SHADOW OPEN MARKET COMMITTEE

Policy Statement and Position Papers

March 12-13, 1978

1. SOMC Members – March 12, 1978
2. Shadow Open Market Committee Policy Statement, March 13, 1978
3. Position Papers

SHADOW OPEN MARKET COMMITTEE

The Committee met from 3:00 p.m. to 10:00 p.m. on Sunday, March 12, 1978.

Members:

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

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

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

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

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

Dr. Rudolph Penner, American Enterprise Institute, Washington, D.C.

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

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

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

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

POLICY STATEMENT
SHADOW OPEN MARKET COMMITTEE
March 13, 1978

A declining dollar, a falling stock market, and rising long-term interest rates describe the reaction by financial markets, at home and abroad, to our government's actions. Currently the nation does not have an economic policy to reduce inflation, balance the budget, and encourage investment growth and high employment.

The stock market, the bond market, and the foreign exchange market shout their disbelief at our government's statements about increasing investment, reducing inflation, balancing the budget, or supporting the dollar. They fear a drift to controls, a reliance on stopgaps, and increased inflation.

The Shadow Open Market Committee repeatedly has urged the Federal Reserve and the Administration to recognize that the nation's problems are long-term problems that cannot be solved by fine-tuning and by stopgap approaches. A policy that looks ahead years, not weeks or quarters, is what is required. Last year this Committee warned that the policies then proposed and subsequently adopted would have the inflationary consequences now apparent to all. This year we urge again that a long-term program be adopted and adhered to.

The problems the nation faces are not intractable. They seem intractable only because the government continues to seek short-term solutions to long-term problems and acts on the false presumption that inflation will not increase as long as resources are counted as unemployed. Such presumptions lead the Administration to solve every problem by pumping up short-term spending and to understate the role of incentives to output and capital formation -- not only tax incentives, but also reduction of business uncertainty caused by accelerating inflation.

Promises to defend the dollar, increase investment, balance the budget, and lower inflation cannot be met if the primary aim of policy is to stimulate short-term spending. Current policy will produce higher inflation, but not the high level of investment the Administration seeks to restore growth of income to the long-term potential of the U.S. economy.

What Has Been Done?

Last year the Carter Administration gave up the commitment to balance the budget by 1981. The Federal Reserve failed to carry out its announced policy of reducing the growth of money. The budget deficit remained high in 1977 and continues high in 1978.

The growth of money stock -- currency and demand deposits -- exceeded 7%, a rate last seen in 1972 and 1973, just before the major inflation began. There is cause for alarm in the continuation of so high a growth rate. No less alarming would be an abrupt reduction of this growth rate. The policy of reducing unemployment first and reducing inflation later has created the expected dilemma.

We cannot expect real investment to reach the growth rates of the 1960's if large budget deficits, highly variable monetary policies, growing restrictions on trade, and misguided policies on energy continue. We cannot expect a more stable exchange rate for the dollar until policies become stabilizing. We cannot expect inflation to slow following a period of sustained increase in money growth from 4.4% in 1975, to 5.6% in 1976, and to 7.4% in 1977. We cannot expect to avoid recession in 1979 if monetary policy shifts suddenly to combating inflation.

Because of the excessive monetary growth that was permitted in 1977, anticipations of future inflation are heightened, and interest rates are rising. To minimize the adverse effects on savings flows to thrift institutions, Federal ceilings on interest rates on consumer deposits should be abolished or raised. These price controls have never served a useful purpose and have done far too much damage. We commend Chairman Miller's recent initiative in this regard.

Last year this Committee warned the Federal Reserve that monetary growth in excess of the announced targets would be detrimental to the durability of this economic expansion. The members of the House Banking Committee cautioned the Federal Reserve to maintain monetary growth within its own announced target ranges. The Federal Reserve did not heed the advice that was given. A mistake in economic policy was made, and now a price must be paid to correct it.

What Should Be Done?

The policy of gradualism brought the increase in consumer prices down from the very high rates of 1973 and 1974 to an average of 4.5% in the last six months of 1977. The economy recovered. The dollar exchange rate remained stable. If we had avoided the burst of government spending and excessive money growth last year, we would have continued to receive the sustained benefits that can only be achieved if government policies are stabilizing. Excessive stimulus last year has continued too long to be abruptly halted.

We propose four steps:

One, the rate of monetary expansion in the past year was between 7% and 7.5%. We urge that the rate be maintained at 6% in 1978.

Two, we recommend reductions of 1% a year in the average rate of monetary expansion until a noninflationary rate of monetary expansion is achieved. The Federal Reserve should commit monetary policy to this stabilizing long-term monetary course in order to fulfill its legal responsibilities under the Federal Reserve Reform Act of 1977.

Three, the Congress should implement the Administration's pledge to reduce the growth of government spending below the growth of private spending during the next three fiscal years.

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

WHERE DO WE GO FROM HERE?

by Allan H. Meltzer

A declining dollar, a falling stock market, and rising long-term interest rates describe the reaction by financial markets, at home and abroad, to the administration's actions. Currently we do not have an economic policy to reduce inflation, balance the budget, encourage investment growth and high employment.

The financial markets see that there is no policy. The stock market, the bond market and the foreign exchange market shout their disbelief at the administration's statements about increasing investment, reducing inflation, balancing the budget, or supporting the dollar. They sense that the lack of policy, the drift to controls, and the reliance on stop gaps will continue.

The Dollar Problem

Each time that Secretary Blumenthal goes abroad, the value of the dollar plunges. The reason is not hard to find. Secretary Blumenthal urges the Germans, the Japanese and others to do as we do. His advice is rejected. Market participants find their worst fears about the United States confirmed. They see, or believe, that the U.S. intends to continue on its present course while Germany, Switzerland, Japan and others continue on their courses.

Secretary Blumenthal cannot "talk the dollar down" any more than his predecessors in the 1960's were able to "talk the dollar up." The Secretary's statements and the responses by his counterparts abroad, however, assure market participants that their worst fears about U.S. policy are correct or possibly understated, so they sell dollar bonds and stocks, sell the

dollars for foreign exchange and invest abroad. By rejecting the Secretary's advice, foreign governments announce that they do not intend to inflate as much as the United States, so the dollars that investors sell flow to those countries that pursue less inflationary policies.

There is no mystery about the flight from the dollar, the decline in the stock market or the rise in rates of interest on long-term securities. Nor is there any mystery about the rise in the value of marks, yen, and Swiss francs. They are all, in large measure, a response to the differences in anticipated rates of inflation in the United States and other countries.

Comparisons of price levels or rates of money growth in the United States and in Germany or Switzerland do not show why investors are shifting from dollars to D-marks. Price levels and rates of money growth are history. The rate of inflation to which investors respond is the anticipated future rate of inflation.

The investors may be wrong. Secretary Blumenthal and his colleagues in the administration may prove to be right. The entire problem may be, as they say repeatedly, that we have expanded output more than others, so that the dollar floats down because we have a trade deficit, that as the others expand, the trade deficit will shrink, the dollar will strengthen and the problem will be over. But the financial markets do not believe that this is the whole truth, however correct it may be in part. They sell dollars for many reasons, but mainly because they believe the United States has no policy to increase investment and reduce inflation.

Energy and the Dollar

President Carter seems convinced that the problem with the dollar is that we import too much oil. He argues that, once the Congress passes

his energy program, the dollar will recover some of its value because oil imports will fall. Although this explanation is popular it is wrong in emphasizing oil imports as the main explanation of the dollar's decline. Germany, Switzerland and Japan import a much larger proportion of the oil and gas they use than we do. Yet their currencies rise as ours falls.

Energy legislation and the dollar are not unrelated. By raising taxes on energy, the administration's energy program reduces the budget deficit and therefore reduces the amount of securities that the Treasury must sell. A lower deficit puts less pressure on the Federal Reserve to print money to finance the deficit, so the anticipated future rate of inflation in the United States will fall. But the tax on energy does nothing to increase the future supply of energy. It is a tax on the efficient use of resources and, therefore, on growth.

The Carter energy program and the response to the program by the Congress cannot be a source of confidence to investors. The government insisted on making the energy problem an energy crisis by building a large bureaucracy, by transferring decisions from markets to administrators, and by refusing to allow prices to allocate current energy supplies efficiently and to increase future supply.

The way in which energy policy has been discussed, the type of legislation proposed, and particularly the failure by Congress and the administration to remove controls on prices is a message to investors at home and abroad that is far more powerful in its implications than the statistics showing a deficit in the current balance of trade. There is no confidence in the U.S. policy because there is no policy for dealing with long-term problems.

There are, instead, expedients and stopgaps designed with much more concern about the distribution of income than the production of income.

Our failure to respond rationally to the higher price of oil tells investors in dollars and in dollar assets, both Americans and foreigners, a great deal about the drift toward political control of markets. The Carter administration did not create the energy problem. They inherited the problem, but they failed to solve it or to offer a rational program leading to an eventual solution.

Investment and Crowding Out

The key to future growth is higher spending on investment in durable capital. Everyone agrees on that.

The administration has proposed a tax cut for business and consumers to stimulate investment by increasing consumer spending and by raising after tax rates of return. These proposals are in the right direction, but they are too small to offset fully the effects of tax increases for social security and proposed taxes on energy. And these are not the only, or even the most important problems faced by those who make investments.

The current and prospective future deficits are major obstacles. The deficits must be financed either by higher taxes, by inflation or both. Businessmen looking into the future cannot fail to see that the Carter administration does not have a policy that will produce a balanced budget, lower tax rates and less inflation.

A few years ago, crowding out was widely discussed. Some argued that part of the saving used to finance large budget deficits would have financed private capital spending. Real rates of interest on long-term bonds would have been lower and real investment higher if the deficit had

been smaller. Perhaps there would have been a little less stimulus then, but more capital, higher productivity and more income now and later.

Others, convinced that crowding out cannot be a problem with unemployment at 7% or 8% argued differently. Large deficits stimulate the economy, produce more income and therefore more saving. The addition to saving finances the deficit. Crowding out can only be a problem at, or near, full employment.

Now, looking back, we can see the outcome more clearly. Although the economy recovered from the 1974 recession at a rate about equal to the average for postwar recoveries, investment has lagged. Total fixed investment in 1972 dollars remains at the level of 1972 and well below the peak reached in 1973. Production of business equipment has risen more slowly than the index of production. New orders for non-defense capital goods, adjusted for inflation, remain well below their previous peak. Contracts for construction of commercial and industrial buildings, in real terms, reached the 1966 level only recently and remain 25% below the peak reached in 1973.

None of the measures of capital spending adjust for the higher proportion of investment in safety and pollution control equipment. If adjustment is made, the rate of growth of capital looks even more puny, and the loss of future real income looks even more startling.

Financial markets repeat the story told by real investment. Spreads between short- and long-term rates of interest remained high during most of the recovery and have widened recently.

None of the evidence shows that deficit spending had no effect on output and employment. But there is now reason for those who denied the

possibility of crowding out to re-examine their arguments. Investment has lagged behind and shows no sign of spurting ahead. Employment has increased but inflation is rising.

The capital markets sense what the government cannot admit. We have no policy to increase long-term investment, lower inflation, reduce unemployment, and lower the real tax burden. We have a series of stopgaps, a drift toward controls, regulation, more inflation and higher real taxes.

Where Do We Go From Here?

Our problems are long-term problems. Inflation is more than ten years old and will not end soon. Investment has lagged for several years. It will not soon spurt ahead and remain high. Productivity is rising, but the rate of increase is below average of the sixties.

None of these problems can be solved by intense concentration on next quarter, next year or the next election. They can only be solved by policies that are able to achieve lower future taxes, less inflation, greater incentive to work and save, less regulation and fewer controls.

The President and those responsible for economic policy must see that investors and financial markets have voted no confidence in their measures. Stopgaps and stimulants will not succeed and will not generate confidence. Tired metaphors about freight trains accompanying pleas to Germany and Japan for help do not inspire confidence or encourage cooperation. More of the same will not solve any long-term problem.

If the government will not plan its own activities and make a public commitment to policies that achieve stability, the private sector will not expect stability. Inflation will remain high, investment low, and we will continue to drift.

PITTSBURGH NATIONAL BANK

TO SHADOW OPEN MARKET COMMITTEE

FROM Jerry L. Jordan, Sr. V.P. & Economist PHONE No. 412-355-3101

SUBJECT POTENTIAL OUTPUT GROWTH DATE 3/10/78

At SOMC meetings in 1974 and 1975 a continuing debate regarding the economic effects of the sharp increase in the world price of oil on real economic capacity was initiated. The basic argument was that the significant and unanticipated increase in the price of oil decreased the economic value of the existing stock of capital that had been designed to be economically efficient at substantially lower energy prices. The wealth transfer from oil consuming nations to oil exporting nations was reflected in the decrease in the present value of long-lived productive assets (stock prices) and a decline in actual current output in oil consuming nations.

The magnitude of the loss and the effects on future growth potential have been debated during the past three years. Alternative assumptions are illustrated in the attached table. The importance of the issue lies in the implications for increased inflationary pressure that would be associated with a given acceleration in the growth of total spending. In other words, how much and how long can stimulus be maintained before reacceleration of inflation becomes highly probable?

Columns I and II in the table show assumptions of potential real output that were discussed at previous SOMC meetings. The estimates in column one are based on the assumptions that higher energy prices and other "real shocks" reduced potential output by 4.5 percent of the actual Q4/1973 level, but the trend growth remained at 3.5 percent. Column II shows a one-time decrease of the Q4/1973 level of only 2 percent, and a decrease of the trend growth to only 3 percent.

More recent estimates based on work by Rasche and Tatom are shown in columns III and IV. Column III shows levels for 1978 based on a continuing trend growth of 3.5 percent and column IV is based on a trend growth of potential of 3 percent.

The table also shows the maximum growth possible from Q4/1977 to Q4/1978 to reach potential by 1978. Under the assumptions discussed at previous SOMC meetings and shown in columns I and II, the potential level will be exceeded early in 1978. Under the estimates based on Rasche-Tatom, the potential level will be reached by year's-end or in early 1979.

Policy Implications

It must be clearly emphasized that the analysis underlying these estimates of real economic capacity do not imply that higher output levels cannot be reached. Much of the existing physical capacity can be put into

production, but it is only economically viable (profitable) to do so at higher output prices. In spite of relatively low capacity utilization numbers during the past three years, basic industries have continued to meet demand increases with price increases. The data shown in the table suggest that further acceleration of inflation should be expected at least by 1979 unless a marked slowing occurs in the growth of total spending.

JLJ

JLJ/lp

Potential Real Output
(billions of dollars)

(Actual real output, Q4/1977 = $1360.7)

	I	II	III	IV
1977:Q1	$1361.7	$1370.5	$1390.7	$1387.3
1978:Q1	1373.5	1380.7	1402.7	1397.9
Q2	1385.4	1390.9	1414.8	1408.3
Q3	1397.4	1401.2	1427.0	1418.7
Q4	1409.4	1411.6	1439.3	1429.2
maximum growth in 1978 to reach potential	3,6%	3.7%	5.8%	5.0%

column I : 4.5% loss in Q4/1973, 3.5% growth
II : 2.0% loss in Q4/1973, 3.0% growth
III : Rasche-Tatom, 3.5% growth from Q2/77
IV : Rasche-Tatom, 3.0% growth from Q2/77

PROJECTIONS FOR THE ECONOMY

Prepared for the

SHADOW OPEN MARKET COMMITTEE MEETING

March 13, 1978

by
JERRY L. JORDAN
Sr. Vice President & Economist
Pittsburgh National Bank
Pittsburgh, PA

Total demand in the economy was strong in 1977 and it is going to be strong again in 1978. The pervasive effects of the severe winter weather in recent months and the depressive effects of the extended strike in the coal industry should not be allowed to obscure the underlying conditions of very strong demand emanating from the highly stimulative monetary and fiscal policies that were initiated in 1977.

A year ago severe winter weather caused many forecasters, espcially those using large scale structural economy econometric models to greatly underestimate the strength of the economy. The Congressional Budget Office issued a report, dated January 11, 1977, entitled "The Disappointing Recovery" and painted a very dismal picture regarding the outlook for 1977 in the absence of massive additional monetary and fiscal stimulus. Specifically, they projected real output growth for 1977 in the range of 3.5 to 5 percent, and unemployment of 7.1 to 7.8 percent.

The newly inaugurated President described economic conditions as being the worst since the great depression of the 1930s. In retrospect, the opening sentence of the Annual Report of the Council of Economic Advisers for 1977, dated January 27, 1978, states "As the new administration took office at the beginning of 1977, the economy was turning up strongly from a period of very slow real growth during the latter part of 1976."

At the meeting of the Shadow Open Market Committee on March 7, 1977 real output growth was projected to be 5.9 percent from the fourth quarter 1976 to fourth quarter 1977. That projection was reviewed and maintained at the September 19 meeting of this committee. Latest data available for 1977 show a growth of real output of 5.7 percent during the four quarter period, only slightly less than anticipated by the SOMC and its deliberations.

At the March 1977 meeting of the Shadow Committee it was recommended that growth of the narrowly defined money supply be held to between 4 and 4-1/2 percent during the year ending in the first quarter of 1978. However, economic projections considered by the Shadow Committee assumed a higher growth in money would most likely occur.

At the September 1977 meeting two very strong back-to-back quarters of monetary growth had already occurred and the committee recommended a sharp reduction in the money stock. Nevertheless, for purposes of economic

projections, it was generally assumed that monetary growth would remain excessive. Consequently, the expected rate of inflation for 1977 was revised upwards. At the March meeting last year a relatively moderate inflation of less than 5 percent had been discussed, but at the September meeting an inflation rate for 1977 of almost 6 percent was projected. Latest data available show an increase in the GNP deflator of 5.8 percent and a rise in the consumer price index of 6.7 percent in the year ending in fourth quarter last year.

As a result of the upward revision in inflation expectations for the year, growth of total spending in the economy, nominal GNP, was expected to be about 12 percent for the year ending in the fourth quarter of 1977. Latest data show the rise to have been 11.9 percent, which is the largest increase in nominal GNP for any year since 1950. Previous years of strong growth in nominal GNP were 1973 and 1972 with rises of 11.1 and 11.7 percent respectively. During the past two years the growth of nominal total spending in the economy was about evenly split between growth and real output and inflation as in shown in Table I.

For 1978 it is expected that growth of total spending in the economy will be somewhat less than in 1977; however, the composition will shift towards approximately two-thirds inflation and only one-third in real output growth. Table II shows projections for nominal income output prices, money, and velocity for the current year.

It must be emphasized that these projections for the growth of the money supply are not in any way recommendations, but are merely assumptions as to the possible final outcome. My recommendations will be that money growth be less than indicated in the table, but my fear is that it may actually exceed that rise. The growth of the narrowly defined money stock, M1, indicated in Table II would be somewhat less than the 7.4 percent increase actually observed for the full year 1977. It would be substantially less than the 8.5 percent increase that occurred in the final three quarters of last year, yet it would still be above the upper limit of the Federal Reserve's own announced target limit of 6.5 percent.

The growth of velocity indicated in the table is above the long-run historic trend rates. This is a result of the lagged effects on nominal income growth of the acceleration in monetary growth that occurred in the last three quarters of last year. In addition, the sharp acceleration in the growth of government spending to a 15 percent rate in the current fiscal year suggests a temporary acceleration in the growth of the income velocity of money. Even if actual monetary growth this year is no more than the 6.5 percent upper limit of the range announced by the Federal Reserve, it should be

expected that inflation will remain very high even in 1979.

The substantial overshoot in monetary growth that occurred especially in the second and third quarters of last year will have a delayed effect on total spending and credit demands that cannot be offset without imposing some costs in terms of reduced real output growth. The Federal Reserve made some progress in 1975 and 1976 in gradually reducing the trend growth of money, but substantial ground was lost last year. Whether or not the acceleration of inflation this year and in 1979 turns out to be only a cyclical increase within a secular downtrend, or is the initial phase of an acceleration towards, or above, the rates experienced in 1973 and 1974 will be to a large extent determined by monetary growth in 1978.

Last year the Federal Reserve was warned that monetary growth in excess of the announced targets would be detrimental to the durability of this economic expansion. The Chairmen of both the Senate and House Banking Committees cautioned the Federal Reserve to maintain monetary growth within their own announced target ranges. The Federal Reserve did not heed the advice that was given. A mistake in economic policy was made, and now a price must be paid in order to correct it. The longer the delay before corrective action is taken, the greater the cost will be in terms of lost output and employment at some time in the next two or three years.

TABLE I
(percent change)

	GNP	Real Output	Price Inflator
Q4/75-Q4/76	9.7	4.7	4.7
Q4/76-Q4/77	11.9	5.7	5.8

TABLE II
(percent change)

Projections for 1978

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

MONEY GROWTH RATES
(% Change from Previous Year)

FROM:	TO:	M1	M2	MONETARY BASE
1971/Q1	1972/Q1	6.8	10.9	7.1
Q2	Q2	6.3	9.7	7.2
Q3	Q3	6.7	10.4	6.9
Q4	Q4	8.4	11.2	8.4
1972/Q1	1973/Q1	8.5	10.5	8.9
Q2	Q2	8.0	10.0	8.2
Q3	Q3	7.2	9.2	9.1
Q4	Q4	6.2	8.8	8.1
1973/Q1	1974/Q1	5.9	8.9	8.1
Q2	Q2	5.7	8.7	8.4
Q3	Q3	5.3	8.3	8.5
Q4	Q4	5.1	7.7	9.0
1974/Q1	1975/Q1	3.7	6.6	8.2
Q2	Q2	4.1	7.3	7.8
Q3	Q3	4.8	8.3	7.9
Q4	Q4	4.4	8.3	7.5
1975/Q1	1976/Q1	4.9	9.4	8.2
Q2	Q2	5.2	9.6	8.7
Q3	Q3	4.5	9.3	8.3
Q4	Q4	5.6	10.9	8.5
1976/Q1	1977/Q1	6.0	10.9	8.2
Q2	Q2	6.0	10.6	7.8
Q3	Q3	7.3	10.9	8.5
Q4	Q4	7.4	9.6	8.9
* 1977/Q1	1978/Q1	8.0	9.2	9.8

*Projected by Pittsburgh National Bank

TWO-QUARTER COMPOUNDED ANNUAL RATES OF CHANGE

	M1	M2	MONETARY BASE
Q1/71 - Q3/71	8.6	11.7	8.1
Q2/71 - Q4/71	9.6	8.0	6.6
Q3/71 - Q1/72	5.1	10.0	6.1
Q4/71 - Q2/72	7.9	11.4	7.8
Q1/72 - Q3/72	8.3	10.8	7.7
Q2/72 - Q4/72	8.9	11.0	9.0
Q3/72 - Q1/73	8.6	10.2	10.2
Q4/72 - Q2/73	7.0	9.0	8.8
Q1/73 - Q3/73	5.9	8.2	8.1
Q2/73 - Q4/73	5.5	8.7	7.4
Q3/73 - Q1/74	5.8	9.7	8.2
Q4/73 - Q2/74	5.8	8.8	9.5
Q1/74 - Q3/74	4.8	7.0	8.8
Q2/74 - Q4/74	4.3	6.6	8.6
Q3/74 - Q1/75	2.5	6.2	7.6
Q4/74 - Q2/75	3.9	8.1	7.0
Q1/75 - Q3/75	7.2	10.4	8.2
Q2/75 - Q4/75	4.9	8.6	8.0
Q3/75 - Q1/76	2.7	8.4	8.1
Q4/75 - Q2/76	5.6	10.6	9.5
Q1/76 - Q3/76	6.4	10.2	8.5
Q2/76 - Q4/76	5.6	11.2	7.5
Q3/76 - Q1/77	5.5	11.7	7.9
Q4/76 - Q2/77	6.5	9.9	8.1
Q1/77 - Q3/77	9.2	10.1	9.1
Q2/77 - Q4/77	8.3	9.2	9.6
*Q3/77 - Q1/78	6.9	8.4	10.4

*Projected by Pittsburgh National Bank

PITTSBURGH NATIONAL BANK

TO SHADOW OPEN MARKET COMMITTEE MEMBERS

FROM Jerry L. Jordan PHONE No. 412-355-3101

SUBJECT TABLE REVISIONS DATE 3/31/78

Attached are revisions to the tables I distributed at the March meeting.

The very strong growth of business loans, in addition to continued strength in consumer and mortgage loans, is producing upward pressure on short-term interest rates. The monetary base rose $1 billion in the past two weeks after remaining unchanged for six weeks.

During the second and third quarters this year, the probability that the money and interest rate pattern of the first quarter (that is, both short-term interest rates and money growth unchanged) is small.

The Fed apparently is attempting a form of "operation twist" since they bought coupon issues for their own account last week while selling Treasury bills to the Bank of Japan from their own portfolio.

JLJ

JLJ/lp

TWO-QUARTER COMPOUNDED ANNUAL RATES OF CHANGE

	M1	M2	MONETARY BASE
Q1/71 - Q3/71	8.6	11.7	8.1
Q2/71 - Q4/71	9.6	8.0	6.6
Q3/71 - Q1/72	5.1	10.0	6.1
Q4/71 - Q2/72	7.9	11.4	7.8
Q1/72 - Q3/72	8.3	10.8	7.7
Q2/72 - Q4/72	8.9	11.0	9.0
Q3/72 - Q1/73	8.6	10.2	10.2
Q4/72 - Q2/73	7.0	9.0	8.8
Q1/73 - Q3/73	5.9	8.2	8.1
Q2/73 - Q4/73	5.5	8.7	7.4
Q3/73 - Q1/74	5.8	9.7	8.2
Q4/73 - Q2/74	5.8	8.8	9.5
Q1/74 - Q3/74	4.8	7.0	8.8
Q2/74 - Q4/74	4.3	6.6	8.6
Q3/74 - Q1/75	2.5	6.2	7.6
Q4/74 - Q2/75	3.9	8.1	7.0
Q1/75 - Q3/75	6.3	10.1	8.2
Q2/75 - Q4/75	4.5	8.4	8.0
Q3/75 - Q1/76	3.7	8.9	8.1
Q4/75 - Q2/76	5.9	10.7	9.5
Q1/76 - Q3/76	5.4	9.6	8.5
Q2/76 - Q4/76	5.6	11.1	7.5
Q3/76 - Q1/77	7.3	12.3	7.9
Q4/76 - Q2/77	7.7	10.3	8.1
Q1/77 - Q3/77	8.3	9.8	9.1
Q2/77 - Q4/77	7.8	9.2	9.6
*Q3/77 - Q1/78	6.1	7.3	10.4

*Projected by Pittsburgh National Bank

MONEY GROWTH RATES
(% Change from Previous Year)

FROM:	TO:	M1	M2	MONETARY BASE
1971/Q1	1972/Q1	6.8	10.9	7.1
Q2	Q2	6.3	9.7	7.2
Q3	Q3	6.7	10.4	6.9
Q4	Q4	8.4	11.2	8.4
1972/Q1	1973/Q1	8.5	10.5	8.9
Q2	Q2	8.0	10.0	8.2
Q3	Q3	7.2	9.2	9.1
Q4	Q4	6.2	8.8	8.1
1973/Q1	1974/Q1	5.9	8.9	8.1
Q2	Q2	5.7	8.7	8.4
Q3	Q3	5.3	8.3	8.5
Q4	Q4	5.1	7.7	9.0
1974/Q1	1975/Q1	3.7	6.6	8.2
Q2	Q2	4.1	7.3	7.8
Q3	Q3	4.8	8.3	7.9
Q4	Q4	4.4	8.3	7.5
1975/Q1	1976/Q1	5.0	9.5	8.2
Q2	Q2	5.2	9.5	8.7
Q3	Q3	4.5	9.3	8.3
Q4	Q4	5.7	10.9	8.5
1976/Q1	1977/Q1	6.3	10.9	8.2
Q2	Q2	6.6	10.7	7.8
Q3	Q3	7.8	11.0	8.5
Q4	Q4	7.8	9.8	8.9
*1977/Q1	1978/Q1	7.2	8.5	9.8

*Projected by Pittsburgh National Bank

Statement by

JERRY L. JORDAN
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before the

Committee on Banking, Finance and Urban Affairs

House of Representatives
United States Congress

March 7, 1978

Mr. Chairman and Members of the Committee:

It is indeed a pleasure to have this opportunity to present my views on monetary policy. I would like to state at the outset that I have been very much encouraged by the role that Congressional oversight of monetary policy has played in recent years. In the three years since these quarterly hearings began under Concurrent Resolution 133, the quality of the discussions concerning the issues involved in the conduct of monetary policy has greatly improved. I think that the process of formulation and implementation of monetary policy has been improved by these hearings, and I am hopeful that further progress will be achieved in the future.

The requirement that the Federal Reserve announce monetary growth targets is potentially an important contribution to the objective of promoting economic stability, but only if the targets can be relied upon. Decision makers in the private sector, both management and labor leaders, would find it valuable to know in advance the rate of inflation that will be tolerated by the monetary authorities. The credibility of the central banks' stated intentions is the key to the success of monetary policies in Germany, Switzerland, and other countries that also announce monetary growth targets. Last year the growth of money exceeded the Federal Reserve's targets by a significant margin, and it is widely believed that the same will be the case this year. These hearings are the appropriate forum for seeking from the Federal Reserve explanations for past errors and assurances that they are serious about announced targets for the future.

In general, there is reason to be optimistic about the outlook for our economy, and for that matter for world economies in the years ahead. There are some unavoidable problems that must be dealt with in the next year or two, but there is still time for a mid-course correction that will lay a foundation for strong growth and declining inflation in the 1980's.

I would like to spend my time this afternoon commenting on what can and cannot be expected from monetary policy in achieving our national objectives regarding capital formation and job creation, while not abandoning the goal of a gradual reduction in the trend rate of inflation. In addition, there are a few issues concerning the measurement and implementation of monetary policy that it is timely to deal with over the next year, and I will suggest that an appropriate role

of Congressional oversight of monetary policy is to monitor the progress towards improving the quality of monetary data and to encourage reconsideration of the techniques used by the Federal Reserve to achieve its monetary growth targets.

I will begin with a brief summary of my views on where we stand at the present time and the appropriate objectives for monetary policy in 1978. On previous occasions the Chairman and other members of this Committee, as well as several witnesses, have emphasized the importance of lags between monetary policy actions and observable responses of the economy. The pervasive effects of the severe winter weather in recent months, especially in combination with an extended strike in a major portion of the coal industry, should not cause us to lose sight of the foundation of very strong demand that has been provided by highly stimulative monetary and fiscal policies that began in 1977 and are continuing at the present time. Growth of the monetary base and the narrowly defined money supply during the last three quarters of 1977 was more rapid than at any time in thirty years, with the exception of 1972. At the same time, the growth of government spending at the Federal level began to accelerate in the second half of fiscal 1977 and is scheduled to rise 15 percent in the current year. Normal lag relationships suggest that the strong thrust from these monetary and fiscal policy actions assure that growth of total spending in the economy will be strong this year. In fact, the average 16 percent rate of increase of personal income in the closing months of last year suggests that additional stimulation of final demand is not necessary at the present time.

Total spending in the economy as measured by Gross National Product rose by almost 12 percent last year, up significantly from the 9.7 percent increase in 1976. That increase has been exceeded in only one year since World War II and was accompanied by a number of other measures of economic performance that are equally satisfying. Total new automobile sales were almost a record and new single family housing starts of over 1.4 million were an all time record. Maybe most important, the actual number of people employed in our economy increased by over seven million last year to achieve both the highest total number of people employed in our history by a significant margin, but also the largest proportion of population of working force age employed that we have experienced other than during World War II.

These excellent results in labor markets do not mean that we do not still have problems with unemployment, but they do suggest that approaches other than general stimulus to aggregate demand must be sought in order to achieve our national objective of job opportunities for all that desire them. I am confident that the overall rate of unemployment will be below 6 percent sometime this year. Progress towards reducing unemployment further involves: much more selective approaches to identifying who the unemployed are and where they are; providing information to potential employers and perspective employees; removing some of the obstructions and barriers to employment that are faced by many people; and providing the kind of training and actual work experience that will enhance the skills and productivity of the unemployed in order that they can become active participants in our economy at acceptable wages.

At the same time that specially tailored programs are implemented to further reduce unemployment, overall monetary and Federal budget policies should be focused on the longer-term objective of achieving a much lower rate of inflation by the mid-1980's. If we are to maintain any hope of eventually returning to the low average rate of inflation that prevailed in the 1950's and early 1960's, aggregate demand policies must be moving in the direction of achieving a growth of GNP

(total spending in the economy) that is less than one-half the rate that was achieved in 1977. In the last few years Federal budget policies have been discussed in the context of a five-year plan, and I believe that such a time horizon also would be appropriate for discussing the monetary policy program. Over the next five years we should be contemplating the monetary policies that would accompany a reduction in the growth of nominal total spending to only a 7 or 8 percent rate that would be associated with a rate of inflation of 4 percent or less and a 3 to 4 percent growth of real output. Such a program would involve a gradual reduction in the rates of monetary growth from the upper ends of the current target ranges announced by the Federal Reserve to no more than the low end of the current target ranges.

It should be emphasized at this point that stability in the growth rates of the monetary aggregates, and only gradual changes in the average growth rates, are far more important than the exact figures that are sought or achieved. I will have more to say about this in a few moments, in connection with some comments on appropriate monetary policies to foster a greater rate of capital spending, but at this point I want to caution against a "whites-of-the-eyes" approach to setting shorter-run monetary growth targets.

A substantial amount of research effort has been devoted to demonstrating that fluctuations in the growth of the money supply around the underlying trend rate are reflected primarly in fluctuations of output and employment, while the trend growth of money over a period of several years is reflected in the prevailing average rate of inflation. The clear implication of this research is that a significant acceleration in the growth of the money supply above the underlying trend can have a short-run positive effect on the growth of output and employment. However, such a policy action sows the seeds of its own failure since an unavoidable dilemma is created wherein a choice must be made between sustaining the new higher growth of the monetary aggregates -- and accepting a rise in the trend rate of inflation -- or, alternatively, suffering the contraction in the growth of output and employment that would be induced by a marked reduction in money growth back towards, or below, the previous trend rate.

In the present environment this means that in 1978 a continuation of 8 to 9 percent growth in the narrowly defined money supply might be accompanied by a somewhat higher rate of output and employment growth than would an immediate return to the previous 6 percent trend rate. However, continuation of the high rates of monetary growth this year would create a situation where the Federal Reserve had no good options remaining once they began to focus on 1979. The choice at that time would be between continuing the high rate of monetary growth and tolerating an acceleration of inflation into the 7 to 9 percent range next year, or administering a dose of traditional monetary restraint in order to combat the emerging inflation and, consequently, necessitating a credit crunch and recession next year.

If the Federal Reserve immediately returns to and maintains monetary growth at no more than the upper ends of the announced target ranges a severe credit crunch and major recession can be avoided. However, a continuation of the policy actions of the past year for another six to nine months would make it less likely that the excesses can be corrected without suffering a major economic adjustment.

This outlook for the next year or two is influenced by an interpretation of the "slack" or idle capacity in the economy that differs significantly from the view put forth by others, notably the Congressional Budget Office staff. Briefly, they take at face value the relatively low capacity utilization numbers and the data that suggest that there still is a large "gap" between actual output and so-called potential GNP, and they conclude that we are not in danger of "spilling-over" into a condition of excess demand and rising inflation.

In my view their analysis might be correct only if the long and deep recession of 1974 and 1975, and the associated decline in capacity utilization, had been caused solely by prior restrictive monetary and fiscal policies. However, we all know that that is not the whole story. During 1973 and 1974 we experienced a number of major one time "real shocks", such as the quadrupling of oil prices, that decreased the real economic capacity of much of the existing plant and equipment. Given the much higher input prices, especially for energy, substantially higher output prices became necessary to restore profitability. Many of the basic industries such as steel, aluminum, rubber, paper, glass and plastics had installed capacity that was economically efficient only at much lower energy prices than prevail today. Some of this capacity was relatively new and modern in a physical sense, but became economically obsolete (unprofitable to operate) at prevailing output prices in view of the significantly higher input prices. Consequently, demand increases in these basic industries have been met, and will continue to be met, with output price increases long before full utilization of physical capacity is reached. This means that the capacity utilization numbers are not a very reliable measure of pressure for price increases in this environment.

This analysis does not suggest that it is not possible to achieve the old potential capacity output levels, but it does suggest that the rate of inflation associated with the achievement of those higher output levels may be considerably greater than a traditional "gap" analysis would suggest. On the positive side, it should be noted that the fact that the nominal price of oil from OPEC has not risen since the middle of last year and, therefore, the real price of oil to the United States has declined, means that (as long as it continues) there will be less inflation than otherwise. On the other side, the eventual resolution of our own domestic energy policies will have a significant bearing on the outcome regarding energy prices and availability.

I have no doubt that movements of interest rates are going to receive a lot of attention in discussions about monetary policy this year. It obviously is tempting to tolerate more rapid growth of money and credit in an effort to prevent increases in interest rates in order to promote increased private investment spending and assure a continued strong flow of funds to the housing industry. But that option carries with it the danger of much more serious problems at a later time.

There is a view that rising short-term interest rates tend to push up long-term interest rates, and tendencies for short-term interest rates to rise must be resisted by the monetary authorities in order to avoid rising long-term interest rates. However, that view is not supported by recent experience nor by theoretical analysis. Since investors pay increasing attention to the growth of the money supply in forming their expectations about future inflation, a more rapid growth of money for the purpose of holding down short-term interest rates would actually cause long-term interest rates to rise more. This is because managers of investment funds, as well as individual savers, would attempt to avoid incurring a

capital loss that would occur when the price of long-term bonds declined as the inflation premium in bond yields was revised upward. The only way to bring about a permanent reduction in long-term interest rates, including mortgage rates, is to permanently reduce inflation.

Last year short-term market interest rates rose approximately two percentage points, and some observers interpreted that as a sign of a more restrictive monetary policy. I disagree with that view. Since the quantity of credit extended was rising at historically very rapid rates, the only interpretation that follows from the rise in the price of credit is that the demand for credit was rising even more rapidly than the ample increase in credit supplied. That is a sign of a strong economy. The rise in short-term yields last year occurred mostly in the spring and summer, at a time when bank reserves and the money supply were growing at the most rapid rates in over thirty years. Such a high rate of monetary growth accompanied by a sharp rise in short-term interest rates occurred in only one other year -- 1972. Certainly the events of 1973 and 1974 suggest that the excessive monetary growth in 1972 was a better measure of monetary stimulus than was the rise in the price of credit.

At the present time, participants in money and capital markets seem to be expecting that short-term market interest rates will rise one percentage point or more this year, that inflation will be at least as rapid as last year, and that long-term interest rates will rise by one-half percentage point or more. It is generally accepted that the money and credit markets will be much tighter this year in spite of the somewhat slower real output growth that is generally expected. Market participants understand that there is no reliable correlation between real growth in the economy and movements in interest rates, as evidenced by recent experiences such as 1973 and 1974. The dominant reason for expecting upward pressure on interest rates this year is that the stimulative monetary and fiscal policies of last year, and continuing into this year, have produced strong credit demands in the private sector which are competing increasingly with the continuing large credit demands of the government sector, all of which leads inevitably to a substantially higher price of credit.

It is important to emphasize that a year ago the forecasts of higher interest rates in 1977 were based on assumptions of an acceleration in the growth of the money supply, <u>not</u> slower growth of money, than had occurred in the previous year. Similarly, continued monetary growth in 1978 at the rate that occurred in the final three quarters of last year would imply a larger rise in long-term interest rates this year and in 1979 than if the growth of money was returned to and maintained at no more than the upper limits at the announced targets.

I firmly belief that if market participants can rely on the Federal Reserve to reduce monetary growth this year to no more than the upper ends of the announced target ranges, the rise in short-term yields will be viewed as only a temporary cyclical increase. Consequently, the rise in long-term yields will be small since there will be no reason to revise upwards expectations about the trend rate of inflation.

The reasons for the apparent paradox -- that slower money growth means a smaller rise in interest rates -- lie in the way market participants form expectations about future credit demands and inflation and in their judgements about actions that may be taken by the Federal Reserve to offset undesired

deviations of monetary growth from their targets. Even though traditional analysis holds that faster growth of money implies lower interest rates and slower growth of money implies higher interest rates, market participants have come to understand that it is actually just the opposite.

Over the past few years market participants have recognized that when faster money growth actually is observed, higher short-term interest rates can usually be expected as the Federal Reserve raises the Federal funds intervention target rate in order to slow reserve availability and bring money growth back down into the target range. Conversely, when money growth persists for some time at relatively slow rates, interest rates begin to decline as market participants begin to expect that the Federal Reserve will increase reserve availability in order to promote faster growth of money to maintain target growth rates. The implication for the present environment is that the way to promote lower long-term interest rates late this year and in 1979 is to allow the competition between government and private sector credit demands to raise short-term interest rates as much as necessary while open market operations by the Federal Reserve provide reserves at a rate that permits money growth at no more than the upper limits of the current long-term target growth ranges.

The obvious problem with this conclusion for economic objectives in 1978 is that tolerating further increases in short-term market interest rates will be viewed by some to be in conflict with the desire to promote a higher rate of capital spending and to insure continued strength in the housing industry. The argument will be heard many times this year that rising short-term market interest rates increase the likelihood of an outflow of savings deposits from the thrift industry, especially of short-term maturities, and that, in turn, implies a reduced availability of funds for construction and mortgage finance of housing. While that analysis by itself is undeniable, the various alternative policies and their implications must be considered.

For the Federal Reserve to merely peg short-term interest rates at near the current levels and tolerate a marked acceleration in the growth of money and credit would delay the occurrence of disintermediation and might assure a continued strong flow of funds to the housing industry through this year. However, those same actions would insure that inflation would accelerate substantially next year and a major credit crunch and recession would become inevitable.

Cyclical movements in interest rates contribute to cyclical swings in home construction activity, but it is also true that high secular rates of inflation have a major adverse effect on the housing industry and people's ability to afford adequate housing. Part of the reason that the demand for housing was so strong last year and residential housing prices rose so sharply was because of people's fears about future inflation. Even though housing prices have risen sharply in the past decade, and in 1977 were substantially higher than just one year earlier in some parts of the country, there was considerable speculative activity based on the assumption that general inflation would be greater and new homes would become even more expensive relative to incomes in future years. A policy of holding down interest rates and permitting very rapid growth in money and credit is not the solution to the problems of the housing industry and the thrift industry, if it means continued high rates of inflation.

Even if nothing else is done and a return of monetary growth to the Federal Reserve's announced target ranges causes increases in short-term interest rates and some disintermediation of savings from the thrift institutions and a downturn in home construction activity, there is no reason to believe that the downturn will be very sharp nor very long in duration. It would be far better to suffer a mild downturn in the next year or so and lay a foundation for resumed healthy growth in the 1980's than it would be to promote vigorous activity this year and into 1979, while risking a subsequent long and deep contraction in the industry.

Now I will turn to some comments about the role of monetary policy in promoting an increased rate of capital spending. First, there is a view about the way government economic policies influence capital spending plans of business that I disagree with. It holds that monetary and fiscal policies can be used to stimulate current consumption spending and thereby give business decision makers the confidence to implement plans for increased productive capacity. According to this view, the key to stimulating capital spending is to take actions that cause this month's sales to increase and order books to fill up. My conversations with business leaders do not support that view.

The experience of the last couple of years suggests that the traumatic events of 1974 and 1975 have caused businessmen to be very cautious about being too myopic in analyzing the strength of final demand for their products. The business community is very sensitive to the possibility that monetary and fiscal policies in the short-run will become overly stimulative and leave the government with no alternative but to combat accelerating inflation either by administering a strong dose of traditional monetary and fiscal restraint which would render any new investment unprofitable during the ensuing recession, or adopting some form of administrative controls over prices which would also render new capacity to be unprofitable. There is a desire by business planners to see government avoid the excesses of short-sighted "stop and go" policies in favor of more stable policies that reflect the kind of patience necessary to promote a prolonged period of continued economic expansion.

A review of the conditions that made possible the extended period of sustained growth in the 1960's suggests that moderation in the monetary and fiscal policies pursued early in the period, especially in 1961 and 1962, dispelled the view that alternating short periods of growth and recession were inevitable. Another development that contributed to the length of the expansion of the 1960's was the willingness of the monetary authorities to suffer a correction of some excesses that were building up part way through the period. The 1966 credit crunch and the mini-recession in the first quarter of 1967 were unfortunate and unpleasant, but they were also probably unavoidable as a result of the overheating of the economy that occurred in 1965 and early 1966. Their occurrence enabled the economic growth to continue for three more years.

In 1978 it is still possible for capital spending to continue to strengthen and in real terms to match or exceed the pace of last year. However, if high rates of monetary growth are the results of policies designed to resist further increases in short-term interest rates this year, then greater uncertainties will be generated about the economic environment that will prevail two or three years from now when new capacity is coming on stream. As a result, corporate planners will want to go slow on major long-term projects until they have a better idea about the timing, depth, and duration of the next recession and until the prospects for some form of administrative controls over prices are assessed. I do not believe that

controls are desirable or necessary, but in business it is prudent to assume they will be imposed.

Now I will turn to some comments about implementation and measurement of monetary policy actions. At the hearings conducted by this Committee in July of last year, the subject of seasonal adjustment of the monetary aggregates was raised, yet the situation is the same today as it was at that time. Two years ago a non-partisan committee of academic economists, commissioned by the Federal Reserve and chaired by Professor Leland Bach, made a number of recommendations regarding the measurement of monetary statistics. Yet no action or explanation for failure to implement the recommendations has been forthcoming from the Federal Reserve, and I think it would be an appropriate role for Congressional oversight to seek some progress on these issues, or at least some reasons why the recommendations have not been implemented.

At the mid-year review of the economy conducted last September by the Joint Economic Committee, Congressman Ruess presented additional views with which I concur substantially and will not repeat at this point, but will only say that they are as relevant today as at that time. In addition, at the hearings of this Committee last July on monetary policy, the subject of lagged reserve requirements was raised and an analysis by the staff was included in the record. I would like to associate myself with the analysis presented by the staff and suggest that on this year's agenda for Congressional oversight the Federal Reserve should be asked to plan a return to coincident reserve requirements or provide a detailed defense of maintenance of the present structure of lagged reserve requirements.

Finally, I concur with the concern expressed by a number of observers regarding the emphasis placed on the weekly money supply numbers, but I would like to suggest that the Federal Reserve's continued emphasis on the weekly average and even daily or hourly Federal funds rate is equally cause for concern, and frequently has been a source of past policy errors. Neither the level of the Federal Funds rate nor the weekly M1 and M2 measures are appropriate short-term operating targets for the Federal Reserve. Alternatively, the adoption of a reserve aggregate, such as the monetary base, as a short-run operating target would enhance the ability of the Federal Reserve to achieve its quarterly and annual money supply growth targets and also to avoid wide cyclical swings of interest rates. Again there is an apparent paradox, in that excessive preoccupation with short-run movements in interest rates and efforts to stabilize them over weekly averages (or even daily) may actually contribute to substantially greater swings in interest rates over full business cycles. In order to minimize the long-run movements in interest rates the Federal Reserve should allow them to fluctuate over a wider range in the very short-run.

In summary, monetary policy actions in 1978 will be critical in determining whether another major recession should be expected in the next few years. Contrary to conventional analysis, the probability I would assign to an occurrence of a major recession in the next two or three years would be greater, the more stimulative are monetary policy actions this year. It is my hope that the Federal Reserve adheres to monetary growth targets for this year that are no higher than were announced, but greatly exceeded, last year.

HARRIS BANK

HEROS
Harris Economic Research Office Service

February 8, 1978

ECONOMIC PROSPECTS THROUGH 1979

Although monetary growth is beginning to ease from the rapid pace which characterized much of 1977, the forecast assumes that the easing represents a temporary adjustment which will be offset soon. As a result, while the boom in sales which took place in late 1977 is likely to taper off by early spring, further sharp advances in the money supply in the months ahead are expected to foster a strong sales trend for the year as a whole. Inflation is projected to move higher throughout the forecast period, and fiscal and monetary stimulus is assumed to be sufficient to maintain real growth in the vicinity of 4%.

A Preliminary View of 1979

While the current forecast projects the path of business activity through 1979, more than the usual number of caveats should be emphasized. First, an expansion through 1979 would mark five consecutive years of business expansion, a relatively long period in terms of historical experience. Second, and perhaps more importantly, the past two years have witnessed an acceleration in the growth of the money supply. This acceleration means that some future economic instability is virtually inevitable in order to contain rising inflation.

The forecast assumes that tighter monetary policies will be avoided during 1978. This view is based upon the belief that the Administration, the Federal Reserve Board, and the developing fiscal policies will all be geared toward stimulating the economy this year. The judgment concerning the course of monetary policies in 1979 becomes much more difficult. Given the 7½% - 8% inflation that is anticipated for 1979 combined with gradually slowing real growth, policymakers will be tempted to implement one of two extremes. The first would be to accelerate monetary growth above 9% in an effort to maintain an acceptable increase in real growth. The second would be to slow monetary growth in an attempt to combat rising inflation. The second extreme would be likely to lead to a recession in late 1979 or 1980 while the first course of action might serve to postpone a recession until after the 1980 election. At this point in time, the ability to predict what policymakers will choose to do is extremely limited. Nonetheless, in spite of these uncertainties, decisions must be made today regarding the probable course of business activity in 1979. The attached forecast recognizes that problem and represents a compromise from two extreme views by allowing monetary growth to continue throughout 1979 at a 9% rate.

A longer term forecast, which will be distributed within the next month, will incorporate the economic implications of both scenarios referred to above. Irrespective of the precise pattern which develops, a recession within one year either way of 1980 appears to be an extremely likely prospect at the current time.

Monetary Aggregates Show Diverging Trends

Monetary growth trends have recently given widely divergent signals on the future course of business activity. Normally, with a six month lag personal income and GNP growth proceed at approximately the rate of expansion in M_2 or 3 percentage points faster than the monetary base and M_1. As the table below shows, there has been a significant slowdown in M_2 growth during the past year.

Monetary Growth
(Annual Rate of Change)

	Jan. '77 - July '77	July '77 - Jan. '78	Oct. '77 - Jan. '78
Monetary Base (currency plus member bank reserves)	8.1%	10.1%	9.7%
M_1 (currency plus demand deposits)	8.5	7.0	5.3
M_2 (M_1 plus time deposits at commercial banks other than large CD's)	10.2	7.5	6.5

This significant slowdown in M_2 growth is assumed to be related to the sharp rise in short-term interest rates which have made savings deposits in commercial banks less attractive than open market securities such as treasury bills. The higher interest rates are believed to have caused people to shift their money assets away from savings deposits thereby resulting in a slower expansion in M_2 relative to M_1. Shifts in the preference for money assets will strongly influence particular money measures and their relationship to the economy. In this vein, the recent extremely rapid advance in the monetary base probably overstates the case of monetary stimulus. During the past six months there has been a $14 billion increase in large CD's at commercial banks. This huge increase in CD's absorbs reserves and requires a larger increase in the monetary base to support M_1 and M_2 than would otherwise be the case. As such, the forecast assumes that in the current environment of sharply rising interest rates, M_1 is likely to be the more appropriate measure for indicating future economic trends. Although this measure also has been characterized by sharply slower growth during the past three months, pressures to expand the money supply to finance the large federal budget deficit and to satisfy the real growth targets of the Administration are expected to lead to extremely rapid increases in money during the months ahead.

Consumer Expenditures and Business Capital Investment

As a result of various policies already enacted or proposed, there is more than the usual difficulty in trying to assess the direction of the major components of total spending. For example, in viewing consumer

expenditures, adjustments have to be made for the higher social security taxes, the proposed tax cut and tax reforms, the impact of an energy policy on fuel prices and auto sales, as well as a host of other factors. Given the overall forecast for a fairly strong pace of spending, the net impact of various policies is expected to cause (1) only a modest rise in auto sales during both 1978 and 1979 and (2) relatively rapid inflation in the service area and hence rapid increases in expenditures for services, along with a relatively slow advance in expenditures on nondurables, particularly during 1978.

The trend in business capital investment will result also from highly diverse inputs. On the positive side, the sharp increase in corporate profits in recent years, higher capacity utilization rates, and the promise of further expansion argue for a strong increase in capital expenditures. However, the combination of higher interest rates, a negative business environment in Washington, and the negative impact on private savings resulting from a large federal budget deficit and higher social security payments should act as a drag on investment. The net impact of all these factors is seen resulting in a 7% - 8% increase in real capital expenditures. This is several percentage points above recent surveys but also represents a fairly weak performance for capital spending at this stage of the cycle.

Government

President Carter's proposed tax plan includes cuts for individuals and business totaling $33.9 billion in 1979. These cuts are linked with reforms that would increase taxes by $9.4 billion next year. The forecast assumes that the cuts will be larger and the reforms fewer after Congress overhauls the President's package. The net reduction in income taxes, generally effective October 1, 1978, is expected to lower individual and business taxes by $23.5 billion and $8.4 billion in 1979, respectively. However, social security tax increases will reduce personal income and pre-tax profits in total approximately $5 billion this year and $8 billion next year.

Further Increases in Inflation

Inflation continues to rise throughout the forecast period. An inflation rate of approximately 7% is forecast for the current year and the rate moves up to 8% by the end of 1979. The main rationale behind the inflation numbers is the prior trend in the growth of the money supply. Historically, there has been a tendency for the inflation rate in a particular year to reflect the average monetary growth over the previous two years as indicated by M_1. In the two years ending in January of 1978, the money supply (M_1) averaged a 7.0% per year rise. This suggests that there is strong pressure for a boost in the inflation rate to 7% during the upcoming twelve months. Furthermore, the assumption in the forecast that monetary growth is likely to be close to 9% throughout both 1978 and 1979 suggests that inflation will eventually reach 9% in 1980. Hence, the underlying trend is for a continued strong rise in inflation.

Financial Markets

The upward trend in inflation for 1978 and 1979 means that interest rates will move higher. As inflationary pressures build and credit demands tighten, long term interest rates (new issue AA industrial bonds) are expected to rise from 8.4% in the first quarter of 1978 to approximately 9% by the fourth quarter. A further rise to 9.6% is anticipated by the end of 1979. Moreover, should monetary growth in fact average 9% during this year and next as is anticipated in the forecast, there will be strong pressures for further increases in long-term rates beyond 1979.

As inflation and interest rates rise and the economy enters its fourth and fifth years of expansion, profit gains are expected to slow. On a pre-tax basis, profits are expected to be up just under 9% from the fourth quarter 1977 to the fourth quarter 1978 and approximately 5% during the subsequent four quarters. However, the anticipated corporate tax reductions are expected to result in a sharp rise in after-tax profits in the fourth quarter of this year. During 1979 after-tax profits adjusted for the impact of inflation on accounting practices are expected to be up slightly.

Summary

Business activity will continue to advance during 1978, although at a somewhat slower pace than last year. Interest rates and inflation will move higher as the economy moves closer to full utilization of capacity. For 1979 developments are highly uncertain. Rising inflation, higher interest rates and slower real growth will create unstable business conditions, and policymakers will be subject to extreme pressures in formulating policies. At any point in time a move toward containing inflation could throw the economy into a recession. While the preliminary forecast for 1979 assumes that the thrust of economic policies continues to be geared toward expanding business activity, it is difficult to place any high degree of confidence in the ability to forecast policy changes 1 to 2 years before they occur. However, the higher inflation and rising interest rates that will result from past stimulus make the economy highly susceptible to a recession within the next few years.

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2/21/78

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

	ACTUAL 1977:4	FORECAST 1978:1	1978:2	1978:3	1978:4	1979:1	1979:2	1979:3	1979:4	YEARS 1976	1977	1978	1979
GROSS NATL PRODUCT	1963.7	2016.1	2068.1	2123.6	2183.1	2246.4	2312.0	2380.0	2450.1	1706.4	1890.1	2097.7	2347.1
%CH	0.4	11.1	10.7	11.2	11.7	12.1	12.2	12.3	12.3	11.6	10.8	11.0	11.9
CONSTANT DOLLAR GNP	1360.7	1375.7	1389.0	1403.1	1417.4	1432.0	1446.4	1460.7	1474.9	1274.7	1337.5	1396.3	1453.5
%CH	4.0	4.5	3.9	4.1	4.1	4.2	4.1	4.0	3.9	6.0	4.9	4.4	4.1
PRICE DEFLATOR	1.4432	1.4655	1.4889	1.5135	1.5403	1.5687	1.5984	1.6294	1.6612	1.3386	1.4129	1.5020	1.6144
%CH	6.1	6.3	6.5	6.8	7.3	7.6	7.8	8.0	8.0	5.3	5.6	6.3	7.5
CONSUMPTION EXPENDITURES	1260.2	1292.3	1324.3	1356.9	1394.4	1434.8	1477.2	1522.5	1569.2	1093.9	1211.4	1342.0	1500.9
%CH	14.3	10.6	10.3	10.2	11.5	12.1	12.4	12.8	12.8	11.6	10.7	10.8	11.8
DURABLES	186.3	191.6	197.2	202.9	208.7	214.7	220.8	227.2	233.7	158.9	179.9	200.1	224.1
%CH	21.1	12.0	12.1	12.0	12.1	11.9	12.0	12.0	12.1	19.6	13.2	11.2	12.0
NONDURABLES	500.0	511.0	521.7	532.7	545.5	559.6	573.9	590.4	607.4	442.8	480.7	527.7	582.8
%CH	16.0	9.1	8.7	8.7	10.0	10.7	10.7	12.0	12.0	8.2	8.6	9.8	10.4
SERVICES	573.9	589.7	605.4	621.4	640.2	660.6	682.5	704.9	728.1	492.3	550.8	614.2	694.0
%CH	10.7	11.5	11.0	11.0	12.7	13.3	14.0	13.8	13.8	12.3	11.9	11.5	13.0
INVESTMENT EXPENDITURES	305.2	313.5	321.3	331.4	337.9	349.0	358.8	368.2	374.8	243.3	293.9	326.0	362.7
%CH	2.1	11.3	10.3	13.3	8.0	13.8	11.8	10.9	7.3	28.7	20.8	10.9	11.3
NONRES FIXED EXPEND	194.9	201.2	207.6	214.1	221.0	228.4	236.0	243.9	252.2	161.9	185.4	211.0	240.1
%CH	16.7	13.5	13.3	13.3	13.5	14.0	13.9	14.2	14.3	8.6	14.5	13.8	13.8
PRODUCERS DUR EQUIP	130.1	134.2	138.4	142.6	147.1	152.0	157.1	162.5	168.0	106.1	123.9	140.6	159.9
%CH	17.7	13.2	13.1	13.0	13.2	13.9	14.0	14.4	14.4	10.2	16.8	13.5	13.7
BUSINESS STRUCTURES	64.8	67.0	69.2	71.5	73.9	76.4	78.9	81.5	84.2	55.9	61.6	70.4	80.2
%CH	14.8	14.3	13.8	14.0	14.1	14.2	13.7	13.8	13.9	5.7	10.2	14.3	14.0
RES FIXED EXPEND	99.6	100.6	100.6	99.6	97.5	95.5	92.5	88.6	83.8	68.0	91.0	99.6	90.1
%CH	34.4	4.1	0.0	-3.9	-8.2	-8.0	-12.0	-15.8	-20.0	32.3	33.7	9.5	-9.5
INVENTORY CHANGE	10.7	11.7	13.1	17.7	19.4	25.1	30.4	35.7	38.8	13.3	17.4	15.5	32.5
NET EXPORTS	-15.1	-14.3	-13.3	-12.3	-11.3	-10.3	-8.3	-6.3	-5.3	7.8	-10.1	-12.8	-7.5
GOVT PURCHASES	413.4	424.6	435.9	447.6	462.1	473.0	484.2	495.6	511.4	361.4	394.9	442.5	491.0
%CH	13.1	11.3	11.1	11.2	13.6	9.8	9.8	9.8	13.5	6.6	9.3	12.0	11.0
FEDERAL	153.8	157.5	161.1	164.9	171.3	173.8	176.4	178.9	185.7	130.1	145.4	163.7	178.7
%CH	16.3	10.0	9.5	9.8	16.5	6.0	6.1	5.8	16.1	5.5	11.8	12.5	9.2
MILITARY	98.5	100.9	103.2	105.6	109.7	111.2	112.8	114.3	118.7	86.8	94.3	104.8	114.2
%CH	12.7	10.1	9.4	9.6	16.4	5.6	5.9	5.4	16.3	3.4	8.7	11.2	9.0
OTHER	55.3	56.6	57.9	59.3	61.6	62.6	63.6	64.6	67.0	43.3	51.2	58.9	64.5
%CH	23.1	9.8	9.5	10.0	16.5	6.7	6.6	6.4	15.7	10.0	18.1	15.0	9.5
STATE & LOCAL	259.6	267.1	274.8	282.7	290.8	299.2	307.8	316.7	325.7	231.2	249.5	278.8	312.3
%CH	11.0	12.1	12.0	12.0	12.0	12.1	12.0	12.1	12.0	7.2	7.9	11.8	12.0

NOTE: PERCENTAGE CHANGES AT ANNUAL RATES; REVISED DATA FOR 1977:4

2/21/78

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

	ACTUAL	FORECAST								YEARS			
	1977:4	1978:1	1978:2	1978:3	1978:4	1979:1	1979:2	1979:3	1979:4	1976	1977	1978	1979
PRETAX PROFITS*	180.5	182.3	186.7	191.3	196.0	195.4	198.8	202.3	205.8	156.8	172.3	189.1	200.6
%CH	19.1	4.0	10.0	10.2	10.2	-1.2	7.1	7.2	7.1	27.0	9.8	9.8	6.1
TAX LIABILITY	72.0	72.7	74.5	76.3	71.0	69.8	71.4	72.6	73.9	64.8	68.9	73.6	71.9
%CH	16.6	4.0	10.0	10.2	-25.3	-6.6	9.6	7.2	7.1	29.0	6.3	6.9	-2.3
AFTER TAX PROFITS	108.5	109.6	112.2	115.0	125.0	125.6	127.4	129.7	131.9	92.1	103.4	115.4	128.7
%CH	20.2	4.0	10.0	10.2	39.9	1.9	5.8	7.2	7.1	25.5	12.3	11.7	11.5
AFT TAX PROF ADJ[1]	75.0	75.5	77.3	79.1	88.3	87.8	88.4	89.4	90.3	63.3	71.6	80.0	89.0
%CH	-21.7	2.8	9.7	9.7	55.7	-2.4	2.8	4.6	3.9	29.0	13.0	11.8	11.2
PERSONAL INCOME	1602.8	1647.1	1690.6	1735.3	1781.2	1828.4	1881.1	1935.3	1991.0	1382.7	1536.7	1713.5	1909.0
%CH	14.4	11.5	11.0	11.0	11.0	11.0	12.0	12.0	12.0	10.3	11.1	11.5	11.4
TAX & NONTAX PAYMENT	234.6	237.7	245.1	257.2	241.6	249.6	258.5	267.8	277.2	196.9	227.5	245.4	263.3
%CH	15.9	5.4	13.0	21.2	-22.2	14.0	15.2	15.0	14.9	16.5	15.5	7.9	7.3
DISPOSABLE INCOME	1368.2	1409.4	1445.5	1478.1	1539.6	1578.8	1622.6	1667.5	1713.8	1185.8	1309.2	1468.2	1645.7
%CH	14.1	12.6	10.6	9.3	17.7	10.6	11.6	11.6	11.6	9.4	10.4	12.1	12.1
PERSONAL OUTLAYS	1293.0	1325.5	1358.1	1391.1	1429.0	1469.8	1512.3	1557.8	1605.1	1119.9	1242.1	1375.9	1536.3
%CH	14.3	10.4	10.2	10.1	11.4	11.9	12.1	12.6	12.7	11.5	10.9	10.8	11.7
PERSONAL SAVINGS	75.2	83.9	87.4	87.1	110.6	109.0	110.2	109.7	108.7	66.0	67.1	92.2	109.4
%CH	10.8	54.7	18.2	-1.8	160.7	-5.6	4.4	-1.8	-3.8	-17.7	1.7	37.5	18.6
SAVING RATE(%)	5.5	6.0	6.0	5.9	7.2	6.9	6.8	6.6	6.3	5.6	5.1	6.3	6.7
EMPLOYMENT	92.069	92.600	93.200	93.800	94.400	94.900	95.400	96.000	96.500	87.481	90.554	93.500	95.700
%CH	5.6	2.3	2.6	2.6	2.6	2.1	2.1	2.5	2.1	3.2	3.5	3.3	2.4
LABOR FORCE	98.622	99.100	99.600	100.000	100.500	101.000	101.400	101.900	102.300	94.767	97.389	99.800	101.650
%CH	4.4	2.0	2.0	1.6	2.0	2.0	1.6	2.0	1.6	2.4	2.8	2.5	1.9
UNEMPLOYMENT RATE(%)	6.633	6.559	6.426	6.200	6.070	6.040	5.917	5.790	5.670	7.683	7.025	6.314	5.854
PRODUCTIVITY*	14.779	14.856	14.904	14.958	15.014	15.090	15.162	15.215	15.284	14.570	14.769	14.933	15.188
%CH	-1.5	2.1	1.3	1.5	1.5	2.0	1.9	1.4	1.8	2.7	1.4	1.1	1.7
INDUSTRIAL PRODUCTION	1.393	1.410	1.426	1.443	1.460	1.478	1.496	1.513	1.531	1.298	1.371	1.435	1.505
%CH	2.4	5.2	4.6	4.9	4.8	5.0	5.0	4.6	4.8	10.1	5.6	4.7	4.9
MONEY SUPPLY-(M1)	334.133	341.400	348.000	355.600	363.300	371.200	379.300	387.600	396.000	304.192	324.525	352.075	383.525
%CH	7.0	9.0	8.0	9.0	8.9	9.0	9.0	9.0	9.0	5.1	6.7	8.5	8.9
VELOCITY OF M1	5.877	5.905	5.943	5.972	6.009	6.052	6.095	6.140	6.187	5.609	5.823	5.957	6.119
%CH	3.1	1.9	2.6	2.0	2.5	2.9	2.9	3.0	3.1	6.2	3.8	2.3	2.7
MONEY SUPPLY-(M2)	802.933	822.300	840.200	860.500	881.200	902.400	924.200	946.500	969.300	703.833	777.583	851.050	935.600
%CH	7.8	10.0	9.0	10.0	10.0	10.0	10.0	10.0	10.0	9.8	10.5	9.4	9.9
VELOCITY OF M2	2.446	2.452	2.461	2.468	2.477	2.489	2.502	2.515	2.528	2.425	2.430	2.465	2.508
%CH	2.4	1.0	1.6	1.0	1.6	1.9	2.0	2.1	2.1	1.7	0.2	1.4	1.8

NOTE: PROFITS FOR 77:4 ARE ESTIMATES; PRODUCTIVITY IS CALCULATED AS CONSTANT DOLLAR GNP PER WORKER
1) AFTER TAX PROFITS ADJUSTED TO EXCLUDE INVENTORY PROFITS AND ALLOW FOR DEPRECIATION AT REPLACEMENT COST

2/21/78

ECONOMIC OUTLOOK

	ACTUAL	FORECAST								YEARS			
	1977:4	1978:1	1978:2	1978:3	1978:4	1979:1	1979:2	1979:3	1979:4	1976	1977	1978	1979
INTEREST RATES													
NEW ISSUE AA INDUS BONDS	8.040	8.400	8.600	8.800	9.000	9.150	9.300	9.450	9.600	8.250	7.918	8.700	9.375
PRIME RATE	7.673	8.000	8.300	8.650	9.000	9.080	9.160	9.240	9.320	6.841	6.824	8.488	9.200
COMMERCIAL PAPER 4-6 MOS.	6.593	7.100	7.350	7.800	8.250	8.350	8.450	8.550	8.650	5.345	5.612	7.625	8.500
AUTO SALES 1)	11.000	11.337	11.312	11.456	11.497	11.566	11.604	11.645	11.673	10.092	11.217	11.401	11.622
DOMESTIC	8.933	9.240	9.219	9.337	9.370	9.426	9.457	9.491	9.513	8.600	9.133	9.291	9.472
IMPORTS	2.033	2.097	2.093	2.119	2.127	2.140	2.147	2.154	2.159	1.492	2.075	2.109	2.150
HOUSING STARTS 1)	2.143	2.000	1.950	1.850	1.750	1.650	1.550	1.450	1.300	1.541	1.966	1.888	1.488

1) IN MILLIONS OF UNITS--SEASONALLY ADJUSTED ANNUAL RATES
2) IN BILLIONS OF DOLLARS--SEASONALLY ADJUSTED ANNUAL RATES

HARRIS BANK

HEROS
Harris Economic Research Office Service

February 28, 1978

Business Outlook - Monthly Update

Business activity is declining rapidly at the start of 1978 due to the combined impact of an extended coal strike and adverse weather conditions. In addition, highly unusual monetary growth patterns are creating some uncertainty about the prospects for business later this year.

Sales, Output Drop Sharply

Following a strong burst of spending at year-end, the combination of severe snowstorms and the coal strike have sharply curtailed business activity. Retail sales in January were down 3.1% from December. Although the sales decline was fairly pervasive, the auto sector was particularly hard hit. Sales of domestically produced autos averaged an 8.0 million unit annual rate in January compared to an 8.9 million rate in the fourth quarter. The retail sales decline continued into early February, but auto sales were at an 8.6 million unit rate during the first 20 days of the month. There is some evidence to support the view that much of the sales decline is weather-related. A major auto company which analyzed its sales by region showed severe declines from year earlier sales in those regions affected by blizzards, while sales were up 4% from the previous year in those areas where weather was not a factor.

Incomes and production also have shown a marked weakness. Personal income rose only 3% at an annual rate in January after increasing at a 16.5% annual rate in the final three months of 1977. However, a detailed analysis of special factors such as the coal strike, higher social security contributions, etc., shows that personal income rose at about a 9½% rate in January as well as in December after accounting for these factors.

Industrial production fell by .7% in January with cutbacks in auto output leading the decline. Auto assemblies were cut back to an 8 million unit annual rate in response to both lower sales and weather disruptions. Although weather-related difficulties are expected to moderate, the impact of a continued coal strike would be a major factor depressing business activity. The developing weakness in business activity in the first quarter suggests that real output will be up only slightly from the fourth quarter instead of the 4½% annual rate advance that we had expected. Barring any further adverse developments, this weakness will be offset by a more rapid advance in the second quarter.

Inflation Rates Move Higher

Wholesale price movements are beginning to show more rapid increases. During 1976 wholesale prices for finished goods rose at a 3.3% annual rate. In 1977 price trends were distorted by unusually rapid increases in the spring, related to food and adverse weather conditions,

followed by unusually slow increases through the fall. Averaging over the period shows that during the first nine months of 1977, wholesale prices for finished goods increased 6.4% at an annual rate. Between September, 1977 and January, 1978 the advance was 7.3% at an annual rate. This speed-up in wholesale prices is even more disturbing when viewed by stage of processing. Crude materials for further processing, a highly sensitive measure of price pressures, has registered increases of 1% or more per month since October. The performance in wholesale prices suggests that expectations of rising inflationary pressures in 1978 will be borne out. In this regard, consumer prices in January were up 8.4% at an annual rate.

Unusual Monetary Growth Patterns Develop

Recent behavior of the monetary aggregates has been extremely unusual. The monetary base (member bank reserves plus currency), which increased by 9% at an annual rate between February and August of 1977, rose at a 10½% rate during the past six months and almost 12% during the past three months. A similar trend is apparent in Federal Reserve Credit (Federal Reserve holdings of government securities and other assets). Both of these series measure the extent to which the Federal Reserve is providing the raw ingredients for the money supply, and in the case of the monetary base, the growth during the past 12 months is the highest since World War II. Normally, the growth in the narrowly defined money supply (M_1, which consists of currency plus demand deposits) closely parallels the rise in the monetary base while M_2 (M_1 plus time deposits at commercial banks other than large CD's) rises at an even faster rate. Instead, over the past six months the growth in M_1 has slowed to approximately 5% at an annual rate while the growth in M_2 has slowed to less than 7%.

If the latest data on M_1 and M_2 are not being distorted by special factors, then a slowdown in real growth could occur this spring or summer. Before changing the forecast to incorporate this development, several factors should be noted. First and most important, the dramatic rise in the raw ingredients of money suggests that the potential for an expansion in M_1 and M_2 is tremendous and could occur at any time. Second, the money supply figures are due to be revised within the next month on the basis of more complete data. These revisions could show higher growth rates than are now apparent. Finally, the dislocations in the economy associated with the coal strike and the adverse weather patterns could be causing a temporary shift toward currency and away from demand deposits, thus leading to a temporary weakness in monetary growth.

In light of the recent unusual patterns in monetary growth, there is cause for increased uncertainty with respect to future developments. If the monetary base is accurately reflecting the thrust of monetary policy, then monetary growth rates should soon expand more rapidly. Business activity would then soar at the end of the coal strike, interest rates would move sharply higher, and future inflationary pressures would become more intense. However, if the recent slower expansion of M_1 and M_2 was to continue, the economy would be on the verge of a recession this summer, interest rates could then reverse their upward trend, and prospects for future inflation would improve. Since there is

no historical precedent for the unusual monetary patterns observed recently, it becomes difficult to have a high degree of certainty with respect to future developments. Although our forecast continues to call for an expansion in business activity through 1978 with higher inflation and an upward trend in interest rates, the uncertainty surrounding that forecast has increased. In the months ahead a careful analysis of future monetary developments will be needed in order to evaluate the impact on future business conditions.

Summary

Although the recent weakness in business activity is largely attributable to adverse weather conditions and the coal strike, the outlook for the spring and summer months has become clouded by unusual patterns among the monetary aggregates. Meanwhile, inflationary pressures appear to be growing more intense.

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FISCAL POLICY

A Report Prepared for the Shadow Open Market Committee

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President Carter's 1979 Budget

Even though it is expected that we shall be in the fifth year of economic expansion during fiscal 1979, the President recommended a unified budget deficit of $60.6 billion. This is only slightly below the level of $61.8 billion recommended for 1978 and $15.6 billion above the actual level of $45.0 billion for 1977. At "high employment" levels (defined by the Budget to imply an unemployment rate of 4.9 percent), the unified deficit rises from $10 billion in 1977 to $32 billion in 1978 and to $37 billion in 1979. On an NIPA basis, the high employment deficit rises from $17.9 billion in calendar 1977 to $26.9 billion in calendar 1978 and then falls slightly to $22.6 billion in calendar 1979, assuming no policy changes in the 1980 Budget.

The President has successfully advertised his recommended outlay level of $500.2 billion as being "lean and tight". The basis for this claim comes from the fact that outlays are being reduced from 22.6 to 22.0 percent of forecast GNP between fiscal 1978 and 1979. It should, however, be noted that recommended outlays will be 8.2 percent above the 1978 recommended level and 1.6 percent above the level implied by a continuation of "current services."

A net "tax cut" of $24.3 billion is recommended for fiscal 1979, but, in the aggregate, this does little more than offset recently passed

social security increases and the automatic tendency for inflation and real growth to increase tax burdens. The ratio of receipts to GNP is expected to rise from 19.4 percent in fiscal 1977 to 19.6 percent in fiscal 1978 and then to fall to 19.3 percent in fiscal 1979. The total receipts ratio will be higher in calendar 1979 than in calendar 1977, and individual income tax receipts will rise from 10.1 to 10.5 percent of personal income over the two year period.

The few dramatic policy initiatives on the spending side, such as welfare reform and the energy initiatives, do not have large 1979 impacts, and consequently, the changes in the composition of the budget are not important enough to be of macroeconomic significance. In the NIPA budget, total expenditures rise 8.7 percent; purchases, 8.3 percent; transfers, 9.6 percent; and grants, 6.0 percent.

The relatively slow rate of growth of grants in 1979 must be put in context. In the previous three years, from the trough of the recession in fiscal 1975 through fiscal 1978, grants are expected to grow at an annual rate exceeding 15 percent. It is, therefore, somewhat ironic that one of the excuses for the large 1979 deficit is that it is necessary to offset a growing state and local surplus. There is little doubt that that surplus is in part the result of the surge in Federal grants (The main cause is, of course, the economic recovery). In other words, the various "temporary" stimulus programs, which were largely implemented through the grant system, have, to a significant degree, simply increased state and local surpluses at the expense of the Federal deficit. It would seem that a more direct

approach to the "problem" of state and local surpluses would be to cut back on grants. Even an extreme Keynesian would have to admit that the macroeconomic impact of such a cutback would be very small. But, of course, this simple solution is constrained politically by the fact that the aggregate state and local surplus masks continuing financial difficulties in a number of cities.

Is the budget too expansionary? If one accepts all of the forecasts and estimates of the Administration, it clearly is not. The budget forecast of real GNP in 1979 is over 3 percent below the CEA estimate of potential GNP. While one might be concerned by the alloctive impact of the large spending level and by the absorption of private savings by the huge deficit, the degree of macroeconomic stimulus measured in the Keynesian sense is modest given the Administration's estimate of the excess capacity implied by their forecast.

However, everyone would agree that any estimate of the potential capacity of the economy is highly tenuous. The last time that potential GNP was exceeded was in calendar 1973. The CEA estimated potential at $1,228 billion in that year and presumes that it will grow at about 3.5 percent annually through 1979. The 1973 potential was estimated at 4.8 percent unemployment. If it had instead been estimated at 5.5 percent unemployment, potential GNP would have been about $1,212 billion. If, since that time, potential grew at 3.3 percent annually, rather than the 3.5 percent assumed by the CEA, the Budget's forecast of $1,467 billion for 1979 would be within one half of one percent of potential. If potential in 1973 had been estimated at a 6 percent un-

employment rate and if it subsequently grew at 3.4 percent annually, the 1979 forecast of the Administration would slightly exceed potential. In other words, the margin for error is very slim.

The Administration's use of 4.8 percent as the full-employment unemployment rate in 1973 would be considered highly optimistic by most experts. There is less reason to assume that the assumption of a 3 1/2 percent growth rate of potential GNP is biased either upward or downward. (After 1977, the Administration actually uses a range of between 3.3 and 3.8 percent.) Many also believe that the Administration's forecast of actual GNP in 1979 is somewhat optimistic.

Consequently, I would not argue that there is a high probability of exceeding potential in 1979. I would, however, argue that the harm that might be done by exceeding potential, say by one percent, is far greater than the potential harm resulting from falling short by one percent. Any significant acceleration of inflation is likely to be followed quickly by a significant reduction of real growth and a subsequent widening of the gap. Unemployment could easily be at a higher level in the long run than if we let the economy adjust to potential more slowly, wherever that somewhat artificial construct may be. In other words, the social costs of unemployment could be higher in the long run and of course, we would have to bear the additional resource costs of an accelerating inflation rate. These costs may be substantial in part because of interactions between inflation and the tax system. Because of the asymmetry of the risks, I, therefore, conclude that we should approach 1979 with more fiscal caution than is

manifested by this budget.

The Budget in the Short-Run and Estimating Problems

The official, quarter-by-quarter estimates of NIA Federal expenditures show the growth rate of expenditures accelerating through the first three quarters of 1978. Expenditures grow at an annual rate of 8.9 percent in the first quarter rising to 10.7 percent in the second and to 14.1 in the third. The third quarter growth rate is inflated by the cost-of-living adjustment to social security. The growth rate in the fourth quarter is estimated at 11.8 percent. This last quarter is impacted by the Federal pay increase.

The NIA deficit gradually falls from $54.4 billion in the first quarter of 1978 to $48.3 billion in the third quarter. In the fourth quarter, it soars to $65.6 billion when the President's tax cut is presumed to take effect.

As noted above, all of these numbers reflect "official" budget estimates. Unfortunately, OMB still has not been able to cure the "shortfall" problem. In my last report to this committee, I described the political constraints which tend to inflate OMB spending estimates and it appears that they could not be overcome in the preparation of the 1979 Budget.

In my last report, I estimated that 1978 unified outlays would be between $455 and $456 billion rather than the $462.9 billion estimated by OMB in July of 1977. The 1979 Budget lowered the 1978 estimate slightly to $462.2 billion. However, I see no reason to change my last

estimate and will stick with a forecast of $455 to $456 billion. The rate of growth of NIA expenditures is thus likely to fall short of 9 percent in the first three calendar quarters of 1978 as compared to the 11 percent implied by my earlier discussion of the official estimates. It should be noted that OMB will update its official estimates on March 10 -- after this is written, but before our meeting. I do not expect those official estimates to alter my own estimate.

The effects of the bad winter and the coal strike may also lower 1978 receipts somewhat below the $400 billion in the budget, and therefore, I would not expect the 1978 deficit to fall by the entire $7 billion shortfall on the outlay side.

It is not meaningful to talk about a shortfall for 1979 until appropriations actions have been completed for that year. However in the unlikely event that all of the President's policies were adopted and there were no Budget amendments offered by the Administration, outlays would probably fall short of the $500.2 billion recommended for 1979 by about $4 billion. This estimate also assumes that the economy behaves as expected by the Administration in calendar 1978 and in early 1979.

It is interesting to note that while the Administration altered the timing of some payments to make the 1978 deficit slightly higher than the 1979 deficit, the above analysis suggests that they may not be able to maintain this posture very much longer. Thus, we are likely to see the deficit rise in both fiscal 1978 and in 1979 during a fairly substantial economic recovery.

Possible Congressional Reaction

It is always hazardous to attempt to forecast the Congressional reaction to a Presidential Budget, but during an election year forecasting efforts become positively foolhardy. This year's Budget imposes extraordinary political pressures on the Congress and it is quite possible that the new Congressional budget process will not survive in a meaningful form.

Pressures emanate from both the spending and receipts side of the budget. On the spending side, the President recommends few outright cuts, but many of those that are proposed affect programs that have long been elevated to "sacred cow" status by the Congress. Like President Ford before him, Carter proposes savings on school lunches, social security, impact aid for education, the GI Bill, and health costs. Like President Ford, he is very likely to see most of these proposals rejected. There will also be strong pressures to add to the generosity of agriculture policies, and indeed, the budget estimate that spending on agriculture will fall from $9.1 in 1978 to $5.4 billion in 1979 under the President's program makes optimistic assumptions regarding market conditions, the number of natural disasters, and the effectiveness of acreage restrictions.

Since the Viet Nam War, the Congress has made some room for its own initiatives by cutting the President's defense request. However, Soviet intrusion into the Horn of Africa, the SALT talks, and the continuing increase in Soviet defense expenditures will make it unusually difficult this year to cut the President's already-tight defense budget.

On the receipts side, it has already been noted that the President's tax cut does not provide significant real tax relief. But the President's income tax cuts are highly progressive and they do provide real relief to lower income families. There will be strong pressures to provide the same relief to lower income groups while countering the growth in the real burden imposed by income and social security taxes on the middle class. There also seems to be little chance of the Congress passing over $5 billion in individual and business "tax reforms".

While all of this is going on, I find it hard to believe that Congressmen and Senators will be very anxious to stand up and vote for a deficit that is significantly higher than that proposed by the President. As a result, it will be extremely difficult to get a First Budget Resolution out of the Congress and it may take several tries before one passes successfully. On the other hand, one should not underestimate the Congress' ability to compromise difficult issues.

A possible outcome could involve the following elements: (i) Slightly more generous spending policies, but with the Congress assuming some "shortfall" in the President's estimates to hold total spending close to the President's ceiling; and (ii) a slightly deeper tax cut, but effective January 1, 1979 rather than October 1, 1978 with some payroll tax relief to aid the middle class. With appropriately optimistic economic assumptions, the deficit could then be held to the President's level. However, as noted in the beginning of this section, it is foolhardy to make predictions such as those in the last two sentences.

Briefing Paper for the Shadow Open Market Committee

March 12, 1978
by Wilson E. Schmidt*

The foreign exchange market is telling us something. The continuous decline of the dollar from the start of 1977 is not a whisper--it's a scream. Recently released balance of payments data amplify the message. There has been a flight from the dollar.

The dollar dropped 19% in terms of the mark, 38% in terms of the Swiss franc, 22% in terms of the yen, and even 13% in terms of the pound since January 20, 1977. Balance of payments data show a sharp decline in the inflow of private foreign funds in 1977 compared with 1976. The balance on unrecorded transactions--chiefly reflecting private capital outflows--shifted abruptly to an outflow in the last half of the year.

The standard explanation for the decline of the dollar, namely our largest trade deficit ever, cannot explain its performance. True, our recovery has outpaced that of our trade partners, stimulating our imports and restricting foreign demand for our exports. True, our imports of petroleum rose almost 30%. But it must be noted that while the trade deficit dumped about 31 billion dollars on the foreign exchange market, the central banks in industrialized countries probably picked up almost as much in support of the dollar. So something more fundamental seems to have taken place.

The Administration's response to the decline in the thermometer has been short run. They have sought to talk up the mercury. The President made the appropriate noises in his State of the Union address. The Fed apparently intervened in the foreign exchange markets rather heavily in December, January, and February. There was a finely honed statement on U.S. intervention policy which suggested a change in strategy. An expanded swap agreement with the Federal Republic of Germany was put in place. The cosmetics were applied

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beautifully. But they still were just that--cosmetics.

The President's statement was soon lost in the realities of the market. The rhetoric of intervention policy retreated to the old language of preventing disorderly markets. The irrelevance of swap arrangements, no matter what their size, became apparent. It was realized that the combined effect of swapping dollars for foreign currencies with other central banks and their use to buy up dollars was to leave the growth in the stock of money unchanged. The bank reserves absorbed when the Fed bought foreign currencies were returned as the foreign central banks lodged the dollars they gained under the swaps in Treasury securities.

The market went back to look at future fundamentals. How long would foreign central banks, anxious for us to support the dollar, continue their purchases? What would Mr. Miller's policies be? And most of all, the budget deficits that won't go away until 1981 if then. If the Administration won't work on the fundamentals, the market reasoned that controls or taxes on capital movements were the probable answer, despite government denials. The market was awash with rumors of controls, scaring more private capital out of the country. It is a road we have traveled before. The thermometer that takes the temperature of the future got very, very cold.