SHADOW OPEN MARKET COMMITTEE

Policy Statement and Position Papers

September 6, 1974

1. Policy Recommendation of the Shadow Open Market Committee Meeting, September 6, 1974
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Policy Recommendations of the Shadow Open Market Committee
Meeting -- September 6, 1974

Inflation is continuing at a high rate because demand has not yet slowed sufficiently to eliminate shortages and bring about a slowdown in price increases. At its meeting today, the Committee considered domestic and international policy actions to slow inflation without incurring unacceptable social costs.

Domestic Policy

Money has grown over the past year at a 5½% rate. This is a lower rate than was achieved in the preceding year, but the decline results in the main from almost no growth since June 1974 after a very rapid rise from February through May.

For the next six months the Committee recommends the objective of a 5-5½% annual increase in money. It should be the goal of the Federal Reserve to attain that growth rate and reduce variability. This is the same short-term monetary policy that we recommended last March. A rate of growth of 5-5½% would be appropriate as a step toward further reduction to an ultimate non-inflationary rate of about 4% a year.

We recognize that this monetary policy will entail below-normal expansion of output and employment during the transition period. In our view, inflation cannot be reduced without a period of slow growth and possibly a recesssion. As discussed below, we recommend that the Federal Government undertake certain actions to ameliorate the hardships that will result from anti-inflationary policies.

Attempts to curtail inflation through "jawboning" are examples of mis-directed efforts. We fear that establishment of the Council on Wage and Price Stability will divert attention from the government that produces inflation to labor and business, which are the victims of inflation. Jawboning can have no effect on the rate of inflation.

Some now urge controls on the allocation of credit, tax cuts, and Federal spending increases. These programs, if adopted, would shift the costs of inflation and costs of ending inflation from one group to another, but the increases in spending and tax cuts would increase inflation and the total costs of ending inflation.

The most frequent argument against monetary restraint is that monetary restraint was tried and failed in 1966-67 and in 1969-71. This argument is false. In 1966-67, the growth rate of money was reduced by more than 50% in a year. The reduction lowered the annual rate of increase in consumer prices by one percentage point to 2.6% in the second quarter of 1967. The unemployment rate never rose above 3.8%, and the rate of interest on longest term government bonds was 6% when the anti-inflation policy was abandoned as too costly.

In 1969-71, the growth rate of money was reduced again by more than 50%. The rate of inflation fell more slowly this time. However, before controls on prices and wages were instituted, the rate of inflation had been brought to below 4.5% and was substantially lower than the peak rate of 6.2% that prevailed in the first quarter of 1970. The unemployment rate was 5.9%. On average, a worker spent 11 weeks between jobs. The latter figure should be compared to the post-war minimum annual average of 8 weeks or the average of 10 weeks in the booming economy of 1973.

Review of the 1969-71 experience also brings out the very rapid 7.2% rate of increase in the growth rate of money in 1970 and 1971. The policy of monetary restraint was abandoned in the second quarter of 1970 long before price and wage controls were introduced. In addition, the Government budget changed from $3 billion surplus to a $23 billion deficit between the fiscal years 1969 and 1971. The Federal Reserve chose to finance a large part of the deficit instead of continuing the policy of ending inflation. Those who now urge increased spending or tax reductions to compensate the victims of inflation or to alter the distribution of income ask us to repeat these policies. Their programs are more likely to bring higher than lower rates of inflation. Past experience indicates that the Federal Reserve, is likely to finance a large part of the increased budget deficit by increasing the growth rate of money..

Current short and long-term interest rates are at historic highs. These levels reflect the current high inflation rate and anticipation of continuance of these high inflation rates on the part of borrowers and lenders. The only way to bring interest rates down permanently is to bring inflation rates down.

The ceiling rates on savings deposits that are legally imposed are far below current market rates. Hence savings institutions are suffering tremendous outflows of funds. Our Committee recommends that the respective agencies raise the ceiling rates to enable savings institutions to pay market rates for funds. The increased cost of fund to these institutions will sharply reduce their earnings. Their difficulties, however, should not occasion any relaxation of the policy of overall monetary restraint that we advocate. Assistance can better be provided by temporary financial relief during a period of transition.

Similarly, we believe that Government assistance to those experiencing long-term unemployment during the transition to lower inflation should be consistent to the maximum extent possible with the efficient operation of labor markets. Accordingly, we recommend, first, lowering the statutory mimimum wage for teen-aged workers. We recommend that consideration be given to extending the period of unemployment compensation. We also recommend that long-overdue reform of public assistance finally be effected. Proposals to create new jobs at public expense would result in little if any net increase in total employment.

International Policy

The current system of floating exchange rates improves the prospect for success of anti-inflation policy. In a floating rate system, countries can more readily pursue independent monetary policies. This year Germany, Switzerland, and the Netherlands have chosen to reduce their rates of inflation by reducing the growth rate of their money stocks. They have succeeded, despite all the special factors frequently blamed for inflation here and elsewhere.

Their experiences show that it is possible to reduce the rate of inflation, despite the special factors, by reducing the growth rate of money. If the fixed exchange rate system had remained in effect, or had been reestablished, their anti-inflation policies would have been much less successful.

We urge the U.S. Government to continue floating rates and to avoid any agreement requiring intervention. We regret that the Government has agreed to "guidelines" for floating. Such guidelines mask a return to fixed exchange rates and make the return to price stability more difficult.

Old slogans and old concepts about the balance of payments still prevail even though we are floating. Specifically, the Government still reports several different balance of payments deficits on a monthly and quarterly basis. The official settlements deficit, for example, was established during the era of fixed rates, to measure pressure on the foreign exchange markets. This measure showed how many surplus dollars foreign central banks bought in order to keep their exchange rates steady. But now exchange rates are free to fluctuate, so the official settlements measure is no longer relevant. Indeed, it is now misleading. If all the surplus petroleum money were voluntarily invested in liquid assets in the United States, it would be recorded under current conventions as a $50 billion deficit in our balance of payments. It is easy to imagine how the report of such a large ostensible "deficit" would be used by protectionists, export promoters, and would-be capital-controllers, whose policy positions and budget requests are not in the long-run interest of the United States. We, therefore, recommend that the official settlements measure of the deficit be discontinued.

ASSESSMENT OF MONETARY POLICY

Position Paper for the Third Meeting of
the SOMC on September 6, 1974

Karl Brunner

The last meeting of the SOMC in March 1974 recognized that monetary growth moved over the second half of 1973 in the direction recommended at the first meeting of the SOMC in September 8, 1973. The SOMC reaffirmed at the second meeting in March 1974, the original recommendation and proposed that monetary growth should continue at 5% to at most 5 1/2% per annum. This proposal was essentially justified by the SOMC's determination to lower gradually and systematically the inflation rate over the next years.

The position paper prepared for the third meeting examines in a first section recent monetary developments and assesses the prospects for the realization of our recommendation. The second section attends to some important issues raised by James Tobin's critique of our recommendation published in the Brookings Papers on Economic Activity. It also covers some proposals made by influential Congressmen with serious implications for future policies.

I. Recent Monetary Developments and the Prospects of Monetary Growth.

The major contours of the development are summarized in table I. Until June 1973, monetary growth persisted on a comparatively high level. It decelerated subsequently from 8.4% p.a. to 5.3% p.a. in January 1974. Monetary

Table I: The Percentage growth of the Money Stock Between Corresponding Months and the Contribution Made by Proximate Determinants.

12 month period ending with		M	B	k	t	r+l	d
January	1973	8.62	8.01	.46	-1.33	+1.47	.01
February	1973	7.95	7.74	.10	-1.69	1.97	-.17
March	1973	7.06	7.89	-.38	-2.40	2.09	-.14
April	1973	6.94	7.97	-.74	-2.70	2.41	0
May	1973	7.76	7.85	-.32	-2.46	2.53	.15
June	1973	8.36	7.96	-.29	-2.16	2.87	-.01
July	1973	7.72	8.31	-.41	-2.37	2.09	.11
August	1973	7.16	7.76	-.63	-2.66	2.56	.14
September	1973	6.21	7.91	-1.07	-2.87	2.15	.08
October	1973	5.91	7.37	-1.03	-2.75	2.19	.14
November	1973	6.36	7.28	- .77	-2.34	1.96	.23
December	1973	5.96	7.31	- .98	-2.38	1.94	.07
January	1974	5.34	7.11	-1.26	-2.73	2.18	.04
February	1974	5.95	7.42	-1.29	-2.41	1.98	.24
March	1974	6.78	6.96	-1.03	-1.75	2.30	.31
April	1974	6.96	7.38	- .88	-1.88	2.14	.21
May	1974	6.21	7.53	-1.36	-2.22	2.21	.05
June	1974	5.67	7.45	-1.43	-2.52	2.02	.14
July	1974						

Remarks: M = money stock, B = monetary base, k = currency ratio, t = time deposit ratio, r+l = adjusted reserve ratio, d = Treasury deposit ratio.

developments thus adjusted in the second half of the last calendar year to the range of 5% to 5 1/2% recommended in the statement of our first meeting. The table indicates that all the proximate determinants contributed to this deceleration. It should be emphasized, however, that monetary policy not only permitted the retarding effect of the changes in currency and time deposit ratios, but actually reinforced this trend somewhat.

My previous position paper prepared for the second meeting of the SOMC predicted on the basis of the data available at the time (monthly data up to and including January 1974, and weekly data up to the middle of February 1974) that we should expect the gap between monetary growth and the growth rate of the monetary base to diminish in the near future. The statement concluded in particularthat substantial deviations of monetary growth from the growth rate of the base will not persist under present circumstances. The future course of the monetary base thus acquired a strategic role in our evaluations. The expectations of a rising budget deficit suggested on the basis of the Federal Reserve's past behavior that further retardations of the base should be assigned a somewhat lower probability. The previous position paper thus recognized a serious danger of accelerated monetary growth beyond the anti-inflationary range recommended in our first two statements.

An inspection of table I. informs us that an acceleration did actually emerge from January to April, 1974. Monetary growth expanded from 5.3% p.a. to almost 7% p.a. This acceleration was essentially due to the operation of the factors discussed in the previous position paper: The negative contribution of the changes in currency and time deposit ratio subsided substantially over this period and monetary growth moved closer to the "gravitational center" determined by the growth rate of the monetary base. A new phase emerged however in late spring. Monetary growth decelerated again from 7% (April) to 5.7% (June) and probably decelerated further in July and

August. The monetary base continued on the other hand on the general trends followed since August 1973. The previous position paper also noted that this track is beyond the range required for an effective long-run anti-inflationary policy. The current trend thus deserves some careful attention. It should be noted at this stage, that the data used in both tables should be replaced by revisions published in the middle of August. The revised data probably lower the acceleration of the money stock noted in table II.

Table II offers supplementary information for our assessment. It summarizes monetary growth patterns and the contributions made by proximate determinants over shorter run periods. All percentages refer to changes between shifting non-overlapping three month periods. Monetary growth reached a high peak of 9.6% in the middle of 1973 and decelerated in the late fall to 1.6% This rapid deceleration under way at the time of our first session dominated the decline of the year to year changes noted in table I. Inspection of the various columns in table II establishes that the dominant portion of the deceleration resulted from the movements of the proximate determinants beyond the monetary base. The sharp divergence in the development between money stock and base did not persist however. We note an acceleration of the money stock from a growth rate of 1.6% in late fall of 1973 to about 8.5% towards the central portion of 1974. This acceleration exhibits again the "gravitational pull" exerted by the monetary base. We note, furthermore, that the monetary base also accelerated from 5.9% to a growth rate beyond 8%. The shorter-run patterns presented in table II thus confirm the sense of uncertainty and apprehension concerning the monetary developments expressed in the previous position paper. The pronounced retardation experienced in the fall of last year brought the year to year monetary

Table II: Annual Percentage Changes of Money Stock Between Non-Overlapping Three Month Periods.

Period	M	B	k	t	r+l	d
12/72 - 3/73	6.84	8.91	- .74	-3.06	1.93	-.25
1/73 - 4/73	5.40	7.93	-1.57	-4.27	3.58	-.27
2/73 - 5/73	4.95	8.08	-1.94	-4.89	3.78	-.08
3/73 - 6/73	7.49	7.48	-1.10	-3.70	4.42	.38
4/73 - 7/73	9.63	7.07	.57	-2.06	3.41	.63
5/73 - 8/73	9.28	5.98	.99	-1.35	3.05	.61
6/73 - 9/73	5.50	5.16	- .13	-2.23	2.08	.63
7/73 - 10/73	2.06	4.72	-1.84	-3.09	1.90	.35
8/73 - 11/73	1.55	5.88	-2.39	-2.56	.58	.04
9/73 - 12/73	4.48	7.72	-1.70	-1.03	- .27	-.24
10/73 - 1/74	6.46	9.22	-1.16	- .56	- .73	-.31
11/73 - 2/74	7.22	9.19	-1.33	-1.28	.80	-.16
12/73 - 3/74	6.63	8.29	-1.80	-2.27	2.43	-.03
1/74 - 4/74	8.10	8.00	-1.78	-2.41	4.00	.28
2/74 - 5/74	8.54	8.10	-1.65	-2.70	4.46	.31
3/74 - 6/74	8.49	8.63	-1.30	-3.36	4.28	.23

Remarks: The symbols were defined in Table I. The indication of the periods should be interpreted as follows: 12/72 - 3/73 refers to percentage changes at an annual rate between the three month period ending with 12/1972 and the subsequent three month period terminating with 3/1973.

growth into the neighborhood of our recommended level. But this retardation resulted from transitory events and monetary growth was bound to adjust over the longer-run to the path determined by the monetary base, and this path proceeded until the past weeks on a relatively high level. There remains, thus, the danger that monetary growth may evolve at a rate not sufficiently adjusted to lower the rate of inflation by a substantial margin.

An examination of shorter-run patterns of monetary growth since the turn of the current calendar year reinforces the reservations bearing on the current state of monetary affairs. Percentage changes of the money stock and contributions by proximate determinants were computed between non-overlapping four week periods sucessively shifting the periods by one week. The growth rate of the base averages over the whole interval from the beginning of this year to the four weeks ending 7/24/74 at 7.8%. Monetary growth averages at 7%. Moreover, in exactly half of the 26 periods examined, monetary growth exceeded the growth rate of the base and dropped below in the remaining 13 periods. The shorter run patterns thus also exhibit the remarkable strength of the "gravitational pull" exerted by the base. We conclude thus, once more, that the monetary developments over the next 6 to 12 months is essestially determined by the behavior of the Federal Reserve Authorities.. This behavior will be particularly conditioned by the response of our Central Bank to the evolving budget deficit and the (probably) growing political pressures to use financial policies in the hope to control the official rate of unemployment. But this consideration opens a fundamental issue concerning trend and assessment of our future financial policies.

II. The Real Rate of Interest, the Inflationary Bias of Modern Societies, Congressional Labor Market Policy, and Permanent Inflation.

James Tobin contributed recently a paper on "Monetary Policy in

1974 and Beyond" to the house organ of the Brookings Institution (The Brookings Papers on Economic Activity). This paper was explicitly addressed to the views and recommendations of the SOMC. I also understand that this paper was presented and discussed at a meeting of the Federal Reserve Consultants at the Board of Governors. It appears thus important to examine the arguments by Professor Tobin. Three distinct strands should be discerned for our purposes. Tobin argues first that real rates are relatively high and should be lowered by suitable monetary policies in order to prevent economic retardation or stagnation. He proceeds then to assess with the aid of some econometrics the implications of our recommendations with respect to unemployment. This evaluation bears on the social cost of our policy proposal. And lastly, Tobin find an ineradicable inflationary ~~basis~~ bias deeply anchored in our social structure which confronts our policy makers with an immutable dilemma between unemployment and inflation. All three strands of arguments raise fundamental issues of analysis and judgment, and it should be clearly noted where and in which manner our evaluation radically departs from Tobin's analysis. This characterization should enable and encourage a more searching examination of the issues in order to offer better grounds for discrimination between the alternative views.

It seems best to open the first issue with a quote from Tobin: "In my opinion, it is fallacious to conclude that real rates of interest are low simply because current rates of inflation are high compared with normal market interest rates.... The important thing...is the comparison of earnings prospects and interest rates. This is the comparison the stock market makes and it is hard to argue that real rates have declined in any meaningful sense after price-earnings ratio have declined by a third over a year." Tobin

reinforces his argument with a computation showing that the ratio of market value to replacement costs of corporate real capital has dropped below unity, whereas, real profitability of the corporate sector seems to have substantially declined since the middle 1960's. Tobin appears thus to conclude that the real rate of interest is too high and monetary policy should be exercised to lower the real rate.

The analysis underlying our assessment and guiding our policy recommendations radically departs from these contentions. Tobin seems to interpret most of the difference in nominal rates of interest observed in 1964 or in 1973-74 to an increase in the real rate. We argue on the other hand that the real rate remained essentially on the level reached in the early 1960's. The large increase in the nominal rate of interest is thus completely attributed to the emergence of inflation and the incorporation of an inflation premium in nominal rates. The occurrence of such inflation premia has been well established by now in the literature. This comparatively low and relatively unchanged real rate of interest is quite consistent with the behavior of the stock market observed by Tobin. Tobin's suggestive formulation thus seriously misleads the reader. First, no inference is made "simply" from observations of inflation rates in 1974 which are high relative to market rates of interest. The inferences are based on substantial studies bearing on the systematic and persistent relation between inflation and nominal interest rates. And secondly, nobody argued seriously that real rates declined. The contention centers on the denial of Tobin's assertion, viz., that the large increase in nominal rates expresses a substantial rise in real rates.

Tobin refers to the behavior of the stock market to support his claim concerning relatively high real rates of interest. Once again the issue is not whether or not real rates have declined over the past two years. The question addressed involves the interpretation of the decline in stock market values and the implications for monetary policy. In order to clarify

this issue, we consider current market values as the discounted values of future net cash flows of firms having issued the equities. Two major developments substantially lowered in these recent discounted values. We note first an increasing volume of investment expenditures for environmental purposes or for purposes of occupational safety and health. These investment expenditures exert little, if any, effect on future gross receipts of the firm. They raise thus outlays over the shorter run without inducing much of an increase in future receipts. The discounted value of a firms net cash flow is thus bound to fall. This trend will not subside over the next few years and we should expect consequently relatively lower values on the stock market. But the expansion of investment expenditures internalizing social costs of production does not completely explain the persistent decline in market values of firms. Economic policy in general, legislation and regulations are increasingly hostile to private property and profits. A subtle and pervasive attrition of property rights characterizes the general course of western societies future developments. This course is well under way in Western Europe and is also expressed by many detailed events in the USA. The sequential phases of price-wage controls form only a minor segment of the general trend. This trend necessarily lowers the present value of expected net cash flows generated by business firms. It follows thus that the decline of stock market values must be attributed dominantly to influences emitted by our general economic policies affecting the "real structure" of our economy. This analysis of our recent development also implies that monetary policy cannot cope with their phenomena. An expansionary policy will not lower apparently high real rates of interest. It would only raise the rate of inflation still further and also raise the nominal rate of interest. Neither would an expansionary financial policy affect the real conditions dominating the evaluation of the stock market. A new surge of inflationary policies would actually only reinforce the growing institutional and social uncertainties imposed on the market's

evaluation of business firms' future prospects.

The second argument presented by Tobin criticizes the recommendations advanced by the SOMC on the basis of the social costs apparently attached to our recommendations. He uses for this purpose estimates of the unemployment rates implied by the "St. Louis model" and some "Philipps curve model." He finds that the model simulations associate comparatively high rates of unemployment with our proposal. He seems to suggest, therefore, that our policy recommendation is therefore inappropriate or unacceptable. But this categoricalconclusion simply does not follow from the model simulations presented. Neither of the two models has been especially justified as a useful hypothesis about the behavior of unemployment rates. Unemployment rates have generally been difficult to predict and most models were specifically quite unreliable in this respect. The Philipps curve models showed in the recent past repeatedly deviations from observations sufficiently large to question relevance of the longer-run simulation exercised by Tobin. But these longer-range simulations are really made quite dubious and probably also quite irrelevant by a property of economic systems recently emphasized by Robert Lucas at a Carnegie-Rochester Conference on price-wage controls (November 1973). The structural properties and response patterns of an economic system are not invariant relative to different policies and policy patterns. The mechanical simulation of a policy program substantially different from the policy patterns prevailing over the sample period used to estimate the model yields thus little information about the consequences of the program proposed. In particular, the simulations of a model estimated over a period of accelerating inflation probably exaggerates the longer-run unemployment effects of an anti-inflationary program.

The unreliability of Tobin's assessment is not the only flaw of his critique. Even if one accepts the simulations the objection to our recommendation

still does not follow. Tobin totally disregards the social cost of inflation, particularly of an erratic inflation, including the social cost of controls and associated policies systematically associated with inflationary spurts. It is not obvious that the unemployment rate measured by Tobin produces a social cost naturally exceeding the social cost of permanent erratic inflation to be suffered under Tobin's prescription of policy. It is even less obvious that the social costs associated with the most probable course of unemployment attributable to anti-inflationary policies exceeds the social cost of permanent inflation. It is actually our judgment that the balance of social costs justifies a steady and long-range policy of financial moderation. This judgment forms the basis of our proposal and not, as Tobin claims, any unwillingness to recognize the existence of social costs associated with anti-inflationary financial policies.

The general argument developed by Robert Lucas also bears on Tobin's conception of contemporary inflation: "The tormenting difficulty is that the economy shows inflationary bias even when there is significant involuntary unemployment. The bias is in some sense a structural defect of the economy and society, perhaps a failure to find and to respect orderly political and social mechanisms for reconciling inconsistent claims to real income. Chronic and accelerating inflation is then a symptom of a deeper social disorder, of which involuntary unemployment is an alternative symptom.. Within limits the Federal Reserve can shift from one symptom to the other. But it cannot cure the disease.

This passage requires some comments. The views advanced approximate closely the "social conflict explanations" fashionable in January. My age permits me (unfortunately) to remember the time when many economists elaborated on the deflationary bias of modern economies and stressed the difficulty, if not impossibility, for persistent inflationary pressures to emerge in modern economies. The expectation of a deflationary bias dominated the views for

several years beyond World War II. But the scene gradually changed and now we experience the vistas of an inflationary bias. And as before, the new bias is deeply anchored in the social process. One feels occasionally, that it is so "deep", it must be sociological." The meaning of such statements bearing on inherent inflationary (or deflationary) biases remains, however, somewhat obscure. We need not at this stage attend to the precise nature of the social mechanisms envisaged by Tobin. It is sufficient to examine his contention that financial policies can only shift "from one symptom to another." The analysis developed by Lucas bears actually with some importance on this issue. The properties and appearances of the social process unobscurred under the labels "deflationary or inflationary biases" are probably substantially conditioned by the financial policies pursued in the recent past. "Inflationary biases" do not emerge independently of the policy patterns pursued by the governments over many years. It follows, therefore, also that such "biases" are effectively moderated by a persistent course of anti-inflationary policies. In particular, the policy patterns followed determine to a large extent the range available for "shifting between the symptoms." The trade-offs between unemployment and inflation decline with experiences of erratic inflationary policies interspersed with unreliable phases of anti-inflationary reversals. The greatest danger of a "social conflict theory" of inflation follows from its effect on inflation itself. It directs attention away from the crucial conditions of inflation and tends to generate social policy patterns perpetuating inflation.

Among these patterns we note specifically two proposals more frequently mentioned again in recent weeks. These proposals pertain to a man power service agency and credit controls. The first proposal is closely associated with Tobin's emphasis on involuntary unemployment. The unwary reader of Tobin's piece will probably understand that all unemployment is entirely involuntary, imposed by the system and to be suffered with passive acceptance. Pertinent observation

does not support such a view. The social cost of unemployment substantially exceeds the private cost of unemployment. Martin Feldstein's examinations of the structure of unemployment prepared for the ~~Fourth~~ Joint Economic Committee established in particular the comparatively high compensation ratio implicit in unemployment benefits. This ratio apparently is close or above unity for a substantial fraction. The implicit subsidy built into the unemployment compensation is bound to increase the average unemployment ratio as officially measured. The incentives to lengthen intervals between jobs or to increase the frequency of such intervals over the year unavoidably raises the official measure of the unemployment ratio. Changes in social policy expanding the built-in subsidy thus raise the long-run unemployment rate and sharpen thus Tobin's dilemma. Any attempt to exploit financial policies to lower the unemployment rate are bound to fail under the circumstances. They will only accelerate inflation and generate patterns of an apparently intractable inflation. Or alternatively, the higher unemployment rates produced by these policies induce Congressional responses worsening both labor market allocations and inflation. This conclusion applies immediately to the man power service agency. The absorption of unemployed for service jobs by such a government agency strengthens the incentives noted above. Its operation implies that the ratio of unemployed plus service job employees will rise in the average. This trend is augmented by the inclusion of a bureaucracy attending to the service job agency. Moreover, the marginal social productivity of both unemployment and service job employees remains below the marginal social productivity of employment on the market place. Economic welfare is thus lowered by such an agency. Furthermore, the agencies financial requirements expand the budget deficit and contribute to the "social disorder" of most immediate concern for our problem, viz., the inability of our political process to control the budget. The persistent deficits combined with the political pressures conditioning the the responses of a Central Bank obstruct under the circumstances a monetary policy lowering the rate of inflation over an extended period.

The second proposal involves a somewhat typical political response to a problem produced by our past inflationary policies in conjunction with the peculiar structure of our thrift institutions. Inflation created high nominal rates of interest and also removed the ascending yield curve benefitting for many years the thrift institutions. These developments occurred in the context of rigid price fixing constraining the liabilities of thrift institutions essentially adjusted to issue de facto demand to short-term liabilities. The supply of mortgages suffered under the circumstances. The proposal to introduce credit controls emerges of course as an obvious response favored by a variety of politically influential groups. Such controls should direct the supply of credit coercively to politically approved activities, including of course, the securities issued by the government sector. It is necessary to emphasize that credit controls are a useless investment to cope with inflation. They do impose, furthermore, social costs on the economy. First, they direct attention from the course of monetary policy required to moderate inflation. Second, they produce malallocations of resources, and third, they intensify political conflicts and raise incentives to invest in such conflicts. They offer an open invitation to various groups to exploit the political apparatus for purposes of wealth transfers and to move resources in their direction. The unfortunate consequences will be borne by the ~~man~~ mass of the public for the benefit of a small minority with superior competitive skills in the political process determining the operation of the controls. Credit controls are a costly device to "help housing." It makes little sense to "offset" the results of bad policies and a poorly designed institutional structure with another round of bad policies and hasty constraints. We should hope very much that the responsible Congressional Committees may seriously consider to propose removal of the underlying conditions creating the major problem for our thrift institutions. The Hunt Commission offered some

relevant recommendations in this respect. Their recommendations should be usefully supplemented with a determined anti-inflationary course of financial policies.

Background paper for
Shadow Open Market
Committee Meeting
September 6, 1974

Failures of Banks and Other Financial Institutions

by Allan H. Meltzer

The illiquidity of the Franklin National Bank and rumors of liquidity problems at other banks and financial institutions at home and abroad awaken dormant memories of the banking collapse and fears of a new collapse. We have no reason to believe that the rumors are true. However, we believe it is prudent to develop appropriate general policies in the event of insolvency or illiquidity of banks and other financial institutions.

The Federal Reserve's response to the actual and expected loss of deposits at Franklin National creates doubts about their understanding of the proper role of a central bank and the proper response to financial failures. There are three reasons for this conclusion. First, the loans were made to the illiquid bank. Second, the loans were made at rates lower than prevailing market rates. Third, the loans have longer maturity than Federal Reserve discounts and advances to other banks. As a result, costs that should be borne by the owners of Franklin National and the holder's of Franklin's large, uninsured certificates of deposit were shifted to taxpayers. These costs continue.

Other consequences of the policy are much more serious. The policy encourages bankers and large depositors to believe that in similar circumstances they will be treated in a similar way. Instead of accepting the full risk of a highly levered position, they can expect to share the risk with taxpayers. They are encouraged to accept risks they would otherwise avoid.

The appropriate response in the case of temporary illiquidity is for the illiquid bank to borrow in the market. The Federal Reserve should remain willing to lend to any bank on eligible paper at a penalty rate. If lenders,

fearing failure, demand a risk premium that is high relative to expected return on loans, the owners may prefer to close the bank. Or, depositors, fearing insolvency, may withdraw deposits forcing the bank to close.

Insolvency creates a problem for the Federal Reserve particularly if there is a flight from deposits into currency. A flight from deposits at many banks is a form of financial panic. The money stock shrinks and interest rates rise. Banks are required to sell assets at declining prices to pay depositors. Bank failures rise, as in the early thirties.

A century ago, Walter Bagehot described the appropriate policy for a central bank in a time of financial panic. His advise and criticism are as applicable now as at the time he wrote. "Lend freely, at a penalty rate," he advised.

The Bank of England followed a policy of lending in time of crisis. Bagehot's trenchant criticisms of the Bank stressed the Bank's failure to act promptly and the failure to acknowledge in advance that the Bank would be the lender of last resort in any future panic.

Prevention of financial panics did not mean then -- and does not mean now -- that a bank or a large bank should not be permitted to fail. The failure must not spread to solvent, liquid banks or institutions.

The Fed's response to the Penn Central crisis of 1970 contrasts with the response to the Franklin National problem. In 1970, the Fed did not try to prevent the failure; it prevented the failure from spreading through the financial markets. The Fed acted as if it recognized that the lender of last resort has a responsibility to the market and the institutions in the market and not to the particular issuer of securities.

Once the Fed recognizes the extent of its responsibility, doubts are removed about the proper response to a failure of a savings and loan association, a foreign participant in the Euro-dollar market, or any other issuer of financial paper. The Federal Reserve has no responsibility to prevent the failure. It should publicly accept responsibility for preventing the panic from spreading through the market.

The Federal Reserve should issue a policy statement accepting responsibility as lender of last resort to the financial system and denying responsibility to protect any private financial institutions from the consequences of errors and misjudgments. Such a statement should make clear that the policy will not prevent every failure but will seek to prevent a financial panic. The responsibilities of the Fed to the deposit and savings and loan insurance corporations should be clarified to remove any doubt about the ability of the Federal insurance corporations to obtain currency in the case of widespread or spreading failures.

The nature of this statement makes it useful to repeat that we have no information suggesting that a financial panic is likely. Nor, do we believe that the risk of bank failures should prevent the Federal Reserve from restricing the growth rate of money and reducing the growth rate gradually. Bagehot reminds his readers that whenever the central bank responded appropriately, the panic ended within a few days. We have no reason to doubt that his conclusion is as correct now as it was a century ago.

FORECASTS OF ECONOMIC ACTIVITY AND PRICES IN 1974 AND 1975

Recent Developments

Gross National Product in 1958 prices declined at an annual rate of 1.2% in the second quarter, following a 7% decline in the first quarter. Small increases in consumer and government spending in the second quarter were more than offset by declines in housing and net exports. Final demand in 1958 prices was virtually unchanged from the first quarter. The GNP Deflator increased at a 12.3% annual rate in the first quarter and an 8.8% rate in the second quarter.

Industrial production was essentially unchanged in June and July. Retail new-car sales (including imports) were at a 9.8 million seasonally-adjusted annual rate in July (using our seasonal adjustment factors), up sharply from a 9.1 million rate in the first half. Sales in June were depressed because sales contest programs ordinarily held in June were moved up to May this year. The present sales rate reflects abnormally high incentive payments; we expect sales to continue at about the present rate through the balance of the model year (until late September). Truck sales, which were depressed much less than car sales by the gasoline shortage, were at an annual rate of nearly 3 million in July, up slightly from 2.8 million in the first half (sales in 1973 were 3.2 million).

The Consumer Price Index increased at seasonally-adjusted annual rates of 12% in June and 10% in July. The increase in both consumer and wholesale prices in recent months include large increases in goods and services released from controls at the end of April. In addition, however, wholesale farm prices rose sharply in July. It appears that the drought will limit supplies sufficiently to cause sharp increases in retail food prices at least through the rest of this year.

Forecasts

We forecast that real GNP will increase at a 2% annual rate in the second half of 1974 and at a 3.2% rate from the fourth quarter of 1974 to the fourth quarter of 1975. (On this basis, output will decline about 1% during 1974.) We project that the GNP Deflator will increase at a 9.7% annual rate in the second half of 1974, for a 10.1% increase from the fourth quarter of 1973 to the fourth quarter of 1974. We expect the Deflator to increase 8.5% during 1975. Forecasts by quarter are shown in the following table.

	Projected Gross National Product						
	1974		1975				
	Third Quarter	Fourth Quarter	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Full Year
GNP in Current Prices (Bils.)	$1,421	$1,460	$1,501	$1,545	$1,590	$1,636	$1,563
% Over Previous Period (Seasonally-Adjusted Annual Rate)	11.3%	11.6%	11.6%	12.2%	12.2%	12.2%	11.5%
GNP in 1958 Prices (Bils.)	$ 831	$ 835	$ 840	$ 847	$ 854	$ 862	$ 851
% Over Previous Period (Seasonally-Adjusted Annual Rate)	1.5%	1.9%	2.4%	3.1%	3.6%	3.8%	2.3
GNP Deflator (1958 = 100)	171.0	174.9	178.7	182.5	186.2	189.8	184.3
% Over Previous Period (Seasonally-Adjusted Annual Rate)	9.7%	9.4%	9.0%	8.8%	8.4%	8.0%	8.9%

74.1 74.2

4.97 4.95

5.23

GNP$ WK1

Quarterly rates of increase in the money stock (M_1) declined from the second half of 1972 through 1973. In the first two quarters of this year, the money stock accelerated, but since April, the growth rate has slowed again, to a 5% annual rate.

	Quarterly Growth Rates of the Money Stock (M_1)							
	1972		1973				1974	
	Third Quarter	Fourth Quarter	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	First Quarter	Second Quarter
Money Stock (Bils.)	$248.0	$253.2	$257.6	$262.4	$266.1	$269.0	$273.6	$279.4
Percentage Increase Over Prior Quarter (Annual Rate)	8.5%	8.7%	7.0%	7.6%	5.7%	4.5%	7.0%	8.7%

The slowing of inflation we project for 1975 is based on projected acceleration of output, reflecting an expected increase in open industrial capacity and greater availability of raw materials. Our projections of GNP and the money stock (increasing at a 6% annual rate) imply that income velocity (GNP divided by M_1) will continue to increase at the same rate throughout the six quarters beginning at the middle of 1974. If our forecast is correct, therefore, reduction of money growth to a 6% rate will not diminish the expected rate of price increase, and thus lead to a flattening of the increase in velocity, until after 1975.

Revised 9/6/74.

POURING TROUBLE ON OILED WATERS: A BRIEFING FOR THE SHADOW OPEN MARKET COMMITTEE, SEPTEMBER 6, 1974

by Wilson E. Schmidt*

Six months ago when we last met, the world was expecting a major international financial crisis because of the rise in petroleum prices. Projections of woe, malaise, and disaster abounded; the rhetoric was that of crises and of the evil times coming. They did not happen.

Not because the problem went away. We still face the largest structural shift in international payments since the German reparations problem after World War I.

1974 still looks wild. The OECD recently projected a shift in the combined current account of its members from a $4.5 billion surplus last year to $38.5 billion deficit this year. It appears that the petroleum exporters will raise their oil receipts to $100 billion, from $22 billion last year. And it now looks like U.S. imports of petroleum will rise around $20 billion.

I. IF WE HAD BEEN FIXED, WHAT?

It is obvious to all observers, even the most casual, that the fixed exchange rate system could not have withstood this prospect of potential strain. Governments would have undertaken crash decisions and programs to solve whatever they conceived to be the problem. With floating, very little had to be done.

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Look back over the great changes in U.S. balance of payments policy since our deficits arose in the late fifties. Compare the scale of the problem each time a new policy was introduced with the scale of the problem now.

The following table shows the changes in imports and the current account between the year the policy action was taken and the year before and also shows the official transactions to support the exchange rate dollar in the year of the policy action. It is pretty obvious that the past record indicates that the oil crises would have induced drastic policy changes had we been fixed.

	Change in U.S. Imports	Change in Current Account	Official Reserve Transactions
		(Billions of Dollars)	
Tied Procurement (1959)	+2.3	-.6	-2
Interest Equalization Tax (1963)	+.8	-.6	-1.9
Direct Investment Controls (1968)	+1.4	+.2	-3.2[a]
1971 Devaluation	+5.7	-2.3	-29.7
1973 Devaluation	+10.2	-5.5	-10.4[b]

a/ 1967
b/ 1972

Compared with those events, it is obvious that the civil servants and policy makers in Washington would have had to do something, something cosmetic, something real. After all, they are paid to solve problems.

The Under Secretary of the Treasury for Monetary Affairs did not have to slip secretly in and (until his cover was blown) out of capitals negotiating exchange rate changes. There was no public clash, so necessary but unfortunate, between the great powers over exchange rates as in the Fall of 1971, a clash recently lamented very bluntly by the German Chancellor as endangering trust in the U.S.

Nobody had to close foreign exchange markets, as happened eleven times in at least one or more of the major financial markets between 1967 and 1973. American Express did not advertise that its card was better than dollars.

In its classic way, the market replaced negotiations, replaced trips, meetings, replaced civil servants. They could tend to other things, like weights and measures, the things for which we really require government.

As I said, nothing happened. The dollar stood last June at just about the same level as it did on average in 1973. To be sure, it appreciated from November of last year through January and then fell to March, and rose to June. What is so utterly amazing about the float is that the fluctuations were close to being within the margins that would have prevailed if we were fixed again.

II. WHAT WE SURVIVED AND HOW

In their own impersonal way without the benefit of rhetoric, the statistics are slowly coming in to tell us what has happened.

Probably the three key facts to date are these: (1) The

international reserves of those oil producers for which we have data rose by $13 billion during the first half of 1974; (2) U.S. petroleum imports rose from $3.6 billion in the first seven months of 1973 to $13.2 billion during the same period this year; (3) the average U.S. exchange rate recently has been about equal to the average of 1973 and about four to five percent higher than in the early Fall of 1973 when the crisis started.

So far as the United States balance of payments is concerned, our investment income from petroleum operations rose about $2.5 billion and the value of our petroleum and product imports rose by $2 billion between the last quarter of 1973 and the first quarter of this year. There is still substantial uncertainty surrounding the investment income figures, despite the fact that the Department of Commerce has cleaned up some substantial oddities in reporting practices, because the effect of the participation agreements on earnings still cannot be estimated. Also, first quarter earnings probably do not show the full impact of the higher OPEC taxes.

The data suggest substantial recycling through the United States. It is not clear precisely from the data how much money owned by petroleum producers has come to the United States because data do not provide sufficient geographical detail. However, the inflow of money from oil producers, based on data for certain regions and selected countries suggests an inflow of about $7.5 billion (annual rate) during the first half of 1974. During the first half of the year we ran an official settlements deficit of about $7 billion (annual rate) as foreign

official institutions increased their liquid assets here. Every major geographical area appears to have participated in this through May, except Western Europe which reduced its holdings here.

These inflows were recycled through a huge shift in the flow of U.S. private capital, some in anticipation of the petroleum financing problem abroad. U.S. claims on foreigners reported to U.S. banks rose by more than $11 billion in the first half of the year, and very little of this increment was loans to official institutions, suggesting the dominant role of the private market.

There was also recycling abroad. In the first quarter alone, U.K. banks loaned $4.5 billion to their EEC partners. The Euro-currency market continued to rise through May at the 50% growth rate observed in 1973. Data for the first half of 1974 show that medium-term and long-term publicly announced credits in the Euro-currency market were almost $20 billion, compared with $22 billion for the whole of 1973. OPEC borrowing in that market has dropped substantially.

III. SOME TROUBLE AREAS

There are some very troublesome features on the terrain.

First, it is not just existing reserves that are being recycled. The reserves of selected petroleum producers grew by $13 billion through June from the end of the last year whereas total international reserves rose by $11 billion through May. This suggests that the expansion of credit from reserve centers such as the United States and the United Kingdom and in the Euro-dollar market is financing much of the growth

of petroleum producer reserves. If we imagine that all of the $40-60 billion of increased petroleum producers reserves this year were financed by credit expansion, that would imply another 25% or more increase in the world reserves, approximately equal to the annual growth of reserves which caused so much of the inflation in the rest of the world in 1972 and 1973.

It might be thought that to let the petroleum producers take $50 billion of reserves away from the rest of the world would be seriously deflationary there. But the petroleum producers must put the money somewhere, returning the rest of the world's money stock to what prevailed before. Of course, if the authorities in the rest of the world become nervous about their liabilities to the oil producers, excessively deflationary measures could ensue. But with floating rates, they need not worry if they think about it, since their international reserves are protected.

Second, old slogans and old concepts about the balance of payments still prevail even though we are floating. Retention of outmoded doctrines and concepts could induce inappropriate policy actions. Specifically, the United States Government still reports a myriad of deficits on a monthly and quarterly basis. Take one, the official settlements deficit. This was established during the era of fixed rates to measure pressure on the foreign exchange markets. Specifically, it told how many surplus dollars foreign central banks bought in order to keep their exchange rates steady. But now exchange rates are free to fluctuate so it is no longer needed. And in fact the recorded

deficit is now misleading. While our accounts showed a deficit at an annual rate of $7 billion in the first half of the year, the value of the dollar on the exchange market was rising, the opposite of what one would expect from a surplus of dollars on the foreign exchange markets. When foreign governments invest here it is not because they have to support the dollar but because they prefer dollar investments.

Retention of the concept of the official settlements deficit could present a real problem. If all of the surplus petroleum money were to be invested in liquid assets in the United States it would be recorded under current conventions as a $50 billion deficit in our balance of payments. This would top our deficit in the quarter in 1971 when President Nixon took us off gold and started the train of events that lead in March of 1973 to the float. It is easy to imagine how this number would be used by the protectionists, the export promoters, and the capital-controllers whose policy positions and budget requests are not in the long-run interest of the United States. The simple truth is that, with floating, there is now only one true deficit in the balance of payments; it is the entry for Errors and Omissions which serves as a measure of the deficit in the quality of the data. An interim solution, while the United States Government thinks about this problem, is to have all press releases refer to deficits as surpluses and vice versa.

Third, we should begin to contemplate revising our growth target for the money supply in the light of international conditions. In previous meetings of the Committee we have agreed that international transactions have very little to do with the internal state of the

economy because since August 15, 1971 the money supply has not been significantly affected by international transactions. Of course, this elementary truth has largely been disregarded by those who find excuses for our poor past performance in international events, in Russian wheat sales, in anchovies, and in devaluations.

But it has always been clear to monetarists that major changes in the terms of trade of the United States, the prices at which we exchange our goods and services for foreign goods and services could have, under special circumstances, a significant impact. Few would deny, for example, that a permanent downward shift in American productivity would raise prices. An adverse shift in our terms of trade amounts to precisely that. If the prices we pay for imports rise more than the prices we get for our exports, our national productivity has declined. We get fewer goods back for the goods we send out.

As a result of the oil price change and general world inflation, the import prices paid by the United States in the second quarter of 1974 were 50% higher than the second quarter of 1973. At the same time our export prices rose less than 30%. Together these have imposed a 13% adverse shift in our terms of trade. (Twenty percent since 1971.) Given the fact that exports of goods and services now run almost 8% of our GNP, the implied reduction in our real output is 1 percent. (1.6 percent since 1971.) This suggests that whatever monetary growth target was appropriate before the oil price rise might well be shaved a bit to adjust for what appears to be a once-for-all shift in our terms of trade.

(There is the possibility that the income of the American petroleum industry from its foreign operations could rise by enough to offset the rise in the price of our petroleum imports. But, as said before, this is uncertain.)

Fourth, the creeping deform of the international monetary system continues. Already, the member governments of the International Monetary Fund has agreed on changes in the SDR which will make it more usable. In the terms of possibility of returning to fixed exchange rates, this is probably more significant than it appears. The United States Government is unlikely to return to convertibility unless it has an assured right to devalue and this, for political reasons abroad, is enhanced by the effective existence of the SDR.

Early in June, the Chairman of the Deputies of the Committee of Twenty, the group responsible for drafting a deform of the international monetary system, said "...it is evident that governments in the seventies, as in the thirties, are unwilling -- except for relatively brief periods when the hurricane rages or the dykes break -- to let their exchange rates go where they will."

Governments have now agreed through the International Monetary Fund on a set of guidelines for the management of floating rates. These guidelines are innocent looking things at the start but the ghost of Bretton Woods is quickly evidenced; the new-fangled paraphernalia for exchange rate fixing are all about.

The first guideline calls on member governments to intervene in the foreign exchange market as necessary to prevent or moderate sharp

and disruptive fluctuations from day to day and from week to week in the exchange value of its currency. The second guideline extends the horizon from month to month and quarter to quarter, and it adds that intervention to speed the movement of the exchange rate in the same direction as the market should not be done.

The third guideline extends the horizon to four years. Under it the Fund may encourage a member government to intervene in the market to bring "equilibrium in the 'underlying balance of payments,' i.e. in the overall balance in the absence of cyclical and other short-term factors affecting the balance of payments, including government policies which are, or, on internationally accepted principles, ought to be temporary."

It is indeed unfortunate that governments have agreed to this.

As is widely known, the IMF multilateral exchange rate model was employed extensively in the negotiations which led to the first devaluation of the dollar and was very influential in the determination of the new rates. The simple, unassailable fact is that the set of rates established in 1971 failed to produce equilibrium in international payments and broke down beginning in January 1973, ending in the float in March, 1973.

There was an enormous cost in the failure to obtain equilibrium rates, a cost which governments, people and politicians, poor and rich have had to pay in the form of world-wide inflation. As my colleague, David Meiselman, has convincingly demonstrated, the cause of that accelerated inflation in the rest of the world in 1972 and 1973 lay at the door of the U.S. balance of payments deficit in 1972 and early

1973 which expanded the monetary base abroad. Had there been a float, history would have been far more pleasant.

There are enormous technical problems in any exchange rate model that should make a practical man of affairs extraordinarily wary of it as a feasible guide to exchange rate fixing. The essence of any exchange rate model is its estimate of the impact of exchange rate changes on the volumes of exports and imports. This requires an estimate of underlying elasticities of demands for imports and exports in terms of prices. But the quality of the data will simply not allow such estimates, even for the United States which has the best balance of payments data. Because our tariffs are low and cover only a small amount of the goods exchanged, customs valuations are poorly checked. Errors in the flows are very large. For example, the Department of Commerce after hard work has reconciled our data on trade with Canada; the average error for 1970-72 was about $700 million in our net trade. The unit value indicies we produce cover 40% of our exports and 50% of our imports. Being unit value indices rather than price indices, their levels change simply when the unit measured changes, e.g., the unit value of our aircraft exports rose when we began to export jumbo jets some years ago. The wholesale price index for the United States has so much double counting that a recent study of the role of import prices in our inflation estimated that imports were twice as important as recorded. And the consumer price index is so far removed from international trade as to be virtually useless.

Quite correctly, at least in theory, the guidelines tell governments

and the Fund to seek rates that will produce equilibrium in the absence of cyclical and other short-term factors. This involves estimating what imports and exports would be if all countries were at high employment. This in turn requires an estimate of potential income and potential national output. But this is a very tricky concept, hard to measure. Edward Denison, a very close student of our national economic statistics, recently compared his newly-developed series on potential output with those employed by the Council of Economic Advisers. He writes, "...my series shows that actual output declined relative to potential output in both 1968 and 1969, the CEA series based on the unemployment rate shows that it increased in both 1968 and 1969, and the CEA series based on the use of trend values shows that it increased in 1968 and declined in 1969."

The Fund is indeed fortunate in having an excellent research team. And the United States Government is fortunate in having many good civil servants who are laboring hard and precisely to improve the quality of the data with, I might add, much less budget support than their responsibilities would require if we were to return to a fixed rate system. What I am saying is that the real world is still not ready for another computer-assisted exchange rate determination. The market is still the better calculator.

At our peril, we are pouring trouble on oiled waters.

9/74

The Current State of the Budget Estimates

The most recently available official estimates of the Federal Budget for Fiscal 1975 are in the Mid Session Review of the 1975 Budget by the Office of Management and Budget, prepared June 1, 1974 (house Doc. 93-312). These include relatively minor revisions from the February estimates; revenues are revised downward by one billion dollars, and expenditures are revised upward by one billion, so that the unified budget deficit is increased by two billion from an estimated 9.4 billion dollars to an estimated 11.4 billion dollars.

These relatively minor changes perhaps generate the misleading expectation of a high degree of precision in the estimates. In fact, there is a great deal of uncertainty about the ultimate outcome. On the expenditure side of the budget, the OMB, on June 1, was projecting outlays of $305.4 billion dollars on a unified basis. At the same time, a footnote to the table detailing current projections of outlays by agencies (HD. 93-321), p. 13) announces "If interest rates remain high, mortgage committments under this plan (the housing policy recommendations announced May 10, 1974) could cause outlays in 1975 to be up to $3 billion higher." It seems unrealistic to believe that there will be substantial reductions in mortgage rates during the remainder of fiscal 1975, so we should presumably adjust upward the current estimate of outlays to 308.5 billion, and the deficit to 14.4 billion. In examining the changes by agency (Table 1) the largest reduction appears in the Agriculture Department. Since the mid year budget review, however, the Agriculture Department has announced (August 22, 1974) that the drought this summer in the mid-West will require an estimated 500 million dollars in subsidies under the provisions of the Agriculture and Consumer Protection

TABLE 1.--Changes in Budget Outlays by Agency, Fiscal 1974-75.

	Billions $	Percent Total Change
Defense	7.3	.20
Agriculture	- .9	-.03
Commerce	.2	.01
H.E.W.	17.0	.47
(Social Security Trust Funds)	(11.6)	(.32)
H.U.D.	1.1	.03
Interior	.5	.01
Justice	.2	.01
Labor	2.7	.08
(Unemployment Trust Fund)	(1.8)	(.05)
State	.1	.002
Transportation	1.0	.03
Treasury	2.6	.07
(General Revenue Sharing)	(.1)	.003
(Interest on Debt)	(2.1)	.06
Corps of Engineers	.0	.00
A.E.C.	.7	.02
E.P.A.	1.5	.04
G.S.A.	- .7	-.02
N.A.S.A.	.1	.003
V.A.	.7	.02
Foreign Economic Assistance	.5	.01
Other Agencies	1.4	.04
Allowances (Energy Research, Civilian Paying)	.9	.03
Undistributed Intragovernmental Transactions	- .9	-.03
	35.9	

Act of 1973, which requires payments on wheat, feed grains and cotton, if yields fall below 2/3 of "normal" due to natural forces. Thus, total projected outlays increase to 309.0 billion, and the deficit to 14.9 billion.

The Ford Administration has announced its intent to hold total outlays for fiscal 1975 to the 300 billion dollar level in the attempt to relieve inflationary pressures. Is it realistic to believe that any such cuts can come about. Table 1 indicates the changes in outlays by agencies on the basis of a total of 304.5 billion. Four categories which are certainly immune to any budget cutting are Social Security Trust Funds, Unemployment Trust Funds, Interest of Public Debt, and the Veterans Administration. These four categories alone account for 45 percent of the projected change in outlays from fiscal 74 to fiscal 75. President Ford stated in his address to the joint session of Congress that the defense budget would be protected from any unwarrented cuts. This is another 20 percent of the change projected by OMB. Added to the 45 percent indicated above, that totals to 65 percent or 23 billion dollars. Since our 309 billion of projected outlays is only a total of 39.5 billion higher than the estimate of 269.5 for fiscal 1974, this means that 9 billion of a total increase of 16.5 billion (or 54.5 percent) would have to be cut from the budgets of all other agencies to achieve the 300 billion target. This hardly seems realistic given the current inflationary experience.[1]

What possibilities are offered by the recent cuts in Congress of the Urban Mass Transit Bill, and the Department of Defense Appropriation. In the February budget proposals, the projected outlays for fiscal 1975 for the whole of the Unified Transportation Assistance Program amounted to only

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[1] If we make the further assumption that the 3.5 billion of adjustments to housing and agriculture cannot be cut, the 9.0 billion would have to come out of the projected increase of 13.0 billion to all other agencies (70%).

2.5 billion dollars. Of this 1.1 billion is for urban highway grants. Note that the total change in the D.O.T. outlays from fiscal 74 to fiscal 75 as projected by OMB is only 1.0 billion, including the increase associated with the initial phases of the Urban Mass Transit Program. Clearly, this action is going to be an insignificant drop in the bucket during the current fiscal year. The Department of Defense outlay projections cited in Table 1 are 85.8 billion for fiscal 75. Various cuts imposed by the House and Senate suggest an initial appropriation for fiscal 1975 of around 82 billion. If this cut of approximately 4 billion is permanent, then the estimated expenditures are only about 5 billion over the 300 billion administration target level. Since the Department of Defense received a 4.1 billion supplemental appropriation in the late Spring of 1974 to cover unanticipated increases in costs associated with inflation, the Arab-Israeli War, etc., it is perhaps unrealistic to believe that the full cut will stick for the whole year.

On the receipts side of the budget, there is additional reason to doubt that the projections of OMB will be completely realized, and again the evidence suggests that the forecasting error is such to under estimate the magnitude of the deficit. OMB projects revenues on a unified budget basis of 294 billion, associated with an estimate of current dollar Gross National Product of 1401 billion dollars for calendar 1974. This includes the assumption that the proposed reduction in oil depletion allowances and the implementation of a windfall profits tax which has been proposed by the House Ways and Means Committee will be enacted (HD. 93-312, p. 3). This revenue projection is considerably higher than some private forecasters are currently projecting on the basis of essencially the same current dollar GNP for calendar 1974. Wharton, for example, is about 5 billion dollars less.

The current OMB revenue projection is changed from the February estimate by only one billion dollars. Even last February there was considerable comment among observers that the revenue projections were unlikely to be realized. As of June, OMB was admitting that its projections of revenues for fiscal 1974 last February were over estimates of about 3 billion, even after allowing for the fact that the Congress did not pass the proposed windfall profits tax. If we assume that fiscal 75 revenues of 290 billion is a more realistic projection, then the unified budget deficit for fiscal 1975 could be projected at around 20 billion dollars, based on presently available evidence.

What are the implications of a budget deficit of this magnitude for Treasury financing? In the February budget message, the Administration projected that a unified budget deficit of 9.5 billion dollars, would require an increase in Federal debt held by the public (including the Federal Reserve System) of 12.5 billion dollars (see Table 2). As of June, the size of the estimated deficit has grown by 2 billion, but the change in the estimated Federal debt held by the public from the end of fiscal 1974 to the end of fiscal 1975 remains at 12.5 billion. Even if we accept this figure at face value, the increase in the estimated deficit to the order of 20 billion, suggests a required new debt issue of about 21 billion. However, not all of the borrowing by the government is reflected in the treasury debt. There are a total of seven government sponsored enterprises: the Federal Home Loan Banks, Federal National Mortgage Association, Student Loan Marketing Association, Federal Home Loan Mortgage Corporation, Farm Credit Administration (Banks for Cooperatives), Farm Credit Administration (Federal Intermediate Credit Banks), and the Farm Credit Administration (Federal Land Banks). As of February, 1974 these enterprises were projected to borrow 13.6 billion during fiscal 1974. (Federal Budget for Fiscal 1975--Special Analyses, pp. 44 ff.)

TABLE 2.--Financing of Federal Budget Deficits and Government Borrowing Requirements (Billion $).

Fiscal Year	Deficit (Unified Budget)	Decrease or Increase (-) in Cash & Monetary Assets	Increase or Decrease (-) in Liabilities for Checks Outstanding & Deposit Fund Balance	Seignorage on Coins	Outlays of Off-Budget Agencies	Increment on Gold	Change in Federal Debt Held by Public	Net Government Sponsored Borrowings From Public	Total Financing Requirements
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
1971	23.033	---	3.104	.378	.104		19.448	1.503	20.951
1972	23.277	-2.470	4.959	.581	.716		19.442	4.963	24.405
1973	14.301	- .846	-3.921	.400	- .608	---	19.275	8.801	28.076
1974[1]	4.660	3.000	- .798	.448	-2.709	1.219	3.5	13.609	17.109
1974[2]	3.5	n.a	n.a	n.a	n.a	n.a	-1.0	n.a	n.a
1975[1]	9.445	---	- .939	.705	-2.821	---	12.5	1.267	13.767
1975[2]	11.4	n.a	n.a	n.a	n.a	n.a	12.5	n.a	n.a

[1]Estimated February, 1974.

[2]Estimated June, 1974.

Source: Special Analyses, Budget of the U.S. Government Fiscal Years 1972-1975.

As of the end of May, 1974, six of the seven (excluding the Student Loan Marketing Association) had borrowed a total of 12.7 billion dollars (Federal Reserve Bulletin, July, 1974, p. A40). The February, 1974 projection for borrowings by these enterprises for fiscal 1975 was only 1.27 billion dollars. The reason for the reduction in the rate of borrowing was a projected decrease in borrowing by FNMA from 4.7 to 2.0 billion, fiscal 1974 to 75, and a change in the borrowing status of the FHLB from a borrower of 5.5 billion in fiscal 1974 to a net repayer of 5.2 billion in fiscal 1975 (Federal Budget for 1975--Special Analyses, p. 44). Both reductions were projected on the assumption on improving conditions in the mortgage market, and in particular for the FHLB's, the assumption that savings and loan associations would be repaying outstanding advances during fiscal 1975. We are now almost two months into fiscal 1975. During July, 1974, savings and loan associations experienced a net outflow on deposits of 500 million. There are estimates that the net outflow of deposits in S&L's during August may reach 1.6 billion (Business Week, August 24, 1974, p. 12). Under these circumstances, it seems highly likely that the FHLB's and FNMA will be heavy borrowers during the current fiscal year to prop up the mortgage market and in particular to prop up the S&L's who are excluded from effectively competing for funds in the current economy by the various ceilings on deposit rates. It is easily conceivable in the current economy, that these enterprises would be at least as heavily into the capital markets during fiscal 1975 as they were in fiscal 1974, and highly probable that they shall have to borrow even more than in 74. Assuming net borrowing by these agencies at the 74 level of 13.5 billion, our estimates of the total financing requirements for the fiscal year increases to 34.5 billion dollars. It could be argued that these estimates are extremely pessimistic. While it is possible to postulate circumstances under which smaller

financing requirements would prevail, it is also fairly easy to postulate circumstances under which the requirements could be even heavier: for example failure of inflation to subside over the next nine months; rapidly increasing unemployment; and continuing deterioration of the competative position of the savings and loan associations relative to capital markets at the rate of the last two months.