GNP growth to average about 8.9 percent per year over 1984 and 1985. If M1 in the fourth quarter of 1985 is at the center of the dashed band in Chart 1-5, then M1 growth will average 5¾ percent over 1984 and 1985, yielding annual velocity growth slightly above 3 percent. Beyond 1985 the Administration's economic assumptions are based on the view that monetary policy should maintain steady money growth at a rate that declines gradually over time.

As emphasized earlier in this chapter and in Chapter 2, the fiscal policy goals for 1985 are to establish a sound fiscal framework for

Chart 1-5

Alternative M1 Target Ranges for 1985



* Averages of daily figures; seasonally adjusted.

Sources: Federal Reserve (FR) and Council of Economic Advisers (CEA).

the long run by reducing the growth of Federal expenditure and the level of the budget deficit, and by reforming the tax system to foster long-run economic growth.

The Administration's budget proposals provide for a phased reduction of expenditure from the current services baseline. The proposed reduction in the growth of Federal purchases of goods and services is spread over 3 years, starting in fiscal 1986, providing considerable time for the private sector to adjust. Moreover, total Federal purchases will continue to grow, albeit at a slower rate than the baseline current services projection.

Finally, two points deserve mention. First, private sector activity depends importantly on expectations concerning economic policy. Clearly, the sooner fiscal policy changes are enacted, the smaller will be any effect on economic activity from uncertainty over the actions

to be taken. Second, changes in fiscal policy might have significant immediate effects on interest rates; cushioning those effects through monetary policy actions might be counterproductive. Rates may fall due to the resolution of the fiscal uncertainties and the expectation of lower inflation. A monetary policy directed toward stable money growth will ensure that interest rates can adjust readily to changed market conditions.

THE OUTLOOK FOR 1985

The Full Employment and Balanced Growth Act of 1978 requires that the *Economic Report of the President,* together with the *Annual Report of the Council of Economic Advisers,* include an Investment Policy Report and review of progress in achieving the national economic goals specified in the Act.

Investment issues are discussed in a wide range of contexts in this *Annual Report.* The role of high investment in the 1983–84 recovery is discussed earlier in this chapter, as are the economic conditions that contributed to strong investment and the relation of investment to productivity growth. Chapter 2 contains a discussion of the relationship between proposals for revising the tax laws and investment issues. International aspects of U.S. investment are examined in Chapter 3; these include the capital inflow from abroad and its impact on U.S. capital formation. Chapter 6 contains an analysis of how corporate takeovers, mergers, and acquisitions can promote allocation of capital to more productive uses.

The Administration's economic assumptions included in Tables 1–4 and 1–5 show substantial progress toward achieving the goals specified in the Act. Table 1–4 reports the major features of the Administration's 1985 economic assumptions. The expected 4 percent rise in real GNP over the four quarters of the year is slightly higher than the 3.7 percent in the third year of the typical recovery. Labor productivity showed little growth over the second half of 1984 but is expected to grow by 1.7 percent over the four quarters of 1985. Employment growth of 2.3 million persons is projected for 1985, compared with 3.5 million in 1984, leading to a decline in the unemployment rate over 1985.

The inflation outlook for 1985 is good. With moderate expansion in the money aggregates and continuing real growth, the inflation rate, as measured by the GNP deflator, is expected to average 4.3 percent over the four quarters of 1985. Hourly compensation is projected to grow at about 5 percent. Unit labor costs are expected to increase by about 3.5 percent. Business profits should show moderate growth over the year.

TABLE 1–4.—*Economic outlook for 1985*

Item	1984 [1]	1985 forecast
Percent change (fourth quarter to fourth quarter):		
Real gross national product	5.6	4.0
Personal consumption expenditures	4.2	4.3
Nonresidential fixed investment	16.6	6.8
Residential investment	3.5	1.7
Federal purchases of goods and services	14.2	2.2
State and local purchases of goods and services	3.5	2.7
GNP implicit price deflator	3.5	4.3
Compensation per hour [2]	4.2	5.0
Output per hour [2]	2.2	1.7
Level in fourth quarter: [3]		
Unemployment rate (percent) [4]	7.1	6.9
Housing starts (millions of units, annual rate)	1.6	1.7

[1] Preliminary.
[2] Nonfarm business, all persons.
[3] Seasonally adjusted.
[4] Unemployed as percent of labor force including resident Armed Forces.

Sources: Department of Commerce (Bureau of Economic Analysis and Bureau of the Census), Department of Labor (Bureau of Labor Statistics), and Council of Economic Advisers.

Supported by continuing growth in real disposable income, personal consumption expenditures are expected to increase 4.3 percent this year compared with 4.2 percent in 1984. Residential construction activity is expected to be fairly strong with housing starts of about 1.7 million units. Business fixed investment is expected to continue to grow faster than GNP. As a result, real investment as a share of GNP should continue at record levels next year.

Projected growth in real Federal purchases over the four quarters of 1985 is low due to assumed cuts in purchases in the fourth quarter of 1985 (the first quarter of fiscal 1986). State and local purchases are expected to grow at a slower rate in 1985 than in 1984 in order to maintain a balance with revenues. Real net exports of goods and services are expected to increase in 1985; however, the trade balance is projected to remain in deficit.

THE OUTLOOK FOR 1986–90

Table 1–5 reports the Administration's economic assumptions for selected economic indicators for 1986–90. These economic assumptions reflect projected trends and should not be interpreted as year-to-year forecasts. Table 1–3, discussed earlier in the section on economic growth reports the Administration's projection of the supply side of the economy in a consistent growth accounting framework.

The three sections of this chapter have discussed economic performance, principles, and prospects. Principles are the most important. Without them, the reasons the U.S. economy has performed as

TABLE 1-5.—*Administration economic assumptions, 1985-90*

[Calendar years]

Item	1985	1986	1987	1988	1989	1990
	Level					
Employment (millions) [1]	109.1	111.3	113.5	115.8	117.7	119.4
Unemployment rate (percent) [2]	7.0	6.9	6.6	6.3	6.1	5.8
	Percent change					
Consumer prices [3]	4.1	4.3	4.2	3.9	3.6	3.3
Real GNP	3.7	4.0	4.0	4.0	3.9	3.6
Real compensation per hour [4]	.3	1.3	1.8	2.7	2.9	3.1
Output per hour [4]	1.5	1.6	1.7	1.8	2.2	2.4

[1] Employment series includes resident Armed Forces.
[2] Unemployed as percent of labor force. See footnote 1.
[3] For urban wage earners and clerical workers
[4] Nonfarm business, all persons.
Source: Council of Economic Advisers.

it has cannot be understood. Without policy principles, the prospects for the future are uncertain because sustained public support for good economic policy depends on public understanding. The performance of the U.S. economy over the past 2 years suggests that the Administration's policies are beginning to pay off. A continuing commitment to these policies can produce strong and sustained economic growth.