

**SHADOW OPEN MARKET  
COMMITTEE**

Policy Statement and  
Position Papers

March 18-19, 1990

PPS-90-01



**THE BRADLEY  
POLICY  
RESEARCH  
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Public Policy Working Paper Series

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## SHADOW OPEN MARKET COMMITTEE

The Shadow Open Market Committee met on Sunday, March 18, 1990 from 2:00 p.m. to 6:00 p.m. in Washington, D.C.

### Members of the SOMC:

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**Dr. Anna J. Schwartz**, National Bureau of Economic Research, Inc., 269 Mercer Street, 8th Floor, New York, New York 10003 (212/995-3451).

**\*On leave at the Bank of Japan until April 1, 1990.**

## **SOMC POLICY STATEMENT SUMMARY**

Washington, March 19 -- The Shadow Open Market Committee today questioned the legal basis for large scale intervention and speculation in foreign currencies by the Federal Reserve. The SOMC, a group of academic and business economists who regularly comment on public policy, said Congress should hold hearings "to determine whether an explicit grant of authority to conduct these operations" is in the national interest.

At the same time, the Committee commended the Federal Reserve for its efforts to achieve zero inflation. "A policy of reducing inflation is the only reliable way to achieve a sustained reduction in market interest rates," the SOMC statement said. The SOMC recommended that the Federal Reserve keep the growth rate of the monetary base "close to an annual rate of 4 percent" to help achieve this goal.

On the question of Federal Reserve intervention in world financial markets, the Committee charged "there is no economic rationale" for the U.S. government's \$45-billion foreign currency portfolio -- mainly D-marks and yen. "Taxpayers are taking risks of loss and getting no benefits," the SOMC said in its policy statement.

The statement also criticized the Federal Reserve's practice of "warehousing" foreign currencies for the Treasury's Exchange Stabilization Fund. The Committee pointed out that such transactions amount to a direct loan from the Federal Reserve to the Treasury, outside the Congressional appropriation process. These direct loans totaled \$7-billion on October 31, 1989, the most recent date for which figures are available.

"We recommend that Congress decide whether off-budget loans to the Treasury's General Fund and its Exchange Stabilization Fund by the Federal Reserve are permissible.

The SOMC, which meets in March and September, was founded in 1973 by Professor Allan H. Meltzer of Carnegie Mellon and the late Professor Karl Brunner of the University of Rochester.

The SOMC statement discussed the economic consequences of German reunification. The Committee made three points: (1) Assuming "proper monetary policy," combination of the two German currencies will not increase inflation. (2) The recent rise in German interest rates reflects "the prospect of new investment opportunities and increased consumption in Eastern Europe," which will benefit the world economy. (3) Changes in Eastern Europe "do not portend a weakening in the Federal Reserve's control of U.S. monetary policy."

The Shadow Committee backed a plan currently under study at the U.S. Treasury to integrate corporate and personal taxes. "Full integration would lower the tax on capital investment and encourage capital formation. It would reduce the appeal of leverage by

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lowering the relative cost of equity capital. It would reduce the importance of financing decisions. These are socially beneficial changes that we fully support."

However, the statement warned that proposals -- for example, by Senator Daniel Moynihan -- to alter Social Security payroll taxes "to achieve desired federal budget outcomes would be short-sighted and ill-advised. Political rhetoric and the debate about budget accounting rules should not obscure the need to provide sufficient capital to support future generations of retirees."

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Monetary policy remains consistent with moderate recovery and declining inflation. Annual growth of the monetary base -- bank reserves and currency -- have remained close to the rate recommended at our last meeting. Growth of other monetary aggregates has been moderate also and consistent with the Federal Reserve's announced aim of reducing inflation.

The recent large increase in the base appears to be mainly a onetime increase in demand by foreigners for U.S. currency. For 1990, we recommend that the Federal Reserve keep the growth rate of the monetary base close to an annual rate of 4 percent measured from 1st quarter 1990. Due regard should be taken to accommodate continued foreign demand for currency.

In recent testimony to Congress, Federal Reserve Chairman Greenspan repeated the emphasis the Federal Reserve now gives to maximum sustainable growth and zero inflation. Chairman Greenspan's statement recognizes that "by ensuring stable prices, monetary policy can play its most important role in promoting economic progress." Several Federal Reserve bank presidents and the recent annual report of the Council of Economic Advisers express similar views. We support these statements. We commend the Federal Reserve for its stand.

The views expressed by the Council and the Federal Reserve contrast with much public comment that treats lower inflation and sustainable growth as alternatives that cannot be achieved together. Advocates of this view favor faster money growth to lower interest rates and increase spending and output. This is a mistake. Interest rates are lowest in countries with lowest inflation. Maintaining a policy of reducing inflation is the only reliable way to achieve a sustained reduction in market interest rates.

***Foreign Exchange Market Intervention***

Our September 1989 policy statement misstated the loss on foreign exchange intervention for the year ending July 1989. We regret the error in reporting the losses incurred by the Treasury's Exchange Stabilization Fund and by the Federal Reserve. For the nine month period ending October 31, 1989, the Federal Reserve reported an unrealized profit of \$362-million on foreign exchange holdings. There were no realized gains or losses in this period. During the same period, the Exchange Stabilization Fund reported realized profits of \$197-million and unrealized profits of \$81-million.

More important than the periodic gains or losses are: (1) the amount of U.S. government intervention and speculation in foreign currencies; (2) the legal basis for intervention and the warehousing of foreign currencies; and (3) the economic rationale for the intervention.

### Intervention

The combined holdings of foreign currencies by the Federal Reserve and Treasury are estimated by the International Monetary Fund at \$45-billion for January 1990. The last figure reported by the Federal Reserve, for October 1989, was \$41.6-billion -- \$29-billion at the Federal Reserve and \$12.6-billion at the Treasury. Much of this large accumulation is recent. From March to October 1989, combined holdings of foreign currency increased more than \$21-billion. There is no economic rationale for the magnitude of current holdings.

Federal Reserve and Treasury holdings of foreign currencies consist mainly of German D-marks and Japanese yen. If the dollar appreciates against these currencies, taxpayers will experience losses in proportion to the appreciation of the dollar. There is no economic rationale for exposing taxpayers to this risk of loss.

The economic benefits of exchange market intervention have been studied repeatedly. These studies generally distinguish between sterilized and non-sterilized intervention. In sterilized intervention, purchases or sales of foreign exchange are offset by sales or purchases of domestic securities. Virtually all studies conclude that sterilized intervention has no lasting effect and probably no effect at all on exchange rates. Most Federal Reserve intervention has been sterilized, so taxpayers are taking risks of loss and getting no benefit. There is no economic rationale for imposing these costs and risks on taxpayers.

We question the legal basis of these operations as have others in the past. The General Counsel of the Federal Reserve, in an opinion with which the Attorney General concurred, found in 1962 that the Federal Reserve was authorized to conduct these operations. However, Congress has not provided a firm legal foundation for these opinions.

We recommend that Congress hold hearings to determine whether an explicit grant of authority to conduct these operations is deemed to be in the national interest. If intervention is to continue, Congress should limit the amount of permissible intervention and limit the amount of foreign currencies held by the Federal Reserve and the Treasury. Congress should also assign responsibility for intervention either to the Federal Reserve or to the Exchange Stabilization Fund.

### Federal Reserve Loans to the Treasury

From time to time, the Federal Reserve undertakes so-called warehousing of foreign currencies for the Treasury's Exchange Stabilization Fund. Warehousing amounts to a direct loan from the Federal Reserve to the Treasury, bypassing Congressional appropriations. In January 1977, the Federal Open Market Committee limited such loans to \$1.5-billion. The FOMC increased this limit to \$10-billion in September 1989. On October 31, 1989, the amount held as "warehoused funds" was \$7-billion.

Initially, the Federal Open Market Committee relied on the Thomas Amendment as the legal justification for these loans. However, the Thomas Amendment expired in 1981. Since 1978, the Federal Reserve has also made direct loans to the Treasury's General Fund. The Treasury has used these funds, not appropriated by Congress, to acquire foreign currencies.

We recommend that Congress decide whether off-budget loans to both the Treasury's General Fund and its Exchange Stabilization Fund by the Federal Reserve are permissible and, if so, whether these loans should be subject to the Congressional appropriation process.

### The G-7 Meeting in April

On April 7, Treasury Secretary Brady is scheduled to meet with G-7 finance ministers to discuss currency fluctuations and foreign exchange market intervention. Despite frequent claims to the contrary, the dollar has not appreciated in recent months. The appropriate measure of appreciation is the trade-weighted index, showing the price of the dollar relative to our trading partners. According to the Federal Reserve Board's index, the dollar reached a recent peak in June 1989 and is now 10 percent lower. Further, part of any appreciation or depreciation reflects differences in expected or actual rates of inflation. These changes in nominal exchange rates do not affect the competitive position of the U.S. or its trading partners.

Secretary Brady should avoid any commitment to devalue the dollar by purchasing foreign currencies. Sterilized intervention has no effect on exchange rates. Unsterilized devaluation raises the prices of goods and services at home. Neither sterilized nor unsterilized intervention serves the interests of U.S. producers or consumers.

### *German Economic Unification*

In February, Chancellor Kohl proposed a unified monetary system for greater Germany. His proposal was, in part, a response to the migration of East German workers to West Germany. Discussion about a unified Germany is underway.

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The prospect of integration has raised concerns about inflation and interest rates -- not only in Germany but in other economies as well. These concerns are based on a misunderstanding. Proper monetary policy can avoid any sustained inflationary effect. Much of the recent rise in German interest rates reflects the prospect of new investment opportunities and higher consumption in Eastern Europe. These developments represent potential gains for Germany, Europe, the U.S. and the rest of the world. An increase in real interest rates cannot be suppressed by Federal Reserve actions. Like all changes in real interest rates, it is a signal for redirection of resources. It does not portend a weakening of the Federal Reserve's control of U.S. monetary policy.

Much attention has been directed to the choice of exchange rate between East and West German marks and the effects of the choice on inflation. The problems of economic unification are much greater than the problems of monetary integration or the choice of an exchange rate, and most of the problems are independent of the choice of an exchange rate. Once the barriers to migration from East to West Germany were removed, market forces began to integrate the two economies. Migration is driven by real economic forces and will not be much affected by the choice of exchange rate. It is important, here as elsewhere, to separate monetary and real effects.

### Inflation

There are two principal issues about inflation. *First*, the choice of the exchange rate for East marks has no necessary implication for German inflation. The West German Bundesbank does not have to provide a net increase in the money stock to pay for the retirement (exchange) of East German marks. The Bundesbank can offset the effect on the West German money stock and prevent an increase in the price level.

*Second*, any increase in the general price level would be a onetime effect, not a sustained increase in the rate of price change. If after unification the money stock increased more than the GNP of the united Germany, prices would rise. The rise would be a onetime change that would not continue unless the Bundesbank increased money more rapidly than output.

### Relative Prices

The principal problems are not monetary. There are larger subsidies for food and housing in East than in West Germany and very different social welfare benefits in the two parts of Germany. Unemployment compensation in West Germany is higher than the wages received by many workers in East Germany. This acts as an incentive to migration from

East to West. The West German policy of providing shelter for migrants also encourages migration from East to West.

These, and many other, social policies on both sides of the former border distort the prices of goods and labor. The distortions make rational calculation and allocation difficult or impossible. Differences of this kind cannot be removed by choosing an exchange rate. Economic decisions to migrate depend mainly on current and future income and purchasing power in different locations. Differences in taxes and subsidies are important in these calculations. The nominal exchange rate is not.

Unless the real distortions are reduced, by adjusting social policies, migration will continue. To integrate successfully and at lowest cost, market forces must be permitted larger scope in resource allocation. Decisions about taxes and subsidies are the critical decisions for successful German economic unification. These decisions can make the adjustment less disruptive and costly to both German economies.

### The Role of the U.S. in Eastern Europe

The collapse of communism in East Germany and Eastern Europe is a potential gain for the world economy. With proper policies, the productive potential of an educated population can be directed toward more productive tasks. The early optimism can be lost, however, if the acceptance of market discipline is delayed.

Bureaucracies in much of Eastern Europe have strong vested interests in the present system of state control and direction. Maintaining state ownership of resources, failure to adopt a legal system based on private ownership and binding contracts, and unwillingness to provide the political, legal and accounting framework for a market economy will retard development in Eastern Europe. Western countries, including the United States, can be most helpful in providing technical assistance for developing this framework.

Government-to-government financial aid for development is often counter-productive. The experiences of Latin America and Africa illustrate some of the failures. A main reason for these failures is that development aid often sustains subsidies to unproductive enterprises and discourages private ownership. In Eastern Europe, state enterprises must be sold to private owners and large bureaucracies must be removed, not retained. Reliance on market processes, not government aid, is the most effective way to speed development.

### ***Taxes***

The Administration's budget proposes reductions in the capital gains tax, new tax-advantaged family savings plans (FSAs) and an expansion of individual retirement

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accounts (IRAs). Senator Moynihan has proposed a reduction in Social Security Taxes. House Ways and Means Committee chairman Rostenkowski has suggested a wide-ranging package of tax increases (including income taxes) as part of a broad deficit-elimination proposal. In addition, the Treasury is considering integration of corporate and individual taxes.

We advocate full integration of the corporate tax and the individual income tax. Full integration would eliminate double taxation of dividends. Interest payments and dividend payments would be taxed equivalently. Corporations would have little incentive to issue debt and retire equity to reduce corporate taxes.

Full integration would lower the tax on capital investment and encourage capital formation. It would reduce the appeal of leverage by lowering the relative cost of equity capital. It would reduce the importance of financing decisions. These are socially beneficial changes that we fully support.

The Administration's proposal to exclude from taxation a portion of capital gains would increase saving and improve economic efficiency. The proposed FSAs would exempt from income taxes interest income from non-deductible contributions. The FSAs would be separate from IRAs and 401Ks. IRAs would be expanded and penalties on early withdrawals would be waived for first-time home purchasers. IRAs and the newly-proposed FSAs are relatively costly ways to increase total saving since some of the contributions to these accounts are not net additions to aggregate saving.

Senator Moynihan's proposal to roll back payroll taxes has refocused the fiscal debate on Social Security surpluses and the share of taxes paid by different income groups. Reducing payroll taxes would increase unfunded Social Security liabilities and require either higher payroll taxes or lower Social Security benefits in the future. Thus, lowering payroll taxes is a drain on the future capital stock and redistributes wealth from future to current generations.

The Social Security tax has always been regressive because there is a cap on wages against which Social Security taxes are assessed. However, the Social Security benefit structure provides substantially higher benefits for retirees with low earnings histories. Accordingly, Social Security's combined tax and benefit structure is highly progressive, with current retirees with low income histories receiving the highest benefits relative to their lifetime taxes. By contrast, future retirees face significantly lower expected rates of return on their lifetime payroll taxes. Reducing Social Security payroll taxes without reducing benefits would accentuate these intergenerational inequities.

Altering payroll taxes to achieve desired federal budget outcomes would be short-sighted and ill-advised. Political rhetoric and the debate about budget accounting rules

should not obscure the need to provide sufficient capital to support future generations of retirees.

Chairman Rostenkowski's deficit-elimination plan includes a freeze on non-means-tested entitlement programs and Social Security, as well as higher income taxes. Any rise in income taxes would be counterproductive. Spending for Social Security and other non-means-tested entitlement programs has risen significantly as a share of total federal outlays and national output. We support limiting outlay increases in these programs.

Previous large budget imbalances have been reduced significantly. Spending and deficits have been reduced sharply as a percent of GNP. The primary deficit (the deficit less net interest outlays) has been eliminated. The ratio of public debt to GNP has stabilized. The fiscal policy debate should focus on the objectives and economic effects of federal spending and tax policies and their impact on allocation of national resources.



## THE U.S. ECONOMY IN 1990/91

Jerry L. JORDAN  
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### *Summary*

The slow national economic growth of late 1989 and early 1990 will set the stage for a more sustainable pace of expansion well into the new decade. Output and employment growth will increase later this year and in 1991, but will stay well below the robust expansion of 1987/88. Inflation reached a cyclical peak in the first half of 1989 and can be expected to decline for at least the next two years.

This outlook for modest growth and falling inflation for the near future will be accompanied by reduced volatility of interest and exchange rates compared with the previous two decades. Oil prices are expected to average somewhat below \$20 per barrel through 1991, and food prices will retreat from the recent cold-weather induced highs. Consumer spending will grow at a subdued rate, and major sectors such as residential construction and automobile production will operate at much lower levels than in the mid-1980s.

Growth of capital spending by businesses in 1990 will be well below the rates of the past few years -- a reflection of the contraction of corporate cash flows. However, capital spending in 1991 is forecast to be fairly robust. Exporting and import-competing industries will continue to outperform other sectors of the economy.

Defense spending by government will fall by about 4 percent a year in real terms for much of the 1990s. Consequently, regions and industries of the economy that were stimulated by the defense buildup of the 1980s will be adversely affected this decade. Spending by government and private industry for environmental purposes will trend higher for many years to come.

The torrid rate of real estate price increases during the late 1980s is now over for most of the country. For 1990/91, appreciation of house prices is not likely to exceed the rate of inflation except in a few areas such as the Pacific Northwest. Sale of assets the government acquired from failed thrifts and banks will continue to depress real estate markets in some southwestern and northeastern states.

Although the unemployment rate is forecast to rise somewhat this year, the Federal Reserve is not expected to shift to a sharply more stimulative monetary policy. Sustained monetary restraint means that such indicators as personal income and retail sales will grow more slowly on average than in the recent past. The resulting short fall of tax receipts at both the state and the federal levels will constrain spending by governments.

### ***U.S. Outlook for 1990/91***

Since our meeting last September, a number of changes have taken place -- some of which will produce only temporary effects, while others will have long-term impacts.

- (1) Unusually cold weather in various parts of the United States at the end of 1989 pushed food and energy prices up steeply. Although unsettling to consumers, the resulting price spike in the first part of 1990 will be temporary.
- (2) Long-term interest rates have climbed sharply in the first part of 1990. U.S. interest rates are now high relative to expected inflation and economic growth and are, therefore, likely to move lower.
- (3) The pace of change in Eastern Europe should bolster growth opportunities for the United States, although immediate export potential will be modest. Changes in the Soviet Union will permit significant reductions in defense spending, although such changes will also lower growth prospects of some industries and regions.
- (4) Fiscal policy has taken some unexpected turns. Defense spending projections have been scaled further downward, and the overall deficit picture began to look somewhat brighter toward the end of 1989. However, Senator Moynihan (D-NY) has proposed rolling back the 1990 social security payroll tax increase to prevent the current surplus from being used to fund other government programs.

Our view of the U.S. economy remains relatively unchanged. We expect no recession, although growth in the first part of 1990 will be slow -- below 2 percent. We still expect interest rates to move lower in the second quarter of 1990.

### **Policy Assumptions**

The Bush administration has submitted a budget for fiscal 1991 that formally complies with the Gramm-Rudman deficit target of \$64 billion. The actual deficit for fiscal 1991 is expected to be much higher.

Defense spending is slowing, and real declines averaging 3-4 percent per year seem likely during the next four to five years. Any "peace dividend," however, has already been claimed in demands for higher spending on child care, education, drug control, infrastructure, foreign aid, and the environment. Consequently, an increase of Federal spending significantly larger than 3 percent shown in the administration's 1990 budget seems likely.

The Federal Reserve continues its balancing act between fighting future inflation and maintaining current economic growth. Since last spring, it has gradually reduced its target for the Federal funds rate from a peak of nearly 10 percent to 8.25 percent. Its strategy during recent months has been to make a small cut in the funds rate (25 basis points) and then wait to assess the impact.

We believe that **three more quarter-point reductions in the funds rate** will occur by mid-year as the soft economy puts downward pressure on market interest rates. The growth of the **monetary base** (currency and bank reserves) is likely to pick up to **over 5 percent** this year and in 1991 from the very low rate of about 3 percent in 1989. This is an expectation, *not a recommendation*.

The Federal Reserve remains highly committed to reducing inflation over the next five years. Even though a zero inflation target may not be achieved, monetary policy is likely to restrain the growth of total spending in the economy. Several members of the Federal Reserve see the economy's real growth potential as only about 2.5 percent a year and may attempt to keep actual growth close to that perceived non-inflationary limit.

### Economic Growth

We look for a relatively modest gain of **2.2 percent in real GNP this year** (fourth quarter to fourth quarter). The non-farm economy is expected to expand this year at about the same pace as in 1989 on balance, but second-half growth is expected to be about double that of the first half. The higher growth at about long-run potential is forecast to continue in **1991**, with real GNP up **2.7 percent** next year.

The two major forces affecting growth in 1990 will be a more accommodative monetary policy and a continued sizable demand for American exports. A pickup in monetary growth should bolster spending in general, with at least modest increases in consumer expenditures, housing, and capital outlays. Both consumer and capital-goods producers should realize moderate export gains in 1990, as growth in Europe, the Far East, and Mexico will be relatively strong.

**Consumer spending** will rise in line with incomes in 1990 -- about 2 percent in real terms. A total of **14.4 million cars and light trucks** are expected to be sold, about equal to the 14.5 million total of 1989.

We believe that 1989 marked the low point for the housing cycle nationally. The rise in 1990, however, is likely to be modest with an increase to **1.43 million housing starts** from 1.37 million in 1989.

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For 1991, we forecast that 1.54 million housing units will be started. This level contrasts with 1.81 million units built in 1986, before demographics of the aging "baby-boom" population began to limit the number of new units.

**Business capital spending** should pick up by the second half of 1990 with some improvement in profits and the ongoing efforts of companies to improve labor productivity, inventory control, and other operating efficiencies. Energy companies plan to conduct a significant amount of oil and natural gas drilling this year. Investment in infrastructure should also be sizable. Finally, the commercial aircraft business continues to boom, with strong orders for new planes as well as rehabilitation of older equipment.

In the area of **non-residential building**, the oversupply of offices, hotels, and other commercial space in many locations will limit new construction in the current year. **Defense spending** will be down, affecting both primary contractors and their many subcontractors.

**Job growth** is likely to slow in 1990 as companies attempt to improve profit margins and adjust to a moderate pace in overall sales and shipments. We expect the overall **unemployment rate** (including the military) to rise from 5. \_\_ percent in February to about 5.6 percent in the third quarter. The jobless rate would then drift slowly back to about 5.1 percent by the end of 1991.

**Manufacturing sector employment** fell through most of 1989 with a loss of 300,000 jobs between the peak in March 1989 and January 1990. The weakest segments have been autos, computers, and their supplier industries. With the exception of aircraft, most other manufacturing industries were essentially flat in terms of new orders, production, and employment as 1990 began. Many furloughed auto workers have already been recalled, but a number of auto plants will see temporary or permanent closure this year. Hiring in other manufacturing industries is likely to be slow in 1990, although conditions should gradually improve as the year progresses.

Meanwhile, employment growth has continued almost unabated in the broad service sector. A **squeeze in profit margins** for retailers and service businesses is, however, expected to slow the pace of employment gains in 1990.

**Profit margins** fell to recession levels last year but should gradually improve in 1990. Many companies faced rising labor costs (especially for health insurance and other benefits) as well as higher average interest expense. At the same time, product demand was not strong enough to pass on those cost increases. Lower average interest rates, a slowdown in new hiring, and a pickup in general economic activity in the second half of 1990 should begin to help the profit picture later this year.

### Inflation

Prices rose last year at the highest rate since 1981. Consumer prices increased 4.6 percent on a year-end to year-end basis in 1989, slightly faster than the 4.4 percent inflation rate of each of the prior two years.

The bitter cold at the end of 1989 increased demand for energy substantially while cutting the supply of various winter crops. The result has been sizable energy and food price increases in the first part of 1990, which will send consumer prices up at an annual rate of about 6 percent in the first quarter of the year. Subsequent actual declines in food and energy prices should dampen inflation in the spring and summer to an annual rate of less than 4 percent.

The impact of tighter monetary policy during the past two years should be an easing of basic inflationary pressure this year and next. Consequently, we continue to expect that consumer prices will be up about 4.2 percent this year and 4.0 percent in 1991.

Total employee costs rose 5.0 percent last year, and a similar rise appears likely in 1990. We are forecasting an increase of 4.7 percent in 1991. Health-care costs show no sign of slowing, although a reduction in social security taxes would moderate the rise in labor costs.

### Interest Rates

We believe interest rates will decline further towards a trough around mid-1990. The pace of economic growth will be the most important force affecting the trend of short-term rates. Weakness in the economy will push market rates lower and will also encourage the Federal Reserve to be more expansive and reduce its target for the Federal funds rate. We look for the funds rate to fall to a low of about 7.5 percent by mid-year from 8.25 percent in early March. The prime rate is likely to fall from 10 percent recently to at least 9.5 percent, and possibly 9 percent, by summer.

A pickup in economic growth would then push short-term interest rates gradually higher in the second half of 1990 and through 1991. The Fed funds rate would average about 7.75 percent in the fourth quarter of this year and 8.45 percent in the final quarter of 1991. The bank prime rate would be 9.5 percent at year-end and 10.0 percent during most of 1991.

Long-term interest rates rose in early 1990 -- from an average of 7.9 percent in both November and December 1989, 30-year government bond yields increased to about 8.5 percent in early March. With real economic growth in the United States of only about 2 percent and inflation of close to 4 percent, a long-term bond yield of 8.5 percent would

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seem unsustainable. Consequently, we believe that **30-year bond rates** will move back **down to 8 percent** by the middle of this year. The long-bond yield is likely to stay close to 8 percent during the remainder of 1990 and in 1991.

While many savings and loan institutions have cut back lending and sold assets to meet new capital requirements, no major increase has occurred in the spread of 30-year fixed-rate mortgages over 30-year government bonds. An easing in 30-year bond yields should be accompanied by some reduction in mortgage rates from the 10.25 percent level in early March. We are forecasting that **mortgage rates** will **ease** to a low of about 9.8 percent by the middle of the year and stay below 10 percent through the balance of 1990. Mortgage rates would then inch back to about 10 percent by the middle of 1991.

# MAJOR ECONOMIC INDICATORS

	QUARTERLY												4th QUARTER					
	1989				1990				1991				% Change		% Change		% Change	
	I	II	III	IV	I	II	III	IV	I	II	III	IV	1989 Actual	'89/'88	1990 Actual	'90/'89	1991 Forecast	'91/'90
<b>GROSS NATIONAL PRODUCT</b> (Billions of \$, annual rate)	5113.1	5201.7	5261.0	5337.0	5411.6	5491.9	5590.4	5690.0	5772.9	5864.5	5961.9	6057.9	5337.0	6.4	5690.0	6.4	6057.9	6.7
% Change, annual rate	7.9	7.1	6.2	4.3	5.7	6.1	6.6	7.3	6.7	6.5	6.8	6.6						
<b>REAL GNP</b> (Billions of 1982 \$, a.r.)	4106.6	4132.5	4162.9	4168.1	4179.5	4196.2	4226.3	4259.7	4288.1	4315.7	4348.7	4378.6	4168.1	2.4	4259.7	2.2	4378.6	2.7
% Change, annual rate	3.7	2.6	3.0	0.5	1.1	1.8	2.7	3.2	2.7	2.8	2.9	2.6						
<b>REAL FINAL DOMESTIC SALES*</b> (Billions of 1982 \$, a.r.)	4140.6	4161.5	4205.9	4201.9	4223.8	4236.7	4262.8	4293.5	4321.1	4348.1	4376.7	4406.1	4201.9	1.8	4293.5	2.2	4406.1	2.6
% Change, annual rate	1.3	2.0	4.3	-0.4	2.1	1.4	2.3	2.8	2.8	2.5	2.7	2.7						
<b>REAL CHANGE IN INVENTORIES</b> (Billions of 1982 \$, a.r.)	24.5	19.1	21.9	32.6	15.5	17.0	20.0	22.8	25.0	26.5	29.0	31.5	32.6	N/A	22.6	N/A	31.5	N/A
<b>GNP DEFLATOR</b> (1982=100)	124.5	125.9	126.9	128.0	129.5	130.8	132.0	133.3	134.6	135.9	137.2	138.4	128.0	3.8	133.3	4.2	138.4	3.8
% Change, annual rate	4.0	4.6	3.2	3.5	4.7	4.2	3.8	4.0	3.9	3.6	3.8	3.7						
<b>CONSUMER PRICE INDEX</b> (1982=100)	121.9	123.8	124.8	125.6	127.5	128.7	129.9	131.1	132.5	133.8	135.1	136.4	125.8	4.6	131.1	4.2	136.4	4.0
% Change, annual rate	5.4	6.4	2.6	3.9	5.6	3.6	3.6	4.0	4.1	4.0	4.0	3.9						
<b>AUTO SALES</b> (Millions, annual rate)	9.8	10.3	10.6	8.7	9.9	9.7	10.0	10.1	10.3	10.4	10.5	10.3	9.9**	-6.9	9.9**	0.2	10.4**	4.4
<b>HOUSING STARTS</b> (Millions, annual rate)	1.52	1.35	1.34	1.33	1.35	1.37	1.49	1.52	1.54	1.54	1.54	1.55	1.37**	-7.7	1.43**	4.3	1.54**	7.5
<b>INDUSTRIAL PRODUCTION</b> (1977=100)	140.7	141.8	142.2	142.3	142.4	142.6	143.6	144.9	146.0	147.0	148.1	149.2	142.3	1.7	144.9	1.8	149.2	2.9
% Change, annual rate	2.3	3.2	1.1	0.3	0.2	1.2	2.3	3.6	3.0	2.8	3.1	2.9						
<b>NONFARM EMPLOYMENT</b> (Millions)	107.7	108.3	108.9	109.4	109.8	110.0	110.3	110.8	111.3	111.8	112.3	112.8	109.4	2.4	110.8	1.3	112.8	1.8
<b>UNEMPLOYMENT RATE, ALL WORKERS</b> (Percent)	5.1	5.2	5.2	5.3	5.3	5.5	5.6	5.4	5.4	5.3	5.2	5.1	5.3	N/A	5.4	N/A	5.1	N/A
<b>CORPORATE PRETAX OPERATING PROFITS</b> (Billions of \$, annual rate)	316.3	307.6	295.2	295.5e	294.0	297.0	302.0	309.0	315.0	320.0	325.0	333.0	295.5e	-13.1	309.0	4.6	333.0	7.8
% Change over year ago	-0.6	-5.4	-10.8	-13.1	-7.1	-3.5	2.3	4.6	7.1	7.7	7.8	7.8						
<b>PROFITS AFTER TAXES</b> (Billions of \$, annual rate)	173.6	161.1	152.4	152.0e	150.0	153.0	158.0	163.0	165.0	168.0	173.0	178.0	152.0e	-13.4	163.0	7.2	178.0	9.2
% Change over year ago	8.6	-3.5	-12.0	-13.4	-13.6	-5.0	3.7	7.2	10.0	9.6	9.5	9.2						
<b>MONETARY BASE</b> (Billions of \$, a.r.)	277.7	278.7	280.8	283.6	287.3	291.2	295.0	298.6	302.6	306.3	310.2	314.1	283.6	3.3	298.6	5.3	314.1	5.2
% Change, annual rate	4.7	1.5	3.0	4.1	5.3	5.5	5.3	5.0	5.5	5.0	5.2	5.1						

NOTE: All quarterly series are seasonally adjusted; % change, annual rate calculated from prior quarter; calculations based on unrounded data; a.r. = annual rate; e=estimate. \*Excluding Commodity Credit Corp. purchases

\*\*Annual total; N/A = Not applicable



# SHADOW OPEN MARKET COMMITTEE

Jerry L. Jordan

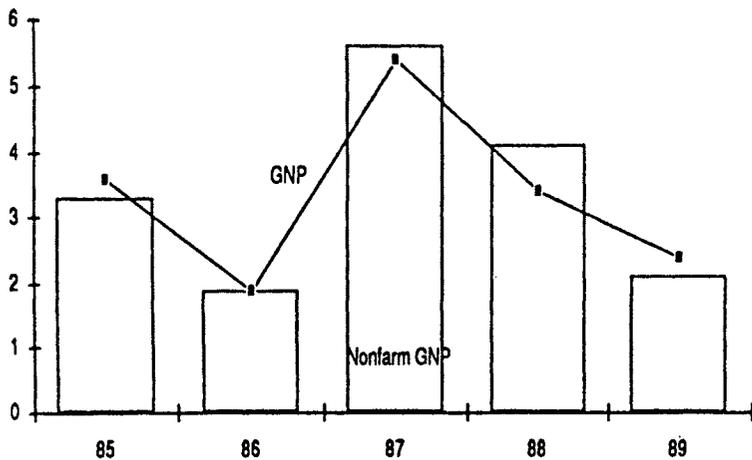
Chief Economist & Senior Vice President

First Interstate Bancorp

March 18-19, 1990

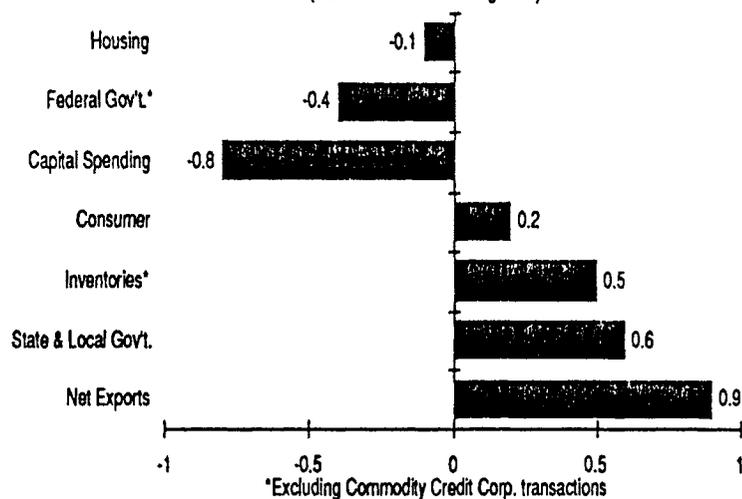
### REAL GNP, Q4 TO Q4

(Percent change)



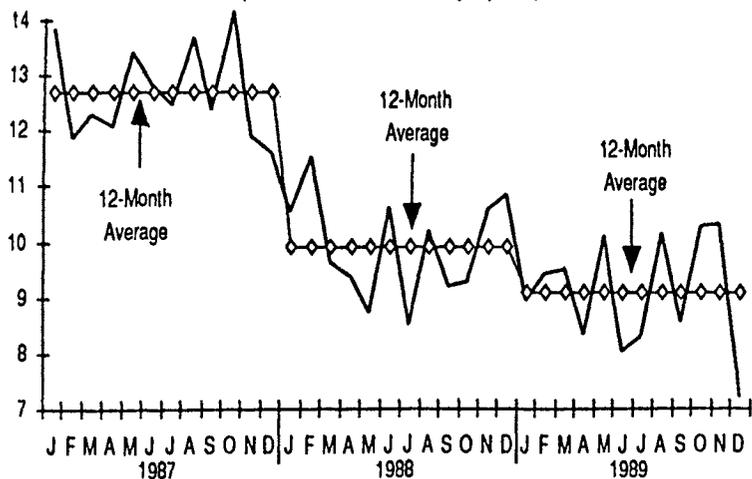
### CONTRIBUTIONS TO 4TH QTR PERFORMANCE

(Distribution of 0.9% real growth)



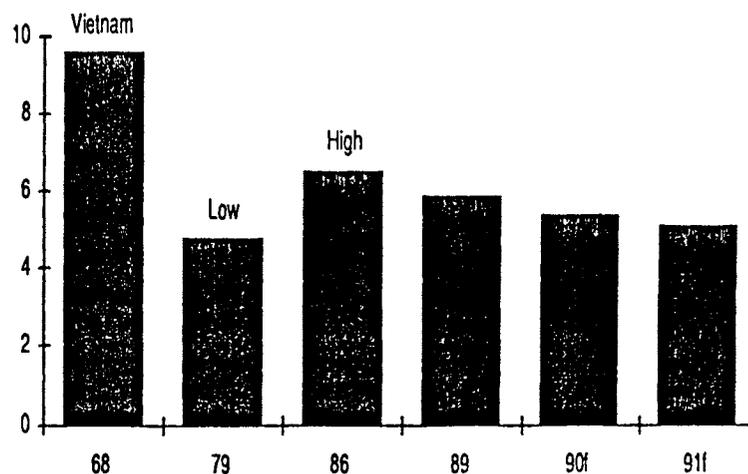
### MERCHANDISE-TRADE DEFICIT

(Billions of dollars, seasonally adjusted)

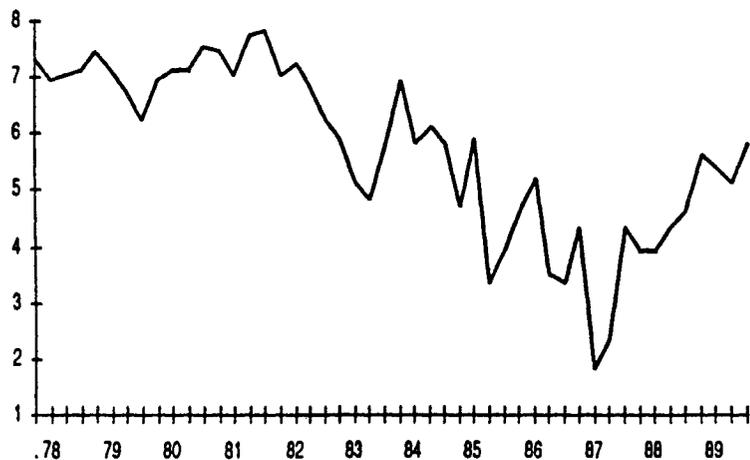


### DEFENSE SPENDING WANES

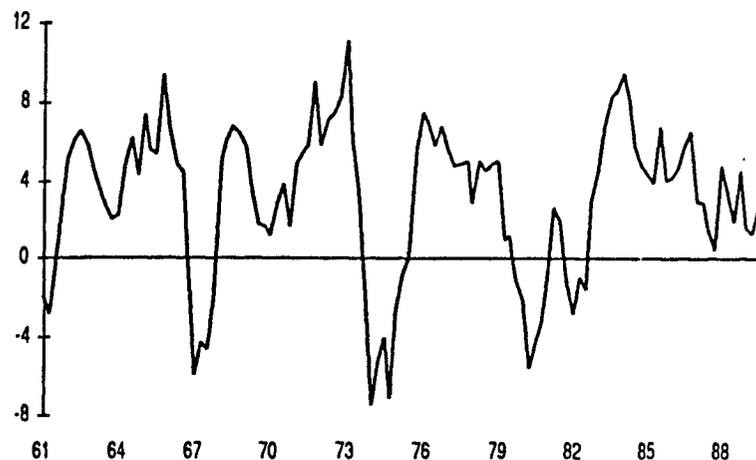
(Defense outlays as percent of GNP, fiscal years)



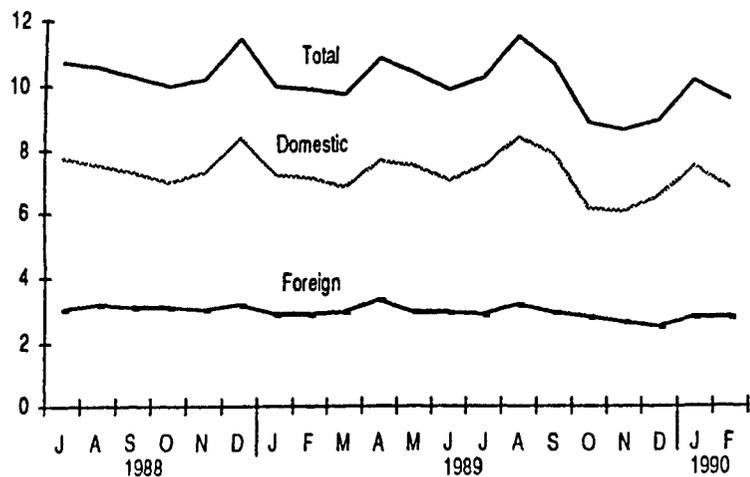
**PERSONAL SAVING AS A % OF DISPOSABLE INCOME**  
(quarterly).



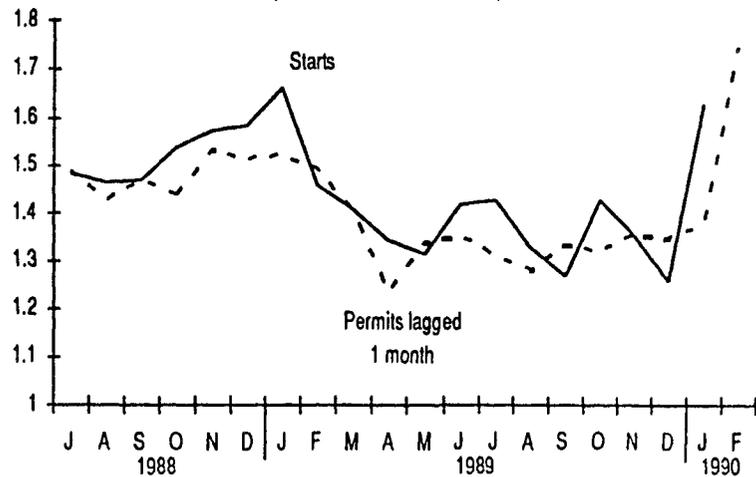
**REAL RETAIL SALES**  
(Quarterly, percent change over year ago retail sales/personal consumption deflator for goods)



**AUTO SALES**  
(Millions of units, annual rate)

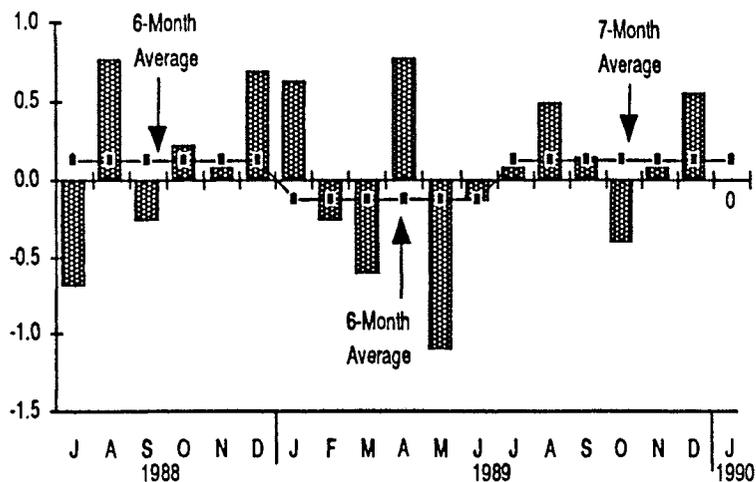


**HOUSING STARTS & PERMITS**  
(Millions of units, annual rate)



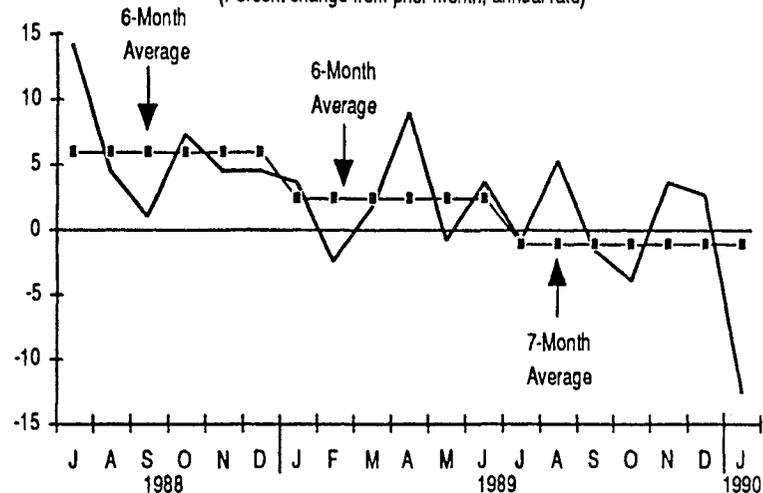
### INDEX OF LEADING ECONOMIC INDICATORS

(Percent change from prior month)



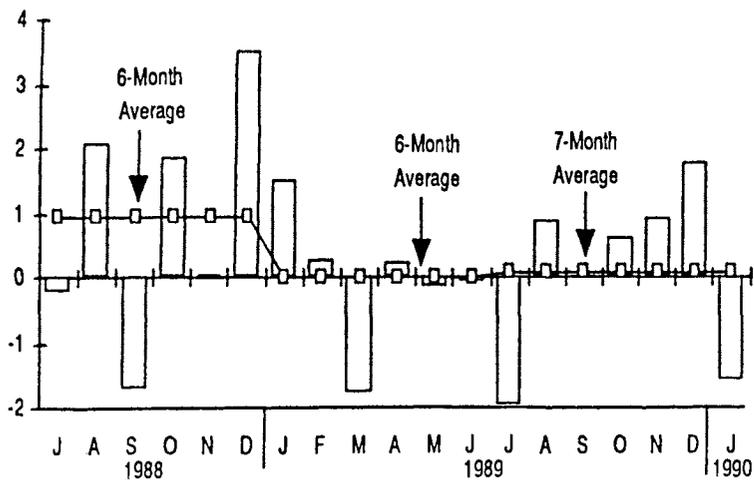
### INDUSTRIAL PRODUCTION

(Percent change from prior month, annual rate)



### DURABLE GOODS ORDERS

(Percent change, 3-month moving average)



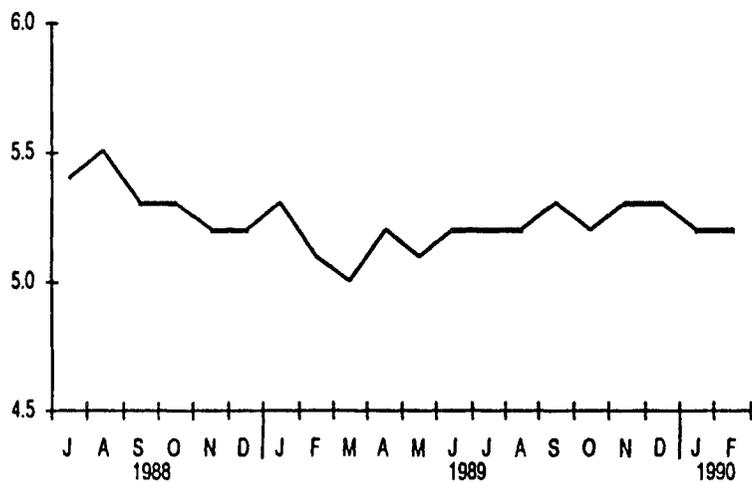
### PURCHASING MANAGERS' INDEX

(Percent)



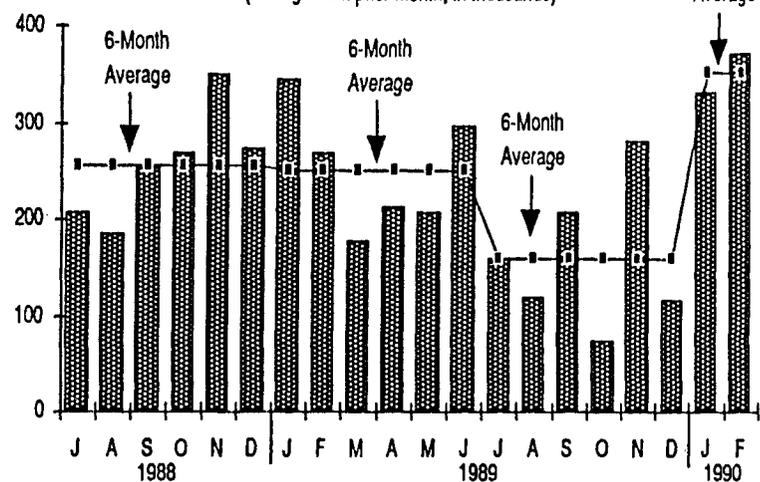
### UNEMPLOYMENT RATE

(All Workers, Percent)



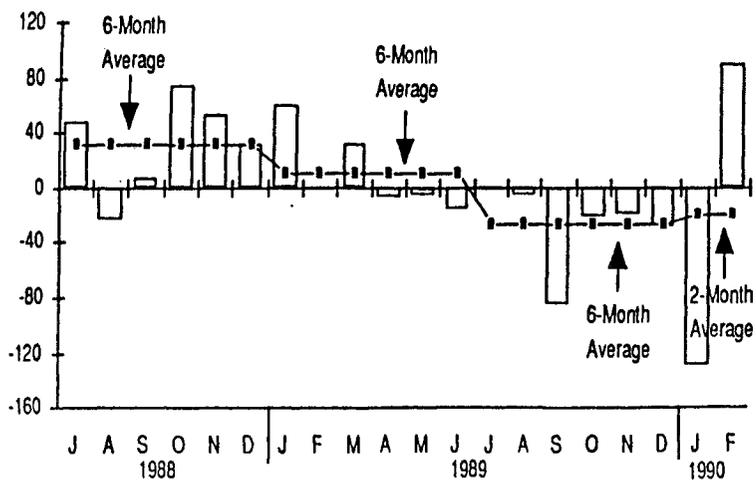
### NONFARM EMPLOYMENT GROWTH

(Change from prior month, in thousands)



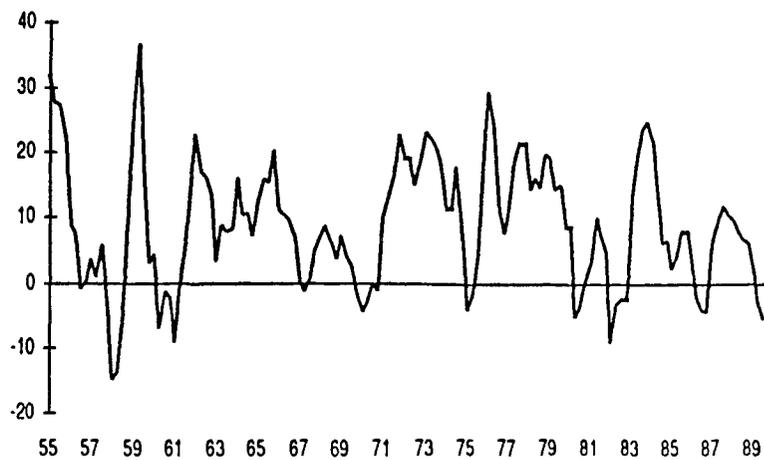
### MANUFACTURING EMPLOYMENT

(Change from prior month, in thousands)

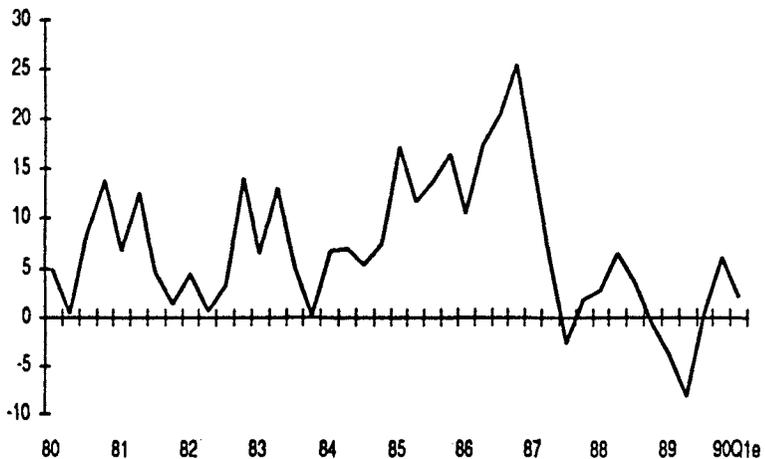


### CORPORATE CASH FLOW

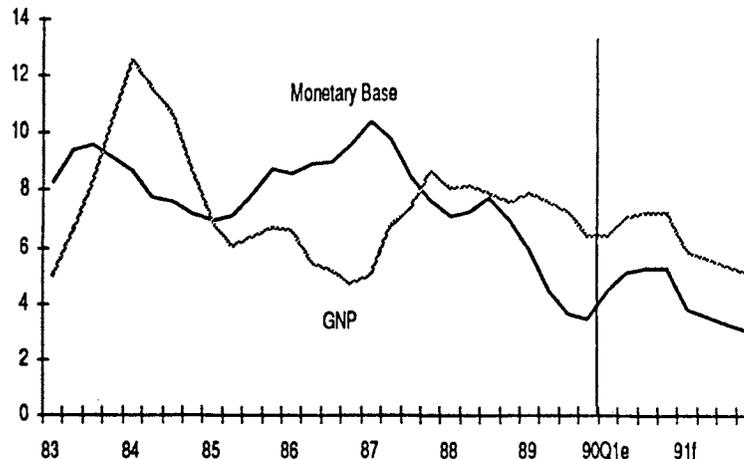
(Quarterly, percent change over prior year)



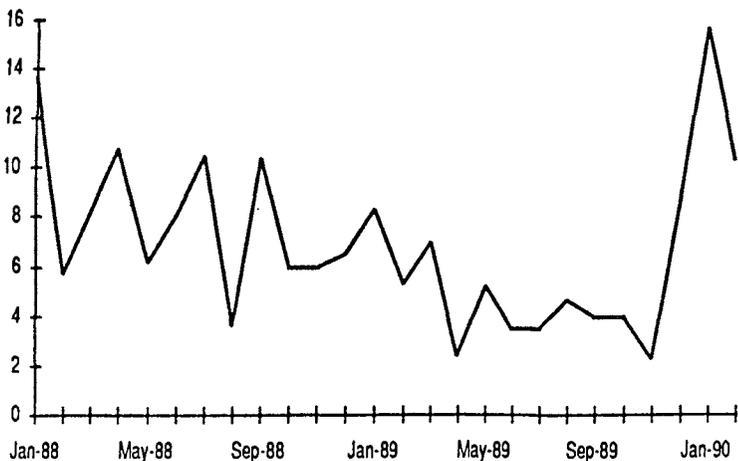
**TOTAL RESERVE GROWTH**  
(Percent change over prior quarter, annual rate)



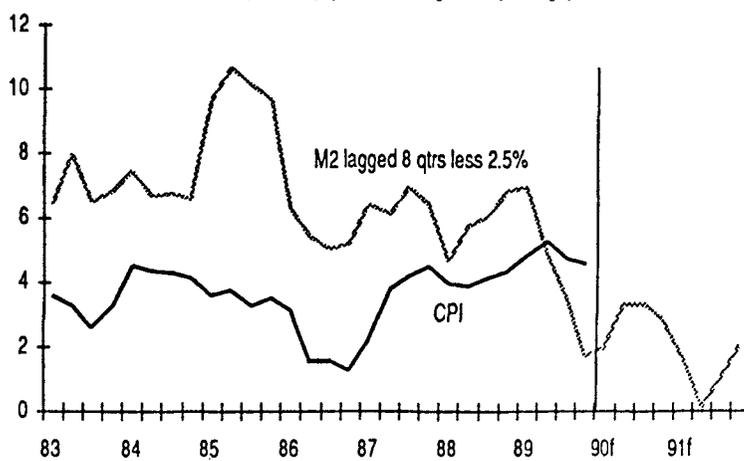
**MONETARY BASE AND GNP**  
(Quarterly, percent change over year ago)



**CURRENCY GROWTH**  
(Percent change over prior month, annual rate)

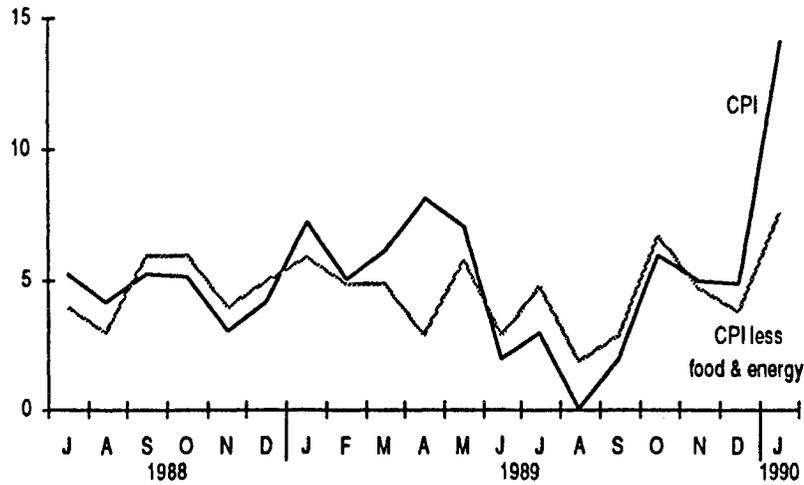


**MONEY AND PRICES**  
(Quarterly, percent change over year ago)



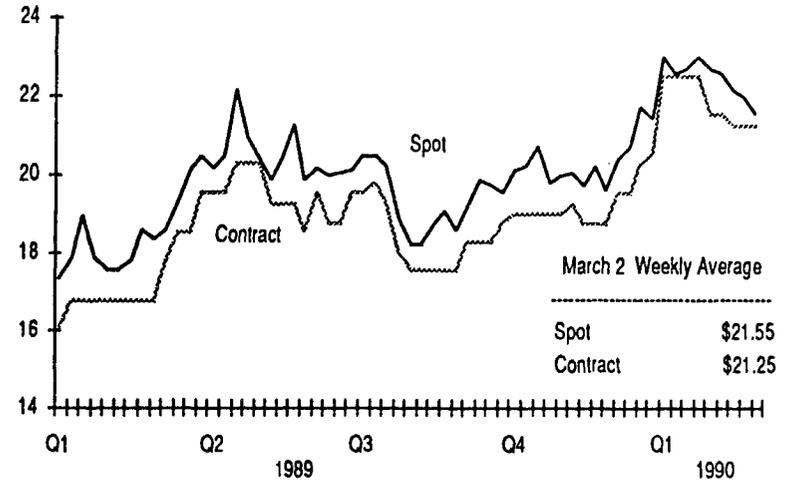
### CONSUMER PRICE INDEX

(Monthly change, annual rate)



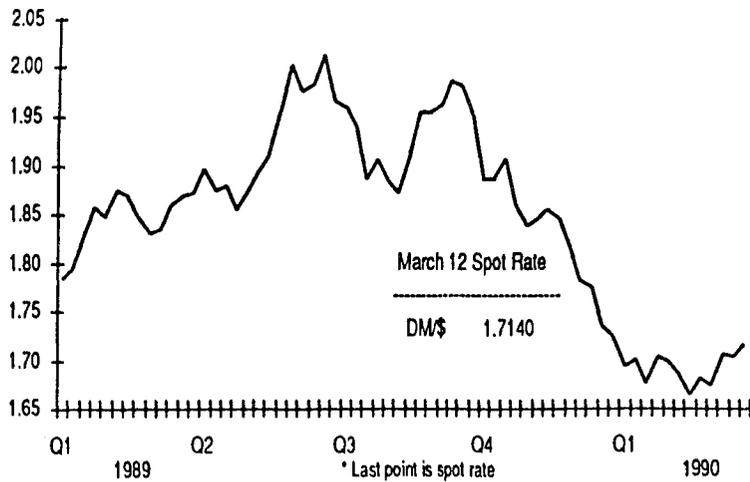
### CRUDE OIL PRICES

(West Texas Intermediate, dollars per barrel)



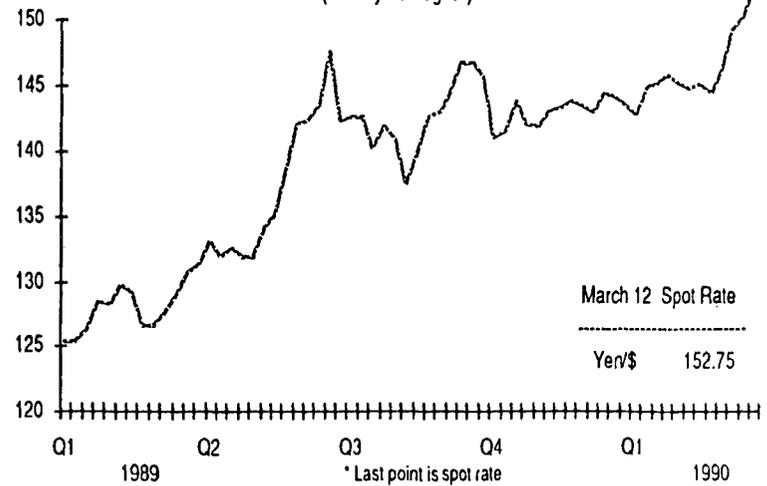
### EXCHANGE RATE - DM/\$

(Weekly averages\*)



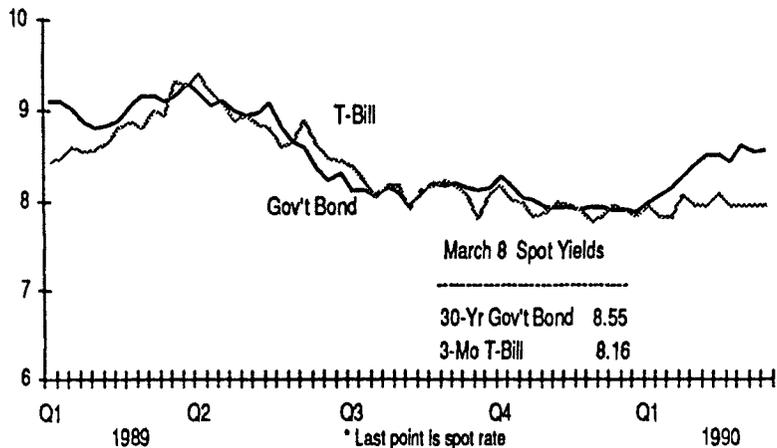
### EXCHANGE RATE - YEN/\$

(Weekly averages\*)



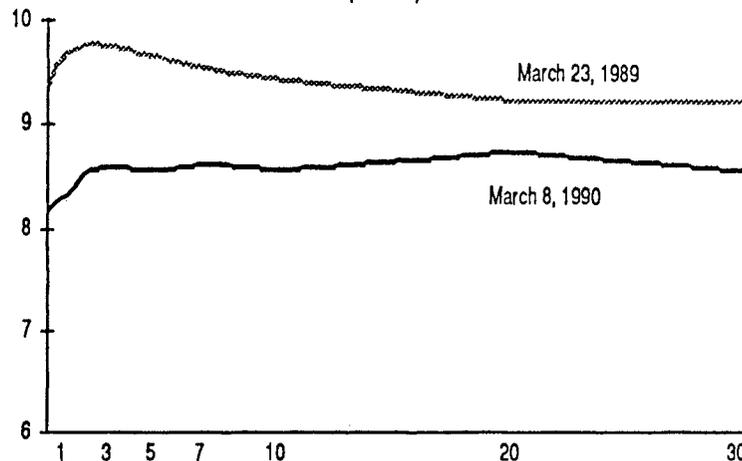
### 3-MONTH T-BILL & 30-YEAR GOVERNMENT BOND-EQUIVALENT YIELDS

(Weekly averages\*, percent)



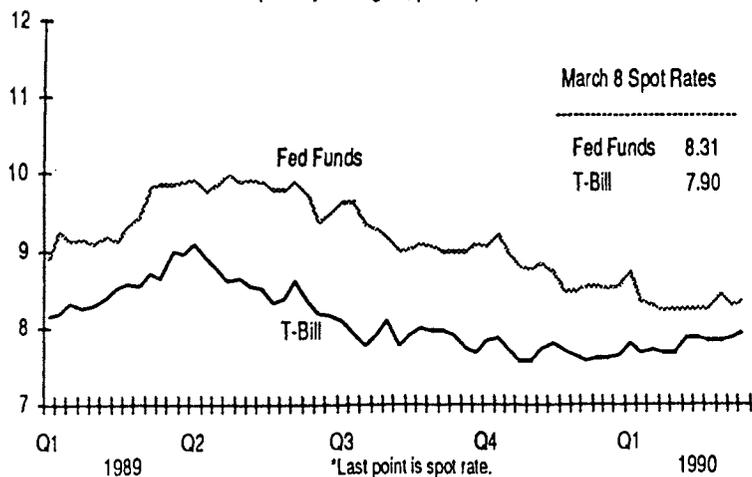
### YIELD CURVE, 3 MONTHS TO 30 YEARS

(Percent)



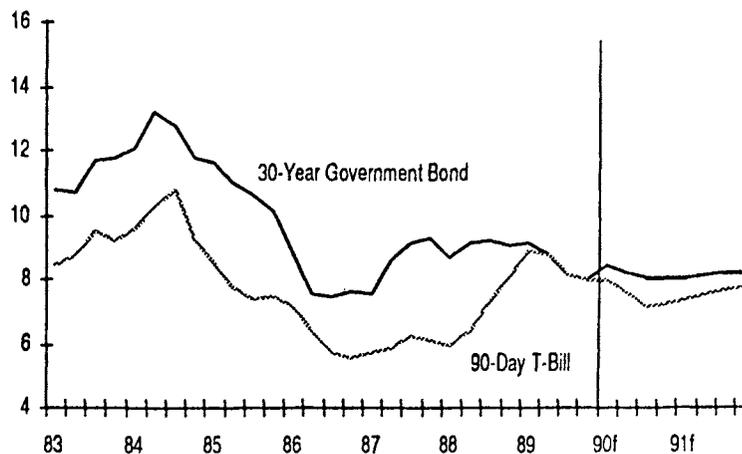
### FED FUNDS & 3-MONTH T-BILL QUOTED RATES

(Weekly averages\*, percent)



### INTEREST RATE FORECASTS

(Percent, quarterly averages, bond equivalent yields)



## **A FISCAL POLICY UPDATE**

**Mickey D. LEVY**  
First Fidelity Bancorporation

In recent years, federal spending and deficits have declined significantly as a percent of GNP, the earlier sharp rise in the federal debt-to-GNP ratio has been halted, and the huge primary deficit (budget deficit excluding net interest outlays) has been eliminated. More progress on reducing the budget imbalance is projected, but frustration and political maneuvering has sidetracked the debate to such issues as social security and on-budget versus off-budget accounting. In addition, both the Administration and Congress are bracing for the reality that the Gramm-Rudman-Hollings (Balanced Budget Act, or GRH) deficit target of \$64 billion in fiscal year 1991 will be impossible to achieve. Such concerns are unlikely to yield rational fiscal decisions. More attention must be paid to the important issues of the allocative impact of fiscal policies, and what the structure of spending and tax programs imply for the mix and level of short and long-run economic output.

### ***Recent Budget Trends***

A string of budget legislation and sustained economic expansion have significantly reduced the budget imbalance from its earlier peaks:

- Federal spending growth slowed to a 5.8 percent annual rate from FY1983 to FY1989 (2.6 percent in real terms), compared to 12.2 percent from 1974-1983 (4.1 percent in real terms). Consequently spending as a percent of GNP has declined from a peak of 24.3 percent in 1983 to 22.2 percent in 1989, retracing approximately half of its earlier rise.
- Net interest outlays has risen from 2.7 percent of GNP in 1983 to 3.3 percent in 1989; consequently, federal spending excluding net interest outlays have dropped sharply, from 21.6 percent to 18.9 percent. Most of the reduction in outlays have occurred in defense and non-defense discretionary programs, while outlays for social security and other non-means tested entitlement programs have risen as a share of federal outlays.
- The federal budget deficit has receded from 6.3 percent of GNP in 1983 to 2.9 percent in 1989. The deficit has fallen from a peak level of \$221 billion in 1986 to \$152 billion in 1989. Further declines are projected.
- The primary deficit (the budget excluding net interest outlays) has been eliminated. A primary surplus of \$2.4 billion in 1979 deteriorated to a

primary deficit of \$118 billion in 1983 and \$85.2 billion in 1986. Largely as a consequence of sharply slower growth of non-interest outlays, the 1989 budget excluding net interest outlays was in surplus by \$16.8 billion. Larger primary surpluses are projected.

- The soaring rise in the public debt-to-GNP ratio has been halted. It zoomed from 24.3 percent in 1974 to 41.5 percent in 1986, but has stabilized around 42.6 percent in the 1987-1989 period. It is projected to recede gradually.

Further progress on reducing the budget imbalance will be limited temporarily in 1990-1991 as a consequence of the substantial increase in on-budget outlays to finance the Resolution Trust Corporation's (RTC's) restructuring of the savings and loan industry. While the Administration's budget projections do not include the RTC's need for additional working capital in the 1991 budget, the CBO estimates that the RTC will borrow \$24 billion in 1990 and \$31 billion in 1991 from the Federal Financing Bank (FFB), and these additional costs of S&L case resolutions will count as budget outlays and add to the deficit, pushing it well above Administration projections.

The deficit will continue to recede in dollar terms and as a percent of GNP, although the increased outlays for the RTC will inhibit progress in 1990-1991. The speed at which the deficit declines depends crucially on economic and interest rate outcomes and whether President Bush's budget proposals are enacted. The Administration's Budget projects a current services deficit of \$84.7 billion in 1991 and proposes sufficient spending cuts and revenue increases to barely meet the GRH target with a deficit of \$63.1 billion. It proposes a deficit of \$25.1 billion in 1992 and surpluses beginning in 1993, driven primarily by slower spending growth (4.3 percent annual average from 1991 to 1994). The CBO's projections are significantly more pessimistic: its baseline budget issued in January projects a 1991 deficit of \$138.0 billion, while its reestimate of the Administration's budget, which includes the President's proposals but also the substantial increases in outlays for the RTC, projects a \$131 billion deficit. The CBO baseline budget projects very little deficit reduction through 1994.

The Administration assumes 2.4 percent real GNP growth in 1990 and a healthy bounceback above 3.0 growth beginning in 1991, while the CBO assumes 1.7 percent growth in 1990 and a more modest rise to 2.5 percent beginning in 1991. The different growth projections reflect the Administration's optimism about productivity gains. The Administration projects modest declines in inflation, while the CBO assumes virtually no improvement. The Administration also projects significantly lower interest rates than the CBO in nominal and real terms.

During 1990-1992, real GNP growth is likely to be closer to the CBO's more modest forecast, while inflation is likely to fall below both the Administration's and CBO's forecasts. Criticizing interest rate projections may be unfair, since they involve substantial uncertainties, but the Administration's projection of sharply declining *real* rates is seemingly inconsistent with its projected strong bounceback of real GNP growth that is driven primarily by stronger productivity gains. Projections with either more moderate real growth or higher real interest rates, consistent with historical standards, would generate higher deficit projections. Recently, the Administration has admitted that weak economic performance will drive 1991 deficits above levels projected in the *Budget*.

Failure to enact the Administration's budget proposals will also slow progress on deficit reduction. The Administration proposes substantial deficit cuts -- \$36.5 billion in 1991, \$46.9 billion in 1992, and \$75.6 billion in 1994. In general, few cuts are proposed in non-defense discretionary programs, and the several recommended cuts are old proposals that already have been rejected. Large cuts are recommended in Medicare payments to doctors and hospitals and in COLAs for civil service and military retirement, and unspecified cuts have been designated for farm price supports and federal employee health benefits. No cuts are proposed for social security. The President proposes a 2 percent annual decline in real defense outlays. Given rapidly changing world events, actual cuts in defense outlays may exceed this proposal for the 5-year period, but the larger cuts probably would occur in the later years.

The Administration proposes several significant tax policy changes designed to encourage saving and investment. The proposed exclusion of a portion of capital gains subject to taxation would raise investment, but the extent of the response is uncertain. Its enactment is unlikely this year, due to strong opposition primarily on distributional grounds and, according to congressional estimates, its negative impact on tax receipts over a 5-year projection period. The proposed Family Savings Account (FSA) is appropriately designed to encourage savings. Its near-term revenue losses are limited by "back-loading" the tax benefit to participating contributors, which increases its political attractiveness. The proposal to eliminate penalties on early withdrawals from IRA accounts for certain new home buyers is politically attractive. However, it would allocate more savings to housing rather than equity, which is inconsistent with long-run economic growth.

Another tax policy alternative under consideration by the Administration but not included in the *Budget* is a partial or full integration of the individual and corporate income taxes. This could involve several provisions, including allowing corporations to deduct a portion of dividends (as is allowed in most industrialized nations). Reducing the double taxation of dividends has many advantageous economic characteristics, including reducing

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the current bias against equity financing relative to debt financing, but in the past it has not had a natural base of political support. The recent problems with junk bonds may create the political environment in which Congress would find this tax policy attractive.

It is unlikely that much of the Administration's spending cut proposals will be adopted, and the chances are low for immediate enactment of a capital gains tax cut or a partial income tax integration. Recently, Chairman Dan Rostenkowski of the House Ways and Means Committee has proposed a broad plan to reduce the deficit, which includes a freeze on most federal spending programs, including social security, but also higher personal income taxes. If the proposal to cut spending in social security and other non-means-tested entitlement programs becomes part of the mainstream fiscal policy debate, the political logjam that has been a major stumbling block to meaningful deficit cutting would be broken.

Despite this possibility, it is virtually certain that the budget outcome in 1991 will grossly violate GRH's \$64 billion deficit target. Several outcomes are possible. If real GNP falls below 1 percent in two consecutive quarters, Congress may vote to suspend GRH's sequestration process. Whether first quarter 1990 GNP triggers that process remains uncertain. Second, since the GRH law requires only that OMB's budget projections, not actual budget outcomes, achieve the deficit targets, the Administration may choose to adopt a blatantly unrealistic budget projection. However, the political costs of doing so may be very high. Third, the GRH law may be amended, with the deficit targets once again stretched out.

Fourth, the Administration may threaten sequestration to extract a significant budget compromise from Congress. Across-the-board cuts were implemented last fall, but they were very small (\$5.7 billion total); potentially large cuts would be required to meet GRH's 1991 target (\$75 billion without legislation). Although large across-the-board cuts are not expected, the shift in national security needs and defense spending may alter the perceived winners and losers of sequestration. Until recently, the threat of sequestration was exerted somewhat evenly across the political spectrum, as conservatives did not want to cut defense spending and, in general, liberals did not want to cut non-defense spending. The threat of large cuts to non-defense programs may now substantially exceed the threat of cuts in defense, and the Administration may try to use this political shift to its advantage.

### ***The Social Security Debate: Political Maneuvering, Not Rational Debate***

Senator Moynihan's proposal to roll back scheduled payroll tax increases has initiated debate about social security, broader tax policy issues, and on-budget versus off-budget accounting. Much of the debate about payroll taxes and social security is driven by current

budget concerns, while the debate about on-budget versus off-budget accounting is simply political maneuvering. The resulting confusion may prove counter-productive.

Social security was taken off-budget by the Balanced Budget Act of 1985; its balances are included in the GRH deficit calculations, but its outlays are excluded from sequestration. Both the Administration and CBO regularly display separately and combined social security balances and the unified budget in the summary budget figures. Recently, as a consequence of higher payroll taxes enacted as part of the Social Security Amendments of 1977 and 1983, social security has been accumulating surpluses, and those surpluses have been offsetting deficits in the unified budget. Moreover, a sizable and rising portion of projected surpluses in the 1990s are intergovernmental transfers of interest. These social security surpluses are not "hiding" larger deficits in the unified budget, except to those who have just observed the distinction for the first time. The surpluses in the social security trust funds are obligated to future social security payments. Nevertheless, social security balances are a convenient bookkeeping entry within the federal budget and, in fact, reserves are "lent" to the general fund and spent for general purposes. Despite the unique nature of social security, the total federal budget including social security is the most important measure from the perspective of credit markets and the national savings.

Whether social security balances are counted on-budget or fully split off from the budget has little economic impact. (A more constructive fiscal debate would involve the budgeting treatment of direct federal loans and federally guaranteed private loans.) What is important is the distributive and allocative effects within and across generations of social security's tax and spending structures. The current debate is not addressing these issues. Demographic fluctuations increase the complexity of designing a tax and benefit structure to meet social security's objectives fairly and efficiently. Clearly, either rolling back scheduled payroll tax increases or spending a portion of the mounting social security surpluses raises the government's unfunded liabilities and imposes higher taxes on future generations, or requires that future social security benefits be lowered. Moreover, reduced payroll taxes not offset by spending cuts or tax increases would temporarily raise the consumption share of national output, while offsetting tax increases would have other adverse economic consequences. Altering current payroll taxes to achieve a desired federal budget outcome is short-sighted budget policy and may exacerbate structural problems in the social security system.

Confusion about payroll taxes and social security has also created a flawed basis for assessing the distribution of the tax burden, which misguides the fiscal debate. Recent findings of increased regressivity of the tax burden stem entirely from the rising total tax

share of payroll taxes. But since payroll taxes are part of the social insurance program, their distributional characteristics must be considered in conjunction with the distribution of social security benefits. For current retirees, social security's benefit and tax structure is highly progressive, with benefits relative to lifetime payroll tax contributions inversely related to a retiree's income. Moreover, because payroll taxes were so low prior to the early 1970s, current retirees enjoy very high rates of return on their lifetime payroll tax contributions, while current workers (particularly younger ones) will receive very low rates of return. Rolling back payroll taxes now will only accentuate this intergenerational redistribution of wealth, which would be unfair in terms of accepted standards of equity and also drain the future capital stock.

### ***Refocussing the Fiscal Debate***

The single-minded obsession of economic policymakers with the budget deficit must be tempered. The budget imbalance has already been reduced substantially, and further improvement is projected. Moreover, fiscal policy is vastly more complex than just the size of the deficit. Policymakers must consider more carefully the relative benefits and costs of different proposals to reduce the deficit in terms of the broader objectives of fiscal policy, including the desired rate and mix of national output in the short and long-run, as well as the objectives and economic impact of the spending and taxing structures underlying the deficit. The allocation of national resources between the public and private sectors and between consumption and investment must not be overshadowed by short-sighted attempts to achieve the artificial GRH deficit targets.

Policymakers should reexamine the objectives of specific spending programs and whether their current structures efficiently achieve those objectives. Social security, with its flawed design and persistently rising real outlays is a good example. It is ironic that the current fiscal debate attempts to use social security to "impose discipline" on the unified budget, when in fact the opposite discipline would be more constructive. Unfortunately, GRH excludes from sequestration social security and over half of all budget outlay programs, and only reinforces certain misplaced fiscal values.

Economic responses to taxing and spending structures must not be ignored. Attempts to reduce the deficit by raising taxes may not raise national saving if private saving is discouraged, and will not improve U.S. competitiveness if it discourages investment, raises private costs of production, or otherwise dampens productivity.

These important issues must not be neglected by policymakers as they jockey for political advantage.

Table 1

**SELECTED BUDGET PROJECTIONS**  
(Fiscal Years)

	actual 1989	1990	1991	1992	1993	1994
<b>Receipts</b>						
President's Budget	990.7	1073.5	1170.2	1246.4	1327.6	1408.6
President's Baseline	990.7	1072.8	1156.3	1234.9	1323.5	1401.9
CBO Baseline	990.7	1067.0	1137.0	1204.0	1277.0	1355.0
CBO Est. of Pres. Budget	990.7	1068.0	1146.0	1208.0	1276.0	1356.0
<b>Outlays</b>						
President's Budget	1142.6	1197.2	1233.3	1271.4	1321.8	1398.0
President's Baseline	1142.6	1194.8	1241.0	1290.4	1343.6	1394.0
CBO Baseline	1142.6	1205.0	1275.0	1339.0	1418.0	1484.0
CBO Est. of Pres. Budget	1142.6	1226.0	1277.0	1292.0	1355.0	1404.0
<b>Deficits</b>						
President's Budget	152.0	123.8	63.1	25.1	5.7*	10.7*
President's Baseline	152.0	122.0	84.7	55.5	20.1	7.9
CBO Baseline	152.0	138.0	138.0	135.0	141.0	130.0
CBO Est. of Pres. Budget	152.0	158.0	131.0	84.0	79.0	47.0
Amended GRH Targets (1987)	136.0	100.0	64.0	28.0	0.0	—
<b>Receipts, % Change</b>						
President's Budget	9.0	8.4	9.0	6.5	6.5	6.1
CBO Baseline	9.0	7.7	6.6	5.9	6.1	6.1
<b>Outlays, % Change</b>						
President's Budget	7.4	4.8	3.0	3.1	4.0	5.8
CBO Baseline	7.4	5.5	5.8	5.0	5.9	4.7
<b>As a Percentage of GNP:</b>						
<b>Revenues</b>						
President's Budget	19.2	19.6	19.9	19.7	19.6	19.5
CBO Baseline	19.6	19.6	19.5	19.4	19.3	19.3
<b>Outlays</b>						
President's Budget	22.2	21.8	20.9	20.1	19.5	19.4
CBO Baseline	22.1	22.0	21.7	21.5	21.2	20.8
<b>Deficit</b>						
President's Budget	2.9	-2.3	-1.1	-.4	0.1*	0.1*
CBO Baseline	2.6	2.5	2.4	2.2	2.1	1.8
<b>Publicly-held debt</b>						
President's Budget	42.5	41.9	40.0	37.7	34.9	31.9
CBO Baseline	42.5	42.6	42.4	42.0	41.5	40.8

\* Surplus

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Table 2

**CBO, ADMINISTRATION, AND BLUE CHIP ECONOMIC PROJECTIONS  
(Calendar Years 1989-1995)**

	Estimated	Forecast		Projected			
	1989	1990	1991	1992	1993	1994	1995
<b>Nominal GNP</b>							
<b>(Billions of dollars)</b>							
CBO	5,236	5,534	5,893	6,279	6,688	7,121	7,579
Administration	5,236	5,583	6,002	6,439	6,881	7,324	7,771
<b>Real GNP (Percentage change, year-over-year)</b>							
CBO	2.9	1.7	2.4	2.5	2.5	2.4	2.4
Administration	3.0	2.4	3.2	3.2	3.1	3.0	3.0
Blue Chip	2.9	1.6	2.4	3.1	3.0	2.6	2.5
<b>Consumer Price Index</b>							
<b>(Percentage change, year-over-year)</b>							
CBO	4.8	4.0	4.3	4.3	4.3	4.3	4.3
Administration	4.8	3.9	4.0	3.9	3.6	3.3	3.0
Blue Chip	4.8	4.3	4.2	4.3	4.3	4.3	4.2
<b>Implicit GNP Deflator</b>							
<b>(Percentage change, year-over-year)</b>							
CBO	4.2	4.0	4.0	4.0	4.0	4.0	4.0
Administration	4.2	4.1	4.2	3.9	3.6	3.3	3.0
Blue Chip	4.2	4.0	4.0	4.1	4.1	4.2	4.1
<b>Three-Month Treasury Bill Rate (Percent)</b>							
CBO	8.1	6.9	7.2	6.9	6.5	6.1	5.8
Administration	8.1	6.7	5.4	5.3	5.0	4.7	4.4
Blue Chip	8.1	7.3	7.3	6.9	7.0	6.9	6.8
<b>Ten-Year Government Note Rate (Percent)</b>							
CBO	8.5	7.8	7.7	7.6	7.5	7.4	7.3
Administration	8.5	7.7	6.8	6.3	6.0	5.7	5.4
Blue Chip	8.5	7.9	7.9	7.9	7.8	7.9	7.9
<b>Inflation-Adjusted Three-Month Treasury Bill Rate</b>							
CBO	3.5	2.8	2.8	2.6	2.2	1.8	1.5
Administration	3.7	2.6	1.4	1.5	1.5	1.5	1.5
Blue Chip	3.5	3.0	3.0	2.6	2.7	2.6	2.6
<b>Spread Between Ten-Year Government Note and Three-Month Treasury Bill Rate</b>							
CBO	0.4	0.9	0.5	0.7	1.0	1.3	1.5
Administration	0.4	1.0	1.4	1.0	1.0	1.0	1.0
Blue Chip	0.4	0.6	0.6	1.0	0.8	1.0	1.1

SOURCES: Congressional Budget Office; Office of Management and Budget; Eggert Economic Enterprises, Inc., Blue Chip Economics Indicators.

## **DISMAL LANDSCAPE**

H. Erich Heinemann  
Ladenburg, Thalmann & Co., Inc.  
March 19, 1990

At the ides of March, the economic landscape presents a dismal prospect. Federal Reserve actions have led to a substantial deceleration of monetary growth. As a result, aggregate business activity stalled and may soon begin to decline. From August 1989 through January 1990, total business sales -- measured in constant 1982 dollars -- dropped at an annual rate of 6.2 percent.

Profits of both financial and non-financial corporations have collapsed. According to the Commerce Department, pretax profits of the financial sector (excluding the Federal Reserve banks) were at an annual rate of \$1-billion in the fourth quarter of 1989. That was down 90.7 percent from the final three months of 1988. The Bureau of Labor Statistics' index of profits per unit of real output earned by non-financial corporations declined at an annual rate of 39 percent in the fourth quarter. It was 23.9 percent below the comparable period a year earlier.

Consumer spending is stagnant. Real retail sales in February 1990 were slightly lower than in November 1988. Merchants who chose to ignore the fundamental weakness in the consumer sector are now in the bankruptcy courts. Industrial production has hardly changed in the past year. Real construction activity -- both residential and nonresidential -- has been flat since 1986. Corporate cash flow, which finances business investment in plant and equipment, has started to decline. It will drop more as profits slide to lower levels. Capital spending will follow suit.

Exports are mired in a deep rut. Preliminary figures suggest that the merchandise trade deficit increased substantially in January. The monthly trade deficit has averaged \$9.4-billion since May 1988. If our calculations are correct, the trade report tomorrow will show a deficit close to that average -- sharply higher than the \$7.2-billion recorded in December. Over the last 21 months, the three-month moving average of the trade deficit has been in a narrow range between \$8.8-billion to \$10.2-billion.

### ***Recession in 1990***

We remain convinced that a recession is on the docket for 1990. Recent data suggest that the decline, when and if it develops, will be more severe than we forecast last year (see *Prospects*, March 13, 1989). Macroeconomic forces that would generate recovery are not in sight. True, the Fed stopped draining reserves out of U.S. banks last July. Since then, the money managers have replaced a modest amount of the funds they previously

withdrew. Nonetheless, total reserves of depository institutions -- the raw material for the money supply -- were lower in February 1990 than in April 1988.

On the bright side, tight money has improved the outlook for inflation. To be sure, core inflation -- year-over-year changes in the CPI less food and fuel -- has remained between 4 and 4.5 percent. However, the sharp reduction in monetary growth has had, and will continue to have, a cumulative, highly beneficial effect on price behavior. The collapse in corporate profits is dramatic evidence of the fact that producers have been unable to raise prices to offset rising costs.

Rep. Stephen Neal (D-NC) has introduced a resolution in the House of Representatives that would direct the Federal Reserve to achieve zero inflation. Fed policymakers support the resolution. Moreover, they are acting as though Congress had passed the bill and the President had signed it. In reality, there's little or no chance that Mr. Neal's initiative will become law. In our view, the Fed has created unnecessary risks by pretending that zero inflation was already the law of the land.

### ***Battered Budget***

The federal budget is likely to suffer substantially as economic growth falls short of the optimistic scenario outlined by the Bush Administration. On the basis of the national income accounts, the federal deficit -- including the surplus in Social Security -- was at an annual rate of about \$156.4-billion in the fourth quarter of 1989. Exclusive of Social Security, the deficit was \$222.6-billion. On both measures, the deficit was far, far away from the fictional targets in the Gramm-Rudman-Hollings Balanced Budget legislation.

Tax receipts will weaken as the rate of growth in income slows. Expenditures will rise as contracyclical income maintenance programs automatically kick into action. The G-R-H program will likely be suspended. Rep. Daniel Rostenkowski (D-IL), the powerful chairman of the House Ways and Means Committee, last week proposed a "cold turkey" plan for balancing the budget that included repeal of G-R-H. Who knows, maybe Congress will actually make some difficult fiscal policy decisions.

Many conservative analysts take comfort from the fact that both federal spending and the federal deficit have declined substantially as a percent of GNP. Indeed, the so-called primary budget -- which excludes net interest payments -- is in substantial surplus. However, portfolio managers should not get carried away with such an approach.

These are normal cyclical developments. Federal outlays always decline as a share of GNP during a period of economic expansion, as does the federal deficit. Similarly, the primary budget almost always goes into surplus prior to a peak in the business cycle. The one exception to this rule was in the 1950s. While the current business cycle represents the

longest peacetime expansion since World War II, the improvement in the federal budget has been well below par, especially as a share of GNP.

### ***Rosty's Cold Turkey***

Mr. Rostenkowski's plan to balance the federal budget is a straightforward package of \$255-billion in spending cuts from 1991 through 1995 and \$195-billion of miscellaneous tax increases. The Bush Administration, which may have played a backstage role in drafting the plan, immediately accepted it as a basis of negotiation in the ongoing budget debate. Mr. Bush said that he would continue to oppose new taxes. However, definition of which taxes fall within the President's proscription and which do not is increasingly a semantic game, rather than a matter of serious discussion.

Unfortunately, chances are slim that Congress will pass, or that the President would accept, the plan. While Mr. Rostenkowski did not address, perhaps even consider, many thorny issues in tax policy today, his package has the great advantage of eliminating the deficit in only three years -- as he put it, of going "cold turkey" from red ink to black. Clearly, a federal surplus would help reduce personal consumption and government purchases, thus freeing labor and plant capacity for the production of investment goods and exports. Long-run, that is just what the doctor ordered.

At the same time, there are other tax issues which portfolio managers should monitor carefully. Most important, is the extraordinary increase in effective corporate tax rates that occurred during the Reagan Administration. Combined federal, state and local corporate income taxes now exceed 48 percent of pretax corporate income, the highest since the Korean war.

From the viewpoint of a tax accountant, the data tend to overstate effective tax rates. They include actual tax accruals, but they exclude corporate capital gains from income. To an economist, however, capital gains do not represent income in any meaningful sense. Rather, a capital gain is simply the result of transferring an asset from one period to another. This is why capital gains are excluded from GNP.

### ***Soak the Rich***

As we see it, the increase in corporate tax rates in the 1980s has played an important role in the sharp decline in net investment in the U.S. Until the 1980s, the focus of debate over tax policy was over whether and how to reduce taxes on income from capital. Congress financed expansion of government services by increasing taxes on labor income. The combined Social Security tax rate has gone up about three percentage points per decade during the postwar period.

According to C. Eugene Steuerle, a senior fellow at the Urban Institute in Washington and a former senior tax strategist in the Reagan Administration, this is likely to change in the 1990s. "I expect that considerable attention may soon be paid to the ways in which workers are taxed under both the Social Security and the income tax." Since no one knows who actually pays corporate taxes (consumers, workers or stockholders), Congress may well be tempted to enact further hikes in effective corporate rates.

By contrast, we support the proposal by our colleagues on the Shadow Open Market Committee to integrate corporate and individual income taxes. Taxes should be paid once, by stockholders, not twice or three times as under the present system. Not only would full integration eliminate double taxation of dividends, but interest and dividends would be taxed equally. Corporations would have little incentive to sell debt and retire equity. Full integration would also lower taxes on investment income and encourage capital formation. Short of repealing the corporate income tax and replacing it with a broad-based consumption tax, integration of corporate and personal taxes would be the most important single step Congress could take to improve the competitive position of America in the world economy.

### *False Signals*

Meanwhile, portfolio managers have to guard against false economic signals generated by mild winter weather. A variety of factors distorted the report that employment took a big jump in February. Because of warm weather, construction, manufacturing, transportation and retailing were all affected substantially.

Weather-related shutdowns have been rare this winter. However, this does not suggest an improvement in the underlying trend. Rather, the economy has simply borrowed from the future. Employment always goes down during the winter months. Because of the mild winter, the drop was less than normal. Seasonally adjusted, that was equivalent to a gain.

Employers laid off fewer workers than usual in January and February. Thus, they will have fewer to rehire when the weather improves in March and April. Seasonally adjusted, a subnormal hiring rate this month and next will translate into a decline in employment.

### *Contrasting Views*

To understand the economy at present, you need to step back from a mass of contradictory data. For example, the Bureau of Labor Statistics publishes competing measures of the labor market. In one version, the BLS counts the number of nonfarm payroll jobs. In the

other, the agency surveys a panel of roughly 60,000 households to determine the number of people who have jobs. The household survey is the basis for the widely reported figures on the unemployment rate.

Currently, the payroll series is the stronger. On this yardstick, seasonally adjusted nonfarm employment increased by 700,000 in the past two months and by 1.7-million since last June. According to the household survey, by contrast, nonfarm employment went up only 280,000 since December, and by 550,000 since mid-year 1989. The BLS did not actually count all the payroll jobs it reported. Rather, the agency simply assumed that new businesses create about 80,000 jobs a month. No one knows whether that assumption was correct.

Of course, BLS statisticians adjust the employment data to take account of normal seasonal variations. The actual job count declined by 1.5-million from December to February, or roughly 1.5 percent. If the weather had been normal this year (more snow and a lot colder), employment would have dropped more than 2 percentage points. Therefore, on a seasonally adjusted basis, the job market improved -- notwithstanding longer lines at unemployment offices.

That's not all. The payroll series showed that employment in "service producing industries" accounted for 98.6 percent of the reported jump of 2.6-million jobs during the year ended February 1990. However, the household survey reported that employment in "service occupations" declined by 258,000 over the past year. The unemployment rate for service workers was 6.8 percent in February, up from 6.3 percent last year.

In a country as diverse as the U.S., no one knows for sure which of these contrasting measures provided a better picture. However, the recent pattern was not unusual. Reported gains in payroll employment normally exceed changes in total employment at the end of a period of economic expansion. The big increases in payroll jobs in the last few months may represent a warning the economy is about to go into recession.

Even with a jump in auto employment last month, most manufacturers laid off workers. According to the BLS, 76 of 141 industries reduced their employment in February. Manufacturing industries cut jobs on balance during 10 of the last 11 months. The BLS indicated that weakness in manufacturing jobs was "particularly apparent ... in six industries, including textiles, apparel, rubber and plastics."

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***Take Heed***

Mr. Greenspan should take heed of the weakness in corporate profits. On nine occasions since World War II, profits declined as much as they have in the past year. In seven of those nine episodes, the economy had either entered, or was about to enter a recession. The White House has scouting parties out looking for Mr. Greenspan's scalp. In such an environment, the Fed can ill afford to allow the slowdown in the economy to get out of control.

## **FOREIGN EXCHANGE MARKET INTERVENTION**

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Congressional oversight of foreign currency purchases by the Federal Reserve and the Exchange Stabilization Fund is long overdue. Congress should scrutinize the validity of the legal grounds on the basis of which the Federal Reserve intervenes in the foreign exchange market and provides warehousing facilities for the Treasury's foreign currencies.

### ***What is the Federal Reserve's Legal Authority to Intervene?***

Nothing in the Federal Reserve Act of 1913 and as amended authorizes foreign currency operations by the Federal Reserve System. Section 14(e), which empowers the Federal Reserve to maintain accounts with foreign correspondents, served as the legal justification in January 1962 for approval by the Federal Open Market Committee of a program of System foreign currency operations.

An opinion of the FOMC's General Counsel, concurred in by the General Counsel of the Treasury and the Attorney General of the United States, found that the Federal Reserve Banks under existing law were authorized to conduct such operations.

Two governors dissented. Governor Mitchell's dissent in part was based on the need for prior "legislative clarification of the System's statutory authority to acquire, hold, and sell foreign currency assets" (*Annual Report*, 1962, p. 56). Governor Robertson also questioned the legality of the proposed operations. In addition, he noted the "express intent of Congress to confer upon the Treasury's Exchange Stabilization Fund a limited authority for operations to stabilize the exchange value of the dollar." He saw no need for two separate agencies to be engaged in buying and selling foreign exchange.

Despite their dissent, at the FOMC meeting on February 13, 1962, the two governors voted affirmatively for the implementation of the decision of the majority in January to initiate "an experimental program of System foreign currency operations." The experiment has been in effect for 28 years, with dubious consequences noted below.

Congress should hold hearings to determine if Fed intervention is in the national interest. Should it so determine, Congress should specify in legislation the circumstances and amounts of permissible intervention, and appropriate the funds for intervention operations.

***What is the Legal Authority for Warehousing?***

Congress, in the Gold Reserve Act of 1934, gave the Treasury \$2 billion to establish the Exchange Stabilization Fund to deal in gold, foreign exchange, securities, and other credit instruments for the purpose of stabilizing the exchange value of the dollar. The original capital was reduced by \$1.8 billion, which became the U.S. subscription to the IMF in 1946-47.

In March 1961, with the Federal Reserve Bank of New York as its agent, the Treasury for the first time since the late 1930s entered into foreign exchange transactions for monetary purposes.

The first warehousing for the ESF occurred in November 1963, when the FOMC authorized spot purchases of \$100 million of Italian lire, and other European currencies, and their simultaneous forward sale to the Treasury to cover outstanding Treasury debt in these currencies. The operation was also described as an experiment, to be reconsidered by the FOMC as occasion warranted.

In January 1977, the FOMC agreed to a suggestion by the Treasury that the Federal Reserve undertake warehousing of foreign currencies on occasions when the resources of the ESF were inadequate. The amount was set at \$1½ billion, with a proviso that the FOMC at its organizational meeting each March would review the arrangement. In December 1978, the FOMC extended warehousing to the Treasury's General fund as well as the ESF. The Fed thus offered to lend its resources to the Treasury, bypassing Congressional appropriations. In March 1980 the FOMC decided that it was prepared to warehouse for the Treasury or for the ESF up to \$5 billion of foreign currencies, with the understanding that it would be subject to annual review. That understanding was observed for some years, but no annual review has occurred since 1986.

The total of warehoused funds for the ESF as of October 31, 1989, the latest report date, was \$7 billion, in excess of the ceiling established by the FOMC in 1980. Some members of the FOMC have expressed concern at the extent of warehousing, and urged the Treasury to seek Congressional approval of the amount currently on the books of the Federal Reserve.

Congress should determine whether warehousing for the ESF is permissible and, if so, whether it should be fully funded by the Treasury with the Fed acting only as the Treasury's agent, or with funds specifically appropriated by Congress.

### ***Recent Developments in Intervention***

The Federal Reserve and the Treasury increased their foreign currency holdings in the period from March 1989 until October 1989, the latest date on which the two authorities reported, continuing the intervention operations in the foreign exchange market that we noted in our last report.

Of the combined total of \$41.6 billion in foreign currencies owned by the authorities in October, the Federal Reserve held \$29 billion, an increase of \$18.5 billion since March. The Treasury's Exchange Stabilization Fund held \$12.6 billion, an increase of \$2.8 billion over its March holdings.

Purchases of foreign currencies by the authorities since October 1989, according to *International Financial Statistics*, raised the combined total to \$45.2 billion in January 1990.

The two most important foreign currencies the U.S. authorities have purchased are yen and D-marks. Despite these purchases, the dollar strengthened against the yen and was roughly unchanged against the D-mark. The monetary authorities are engaged in a speculation that yen and D-marks will appreciate in relation to the dollar. This gamble contradicts the monetary policy objective that Federal Reserve officials have repeatedly stated they seek, namely, achieving a zero inflation rate over a five-year period.

It is not possible to say at this time whether the gamble has achieved gains on foreign currency assets. The Federal Reserve and the Treasury report realized and unrealized profits (losses). Profits are realized only when purchases have been sold at a price higher than the currencies were bought. The Federal Reserve sold no foreign currencies in the three quarters ending October 31, 1989.

The unrealized portion of profits -- the change in the cumulative valuation profit -- is clearly subject to the choice of end-of-period exchange rate valuation. An unrealized gain reflects not only exchange rate change but also a change in the composition of the foreign currency portfolio.

In the three quarters ending October 31, 1989, the Federal Reserve reported one quarter in which the change in unrealized gains was negative, two quarters in which the change in unrealized gains was positive for a total of \$361.7 million.

Federal Reserve publications report Treasury realized and unrealized profits for quarterly dates covering months 2-4, 5-7, 8-10, and 11-1. For the first three of these quarters through October 1989, the Treasury had realized profits of \$196.9 million and change in unrealized profits of \$80.9 million. The ESF reports for calendar quarters. Its latest report for nine months from October 1, 1988, to June 30, 1989, records a loss on

foreign exchange of \$510 million with no detail on the realized and unrealized components.  
Who speaks for taxpayers when intervention risks losses?

Foreign currency purchases have changed the composition of the portfolio of the Federal Reserve banks. The Federal Reserve sterilizes its official intervention, reducing its open market operations in domestic assets to offset its acquisition of foreign currencies. The monetary base therefore is unchanged from what it would have been in the absence of intervention. Sterilized intervention does not change the national money supply. Non-sterilized intervention is monetary policy based on open market operations in foreign rather than domestic assets. It could just as well be conducted as domestic monetary policy.

In the seven months from March to October 1989, the monetary base grew by \$4 billion. During that period domestic interest-bearing securities held in the System Open Market account declined by \$11.6 billion. Accordingly, net income of the Federal Reserve Banks and the amount that they rebate to the Treasury has been reduced.

#### CORRECTION

The \$500 million loss on its foreign exchange market intervention in 1988 reported by the Federal Reserve was inaccurately described in our policy statement of September 18, 1989. The loss was a sum of a realized gain and an unrealized loss, not a realized loss only.

We withdraw our estimate of the loss sustained in its foreign exchange operations by the Fed in the year ending July 1989. The estimate is not verifiable.

Contrary to the statement, the Exchange Stabilization Fund reports profit or loss in the quarterly issues of the *Treasury Bulletin*.

**THE GERMAN DEMOCRATIC REPUBLIC: ECONOMIC GOALS,  
CONSTRAINTS AND MONETARY REFORM**

William POOLE  
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On 6 February, Chancellor Helmut Kohl of the Federal Republic of Germany (FRG) proposed unification of the East and West German currencies. This proposal generated immediate concern over the rate at which marks issued by the German Democratic Republic (GDR) would be exchanged for Deutsche marks (DM) and the implications of the proposal for inflation of goods prices quoted in DM. (Note that marks issued by the GDR are sometimes called "ostmarks," or "OM.") Later, on 13 March, Chancellor Kohl announced his intention to convert "small" personal holdings of OM by GDR residents to DM at a rate of 1 DM for 1 OM. "Small" was left undefined and the conversion rate for the rest of OM-denominated assets was left for future decision.

To analyze these developments, we need to sort out a number of separate issues, most of which are not monetary issues at all. I'll start with a list of essential points. To avoid awkward terminology, I will use "GDR" to refer to the territory presently governed by the GDR whether that territory continues to be governed separately or is governed as a part of a single Germany.

- (1) The GDR has issued currency and other financial assets denominated in its own currency. With monetary unification, there will be a wealth transfer from the FRG to holders of OM-denominated assets. The net size of that transfer will depend on the amount of the personal holdings of OM to be converted at the one-for-one exchange rate, the amount of non-personal holdings of OM, the exchange rate on the non-personal holdings, and on the value of the assets the GDR turns over to the FRG in conjunction with the currency unification. However, it is important to recognize that the exchange rate used to convert OM assets to DM assets has no necessary relation to the exchange rate used to convert goods prices from OM to DM for goods presently priced in OM. To avoid confusion, it is best to confine the term "exchange rate" to the rate or rates at which OM currency is exchanged for DM currency. Exchange rate issues arise for all deposits and other assets whose prices in terms of OM currency are fixed at 1.0. The central point is to distinguish between the conversion of OM financial assets to DM financial assets and the conversion of GDR goods and factor prices

to DM. These are two entirely different issues. (More on this point in item 4 below.)

- (2) The exchange rate has no necessary implication for the effect of currency unification on the size of the DM money stock. There is much unnecessary confusion on this issue. The FRG can pay for some or all OM assets converted to DM by issuing DM bonds either directly to holders of OM assets or by selling bonds in the open market to absorb DM created in the OM to DM exchange.
- (3) Pensions currently paid in OM have had a real value determined in part by GDR subsidies for food and housing. The exchange rate for converting OM currency to DM has no necessary implication on how pensions presently paid by the GDR in OM will or should be converted to pensions paid in DM.
- (4) As emphasized in item 2 above, currency unification has no necessary implication for the DM prices of goods and factor services (especially wages) currently stated in OM. Any attempt to convert prices of goods and factor services from OM to DM through central direction can only cause great difficulty. Prices in DM of GDR-produced goods and of factor services in the GDR must be free to adjust if the GDR economy is to be transformed to a market economy.
- (5) The cost to the FRG of merging the two Germanies will depend critically on whether the FRG continues its policy of making its social welfare benefits available to those who migrate from the GDR to the FRG. ("Merging," by the way, is a nice, neutral word that avoids the overtones and undertones of using "unification" versus "reunification" or vice versa.) If social welfare benefits remain available to GDR residents who migrate to the FRG, then there is no easy way to calculate the total cost to the FRG of converting GDR pensions and other benefits to DM at various rates. For example, if the conversion rate is low, so that benefits in the GDR are low, some people will simply move to the FRG and collect high FRG benefits. The total cost will then depend both on the DM value of benefits for GDR residents and on the number of GDR residents who migrate to the FRG. The cost to the FRG will also depend greatly on the disposition of property owned by the GDR government. It may make sense, for example, for the GDR to give the housing stock to current residents, or sell the housing stock to residents at low prices, and eliminate all housing subsidies at the same time.

- (6) The sharp increase in bond yields in the FRG in recent months, and especially since late January, probably reflects a mixture of higher inflation expectations and a higher expected real rate of interest. It is not implausible to believe that the higher nominal rate reflects higher inflation expectations and a higher real rate in roughly equal measure.

In the body of this memo I'll take up these points, although not precisely in the order listed above.

### *The Politics of Wealth Transfers*

As is so often the case with political issues, much of the discussion within the FRG and GDR concerning their merger involves issues of wealth transfers. Residents of the GDR quite naturally want to keep what they have, or think they have, and if at all possible to get more. Residents of the FRG quite naturally want to limit the size of their wealth transfer to GDR residents.

According to a recent article in *The New York Times*, personal savings accounts in OM in the GDR are worth about \$100 billion when converted to DM one-for-one and given the recent DM/\$ exchange rate.<sup>1</sup> That works out to about \$6,300 per capita for GDR residents or 1/2 to 2/3 of average annual income in the GDR. However, \$6,300 per capita is a gross figure; we do not yet know what assets the GDR will be turning over to the FRG as part of currency unification. A factor increasing the size of the transfer is that businesses now have an incentive to minimize their OM holdings and individuals may have an incentive to accumulate more. A recent article in *The Wall Street Journal* indicates that the exchange will be limited to "small savers," which presumably means that there will be a limit to the amount an individual can exchange at the one-for-one rate.<sup>2</sup> Chancellor Kohl has not been explicit enough about the currency exchange plan to know how the incentive for OM transfers from businesses to individuals might be affected. We do not know what the cap on exchanges at the one-for-one rate will be or what rate will be applied to holdings beyond the cap. The FRG may attempt to limit exchanges to holdings as of a particular date. Nor is it clear whether GDR residents who have migrated to the FRG retain title to their OM savings accounts. As with all multiple exchange rate schemes, there is a powerful incentive for individuals and enterprises to restructure balance sheets to maximize OM assets subject to exchange at a high DM rate.

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<sup>1</sup> Ferdinand Protzman, "Bonn Sets Mark Rate on Savings," March 14, 1990, p. D1.

<sup>2</sup> "Kohl Backs Rate of 1 to 1 for Some Mark Conversions," *The Wall Street Journal*, 14 March 1990, p. A15.

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Issues concerning conversion of OM assets to DM are one-shot in nature. A far larger issue concerns pensions, health benefits, and the like presently received by GDR residents. The present value of continuing these programs with unchanged real value is very large. We should not consider these programs to be "commitments" or "obligations;" there will have to be a negotiation over their future scale. It makes no sense to think about converting benefits presently denominated in OM to DM at some exchange rate chosen for converting existing financial assets. This issue of converting benefits, especially pension benefits, is complicated by the large subsidies for food and housing in the GDR. These subsidies will have to be eliminated. I will argue below that elimination of these subsidies is not really a policy issue because the GDR, whether merged with the FRG or not, does not have a genuine choice now that borders are open.

Finally, decisions on how to convert on-going benefits should take account of the fact that people can migrate from the GDR to the FRG. As a matter of economics, it would have been possible to wipe out the real value of OM financial assets by selecting a low DM conversion rate, and there would not have been anything GDR residents could do about it; their only recourse would have been through electoral processes. The issue with on-going future benefits is quite different because GDR residents can move to the FRG. I'll take up the important migration issue later.

The FRG has an election scheduled for December, and it is possible that the merger will take place quickly enough that GDR residents will vote in that election. The decision may depend in part on the outcome of the GDR election on 18 March. (This date was no doubt chosen to coincide with the SOMC meeting and to make this memo more difficult to write!) Even if the merger occurs after December, there does not seem to be much doubt that the event will occur within a few years. Political parties in the FRG are quite naturally positioning themselves to bid for votes in the GDR; this maneuvering, of course, had something to do with the timing of Chancellor Kohl's announcement of a one-for-one exchange rate. Much press commentary has argued that GDR voters are more likely to vote Social Democratic than Christian Democratic, and the conclusion of this analysis seems to be that the present FRG government is being pulled to the left, toward generous social welfare benefits for GDR residents. I am surprised that there is so little attention being paid, at least in the U.S press, to pressures working in the opposite direction. When FRG residents become fully aware of the large cost of converting OM assets to DM and of making FRG social welfare benefits available to GDR residents, it is surely inevitable that policies involving these large wealth transfers will lose some votes in the FRG. I have no idea how all this will work out, but am merely expressing mild surprise that the argument so far seems all one way.

***Constraints -- Migration and Arbitrage***

Perhaps the most difficult part of the wealth transfer issue concerns the fact that it is not feasible for the FRG to deny benefits to GDR residents and at the same time make benefits available to all FRG residents *including* migrants from the GDR. The border is open. The *only* way to maintain lower benefit levels for present GDR residents is to base benefits not on current place of residence but on place of residence as of, say, November 1989 when the Wall opened, or as of some other date. Whether such a policy is politically and administratively feasible I do not know, but it is clear that with an open border it is impossible to sustain a policy of large differences in benefits based on current place of residence.

Relative living standards in the GDR and FRG provide an indication of the incentive for migration from the former to the latter. The table at the top of the next page compares several consumption indicators for the two areas. Aggregate income statistics suggest that per capita income in the FRG is perhaps twice that of the GDR. The consumption indicators in the table do not allow for the quality differences. As an aside, we can see that the GDR government was very interested in communicating with households, as shown by the high fraction of households with TV sets, but not interested in having households communicate with each other, as shown by the small number of telephones.

Migration from the GDR to the FRG has been running at about 2,000 people per day, both before and after the demise of the GDR's communist government. At this rate, the country will be entirely depopulated in 22 years. We can be sure, of course, that this outcome will not come to pass, but the key to understanding the situation is to figure out what will keep people in the GDR. Merger of the two Germanies will not automatically solve the problem. The migration from the GDR to the FRG is a type of arbitrage. It seems safe to assume a continuing absence of political and physical barriers to this migration; a communist GDR could not keep its people in and it seems unlikely that the FRG would now erect physical barriers to try to keep these people out. However, because the migration is causing significant strains in the FRG -- housing is short and there are not enough jobs at the moment for all the migrants -- the FRG may well reduce or eliminate various benefits for migrants from the GDR. With regard to social welfare benefits, the issue is the incentive to migrate; this issue has nothing to do with the rate at which GDR benefits in OM are converted to DM per se but rather with the purchasing power of benefits in the GDR relative to those in the FRG. Even if existing GDR benefits were to be converted to DM at a rate of 1 OM = 1 DM, GDR benefits would be low compared with FRG benefits. We should not focus on the conversion rate but rather on the relative levels

Consumption Indicators, 1988 German Democratic Republic and Federal Republic of Germany		
	GDR	FRG
Percentage of Households owning:		
Motor car	52	97
Freezer	43	77
Television	96	98
Color television	52	94
Telephone	7 (1985)	98
Monthly rent (two bedroom apartment)	75 M	411 DM
Average living space per person (square meters)	27	36

Source: The Institute of International Finance, Inc., based on official FRG and GDR statistics.

of benefits in real terms and whether all residents of the FRG, including migrants whenever they might arrive, are eligible for FRG benefits.

Eliminating FRG government subsidies for migration will not eliminate the migration incentive for skilled people who have good employment opportunities in the West. An individual's standard of living in the GDR must approach the standard available to that same individual in the FRG or that person will move. Of course, migration decisions depend on more than a narrow comparison of income levels. People are often willing to remain in their home towns with friends and familiar surroundings even though a higher salary beckons elsewhere. Young people, though, are more footloose. The GDR cannot retain population in the long run by appealing only to old people. Individuals who might migrate must see living conditions, or expected future living conditions, in the GDR approach those in the FRG; differences comparable to those across various regions of the FRG might well remain, but these differences are small compared to the present gap in conditions between the two Germanies. As policies are announced it will be important to see how they affect expectations about the future.

The incentive to migrate is an important constraint on what policies the GDR, the FRG, or a merged entity can adopt. The longer the migration incentive issue is unresolved, the longer the migration will last and the larger it will be. There is no point in discussing what is "fair" and what is not; the simple fact is that people will move, like it or not, as long as the FRG maintains a policy that permits migrants to receive generous social welfare benefits. In short, migration is forcing quick decisions on merger of the two countries; a gradual step-by-step process spread over a period of years cannot work.

The principle of arbitrage is also the basis for understanding some of the price reform issues facing the two Germanies. As shown in the table, at a conversion rate of 1 M = 1 DM, housing is much cheaper in the GDR than in the FRG. The same is true of food. The GDR provides heavy subsidies for these goods. The subsidies will have to go, and go fast. Residents of both the FRG and Poland are crossing borders to buy food in the GDR. Others are working in the FRG while living in the GDR to take advantage of low rents. These arbitrage activities increase the total subsidy burden in the GDR and simultaneously reduce the tax base to support them.

It is important to recognize that migration and trade issues are especially closed linked for the FRG and GDR. There has been some talk of maintaining an "administrative border" between the two areas even after merger.<sup>3</sup> Part of the motivation for such a border could be protectionist -- to control sales of GDR output in EEC countries. There is no question that integrating the GDR economy into the EEC will upset some established trade relations, but protectionist policies would be very short-sighted. Those residents of the GDR who are potentially productive need the promise of rapid gains in income or they will move to the FRG to realize their potential. Rapid economic development in the GDR will not depress the EEC as a whole, but resources will have to be reallocated from EEC industries competing with GDR industries with a comparative advantage to other EEC industries supplying capital and other goods in which the GDR has a comparative disadvantage.

### ***Monetary Issues***

The official exchange rate of one-to-one clearly overvalues the OM. According to *The New York Times* article cited earlier (note 1), the free market rate was about 20 OM to 1 DM shortly after the Wall opened in November. More recently, the rate has been about 4 OM to 1 DM on speculation on the rate the FRG would select for the currency unification. Now

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<sup>3</sup> See Steven Prokesch, "Economic Border Urged Even After German Unity," *The New York Times*, March 14, 1990, p. A19.

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that the FRG has decided on a one-for-one exchange for some balances it will be important to complete the currency unification promptly. "Promptly" literally means next week or the week after. Speculation on the exchange rates to be used in the currency unification is likely to cause volatile fluctuations in the free market rate between the two currencies. Moreover, at this point, the GDR can finance anything it pleases, including food and housing subsidies, bonuses to workers and government officials, etc., by printing OM. The OM rate against the DM will be maintained at some level or other by speculation on the ultimate exchange rate. It is an untenable situation for the Bundesbank and for the FRG as a whole for the GDR to be able to increase the amount of the ultimate wealth transfer by printing OM without constraint.

Discussion of a one-for-one exchange touched off inflation fears when Chancellor Kohl first proposed currency unification in early February, and these fears surfaced anew when Kohl announced that the one-for-one rate had been decided. Some have argued that the DM money stock would rise substantially with such an exchange. I have already pointed out that there is no *necessary* connection between the exchange rate and the size of the increase in the DM money stock. What *is* true is that there will be an increase in the demand for DM when that currency becomes generally used in the GDR. It will be difficult to predict the size of the increase in the demand for DM and so difficult for the Bundesbank to estimate the proper size of the DM money stock after monetary unification.

It is also true that the FRG may be led, one way or another, to pay for some of the wealth transfer through inflation. Voters in the FRG may find the increases in real interest rates flowing from the wealth transfer so large that they apply political pressure on the Bundesbank to inflate in an effort to hold rates down. What this means, though, is that we should not form our views on the likely rate of inflation by making a mechanical calculation from the amount of OM to be converted to DM but instead analyze the size of the wealth transfer and its likely effects on real interest rates. As I have pointed out earlier, the conversion of financial assets is only a part of the total wealth transfer, and probably not the largest part.

As can be seen in Figure 1 on page 54, in recent months interest rates have increased very substantially in the FRG, especially since 6 February when Chancellor Kohl broached the idea of monetary unification.<sup>4</sup> As the figure also shows, Frankfurt stock prices (Commerzbank total share price index) have not fluctuated in a particularly pronounced fashion or direction. Nor has the DM behaved especially unusually on the foreign exchange markets. The DM appreciated from last summer to the beginning of this year -- the DM price of the U.S. dollar and the yen fell -- but the appreciation is unremarkable. In fact, over the most interesting period since early February when FRG bond yields rose very sharply, the exchange rate has been about unchanged and share prices have not shown any particular direction.

I have relied on my general feel for what is an "unusual" change in one of these series, but to check my intuition I constructed Figure 2 (page 55) showing the monthly bond yield since 1985.<sup>5</sup> The increase in FRG bond yields since last summer really is quite substantial given the recent history of this series.

We have a puzzle, then, in that German bond yields have risen sharply while share prices and exchange rate have not moved all that much. It is important, I think, to look for unusual changes in economic series in a situation such as this one; we do not want to fall into the trap of over-interpreting changes that are actually reasonably normal.

If the increase in the bond yield were caused primarily by an increase in inflation expectations, then the DM should have depreciated substantially. Share prices might also have weakened in these circumstances. But the DM appreciated from the summer to late January, and remained about unchanged over February. The inflation expectations interpretation of higher bond yields does not fit the data.

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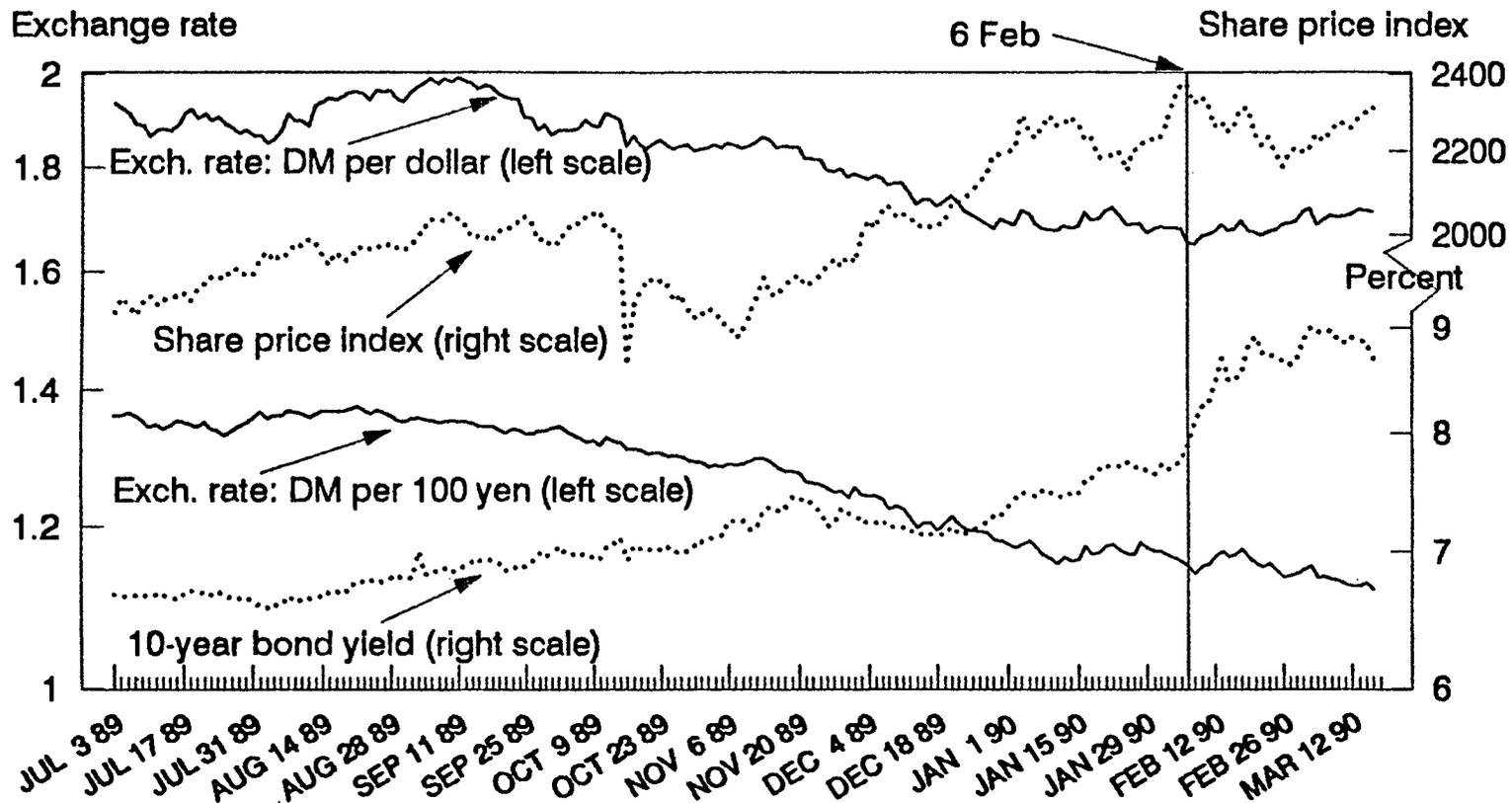
<sup>4</sup> The data in Figures 1 and 2 are drawn from the data bank maintained by Data Resources, Inc., and I want to thank DRI for providing me with access to the data. Commerzbank is the original source for the daily data in Figure 1. The exchange rates reflect Frankfurt trading as of 11:00 a.m. Frankfurt time; the bond yield is the 10-year constant maturity yield on German Government bonds; the share price index is the Commerzbank total index (31 December 1953 = 100). The Bundesbank and the Federal Reserve are the original sources for the monthly data in Figure 2; the FRG series is the average yield on Federal bonds, 10-year constant maturity, and the U.S. series is the average yield on Treasuries, 10-year constant maturity. The February observation for the FRG series was not available as of this writing; I have estimated it by adding to the January observation the increase from January to February in the monthly average of the daily Commerzbank bond yield series.

<sup>5</sup> For reasons I do not understand, the monthly FRG bond yield series in Figure 2 differs from the daily series in Figure 1, and so the levels do not match properly; however, I assume that the two bond yield series must have very similar fluctuations even if their levels differ.

# FIGURE 1

## FEDERAL REPUBLIC OF GERMANY

### FINANCIAL MARKETS, DAILY, 3 JULY 1989 -- 16 MARCH 1990



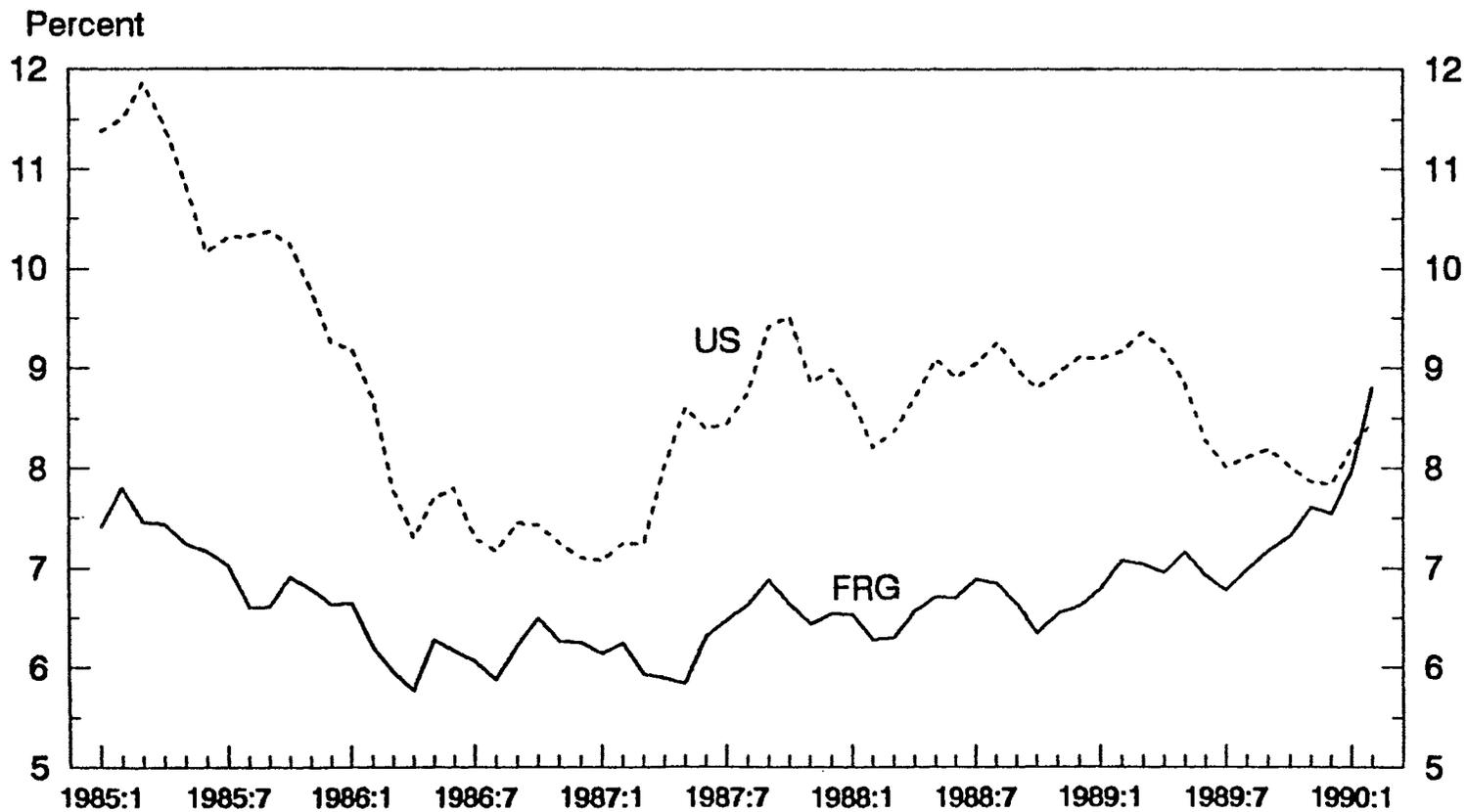
Source: Data Resources, Inc.

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**FIGURE 2**  
**FEDERAL REPUBLIC OF GERMANY AND UNITED STATES**  
**10-YEAR BOND RATES, MONTHLY, JAN. 1985 TO FEB. 1990**

55



Source: Data Resources, Inc.

Shadow Open Market Committee

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If the increase in the bond yield were caused primarily by an increase in the expected real rate of return, then the DM should have appreciated substantially, and perhaps we might have expected share prices to rise. (The implications for share prices are actually rather complicated.) The DM did appreciate somewhat from the summer to February, but changed little during February when bond yields rose especially sharply.

A hypothesis consistent with these observations is that inflation expectations and the expected real rate of interest have both gone up, contributing about equally to the increase in the nominal bond yield. This hypothesis is consistent with the modest increase in bond yields in the United States in recent months, which might reasonably be interpreted as reflecting an increase in the expected real rate of interest for the world as a whole. Given that international capital markets are highly integrated, changes in the real rate of interest in Eastern Europe could not be confined to that area, or simply to Europe as a whole.

If this interpretation is correct, an interesting implication is that the financial markets expect that there really will be significant investment opportunities in Eastern Europe. This view is consistent with the numerous reports of negotiations on joint ventures between Eastern Europe and western firms. There would be no reason for yields to rise in the world's capital markets if investors thought very little capital would be flowing to Eastern Europe.

The real significance of monetary unification in Germany is that monetary and fiscal conditions will be important determinants of flows of labor and capital into or out of the GDR and other Eastern European countries as well. The GDR has a tremendous advantage over the other countries in this respect. The DM is one of the world's most trusted currencies. When the GDR converts to the DM, capital can flow without fear of gross monetary instability. Moreover, once the government of the GDR has lost the power to print money, it will be forced to put its fiscal affairs in order. The GDR will have to cut its subsidies to cut total expenditures and will have a powerful incentive to sell property to gain revenues. These privatization steps need to be taken in any event, but experience suggests that those with vested interests in subsidies and state ownership will resist privatization, covering government expenditures by printing money if need be.

### ***Goals and Policies***

Dispassionate recognition of constraints can be important in setting sensible goals. Assuming that Eastern European countries do indeed want to become as prosperous as Western European countries, they will have to adjust their convictions on the benefits of socialism to the constraints they face. To retain skilled people who have opportunities to migrate, the countries of Eastern Europe simply must permit these people to realize

earnings approaching those in the West. After-tax earnings comparable to those in the West should be permitted but not subsidized in the private sector; those enjoying the earnings must actually earn them and accept the private sector risks that go with high salaries. To attract capital, these countries must establish conditions conducive to private capital flows from the West. Whatever views these countries may have on issues such as income distribution and pricing of necessities, they must face the constraints imposed by conditions in the prosperous economies of the West.

One of the most interesting things to watch will be the skill of political leadership in Eastern Europe in making capitalist rewards palatable. People in these countries were pleased to be rid of totalitarian governments, but many still retain allegiance to socialist goals concerning income distribution and state ownership of the means of production. Economic growth will depend importantly on how Eastern European countries adapt to the competitive world environment within which they are constrained to operate.

When talking of economic goals it is important to remember that people have different goals that often conflict with one another. Of special importance in the present context is the fact that existing bureaucracies have strong vested interests in state ownership. Maintaining state ownership of most enterprises is simply incompatible with rapid economic development.

There is considerable discussion of the need for Western governments to make large development grants to help Eastern European countries transform their economies to market systems. The United States and Western Europe obviously have a very substantial stake in the success of Eastern Europe. Moreover, there are genuine and deep charitable instincts in the West; we want Eastern Europe and the U.S.S.R. to succeed for the sake of the residents of these countries and not just for our own sake.

In my opinion, it is important for Western governments to go slow in providing aid. Eastern European countries cannot be successful unless they adopt market systems open to private investment from their own citizens and from the West. The danger in government-to-government aid is that such aid will support efforts by these countries to pursue some "middle way" that does not in fact provide sufficient private ownership and incentives. As I noted above, there are powerful vested interests in state ownership and subsidies. Western governments should not, in my view, provide any unrestricted aid whatsoever, but only aid for particular infrastructure projects such as highways and airports. We should do nothing that provides any material resources that might be used to sustain state subsidies and state ownership of productive facilities, except for infrastructure. Even infrastructure aid should be conditional on the recipient country being open to foreign investment on a competitive basis. We do not want to encourage or

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sanction exclusive arrangements with foreign firms that permit them to monopolize local markets.

This discussion has emphasized constraints, but that is not the proper concluding note. The opportunities in Eastern Europe are tremendous. The populations are literate and generally skilled. With proper economic organization -- a market system -- these economies can produce far more than they are now producing. This is the "freedom dividend;" it is far larger than the peace dividend available to the West. With the end of the Cold War Western economies might be able to spend 2-3 percent of GNP less on arms, and so have that much more to improve standards of living. In Eastern Europe, production increases of 10-20 percent or more are possible within a few years. There is ample bounty to be shared by domestic populations and foreign investors alike.