SHADOW OPEN MARKET COMMITTEE (SOMC)

Policy Statement and Position Papers

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SHADOW OPEN MARKET COMMITTEE

The Shadow Open Market Committee met on Sunday, March 7, 1993 from 2:00 PM to 6:00 PM in Washington, D.C.

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SOMC POLICY STATEMENT SUMMARY

Washington, March 8—The Shadow Open Market Committee expressed disappointment at the administration's fiscal program and criticized Congressional proposals to change the structure of the Federal Reserve. It called for the rapid approval of a GATT agreement.

The Committee called the $30 billion short-term fiscal stimulus "unnecessary." The economy is growing at a healthy rate and is experiencing the best productivity growth in 20 years.

The long-term package is misguided, the Committee said. "Despite the rhetoric of growth, consumption is favored over investment." Long-term productivity growth and standards of living will not be increased.

Fiscal policy is most effective if used to increase long-term growth. To increase growth, 1) cancel the tax increase on corporate income, 2) tax spending instead of income saving, 3) reduce spending on entitlements and 4) reduce regulation. The administration's heavy reliance on tax increases will slow the economy. The current momentum is strong, however, the Committee said.

The Shadow Open Market Committee (SOMC) meets in March and September. The March 1993 meeting is the 40th meeting.

The SOMC warns that the present low rate of inflation will not remain if the inflationists in Congress succeed in their efforts to reduce the independence of the Federal Reserve. Pressures from Congress make the Federal Reserve less willing to act promptly against a return of inflation.

The Federal Reserve increases the risk of higher inflation by basing its actions on changes in the unemployment rate. This measure is a lagging indicator of the momentum in the economy.

The Federal Reserve should tighten policy slightly by returned growth of the monetary base to 8 percent in 1993. This would lock in the past gains against inflation and contribute to a sustained expansion, the SOMC said.

Immediate approval of the GATT agreement will sustain expansion of trade. The administration currently has no coherent trade policy. It leans in a protectionist direction that encourages interest groups to demand special favors. This will harm the U.S. and world economy if it continues.

SHADOW OPEN MARKET COMMITTEE
Policy Statement
March 8, 1993

Once again output is rising and the economy is on a path toward higher growth. Inflation is low. Unfortunately, the administration has chosen a program that will not increase growth of output and productivity. Taxes will rise, and spending will continue to rise. Additional tax increases will be required by the health reform program. Expectations will be depressed by mandated increases in production costs.

Voters who wanted a change should be disappointed. The new policies of the administration return to the past. Tax rates will rise, spending for redistribution will increase. Despite the rhetoric of growth, consumption is favored over investment, and Members of Congress have tried to neutralize the Federal Reserve as an effective force against a rise in inflation.

The administration speaks with many voices on international trade. U.S. leadership toward a freer more competitive trade policy is threatened. The U.S. should move now to accept the GATT agreement as it stands and complete the current negotiations promptly.

THE CLINTON PLAN

The new administration describes its program as combining short-term stimulus to employment with long-term growth and deficit reduction. President Clinton often says that no one before has tried to reduce the budget deficit while expanding the economy.

His statement is false. On many previous occasions, growth rose while the budget deficit fell. Growth raises incomes and revenues. If government spending is controlled, the deficit inevitably shrinks. Productivity and living standards can rise while the deficit shrinks if government encourages investment and restricts government and private spending for consumption.

President Clinton's plan does not take this course. Government spending for consumption and redistribution would increase. The projected Health and Human Services budget rises by $200 billion in the four years ending in 1997. Total government spending is not reduced, as so often claimed. The President's plan increases total spending 3.2 percent a year or $202 billion in four years, after a $93 billion increase in fiscal 1993. Taxes fall most heavily on corporate and private saving and on private capital.

Despite $126 billion planned reduction in defense spending in the next four years by Presidents Bush and Clinton and $280 billion of tax increases, the structural budget deficit falls only $140 billion in four years. The structural deficit remains above $200 billion in 1997. The share of output spent by government is a better measure of the role of government. This measure falls insignificantly under the President's program.

The program will not achieve its goals. Much of the deficit reduction is confined to later years and depends on spending cuts and program terminations that Congress has rejected many times. Tax increases will slow the economy, so tax receipts will be lower than projected. Already the market for tax exempt bonds is booming. And the Clinton plan brings back tax incentives —soon to be called loopholes—for investment in low income housing and certain types of mortgages.

Experience in many countries shows that deficits have grown despite large tax increases. Chart 1 shows that deficits typically have increased when taxes (government receipts) increased. There is no systematic relation between the magnitude of the tax increase and the magnitude of the change in the government deficit.

The focus of fiscal policy should be on resource use, not deficits. Fiscal policy affects resource use by shifting resources between the public and private sectors and between consumption and investment spending. The Clinton program talks about the desirability of more investment, but does not shift resources toward investment. The administration counts as investment the following additions to spending: $9 billion for food stamps, $9 1/2 billion for AIDS and women's health, $2 1/2 billion for low-income housing, $6 billion for "national service," $2 billion for temporary, summer jobs, $3 billion for community development, and $20 billion to raise the income of the working poor.

Some of these expenditures may be useful. Some will be wasteful. None of the $50 billion mentioned above will contribute much to the increase in knowledge, training, and physical capital that is properly called investment.

Short-term stimulus is unnecessary. The short-term program to create "jobs," like the investment program, includes spending that is unrelated to its objective. Extending unemployment compensation costs $5.6 billion but does not create employment and does not improve skills. Neither does additional spending for AIDS, modernization of tax collection, or inoculation against measles. Temporary investment tax credits change the timing of investment but do not permanently increase investment, productivity and living standards. Temporary changes of this kind increase variability and uncertainty.

The administration claims it will create 500,000 new jobs. Its numbers show that if the proposal was not adopted, the unemployment rate would fall to 6.6 percent in 1994 and 5.8 percent in 1997. The claim that under its program, the unemployment rate would be 6.4 percent in 1994 and 5.7 percent in 1997, achieves a decline of only one or two tenths of a percent. The differences are about 260,000 and 130,000 jobs in an economy that created 1.6 million new jobs in 1992 according to the household survey.

The economy grew 4 percent in the second half of 1992, and the momentum continues. Productivity growth in 1992, 3 percent from 4th quarter 1991 to 4th quarter 1992, was the highest in twenty years. Despite the cutbacks in defense spending, most of the unemployed find new jobs within a few months. Unemployment lasting six months or more has been lower as a percentage of total unemployment than in any major country.

We urge the Congress and the administration to recognize that fiscal policy is most effective if used to meet long-term objectives. They should 1) discard the short-term stimulus package, 2) cancel the tax increases on corporate income, 3) substitute a tax on consumed income (spending) for the current income tax, 4) reduce spending on entitlements and 5) reduce regulation. We believe that this proposed package would do more than the administration's program to increase productivity and standards of living and create better jobs at higher incomes. This program would shift spending from public and private consumption toward productive investment.

TRADE POLICY

The administration should accept the current draft of the Uruguay Round of the GATT negotiations. Substantial reductions in trade barriers have been achieved and significant expansion of trade will result. Issues which remain unresolved should be addressed in a subsequent round of negotiations.

MONETARY POLICY AND INFLATION

Inflation has at least been brought near the zone of price stability. Long-term interest rates are back to levels not seen during expansions since the 1960s. If the Federal Reserve continues to encourage non-inflationary growth, the economy can achieve sustained expansion with high employment. This will encourage long-term investment and productivity.

In the last three decades many financial market commentators have become so accustomed to alternating periods of stop and go monetary policy that they believe that economic expansion necessarily brings inflation. This view is false. We can have expansion without inflation if monetary policy is set now to achieve medium-term price stability. A policy of this kind encourages long-term growth and productivity increasing investment. Unfortunately, we seem likely to repeat the fiscal and monetary mistakes of the 1970s.

Chart 2 shows the recent swings in Federal Reserve actions—measured by the annual growth rate of the domestic monetary base—and the growth of spending, nominal GDP. The domestic base excludes currency held abroad.

In the years since 1985, changes in the growth of spending have followed changes in the growth of the domestic base with a six quarter lag. Slower growth of the domestic base in 1988-90 contributed to slower growth of GDP in 1990-91. During the recession, growth of the domestic base increased, followed by growth of spending.

Recent growth of the domestic base is consistent with growth of nominal GDP of about 7 percent. In fourth quarter 1992, nominal GDP rose 7.1 percent. If monetary expansion continues at recent rates, inflation is likely to rise toward 4 percent by 1994.

We believe growth of the domestic base should be reduced in 1993. To achieve this reduction, growth of the reported base (as published including foreign holdings of currency) should be reduced to about an 8 percent annual rate. The Federal Reserve should measure the domestic monetary base and release this information to the public.

We have little confidence that the Federal Reserve will adopt the policy we recommend for two reasons. First, the Federal Reserve now bases its actions on changes in the real economy, particularly changes in the unemployment rate. This procedure ensures that the Federal Reserve will fail to act in a timely way to prevent a rise in inflation. Second, the Congress encourages delay. The inflationists in Congress, led by Senator Sarbanes, have introduced legislation to make the Federal Reserve less independent and, therefore, less willing to control inflation promptly.

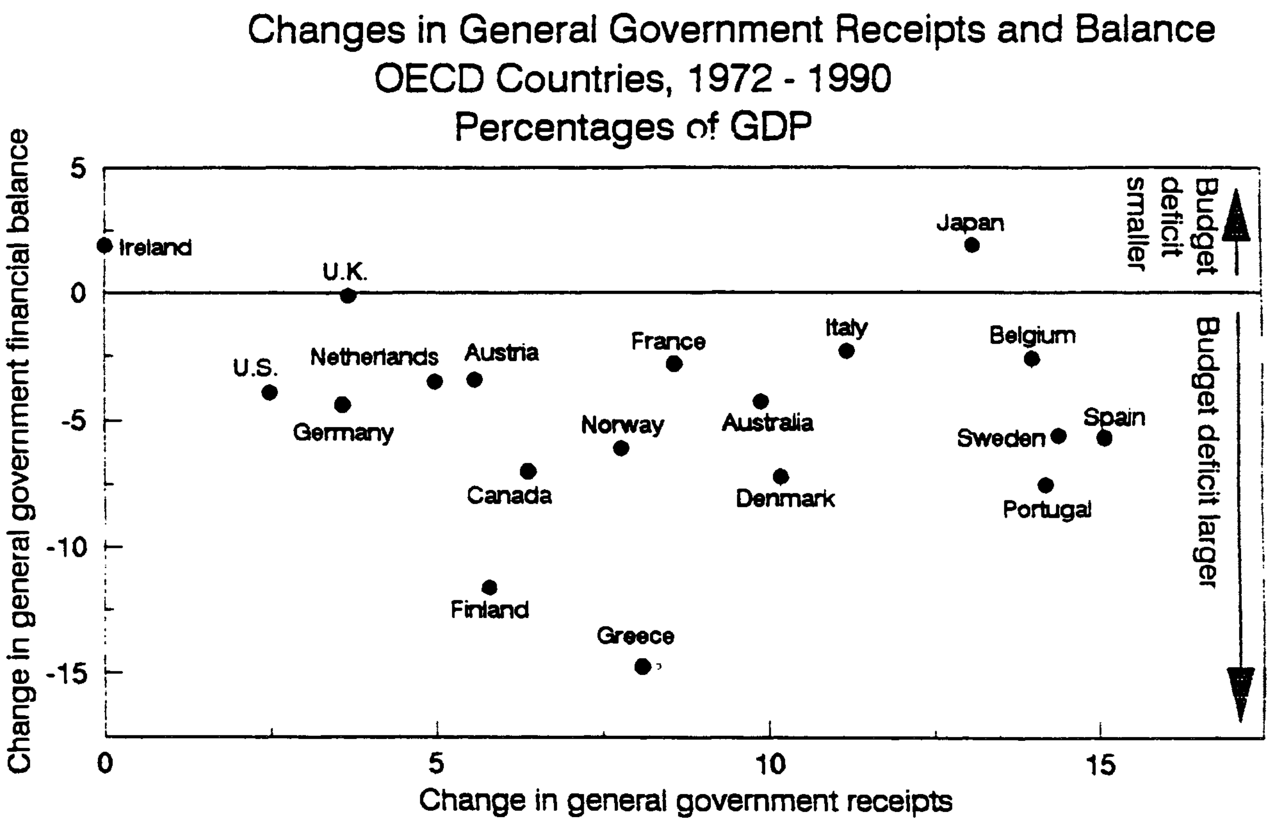
The proposed legislation confuses independence and accountability. Congress and the administration should require greater accountability. They should assign to the Federal Reserve responsibility for maintaining price stability and require the resignation of the members of the Federal Open Market Committee if this objective is not met.

Since 1981, we have urged increased accountability for an independent Federal Reserve. Under our proposal, the Federal Reserve would announce an annual target for money growth. The Federal Reserve would remain independent but would have to choose a single target and specify its rate of growth. If the rate of growth was not achieved, the FOMC members would offer their resignations and an explanation of the reasons for missing the target. The President could accept the explanation or the resignation. A modified version of this proposal, substituting a 2 percent inflation in place of money growth, has been adopted in New Zealand where it has worked successfully.

We congratulate the Federal Reserve and the Treasury on ending the warehousing of foreign currency. The next step should be elimination of authority to "warehouse." Nevertheless, intervention in foreign currency market continues and, with the appreciation of the dollar, exposes the public to the risk of substantial currency losses on the authorities' portfolios.

Should taxpayers pay higher taxes so that monetary authorities can speculate on currency values in the name of policy coordination?

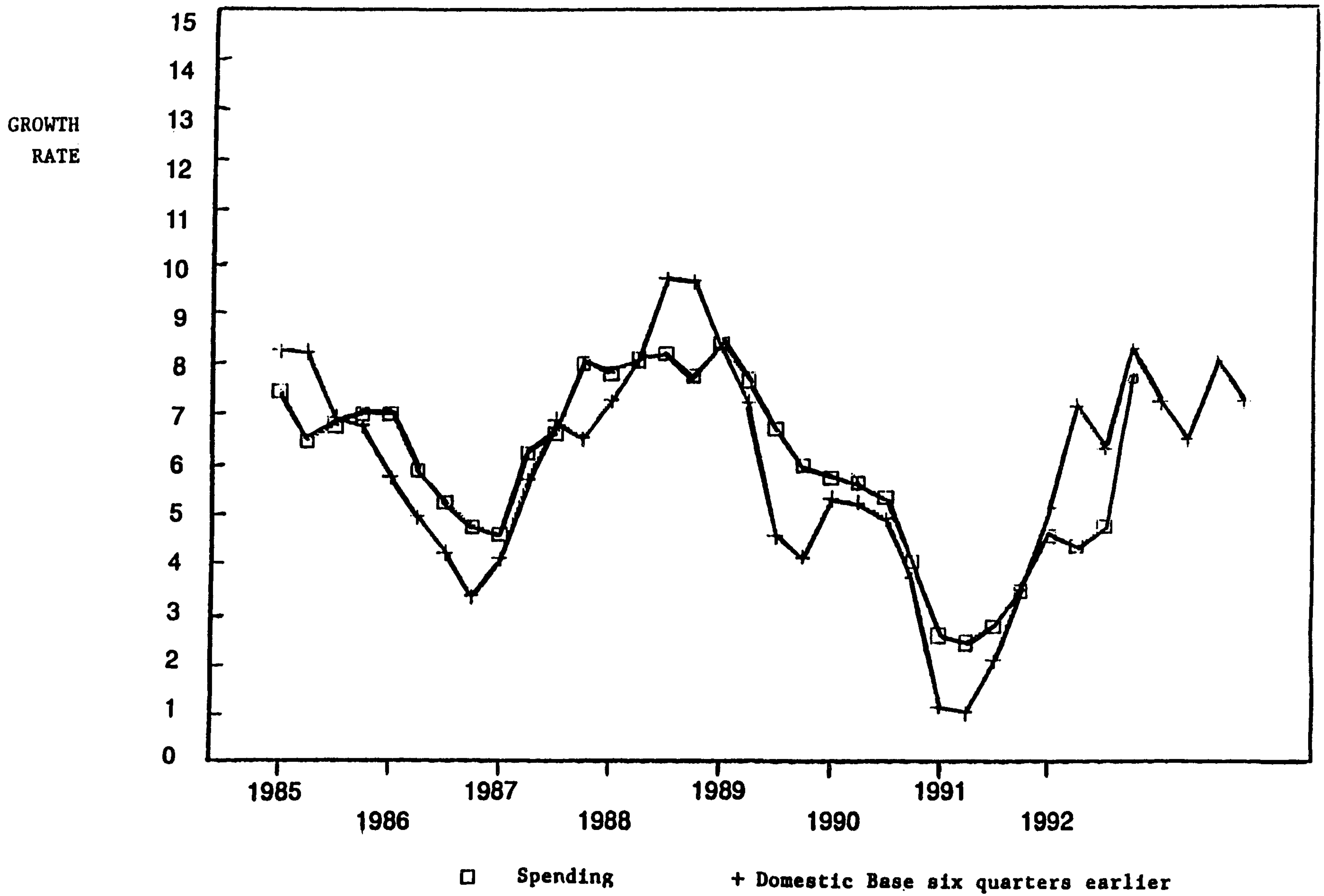
CHART 1



Source: OECD Economic Outlook 1992, Tables R14, R16

Chart 2

GROWTH RATE OF SPENDING AND DOMESTIC MONETARY BASE (GDP)



THE URUGUAY ROUND AND FREE TRADE AREAS

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President Clinton faces two immediate questions of high policy in regard to trade questions:

i) the position to take on the Uruguay Round's completion; and

ii) on the broad question of Free Trade Areas such as NAFTA, where the Clinton-Gore team has already endorsed NAFTA itself subject to further negotiated understandings on environment and labor issues and where the Congress can be reasonably expected to sign on, whether to:

   a) terminate the process of getting more FTAs signed; or

   b) carry on the process with more FTAs being signed only with South America, as was the U.S. policy under the Enterprise for Americas initiative until President Bush's Detroit speech in the campaign; or

   c) proceed with FTAs on a worldwide basis, as promised in the Bush speech, extending them immediately to Eastern European countries, countries of East Asia and indeed everywhere.

THE URUGUAY ROUND

Uruguay Round: Reasons Favoring Conclusion

There are several reasons to conclude this Round, as substantially negotiated to date:

Gains from Success:

1. Economic Benefits:

i) There are the much-advertised gains from expanded trade. The figures bandied about is $200 billion worth of added trade, with associated gains from this trade being a fraction of this number, of course. The numbers are somewhat ballooned up and such numbers are in any case not as hard as they appear to the untrained eye. But the *direction of change* is clear: there will certainly be a significant expansion of trade and associated gains.

ii) The Round's success also translates in political language into jobs. More important, it would spur added investment, just as Europe 1992 stimulated Europe out of its pessimism into more investment. For both reasons, the Round's early success is critical to our and other OECD countries' efforts to escape more assuredly from the global recession.

2. *Political Benefits:*

i) In political terms, each country looks at the political costs of adjustment to imports, thus attaching greater value to concessions gained than to concessions given. (Economists value exports and imports equally, on the other hand, as long as they are a product of appropriate policy design which, President Clinton should note, *excludes* managed or "results-oriented" trade.) By this political criterion, we are almost in a win-win position on the Round: we have gained a great number of concessions (in intellectual property, in services, and in the grain agreement with the EC: all areas where we have major export gains) and made big import concessions mainly in textiles (by agreeing to a 10-year phaseout of the Multi-fibre Agreement, a blot on the trade scene, but then too on a schedule which is end-loaded, sparing us adjustment costs in the early years). For us to turn away from such an *unbalanced trade bargain in our favor*, simply because each lobby wants more and more, would be foolish.

3. *Triumph of Rule of Law:*

The Round also strengthens the Dispute Settlement mechanism and thus helps us, and others, enforce their trading rights without disruptive threats and skirmishes, replacing the law of the jungle with the rule of law. Thus, in the recent oilseeds dispute, the fact that two *impartial* GATT Panels had found in our favor meant that Mrs. Hills could isolate France effectively within the EC with her threat (which carried far more moral force than if we had *unilaterally* decided that the EC was in violation of our trading rights). Again, under the reform included in the Dunkel Draft of the Round agreement, the EC could not have vetoed at the Council the verdict of the second Panel which found in our favor. With these reforms, *everyone* would have to agree to overturn a Panel finding for it not be binding.

Costs of Failure:

i) The costs of failure include, of course, the foregone gains from success.

ii) But there would also be sins of commission. Two may be highlighted.

   a) If the Round fails, even the MacSharry reforms of the EC's CAP policy in agriculture, and the resulting liberalization of trade, will slide back. We will not be able to sit back but will be retaliating, as President Bush began to do during the campaign, with our own export subsidies. The subsidy war will be on third markets' turf in many cases, angering our friends in Australia (recall the strong farmer demonstrations against President Bush), Argentinaand others. It will also bust our budget further.

   b) With the failure inevitably attributed to the "intransigency" of the EC and others abroad, and changed therefore in the political lexicon to their "unfair trade" and "closed markets," one can bet that both the Congress and the administration will find it ever harder to fight off protectionist demands and to silence those who wish to indulge in unilateral aggression such as through Super 301 and 301 actions. Ms. Laura Tyson is already a proponent of such universally-condemned measures; few would be able to dissent effectively from her if the Round is killed and the GATT wounded.

Finishing the Uruguay Round

Unfortunately, the Clinton administration failed to close the Round before March 2nd, requiring, therefore, a renewal of fast track authority. This opens the Round to renewed pressures from special interests which want even more concessions and which, therefore, will work through Congress to attach riders to the renewal of the fast-track authority.

Since the better option of standing up to special interests and to close the Round was not taken, whether willfully or because the Clinton Administration could not get its act together, one must judge this as an important failure of the new administration in trade policy. While the administration's likely request now for renewal of the fast-track authority will probably be sold as a sign of the administration's commitment to multilateralism, this claim would hardly be persuasive. For, having failed to finish the Round before a renewal of the fast-track authority became inevitable, we now face only two options: *either* ask to renew the fast-track authority *or* not ask for it. Surely the latter would be a crazy option to prefer.

It is probable that the Administration itself will want to satisfy the special interests instead of standing up to them: all actions so far, such as the threat to leave the procurement code at the GATT, speak to the Administration's desire to accommodate demands from domestic industrial lobbies. So do the Clinton campaign's promise, the President's chief economic adviser's writings, and the demands in Congress, for revival of the now lapsed Super 301 legislation that strengthens our capacity and willingness to indulge in aggressive unilateralism in trade.

The danger is that, as the new administration accommodates more such demands and policies, hoping to extract more concessions from other nations even as we already have a heavily-unbalanced bargain in our favor, the delicate balance of interests in the "Dunkel draft" (now before us in Geneva for signing to conclude the Round) will unravel. The "fine-tuning" that the Clinton administration presumably wants, in walking to the edge, is dangerous and misjudges badly the increasing sense abroad that the U.S. trade policy is getting captured by special interests and turning myopic. Excessive demands will precipitate, not more concessions, but disintegration of the Round.

Lobbies and Further Negotiations

To close the deal, the Clinton administration will then have to confront the lobbies and tell them; enough is enough.

To do this more effectively, it is important that the lobbies understand that the closing of this Round is not the end of negotiations, that "unfinished business" will continue to be negotiated. The modalities by which this can be done are essentially twofold:

Option 1: Declare a new Round as you close this one. Specify the main issues you will want included in the new Round. The main items of interest will include two areas for sure: competition policy and the need to reconcile the needs of the two great issues of our time: trade and the environment. The President will need to assure the environmentalists, who discovered the GATT only recently, that their misgivings will need extensive negotiations among the trading nations; that they can indeed be addressed satisfactorily in the next Round; and that holding up the current one is simply a spoiler's option.

Option 2: Instead of a new Round, negotiate each area by itself, having open-ended, continuous negotiations much like Mao Tse-tung's "permanent revolution!"

The former option seems preferable, since tradeoffs across issues typically play an important role in advancing the removal of trade barriers. Such tradeoffs are evident in the Uruguay Round itself: EC's agricultural concessions are helping the acceptance by developing countries of our demands in services and intellectual property protection, for example.

BEYOND THE NAFTA ON FTAs VIS-A-VIS MULTILATERALISM

Finally, the three options listed at the outset must be confronted by President Clinton. Of these, Option 1 makes the most sense for reasons sketched below.

In Option 1, we terminate FTAs at Mexico. This means that we concentrate on multilateralism as above, putting our weight wholly and exclusively behind it as we did until 1982.

The main argument for returning to our nondiscriminatory ways in trade and stopping at Mexico with NAFTA, is that we began the U.S.-Canada Free Trade Agreement really because we could not get the EC to agree to starting a new Round in 1982. By threatening "exit," we served notice that only a new Round which would bring the GATT up-to-date with new issues and disciplines would make us return to "loyalty." Well, we *did* manage to jump-start the Uruguay Round and now, with the Round closing, we have jump-started the multilateral process too. Why then proceed with discriminatory trade arrangements any further?

The FTAs approach confined to the Americas, in Option 2, has the further demerit of creating an acute *sense* that we are fragmenting the world economy into another trading bloc, thereby encouraging the creation of a "defensive" Asian bloc centered on Japan, where there is currently none but surely will be, and thus *actually* fragmenting the world economy. This is certainly a deleterious outcome, undermining the GATT process which is now working well. (The GATT-is-dead or GATT-should-be-killed school of economics fails to understand that the FTA approach is no more fast and efficient in reducing barriers than the GATT process. After 35 years since the 1957 Treaty of Rome, the EC is still to dismantle all barriers; the NAFTA involving only three countries has taken a decade to reach its current accord, whereas the Uruguay Round involving 108 countries and a whole slew of issues has only just begun to enter its seventh year and will soon settle! But facts and logic yield to gung-ho regionalism at times.

The problem about the Enterprise for Americas Initiative is that it was mixed up with the FTAs approach by the Treasury and then the State Department under Secretary Baker. Given the hazard it poses to the progress of the multilateral nondiscriminatory trading regime, now well under way, it is time to delink that initiative from FTA offers and to return to the several *other* instruments of aid and solidarity with these new democracies, just as President Kennedy's Alliance for Progress offered in his time (when preferential trading arrangements were most certainly *not* part of the Kennedy initiative).

If President Clinton accepts this argument, then we must stop FTAs at Mexico, deny one to Chile on grounds of high (trade) policy, reaffirm *other* aspects of an initiative for the Americas that do not undermine the multilateral system and its evolution through bloc-formation, and also call off the search for new FTA partners elsewhere, as in Option 3.

Even Option 3, which opens up our FTAs on a worldwide basis to Taiwan, Korea, Eastern Europe, etc, will inevitably (in practice) turn the world into trading blocs. Countries such as India, Pakistan, Egypt, Kenya, Ghana, etc. many of which are turning to outward orientation see themselves as effectively being marginalized by our FTAs policy, since they have no real option to join either the EC or the Japan-centered bloc or our NAFTA, no matter what openendedness we announce. Would the Congress really to able to deliver on an FTA with India, for instance?

Talk is cheap; action will be difficult and improbable. The outcome will in reality be all kinds of world-economy-fragmenting, preferential alliances. Ironically, this would happen just when in fact our leadership at the GATT, and for the GATT, offers the promise of bringing to fruition the efforts of Cordell Hull, Douglas Dillon, President Kennedy and countless others who correctly worked for an open, multilateral trading system.

President Clinton must make his choices soon, before the die is cast with FTAs with Chile, already at the edge, and with Taiwan, eager to explore with us the same possibility.

FEDERAL RESERVE INDEPENDENCE AND ACCOUNTABILITY

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Once again, the Federal Reserve is under attack from lawmakers who propose measures designed to increase the accountability of monetary policymakers while preserving the independence of the institution. Legislation that is currently the subject of debate on Capitol Hill would either remove the voting power of District Reserve Bank presidents or require that they be appointed by the President of the United States and confirmed by the Senate. These efforts (well-intentioned or not) to improve the process of making monetary policy cannot possibly improve the substance of policy, because they do not address the central shortcoming of the present framework: the absence of a single, clear, measurable, and attainable objective for monetary policy. Instead, the political leadership focuses on a mix of objectives that no central bank can deliver. While providing a convenient scapegoat for politicians and protective cover for central bankers, the existence of multiple objectives that vary in importance over time precludes the intentional and lasting achievement of any objective. In particular, price stability and the benefits that accompany it are lost in the process. Price stability should be the dominant objective of monetary policy because it promotes an environment conducive to achieving the highest standard of living that our endowment of real resources and human capital will permit. Federal Reserve independence and accountability are essential to achieving this objective.

Most politicians confuse the notions of independence and accountability, and by doing so blur the debate over central bank reform. As typically used, the phrase "independent but accountable" is meant to imply that monetary policymakers should be insulated from political pressures, yet not allowed free reign. In the most general sense, however, independence and accountability cannot coexist because one cannot be simultaneously "autonomous" and "answerable." Experience over time and around the world illustrates the importance for central banks of insulation from political pressures. Yet at the same time, there remains the dilemma that no public policymaker—however selected—should enjoy complete autonomy.

The answer is to give central bankers freedom of *action* (independence) in the pursuit of a single, clear, measurable, and attainable objective, while making them answerable (accountable) for the *results* of their actions. Independence in pursuing a stated objective—that is, the freedom of action—insulates the institution from political pressures for policies that could impede achievement of the objective. In this context, independence avoids the pitfalls of policy rules that, however flexible and well grounded initially, could become outmoded or under some unforeseen circumstances become destabilizing forces. In contrast, independent policymakers have the freedom to adapt, as markets evolve and our understanding of the economy grows, and implement the most effective methods of achieving the stated objective.

But freedom to act without undue interference is not enough. The Federal Reserve has been one of the most autonomous central banks in the world during the postwar period, yet its performance on occasion has been disastrous—witness the one-third contraction in money in the early 1930s and the fourfold increase in the price level since 1950. In addition to having independence of action, central bankers must be held accountable for the results of their actions. Ideally, central bank policymakers themselves should be held accountable for achieving the policy objective. The Reserve Bank of New Zealand is a good example. The responsibility for achieving an inflation rate of between zero and two percent rests solely with the Governor, who is appointed to a five-year term by the Minister of Finance. The only other explicit charge is to ensure the soundness of the financial system. If the target is not met, the Governor may be removed by the Minister. Concerns over the personalities or politics of central bank officials and the dangers of discretion in policy formulation melt away under a system that combines accountability for specific results with the independence necessary to achieve them. In such a world, the process used to select individual policymakers is important only with respect to its success in attracting and retaining the most skilled individuals.

It is unlikely that recent reform initiatives would improve the current process in the United States. The Federal Reserve Accountability Act of 1993, H.R. 28, introduced in the House on January 5, 1993 would require that the presidents of the Reserve Banks be appointed by the President of the United States and confirmed by the Senate. The Act further instructs the President to include among those candidates representatives of agriculture, small business, labor, consumer and community organizations, women, and minorities. In addition, the selection process for the directors of Reserve Banks would be altered. Three Class A Directors would be elected by commercial banks, as under current practice, with the added stipulation that only domestically chartered and owned banks could vote. Six Class B Directors would be appointed by the Board of Governors, up from three currently, again with directions to include minorities and representatives of specific groups. A stated aim is to make the Reserve Bank Presidents the equals of Governors; however, the twelve Presidents would apparently continue to share five votes at FOMC meetings on a rotating basis (although the bill is not clear on this), whereas the seven Governors would retain permanent voting rights. Comparable bills introduced in the House and the Senate on January 26 would abolish the FOMC, make the Board of Governors solely responsible for the conduct of monetary policy, and establish a Federal Open Market Advisory Council, through which the twelve regional bank presidents could advise the Board of Governors. All of the bills would mandate greater disclosure of policy deliberations and authorize more comprehensive audits of Federal Reserve activities.

None of the legislation would explicitly restrict the independence of policymakers to act, but in the absence of the overriding objective of fostering a high standard of living by maintaining price-level stability, the injection of politics into the selection process would risk compromising policy outcomes. If less emphasis was placed on the skills and experience necessary to formulate and implement polices and stabilize the price level by the President or Congress than by the boards of directors of District Reserve Banks or if the President or Congress actually sought individuals predisposed to pursue objectives other than price-level stability, the substance of policy would suffer. There is every reason to believe this would occur. The appropriate response is to establish the right objective and adopt measures designed to ensure that it is achieved. In contrast, changing the process of selecting policymakers can be counterproductive when they have the option, or even the incentive, to choose the wrong objective. This is especially the case when legislators select individuals precisely because they will make that choice

Congress should pass legislation to direct the central bank to promote the maximum attainable level of employment and output by achieving and sustaining a stable price level. The Federal Reserve should have complete freedom to select procedures and intermediate targets and design and execute strategies without political interference. At the same time, it must constantly be held accountable in a meaningful way for the results of its actions—for producing a stable price level over time. The appropriate committees of Congress or the Executive Branch must have the authority to, and be specifically directed to, remove and replace monetary policymakers if and when the actual price level deviates from stability over a pre-specified time by a pre-specified amount.

Such legislation is unlikely from this Congress. In the meantime, Federal Reserve policymakers should not be distracted from resolutely pursuing price stability by a Congress focused on "fine tuning" the economy with discredited economic theory and practice.

PRESIDENT CLINTON'S ECONOMIC PACKAGE

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The stated purposes of President Clinton's fiscal policy proposal are to provide short-run fiscal stimulus to "guarantee" the durability of the economic recovery, and cut the deficit while increasing outlays and subsidies for public and private investment and income maintenance. Although well intended, the package has more weaknesses than strengths. The short-run fiscal package is inappropriate and wasteful, and is inconsistent with the program's long-run objectives. The deficit-cutting package includes many initiatives that save money and increase efficiency (many have been proposed but rejected before). President Clinton certainly deserves credit for treading where recent politicians have failed. However, the major thrust of the package is disappointing in several key regards: 1) excluding the defense budget, its proposed cuts in spending are insufficient and heavily back-loaded into the later years, 2) it barely cuts into nonmeans-tested entitlement programs and proposes significant new spending of income maintenance, 3) the combined spending and tax proposals fail to materially reallocate resources from consumption-oriented transfer payments to investment-oriented activities, and 4) its key investment tax incentives are temporary, and the overall tax scheme lacks a sense of stability or predictability necessary for business planning and healthy economic growth.

The basic framework of this package is likely to be enacted. If so, it will cut the deficit from current law projections. However, it is unlikely to generate new permanent jobs, or add materially to productive capacity or long-run economic growth. In light of the grand window of opportunity the political and economic environment now provides, in several years President Clinton will likely regret his initial lack of aggressiveness in cutting spending.

SHORT-TERM FISCAL STIMULUS?!

The recession ended nearly two years ago, and the rate of real GDP growth has exceeded 4 percent since mid-1992, so the short-term fiscal stimulus initiative is untimely, costly, and inconsistent with the Administration's deficit cutting objectives. ***It sets a bad tone for fiscal policy by establishing the wrong set of expectations about the role of fiscal policy should play in the economy.*** The package will cost approximately $30 billion. The bulk of the $16 billion proposed stimulus spending would fund a temporary summer jobs program and a summer Head Start program, extension of unemployment compensation benefits ($5.6 billion), "fast spending" public infrastructure programs and a one-time supplemental appropriation ($2.5 billion) for Community Development Block Grants. All of these initiatives are designed to quickly create temporary jobs or provide income maintenance. They will ***not*** create permanent jobs, and the priority of funding projects capable of creating temporary jobs the fastest biases the chances of allocating resources to their most efficient uses.

The proposed stimulus package includes approximately $12 billion in tax investment incentives. The marginal investment tax credit will ***not*** permanently lift business fixed investment; because it is temporary, it will only change the timing of investment and distort its mix by encouraging investment in certain short-lived equipment. **The temporary nature of the subsidy virtually guarantees that the tax system will continue to be unstable and unpredictable, essential elements for business planning, rising investment, and healthy economic growth.**

Clearly the political impetus for this short-term stimulus package is that while real GDP is growing rapidly, the growth in economic output is being generated primarily by productivity gains, while employment is growing only slowly. Nevertheless, it is misguided. Job growth is picking up, and the productivity gains resulting from substantial private sector restructuring creates the basis for permanent employment growth in higher value-added jobs. Budget resources should be allocated to high return activities that raise productive capacity and permanent job growth, not temporary quick fixes based on outdated campaign promises. This is particularly true now that the recovery is durable and real growth is far above its long-run average.

THE DEFICIT CUTTING PROGRAM

The Administration's fiscal package has some positive characteristics as well as some well-advertised negative ones. Its budget proposal and measured savings are based on the economic assumptions of the Congressional Budget Office, which reduces unnecessary and counterproductive debate about economic projections at the expense of budget and fiscal policy. The CBO's assumptions are "realistic" and should not be the source of gross miscalculations that have plagued recent budget proposals and legislation. In fact, if anything, they may be underestimating economic growth and longer-term productivity gains (its baseline projection assumes real GDP will grow less than 3 percent annually through 1995, tailing off to 2 percent in 1998).

Secondly, the deficit-cutting proposal is more meaningful than earlier attempts that established artificial deficit targets like Gramm-Rudman-Hollings and its successors. Those laws failed because their deficit targets were artificial, they invited efforts to circumvent their intent, and they were not accompanied by tax and spending legislation necessary to achieve them. Despite its many weaknesses, the Clinton proposal is a clear repudiation of the deficit targeting approach and an admission that lacking enforceability they only lowered credibility of the fiscal policymakers.

Thirdly, the budget package includes a long list of proposals that would both save budget dollars and generate economic efficiencies. Even though their combined savings would be only a small portion of the proposed deficit reductions, they represent improvements. For example, proposals to reduce some of the government's agricultural price supports and subsidies are wise, as is streamlining the USDA; even bolder initiatives are required. Improving the operating efficiency of the Department of Veterans Affairs, as well as eliminating overlaps in federal educational aid programs, similarly are steps in the right direction. Requiring states to share default costs in the Student Loan Program would improve operations; even if the net savings to taxpayers fall short of projections (because states incurring default-related fees may raise taxes), it would nevertheless create the right management incentives. The effort to extract savings from general government operations is obviously welcomed and should not have any material impact on efficiency. Many of these and other savings initiatives have been proposed before and rejected by Congress, but obviously they now have a better chance of enactment.

Unfortunately, the major shortcomings of the proposal overshadow these positive initiatives. Projections of deficits are reduced but are associated with an enlarged role of the government in the economy, the rapidly growth nonmeans-tested entitlement programs are not materially reduced in scope (although the forthcoming health care package possibly could change this assessment), and many of the new spending initiatives are unlikely to achieve their long-run objectives. The tax policy changes perpetuate economic distortions. The major problem remains that fiscal policy generates a sizable allocation of national resources toward consumption-oriented activity at the expense of saving and investment, which reduces productive capacity and lowers standards of living. The way in which the Clinton Administration proposes to reduce deficits and the new spending initiatives do little to address this long-term problem.

Following the short-term stimulus, which would raise the rate of spending growth and the deficit in fiscal year 1993, the Administration proposes slowing outlay growth to approximately 3.7 percent annualized from 1993-1997, from 4.5 percent annualized growth under current law, and raising the growth of tax revenues to approximately 6.9 percent annually from 5.5 percent under current law (These are estimates based on the Administration's budget document, *A Vision of Change for America,* which does not provide proposed aggregate spending and tax revenue levels, and the CBO's *The Economic and Budget Outlook: Fiscal Years 1991-1997,* January 1993.). Thus, outlays would continue to grow in real terms.

The Administration proposes raising the deficit to $332 billion in FY1993 (5.4 percent of GDP) and then lowering it to $206 billion in 1997 (2.7 percent of GDP), a cumulative five-year (1993-1997) savings from current law of $312 billion. Broken down, the savings would be generated by new revenue increases of $249 billion and $246 billion in spending cuts, offset by $117 billion in new spending initiatives and $66 billion in tax cuts. This would lower budget outlays from 23.5 percent of GDP in 1993 to approximately 22.2 percent in 1997, and raise tax revenues from 18.6 percent to approximately 19.5 percent. The slowdown in actual spending would be less and the acceleration in revenues actually would be more, since several of the key deficit cutting proposals involve raising fees, selling government assets and raising certain taxes that are counted as "off-setting receipts" (negative spending).

More important than the debate about how much budget savings is generated by tax hikes or spending cuts (and how the budget accounts for them) is how the proposal affects the allocation of resources, and here the package is disturbing. It does little to arrest the long-term trend of distorting the allocation of national resources toward consumption at the expense of saving and investment. It does not materially alter the large portion of outlays for nonmeans-tested entitlements, and the new resources actually allocated to true investment are far less than the numbers in the budget proposal imply. Thus, the proposed permanent tax hikes would continue to sap saving and private investment, harming long-run economic growth.

Presently, 50 percent of total budget outlays are for mandatory entitlement programs, and approximately 75 percent of those are not means-tested; the Administration proposes increasing the total share of entitlements and not materially reducing the share of nonmeans-tested entitlements. The highly visible tax hike on social security benefits would reduce net benefits by $21 billion during 1994-1997; this constitutes a minor 1.5 percent reduction from current law and would still provide that net social security outlays would rise at a 4.5 percent average annual rate, and increase as a portion of total budget resources. The proposed cuts in health care are aimed primarily at reducing federal subsidies to medical providers, and do not alter the thrust of government subsidies that support the soaring demand for medical services. The forthcoming health care package must address this issue to successfully contain costs, particularly if health insurance coverage is extended.

The other retirement programs, primarily for military and civil service go untouched. They will cost approximately $70 billion or 4.8 percent of total outlays in 1993, and under current law are projected to grow 5.3 percent annually through 1997 and rise as a percent of total outlays.

It is also questionable whether all of the projected budget savings will be achieved. Concern that most of them are backloaded into the later years is warranted, given past experience (over 40 percent of the proposed savings would occur in 1977). Consider the following general ways these projected savings may erode: 1) legislative slippage, such as further job-creating initiatives, 2) savings in one program offset by higher costs in another (for example, budget savings from reducing military personnel partially offset by higher costs of military retirement, health care, and unemployment benefits or federal spending to keep them temporarily employed), 3) less net government saving due to negative economic impacts (for example, higher revenues from the energy tax partially offset by job losses in certain energy-intensive manufacturers), and 4) general overestimation of savings, for example, in areas such as defense and government administrative streamlining. Whether such rapid cuts in defense ***outlays*** are feasible is uncertain. Net interest outlays are projected to be $35.5 billion lower than under current law ($24 billion due to lower deficits and $11.5 billion by shortening U.S. Treasury debt securities). These potential sources of savings slippage may be offset by stronger-than-projected economic growth.

In this regard, re-estimates of President Clinton's budget proposal by the Joint Tax Committee and the Congressional Budget Office suggest that the Administration overstates the cumulative savings of the legislated changes by approximately $60 billion during 1994-1998. Based on the same economic assumptions, the JTC projects that the proposed tax increases would raise approximately $30 billion less through FY1998 than the Treasury Department estimates, while the CBO projects that the White House's proposed spending cuts would produce approximately $30 billion less than the Administration estimates. The CBO re-estimates also find that the Administration's baseline against which the savings are measured is too high.

There are two general concerns about the Administration's new "investment" spending proposals, which total $160 billion during 1994-1997. A sizable portion of them are actually for income maintenance or activities not directly related to investment. Secondly, some of the true investment initiatives would be geared more toward short-term job creation than raising long-term production capacity. Included as investment initiatives are the earned income tax credit, which was originally established explicitly as an income maintenance offset to higher payroll taxes, and remains a direct income subsidy (cost, $19.6 billion over 1994-1997), additional new spending of $25.6 billion on Food Stamps and various health programs, WIC (the supplemental food program for women, infants, and children, $2.6 billion), the extension of unemployment insurance ($2.4 billion), and the low income housing tax credit ($2.6 billion). These add to over $50 billion; the list goes on.

Certainly, some of the new investment projects may yield high rates of return to society, but the political goal of adding quickly to job growth rather than choosing public projects that offer the highest economic returns raises the chances of misallocating public investment funds. This bias begins with the short-term fiscal stimulus package, in which funds would be allocated to what the Administration refers to as "ready to go" and "fast spending" public projects and a set of "A Summer of Opportunity" initiatives that offer immediate albeit temporary jobs; it continues with permanent programs such as the Dislocated Worker Assistance Act, which will provide $4.6 billion for workers displaced by NAFTA, the defense conversion, and Trade Adjustment. Whether more spending on public investment projects **permanently** adds to (or subtracts from) the nation's productive capacity and job growth depends crucially on the government's ability to choose higher yielding projects than would be chosen by market forces. Over-emphasis on immediate job creation may actually be inconsistent with the Administration's long-term objectives. Studies have found that Head Start provides high rates of return to society, and the Administration proposes significant additional funds for that program ($9.3 billion during 1994-1997). However, previous government-sponsored job training programs generally have provided very low rates of return, so high expectations about the productivity enhancing abilities of the new youth apprenticeship and job training programs are based on leaps of faith. While some of the Administration's investment programs may provide high returns, the deck may be stacked against achieving significant aggregate and lasting benefits from the entire investment program.

Tax Policy. This proposal would involve a significant increase in tax revenues in real terms and as a share of national output, assessed primarily on high income taxpayers through higher marginal rates on personal income and higher FICA taxes earmarked for Medicare, higher taxes on social security benefits, new energy taxes that would fall on all households, and higher marginal corporate taxes whose *aggregate* burden would be offset in 1993-1994 by the temporary marginal ITC. New user fees would be the source of additional revenues. The tax proposals reintroduce degrees of complexity that policymakers strived to eliminate in recent years, and the temporary nature of some key provisions add instability and unpredictability to the tax system.

These tax increases would contribute to lower deficits. Although they would reduce economic activity from what it would be otherwise beginning in 1994, the aggregate elasticity of labor supply is not sufficiently large to reduce jobs and the tax base enough to offset the higher rates and legislated base increases. The economy has sufficient underlying strength so that the tax increases may dampen growth, but not generate recession. However, some of this reduction in government dissaving would be offset by lower private saving and perhaps less foreign capital inflow. Most of the tax hikes would be assessed on income, not consumption. The higher taxes on high income households would reduce the rate of personal saving while the higher corporate taxes after the temporary MITC expires would reduce retained business earnings. Private investment would also be reduced, following a short-run jump in response to the temporary marginal ITC. The higher permanent taxes on business income would reduce expected rates of return on investment, which combined with reduced cash flows, would lower investment. This would reduce expected rates of return on U.S. dollar denominated assets and dampen foreign capital inflows. Private investment decisions would also be distorted by micro tax provisions that would alter expected after-tax rates of return among different types of capital and uncertainty about the future tax structure.

The bottom line is that while the budget proposal would reduce the deficit from current law and arrest the rise in the federal debt-to-GDP ratio, it may not accomplish its long-term objectives of raising investment, productivity, and standards of living. **The crucial issue is whether the resources it would allocate to the government and government-sponsored activities would generate a higher or lower economic rate of return for society than would be provided by private uses from which they are absorbed.** The changes of the mix of spending outlays and the distortive costs of the higher proposed taxes suggest that the long-run economic impact may not measure up to the Administration's expectations. If so, the lesson learned from this attempt at fiscal responsibility is that the way in which deficits are cut are as important, if not more important, than the magnitude by which they are trimmed.

Table 1

BUDGET PROJECTIONS

	1993	1994	1995	1996	1997	Annualized Percent Change 1993 - 1997
Receipts						
Administration	1143	1251	1323	1408	1471	6.9
CBO Baseline	1143	1215	1291	1356	1414	5.5
Outlays						
Administration	1475	1513	1565	1613	1678	3.7
CBO Baseline	1453	1507	1575	1643	1733	4.5
Deficit						
Administration	332	262	242	205	207	
CBO Baseline	310	291	284	287	319	
Administration Current Baseline	319	301	296	297	346	
As a Percent of GDP:						
Receipts						
Administration	18.6	19.2	19.3	19.6	19.5	
CBO Baseline	18.5	18.7	18.8	18.7	18.7	
Outlays						
Administration	23.9	23.2	22.8	22.4	22.2	
CBO Baseline	23.5	23.2	23.0	22.8	23.0	
Deficit						
Administration	5.4	4.0	3.5	2.9	2.7	
CBO Baseline	5.0	4.5	4.1	4.0	4.2	

Sources: Executive Office of the President, A Vision of Change for America, February 17, 1993, and Congressional Budget Office, The Economic and Budget Outlook: Fiscal Years 1994-1998, January 1993.

Table 2

ECONOMIC ASSUMPTIONS

	1992	1993	1994	1995	1996	1997	1998
BASELINE ASSUMPTION	*Percent Change, Fourth Quarter Over Fourth Quarter*						
Real GDP Growth	2.7	2.8	3.0	2.8	2.6	2.2	1.8
GDP Deflator Growth	2.4	2.5	2.4	2.3	2.2	2.2	2.2
Consumer Price Index Increase	3.1	2.8	2.7	2.7	2.7	2.7	2.7
Unemployment Rate (civilian)	7.4	7.1	6.6	6.2	6.0	5.8	5.7
91-Day Treasury Bill Rate	3.5	3.2	3.7	4.3	4.7	4.8	4.9
10-Year Treasury Note Rate	7.0	6.7	6.6	6.6	6.5	6.5	6.4

	1992	1993	1994	1995	1996	1997	1998
ADMINISTRATION POLICY	*Percent Change, Fourth Quarter Over Fourth Quarter*						
Real GDP Growth	2.9	3.1	3.3	2.7	2.5	2.5	2.5
GDP Deflator Growth	2.4	2.8	2.9	3.0	3.0	3.0	3.0
Consumer Price Index Increase	3.1	3.0	3.1	3.3	3.3	3.4	3.4
	Annual Average						
Unemployment Rate (civilian)	7.4	6.9	6.4	6.1	5.9	5.7	5.5
91-Day Treasury Bill Rate	3.5	3.7	4.3	4.7	4.8	4.9	5.0
10-Year Treasury Note Rate	7.0	6.7	6.6	6.5	6.5	6.4	6.4

Sources: *Executive Office of the President, A Vision of Change for America, February 17, 1993, and Congressional Budget Office*

Note: *Baseline assumptions are from Congressional Budget Office, The Economic and Budget Outlook: Fiscal Years 1994-1998, January 1993.*

Table 3

PRESIDENT CLINTON'S HIGHLIGHTS OF THE PLAN

(in billions of dollars)

	1993	1994	1995	1996	1997	1998	1994 - 1997 Total	1994 - 1998 Total
Budget Deficit	**319**	**301**	**296**	**297**	**346**	**390**	**1,241**	**1,630**
Spending Changes:								
Defense Discretionary		-7	-12	-20	-37	-36	-76	-112
Nondefense Discretionary	1	-4	-10	-15	-20	-23	-50	-73
Entitlements	-*	-6	-12	-24	-34	-39	-76	-115
Social Security		-3	-6	-6	-7	-8	-21	-29
Subtotal	*	-20	-40	-65	-98	-106	-223	-329
Debt Service	*	-*	-3	-7	-14	-22	-24	-46
Total Spending Cuts (-)	**1**	**-20**	**-43**	**-73**	**112**	**128**	**247**	**325**
Revenue Increases (-)	**-3**	**-46**	**-51**	**-66**	**-83**	**-82**	**-246**	**-328**
Gross Deficit Reduction	**-2**	**-66**	**-93**	**-139**	**-195**	**-210**	**-493**	**-704**
Stimulus and Investment:								
Stimulus Outlays	8	6	2	1	*	*	9	9
Investment Outlays		9	20	32	39	45	100	144
Tax Incentives	6	13	17	15	15	17	60	77
Total Stimulus & investment	**15**	**27**	**39**	**47**	**55**	**62**	**169**	**231**
Total Deficit Reduction	**13**	**-39**	**-54**	**-92**	**-140**	**-148**	**-325**	**-473**
Resulting Deficit	**332**	**262**	**242**	**205**	**206**	**241**	**916**	**1,157**
Deficit as a percent of GDP	**5.4**	**4.0**	**3.5**	**2.9**	**2.7**	**3.1**	**3.3**	**3.2**

***$500 million or less.**

Table 4

Overview of the President's Proposals

(amounts in billions of dollars)

	1993 estimate	1994	1995	1996	1997
Receipts	1,143	1,251	1,323	1,408	1,471
Outlays:					
Defense	294	278	273	266	250
Nondefense discretionary	262	270	282	293	302
Mandatory	717	753	782	812	868
Net Interest	202	212	227	243	257
TOTAL	1,475	1,513	1,565	1,613	1,678
Deficit (consolidated)	332	263	242	205	207

Note: *nondefense discretionary outlays include outlays for international affairs and domestic programs; consolidated deficit combines on-budget transactions and off-budget transactions (Social Security trust funds and the Postal Service).*

Table 5

CBO ESTIMATES OF THE ADMINISTRATION'S POLICY PROPOSALS
(By fiscal year, in billions of dollars)

	1993	1994	1995	1996	1997	1998
CBO Baseline Deficit[a]	301.6	286.7	284.4	290.0	321.7	359.7
Deficit Reductions						
Discretionary spending	0	-3.4	-7.7	-28.4	-56.2	-63.4
Mandatory spending	0	-4.2	-7.5	-17.8	-25.0	-30.8
Debt service	0	-1.6	-5.2	-11.1	-20.4	-32.2
Subtotal, outlays	0	-9.1	-20.5	-57.2	-101.6	-126.4
Revenues[b]	0	-45.8	-52.4	-68.1	-84.8	-86.0
Subtotal, reductions	0	-55.0	-72.8	-125.3	-186.4	-212.4
Deficit Increases						
Discretionary spending	3.3	13.0	22.6	31.8	39.4	44.5
Mandatory spending	3.3	3.8	5.9	7.0	7.1	7.3
Debt service	0.1	1.4	3.7	6.8	10.6	15.1
Subtotal, outlays	6.8	18.2	32.1	45.5	57.1	66.9
Revenues[b]	0	18.2	13.3	11.7	12.6	14.3
Subtotal, increases	6.8	36.3	45.4	57.2	69.6	81.2
Total Changes	6.8	-18.6	-27.4	-68.1	-116.7	-131.2
President's Budget as Estimated by CBO	308.3	268.1	257.0	222.0	204.9	228.5

SOURCES: Congressional Budget Office; Joint Committee on Taxation.

NOTE: The budget estimates reflect the proposals incorporated in the President's budgetary message of February 17. In early April the President will present a formal budget containing detailed and revised budget proposals and updated budget estimates.

a. Assumes compliance with the discretionary spending limits in the Budget Enforcement Act through 1995; discretionary outlays are assumed to grow at the same pace as inflation after 1995.

b. Increases in revenues are shown with a negative sign because they reduce the deficit. Estimates of the Administration's revenue proposals were prepared by the Joint Committee on Taxation.

Table 6

DIFFERENCES BETWEEN CBO AND ADMINISTRATION ESTIMATES OF THE ADMINISTRATION'S PROPOSED BUDGET
(By fiscal year, in billions of dollars)

	1993	1994	1995	1996	1997	1998
Administration's Estimate of the Deficit	331.4	262.4	241.6	205.3	206.4	241.4
CBO Reestimates of the Administration's Baseline						
Revenues[a]	4.9	b	-6.2	-5.7	-16.0	-27.7
Deposit insurance	-13.9	-3.4	13.6	12.9	-1.5	-1.5
Other outlays	-8.5	-1.8	-1.6	-3.5	-1.5	b
Subtotal	-17.4	-5.2	5.8	3.8	-19.0	-29.2
CBO Reestimates of the Administration's Proposals						
Revenues[a]	-3.6	8.8	4.3	5.7	6.6	5.7
Debt management	0.2	1.6	2.7	3.3	3.9	4.9
Medicare	0	0.6	0.9	0.4	1.3	1.8
Pay offsets	0	0.6	1.0	1.4	1.7	2.0
Debt service	-0.2	-0.1	0.4	0.9	1.6	2.3
Other outlays	-2.0	-0.7	0.2	1.3	2.5	-0.5
Subtotal	-5.6	10.9	9.5	12.9	17.5	16.2
Total Reestimates	-23.1	5.7	15.4	16.7	-1.5	-12.9
President's Budget as Estimated by CBO	308.3	268.1	257.0	222.0	204.9	228.5

SOURCES: Congressional Budget Office, Joint Committee on Taxation, and Office of Management and Budget.

NOTE: The budget estimates reflect the proposals incorporated in the President's budgetary message of February 17. In early April the President will present a formal budget containing detailed and revised budget proposals and updated budget estimates.

a. Increases in revenues are shown with a negative sign because they reduce the deficit. Estimates of the Administration's revenue proposals were prepared by the Joint Committee on Taxation.

b. Less than $50 million.

ECONOMIC OUTLOOK

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The recession ended nearly two years ago, in April 1991. Following an anemic rebound, the economy shifted gears in mid-1992, and real GDP growth exceeded 4 percent in the second half of 1992. Momentum has carried into 1993, and real GDP is projected to continue growing at a healthy pace in 1993, approximately 3 percent-3.5 percent. Fueled by stimulative monetary policy, lower interest rates, growing confidence in the economy and improving fundamentals, there is a higher probability that growth will exceed that range than fall below it.

So far this expansion, most of the growth in economic output has been attributable to productivity gains, while employment growth has been modest. A portion of these productivity gains reflect structural adjustments in the private sector, not merely a cyclical jump that typically occurs at the initial stages of recovery. Such productivity growth creates a strong base for sustained economic expansion, including a pickup in job growth.

The Clinton Administration's economic proposal would provide a modest boost to economic growth in 1993 through its temporary jobs programs and business investment incentives. Beginning in 1994, enactment of the proposed sizable tax increases and the ongoing implementation of the spending package would harm economic activity and alter its mix. However, given the strong economic base, the new fiscal policy would dampen economic growth, but not generate recession.

A SLOW BUT HEALTHY RECOVERY

The recovery from recession began very slowly; real GDP grew 1.6 percent from second quarter 1991 to second quarter 1992. Growth was inhibited by a number of structural adjustments, including declining defense spending, excess inventory of office space and lower business investment in structures, lower expectations of future housing prices, which constrained the rise in housing activity, and general business restructuring of production processes, which limit employment and income growth. As a result, many recessionary-type conditions persisted, despite the growth in output. During this period, export growth remained strong and business investment in information processing equipment staged a robust rebound, but these bright spots were overshadowed by the subpar performance in the more visible sectors of the economy and the lack of job growth.

Positive cyclical factors began to overwhelm these adjustments and generated a marked pickup in economic activity in mid-1992. The most important factor was the Federal Reserve's stimulative monetary policy. In the last year, bank reserves have grown 14 percent, while the monetary base and M1 have grown 12.5 percent, their fastest expansion since 1986. The federal funds rates is at its lowest rate in 30 years and is zero in inflation-adjusted terms. While the entire term structure of rates has receded, the yield curve remains very steep.

The only missing link in these indicators of monetary thrust has been the very slow growth of M2 and the broader aggregates. M2 grew 2.1 percent from fourth quarter 1991 to fourth quarter 1992, below the Fed's target growth band of 2.5 percent-6.5 percent, and it has fallen since then. However, all of this slowdown is attributable to an ongoing dramatic decline in small time deposits (17 percent in the last year), two-thirds of which is from thrift institutions. The decline in CDs has been a direct response of the steepness of the yield curve and the opportunity costs of holding M2 assets. A substantial amount of these financial assets have flowed into stock and bond funds and M1. Banks, which are awash with liquidity and facing weak loan demand (commercial and industrial loans have fallen in the last year) are purchasing large amounts of U.S. treasury securities and other financial assets not counted in M2. These flows in response to opportunity costs do not change the fact that monetary policy has been stimulative. In addition to monetary stimulus, other factors set the stage for a stronger expansion, including lower unit labor cost increases and moderating inflation, declines in real estate prices, a reduction of consumer debt relative to income, and strong growth in corporate profits and improving business balance sheets.

Recent Economic Conditions. The improvement in economic performance in the second half of 1992 was broad-based. Consumer confidence jumped, and strong department store sales and healthy auto purchases contributed to 4.2 percent annualized growth in consumer spending. Residential investment continued to increase. Real exports rose at a 9.5 percent annualized rate, despite deteriorating conditions in Europe and Japan. In response to the marked pickup in product demand, industrial production jumped and business inventory building grew. Business investment in producer durable goods equipment continued to grow robustly. As a result, final sales grew at a 4 percent annualized rate, 5.2 percent in the fourth quarter. Total nonfarm payrolls rose modestly and manufacturing employment troughed after a sustained decline.

During the second half of 1992, nominal GDP growth accelerated to 6.2 percent. The implicit GDP deflator declined to 2.1 percent from 3.1 percent in the first half of 1992. Part of this decline reflected the rapid pickup in business investment in information processing equipment, whose declining prices suppress the implicit deflator; the GDP fixed weight deflator rose 2.9 percent. This acceleration of nominal GDP combined with the decline in M2 generated a pickup in M2 velocity while M1 velocity continued to decline.

Productivity-driven Growth. A common complaint is that the recovery has been slower than recent recoveries and has not created jobs. In fact, most of the increase in economic output has been attributable to productivity gains, while employment growth has been modest. The rapid gains in productivity (productivity in nonfarm business sector has increased 3.1 percent in the last year) are highly encouraging; the factors underlying the gains and the benefits they provide create a strong base for sustained economic growth, including permanent job growth.

Widespread anecdotal evidence suggests that a portion of the productivity gains involves an increase in the permanent efficiency of production in a number of industries. Marked changes have occurred in both management behavior and objectives, and businesses have consolidated and reorganized labor inputs, while investing heavily in productivity-enhancing equipment. This has involved sizable layoffs at certain large firms. The fact that in the past year total nonfarm employment has risen 0.7 percent despite these highly publicized layoffs is a very positive sign; presumably, the new jobs provide higher value added than those that were shed.

The productivity-driven growth has a highly favorable impact on economic performance. It has increased output while easing pressure on wage compensation, thus generating a dramatic decline in unit labor cost (ULC) increases from 5.3 percent in 1990 to 0.7 percent in the last four quarters. Real wages have declined and core inflation has improved; in the last year, excluding food and energy, the PPI rose 1.7 percent and the CPI 3.4 percent, the lowest rate since 1973. In addition, because ULC inflation has fallen faster than product price inflation, profit margins have widened significantly and corporate profits and cash flow have soared; in the last four quarters, operating profits have risen 26.3 percent and net cash flow 12.4 percent. Moreover, the productivity gains have raised the international competitiveness of U.S. firms, supporting continued growth in exports.

These favorable economic fundamentals have contributed to the decline in interest rates and the beginning of a flattening of the yield curve, and provide support for the U.S. dollar exchange rate and the stock market. Productivity gains lower core inflation and reduce credit demands that normally accompany stronger growth, which mitigates the upward pressure on short-term interest rates. The decline in rates and firm stock market reduce the cost of capital either through equity or debt issuance. All of these fundamentals provide an important foundation for sustained economic expansion.

The Outlook. Real GDP is projected to expand approximately 3 percent-3.5 percent in 1993. The recent decline in interest rates is a positive factor, suggesting stronger rather than weaker growth. Consumption growth is expected to moderate to 2.5 percent-3 percent from its rapid 4.2 percent pace in the second half of 1992, in line with the projected growth of real disposable income. Employment will rise modestly, approximately 1.5 percent (excluding the temporary summer jobs programs) and real wages are expected to rise, reflecting the sustained productivity gains, despite continued slack in labor markets.

Business investment is projected to contribute to the healthy growth. Investment in producer durable goods is expected to accelerate above 1992's growth of 9.3 percent reflecting increasing product demand, strong corporate cash-flows and low costs of capital, business confidence, and the Clinton Administration's proposed temporary marginal investment tax credit. As proposed, the ITC would be retroactive to December 1992; its temporary nature will hurry-up certain business investment plans. The large inventory overhang of office space suggests that business investment structures will continue to decline, but it is expected to fall at a lesser rate than in 1992. Given rising confidence in the economy, higher business investment in inventories is projected to add gradually to national output.

The net export deficit is projected to remain unchanged or widen modestly, having a neutral to modestly negative impact on real GDP growth. Exports are projected to continue growing at a healthy rate, but imports will grow as fast, if not faster, with the economic pickup. From fourth quarter 1991 to fourth quarter 1992, real exports rose 5 percent, but import growth accelerated to 9.6 percent. The rapid growth in imports reflects the higher imports of producer durable goods equipment, particularly information processing equipment, as well as consumer goods.

In recent years, many people have consistently underestimated the ability of U.S. industry to export, based on the unfortunate but common perception that it is not "competitive," and more recent concerns about recessionary conditions among major trading partners, particularly Germany and Japan. However, U.S. unit labor costs are lower than in major industrialized nations, including Germany and Japan, and the recent productivity gains and slow wage growth in the U.S. has widened that advantageous gap. In 1991-1992, U.S. export growth to developing nations has accelerated, reflecting their strong economic growth, which has more than offset the slower growth in exports to the industrialized nations. This trend is projected to continue in 1993. Strong growth of exports to developing nations is expected to offset weaker export growth to the developing nations until economics rebound in Europe and Japan.

Impact of President Clinton's Economic Proposal. The proposal should have a modest beneficial impact on economic growth in 1993. In addition to the investment incentives, the temporary jobs programs and quick infrastructure spending programs would temporarily lift job growth and consumer spending. Insofar as the stimulus package is perceived to be temporary, it is unlikely to lift overall confidence in the economy, particularly with sharply higher taxes looming in 1994. The recent decline in interest rates, if they persist, should offset any negative impact the higher deficits and anticipated tax increases. The proposed increases in public infrastructure would offset the negative impact of the planned reductions of defense spending. As planned, this stimulus package will be enacted and put in place immediately, well before the deficit-cutting proposals are enacted and implemented. This provides a temporary boost to the short-term economic outlook, but it does not add permanently to aggregate demand.

Its economic impact turns negative in 1994 with implementation of significant tax increases and certain spending cuts. This proposal includes higher taxes in fiscal year 1994 of $27.7 billion on personal income. $2.8 billion on payrolls (through eliminating the taxable maximum on he HI portion of FICA taxes), $2.7 billion on social security benefits, and $7.7 billion on corporate income. The new energy tax is estimated to raise only $1.5 billion in FY1994 because it would not become effective until July 1994 (thus affecting only one-quarter of the fiscal year); its revenue impact would jump to an estimated $8.9 billion in FY1995.

Although most of the personal income tax increases would be assessed on high income individuals and would have a significant affect on saving, they would dampen consumption. The broad-based energy tax would have a similar aggregate impact on disposable income and consumption as higher oil prices. Energy consumption is relatively price elastic in the short run, so this tax would slow consumption. Its cumulative $49 billion tax increase in 1994-1997 is close to 1 percent of GDP. Coupled with the higher corporate income taxes, the new tax on BTU usage would have a significant adverse impact on energy-intensive manufacturers. The resulting higher operating costs and lower retained earnings would adversely affect their international competitiveness and perhaps slow employment growth. This impact would be partially offset by businesses that take advantage of the temporary marginal ITC.

The underlying strength of the economy suggests that beginning in 1994, this economic proposal would slow the rate of economic growth and affect its mix, but not generate recession. Consumption growth would be reduced while business investment would be boosted through 1994 as businesses take advantage of the investment subsidies. Government purchases would be relatively unchanged in the aggregate, as the sharp increases in public infrastructure would be offset by the planned sharp reductions in defense spending. The shift wold have a sizable adverse impact on the defense industry and regions that rely heavily on military activities, and a positive impact on regions targeting for infrastructure projects, particularly large old urban areas. After 1994, when the temporary investment incentives expire, the environment for private investment is hurt, while the full phase-in of the higher taxes continue to reduce disposable income.

S N A P S H O T

QUARTERLY DATA	Levels 1992 I	II	III	IV	Quarterly % Change (annualize 1992 I	II	III	IV	Yr-to-Yr % Change 1992 I	II	III	IV
Nominal GDP	5840.2	5902.2	5978.5	6082.1	6.2	4.3	5.3	7.1	4.6	4.3	4.6	5.7
GDP	4873.7	4892.4	4933.7	4991.5	2.9	1.5	3.4	4.8	1.6	1.6	2.1	3.2
GNP	4890.7	4899.1	4945.6	NA	3.6	0.7	3.9	NA	1.4	1.4	2.1	NA
Domestic Demand	4895.2	4936.3	4986.4	5039.4	3.0	3.4	4.1	4.3	1.7	2.1	2.5	3.7
Final Sales	4886.3	4884.6	4918.7	4981.5	4.7	-0.1	2.8	5.2	1.3	1.0	1.8	3.1
Consumption	3289.3	3288.5	3318.4	3357.7	5.1	-0.1	3.7	4.8	2.0	1.5	2.1	3.3
Residential Investment	185.6	191.2	191.3	202.7	20.1	12.6	0.2	26.1	13.1	14.6	10.8	14.3
Business Investment	495.8	514.7	518.7	531.1	3.0	16.1	3.1	9.9	-2.2	2.3	4.0	7.9
Inventory Investment	-12.6	7.8	15.0	9.9	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Government Spending	937.0	934.2	943.0	938.0	1.7	-1.2	3.8	-2.1	-0.9	-1.2	0.3	0.5
Exports	565.4	563.4	575.9	589.5	2.9	-1.4	9.2	9.8	9.6	5.1	5.8	5.0
Imports	586.8	607.3	628.6	637.4	3.5	14.7	14.8	5.7	9.9	9.7	9.2	9.6
GDP Deflator	117.7	118.7	119.2	119.9	2.8	3.4	1.7	2.4	2.3	2.9	2.5	2.6
Employment Costs (Private)	113.0	113.8	114.7	115.7	4.0	2.9	3.2	3.5	4.2	3.7	3.4	3.4
Unit Labor Costs (Non-Farm)	134.6	134.9	135.3	135.5	0.0	0.9	1.2	0.6	1.6	0.8	0.7	0.7
Productivity (Non-Farm)	110.6	111.1	111.8	112.9	3.7	1.8	2.5	4.0	2.5	2.5	2.7	3.0
Compensation (Non-Farm)	148.9	149.9	151.3	153.0	3.7	2.7	3.8	4.6	4.1	3.3	3.4	3.7
Corporate Profits A/T (a)	229.7	232.7	222.2	244.4	10.8	1.3	-4.5	10.0	6.2	11.1	6.0	17.8
Operating Profits A/T (a)	247.6	244.3	242.3	280.7	11.4	-1.3	-0.8	15.8	8.5	8.9	13.1	26.3
Net Cash Flow (a)	495.6	504.3	508.1	521.4	6.8	1.8	0.8	2.6	10.0	11.9	11.1	12.4
Current Account (c)	-5.9	-17.8	-14.2	NA	5.3	-47.6	14.3	NA	-72.4	-80.9	-12.6	NA

MONTHLY DATA	Levels 1992 Oct	Nov	Dec	Jan	Monthly % Change 1992 Oct	Nov	Dec	Jan	12 Month % Change 1992 Oct	Nov	Dec	Jan
Purchasing Managers Index	50.7	54.7	55.4	58.0	4.1	7.9	1.3	4.7	-4.7	9.4	17.1	18.9
Non-Farm Payrolls (b)	108.571	108.646	108.736	108.842	74	75	90	106	0.3	0.5	0.5	0.7
Manufacturing Payrolls (b)	18.046	18.068	18.061	18.095	-56	22	-7	34	-1.9	-1.6	-1.5	-1.0
Unemployment Rate (c)	7.4	7.3	7.3	7.1	-0.12	-0.08	-0.03	-0.18	0.46	0.40	0.13	-0.04
Average Workweek (sa)	34.5	34.6	34.4	34.4	0.6	0.3	-0.6	0.0	0.6	0.6	-0.3	0.3
Avg. Hourly Earnings (sa)	10.65	10.71	10.69	10.74	0.2	0.6	-0.2	0.5	2.4	2.8	2.2	2.7
Total Unit Auto Sales	8.3	8.2	8.7	8.6	-0.6	-1.4	5.8	-0.3	0.5	-1.4	7.3	6.3
Domestic Unit Auto Sales	6.3	6.2	6.7	6.6	-1.1	-1.2	7.3	-0.1	3.9	0.8	11.1	10.5
Industrial Production	109.7	110.3	110.5	111.0	0.7	0.5	0.2	0.5	1.2	2.0	2.9	4.1
Capacity Utilization	79.0	79.3	79.3	79.5	0.5	0.4	0.0	0.3	-1.0	0.0	0.8	1.9
PPI	123.3	123.2	123.3	123.6	-0.1	-0.1	0.1	0.2	1.3	1.0	1.3	1.5
PPI Ex. Food & Energy	135.1	135.3	135.5	136.1	-0.1	0.1	0.2	0.4	1.9	1.8	1.8	1.7
CPI	141.7	142.0	142.2	142.9	0.4	0.2	0.1	0.5	3.2	3.0	3.0	3.2
CPI Ex. Food & Energy	148.9	149.3	149.6	150.3	0.5	0.3	0.2	0.5	3.5	3.4	3.4	3.4
Retail Sales	165.6	165.4	166.8	167.4	2.1	-0.1	0.8	0.3	7.2	7.3	7.9	6.6
Housing Starts	1226	1226	1285	1192	0.7	0.0	4.8	-7.2	12.2	13.2	17.5	2.4
Permits	1139	1126	1201	1180	1.2	-1.1	6.7	-1.7	14.6	15.0	11.9	6.7
Federal Budget (d)	-48.8	-32.7	-38.9	29.8	-12.2	12.0	-36.4	45.5	-302	-290	-327	-281
Durable Goods Orders	125.3	123.3	135.1	132.8	4.6	-1.6	9.6	-1.7	4.2	2.4	18.6	12.5
Manufacturing Orders	244.8	243.4	256.2	NA	2.0	-0.6	5.3	NA	2.6	2.0	11.4	NA
Personal Income ($87)	4125.7	4118.5	4157.6	4163.9	0.8	-0.2	1.0	0.2	2.1	2.3	2.2	2.6
Consumption ($87)	3346.7	3349.3	3377.1	3374.4	0.6	0.1	0.8	-0.1	3.3	3.1	3.7	2.5
Personal Saving Rate (c)	4.7	4.4	4.5	4.6	0.31	-0.33	0.17	0.03	-0.57	-0.27	-0.95	0.16
Leading Economic Indicators	149.2	150.2	152.8	152.9	0.3	0.7	1.7	0.1	2.8	3.7	5.6	4.5
Total Business Inventories	836.8	838.2	841.2	NA	0.2	0.2	0.4	NA	1.5	1.7	1.7	NA
Inventory/Total Sales (c)	1.49	1.48	1.46	NA	-0.00	-0.01	-0.02	NA	-0.03	-0.04	-0.09	NA
Merchandise Trade (c)	-7.3	-7.3	-7.0	NA	1.42	-0.10	0.40	NA	-1.38	-3.23	-1.33	NA
3 Month Bill (c)	2.90	3.21	3.32	3.13	-13	31	11	-19	-228	-152	-92	-81
2 Year Note (c)	4.08	4.58	4.67	4.39	19	50	9	-28	-183	-98	-36	-57
10 Year Note (c)	6.59	6.87	6.77	6.60	17	28	-10	-17	-94	-55	-32	-43
30 Year Bond (c)	7.53	7.61	7.44	7.34	19	8	-17	-10	-40	-31	-26	-24
DJIA	3198.7	3238.5	3303.2	3277.7	-2.9	1.2	2.0	-0.8	5.9	8.5	11.6	1.6
S&P 500	412.50	422.84	435.64	435.23	-1.4	2.5	3.0	-0.1	6.6	9.6	12.1	4.6
U.S. Dollar (FRB)	85.0	90.0	90.5	92.4	3.7	5.9	0.5	2.1	-6.2	2.3	5.7	7.3
Yen/$	121	124	124	125	-1.2	2.2	0.1	0.8	-7.3	-4.4	-3.1	-0.4
DM/$	1.49	1.59	1.58	1.61	2.3	6.9	-0.3	2.0	-12.1	-2.1	1.2	2.3
M1	1005.9	1019.1	1026.6	1033.3	1.6	1.3	0.7	0.7	14.4	14.4	14.2	13.4
M2	3496.9	3505.6	3504.0	3492.3	0.4	0.2	-0.0	-0.3	2.2	2.0	1.7	1.2
M3	4186.2	4188.4	4176.4	4149.3	0.0	0.1	-0.3	-0.6	0.7	0.6	0.2	-0.5
C&I Loans & Non-Financial CP	745.9	751.2	746.1	NA	1.1	0.7	-0.7	NA	-1.2	-0.8	-0.6	NA
Consumer Credit	722.4	723.4	725.9	NA	0.0	0.1	0.3	NA	-0.9	-0.6	-0.3	NA

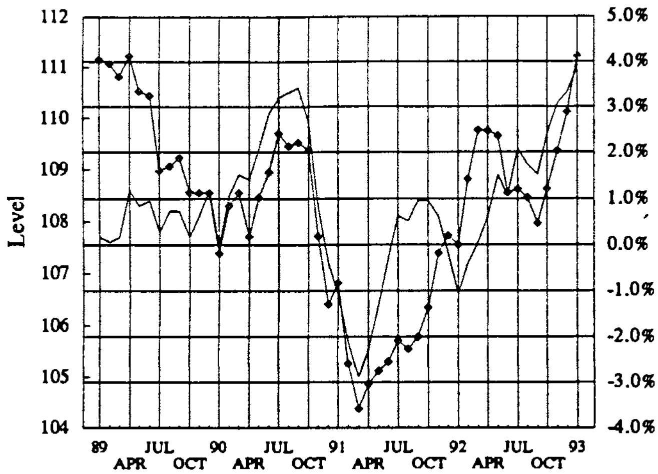
(a) Quarterly % changes are not annualized
(b) Monthly changes are in levels
(c) All changes are in levels or basis points
(d) Monthly: change from same month last year; Annual: sum of past 12 months

05-Mar-93

Chart 1
SELECTED ECONOMIC INDICATORS

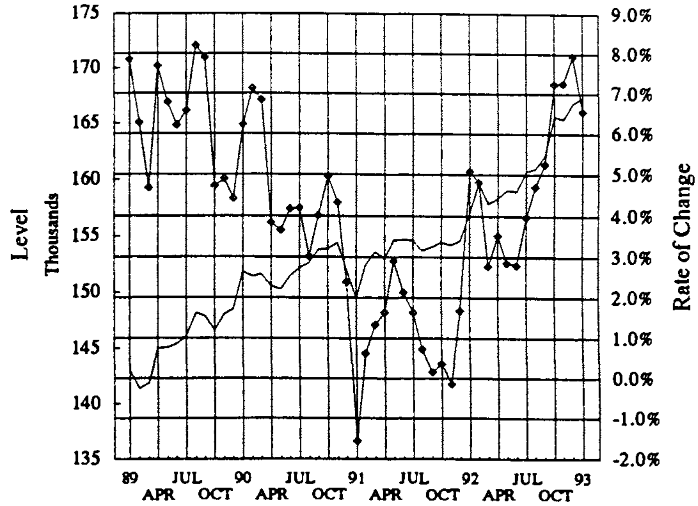
02-Mar-93

Industrial Production



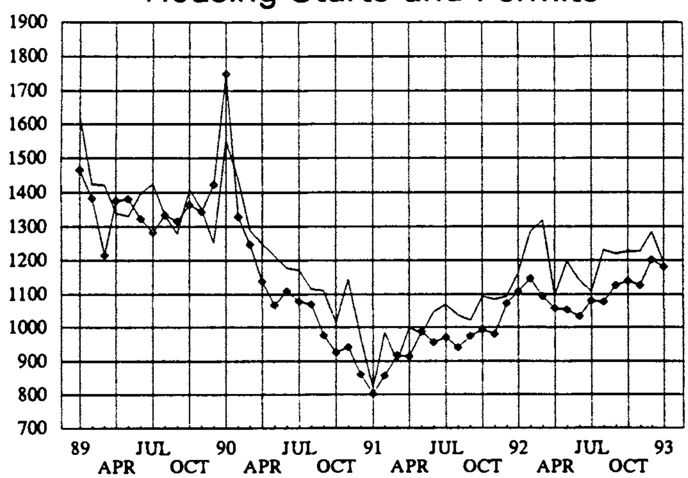
— Industrial Production Index (SA, 1987=100)
—◆— Industrial Production Index (SA, 1987=100) Yr/Yr

Retail Sales



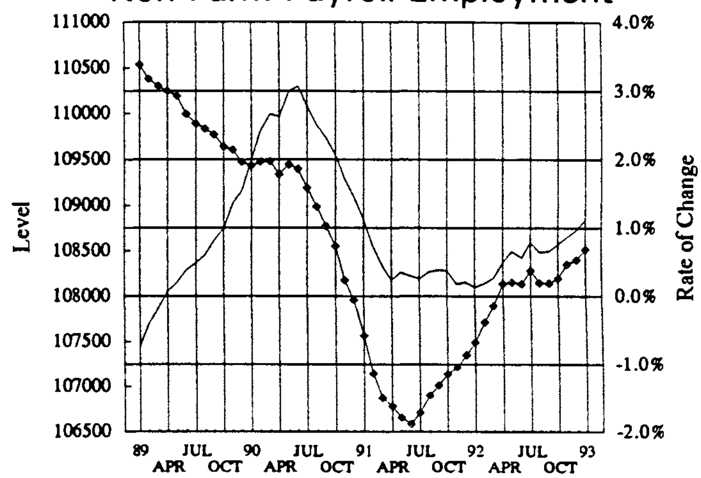
— Retail Sales (Thous.)
—◆— Retail Sales (Thous.) Yr/Yr

Housing Starts and Permits



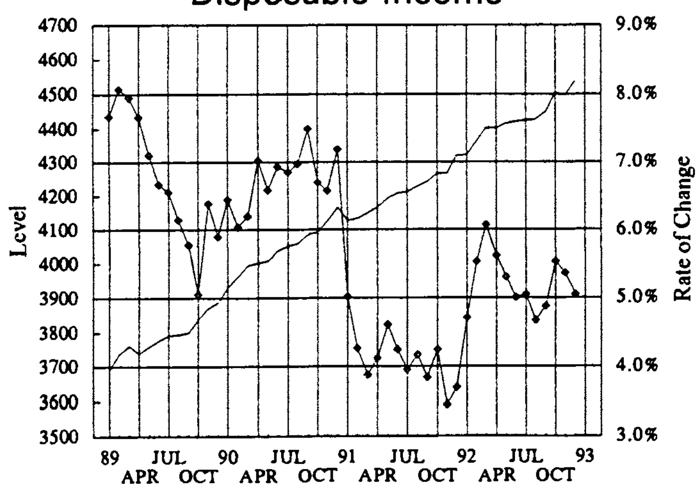
— Housing Starts, Total (SAAR, Thous.Units)
—◆— Housing Permits (SAAR, Thous.Units)

Non-Farm Payroll Employment



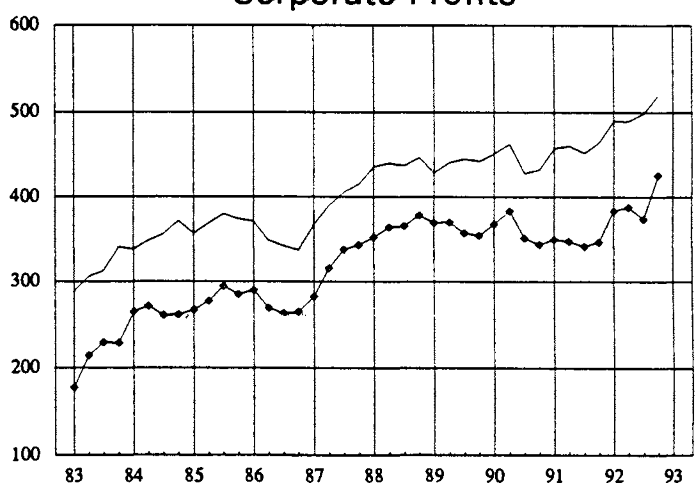
— Total Nonagricultural Payrolls (SA, Thous.)
—◆— Total Nonagricultural Payrolls (SA, Thous.) Yr/Yr

Disposable Income



— Disposable personal income ($Bil)
—◆— Disposable personal income ($Bil) Yr/Yr

Corporate Profits

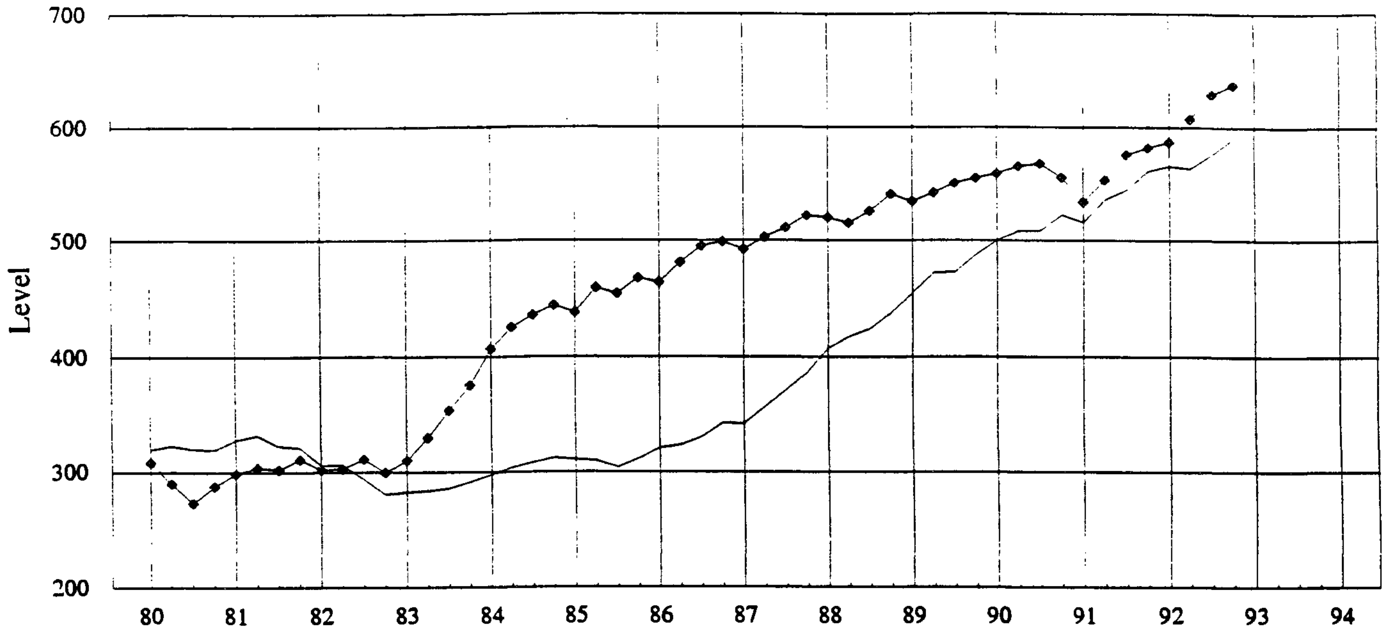


— Net Cash Flow w/IVA and CCA
—◆— Corporate Profits w/IVA and CCA --Economic Profits

Shadow Open Market Committee

Chart 2

Real Exports and Imports



Composition of Real Merchandise Exports and Imports

	91:IV Level	92:IV In $ Bil	Percent of Total	Percent Change 1991:IV to 1992:IV
Exports	407.3	425.5	100.0	4.5
Food, Feed, Beverages	33.4	38.3	9.0	14.7
Industrial Supplies	96.4	93.6	22.0	-2.9
Capital Goods, (Ex. Auto)	172.5	183.7	43.2	6.5
Auto	37.5	42.8	10.1	14.1
Consumer	42.7	45.4	10.7	6.3
Other	24.9	21.6	5.8	-13.3
Imports	482.2	532.6	100.0	10.5
Food, Feed, Beverages	24.5	25.6	4.8	4.5
Industrial Supplies	69.1	72.5	13.6	4.9
Capital Goods, (Ex. Auto)	129.3	160.4	30.1	24.1
Auto	78.3	79.9	15.0	2.0
Consumer	104.6	110.3	20.7	5.4
Other	29.8	31.3	5.9	5.0
Petroleum	46.5	52.6	9.9	13.1

Chart 3

02-Mar-93

Employment, Growth and Productivity

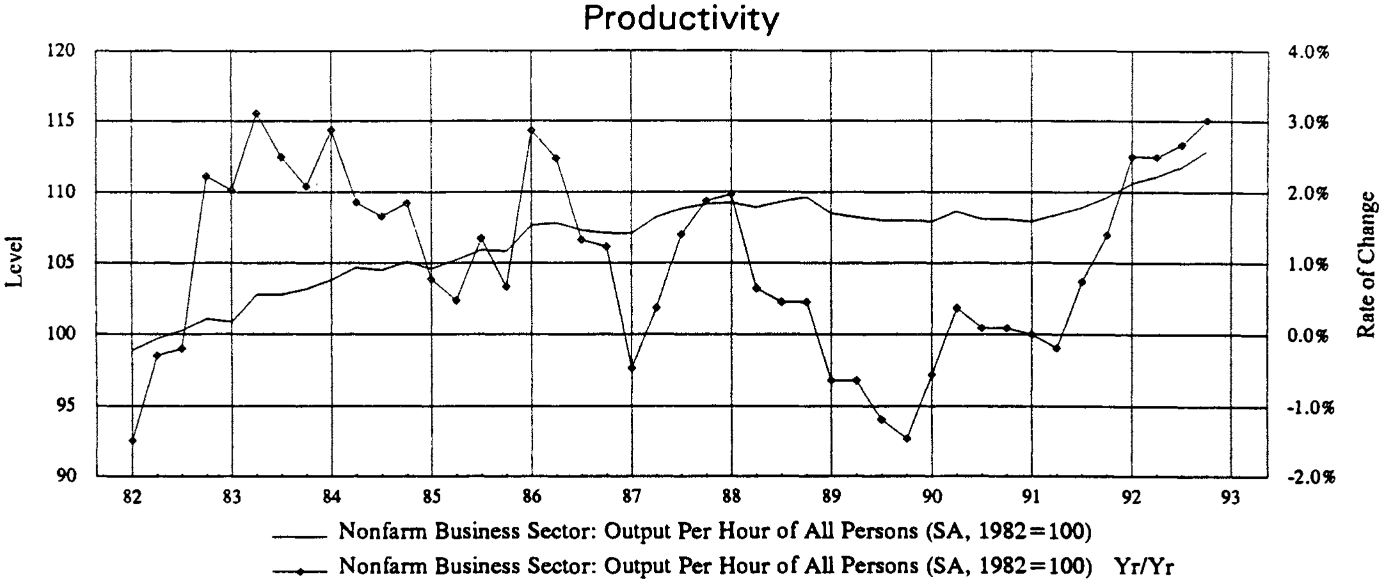
(Year-to-Year Percent Changes)

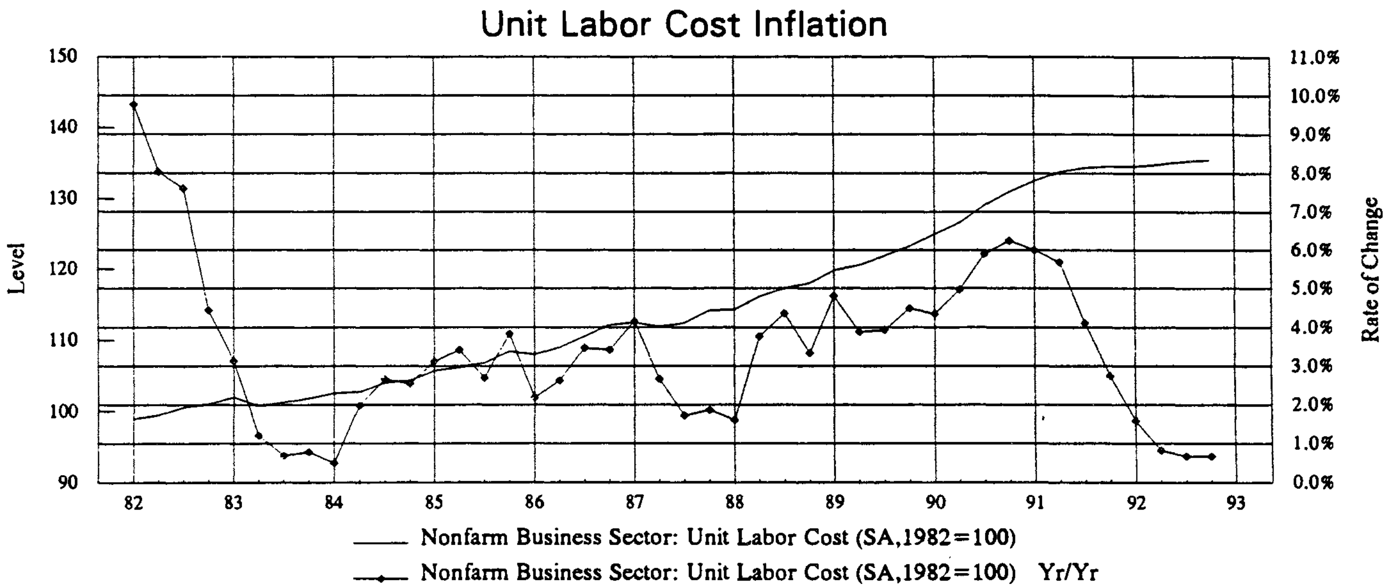
March 7-8, 1993

44

Chart 4

PRODUCTIVITY, UNIT LABOR COST & COMPENSATION





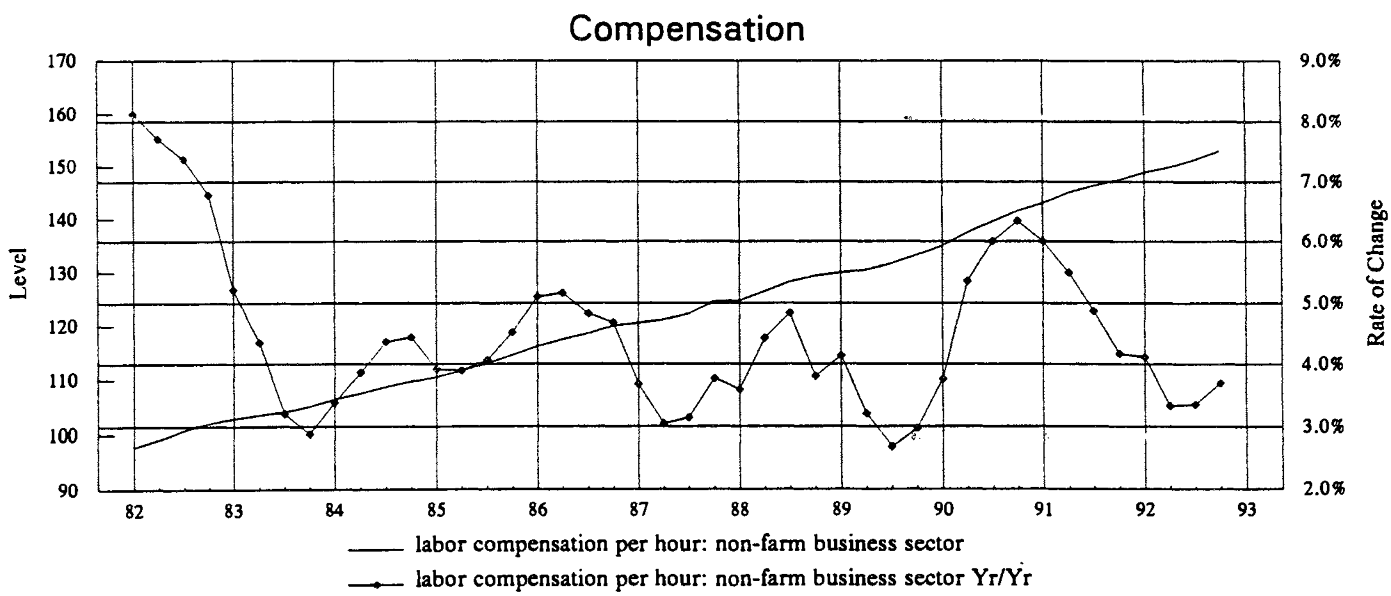
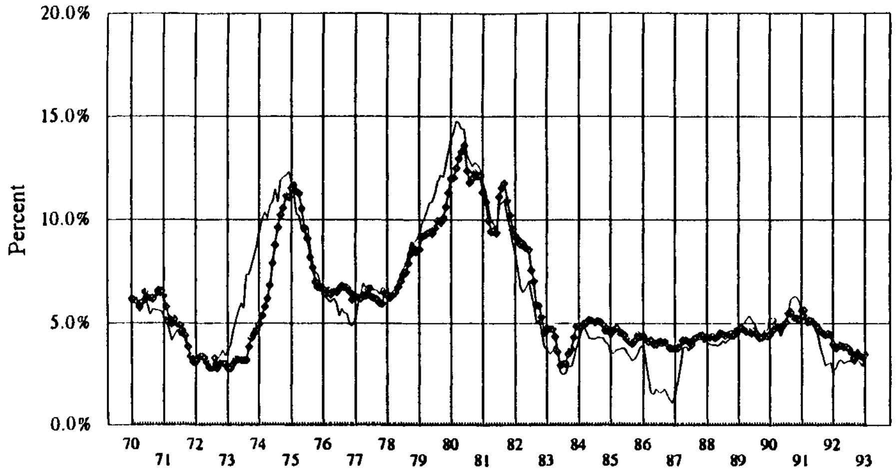


Chart 5

MEASURES OF INFLATION

02-Mar-93

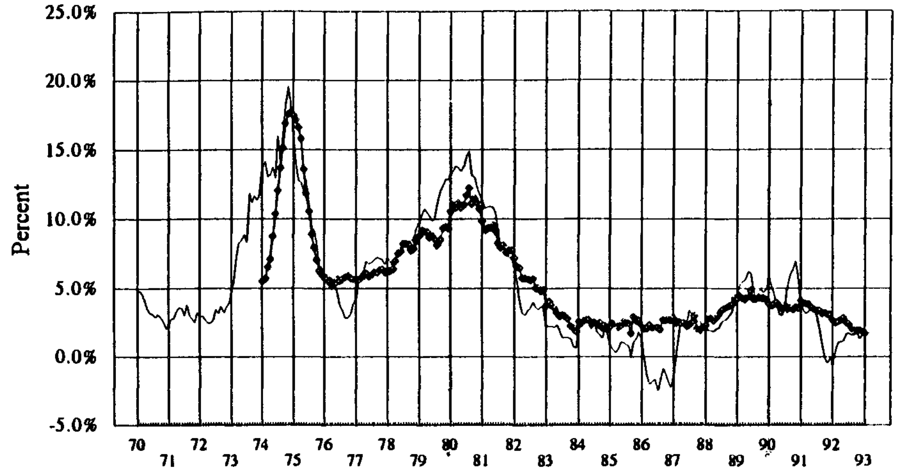
Consumer Price Inflation



— CPI-U, All Items (NSA, 1982-84=100) Yr/Yr

—◆— CPI-U: ALL ITEMS, EX. FOOD AND ENERGY (NSA) Yr/Yr

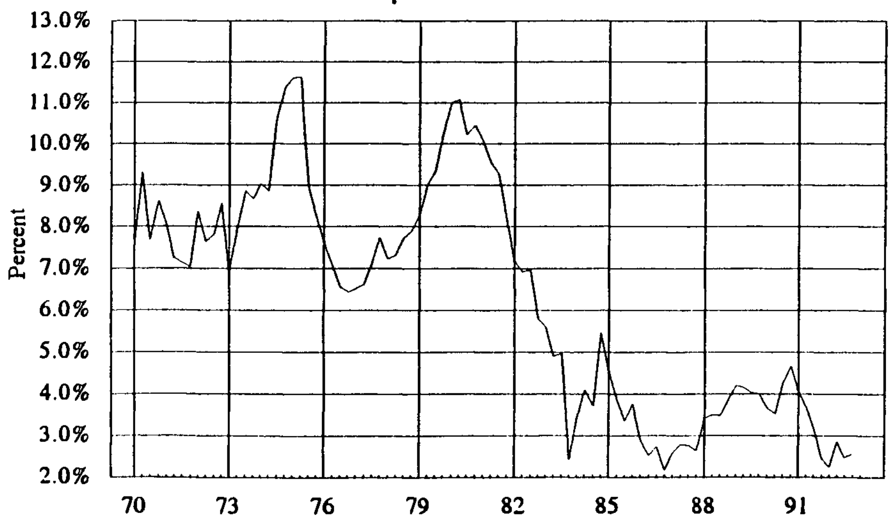
Producer Price Inflation



— PPI: Finished goods (to users,incl. foods, fuel) (1982=100,NSA) Yr/Yr

—◆— PPI: Finished Goods Less Food and Energy (NSA, 1982=100) Yr/Yr

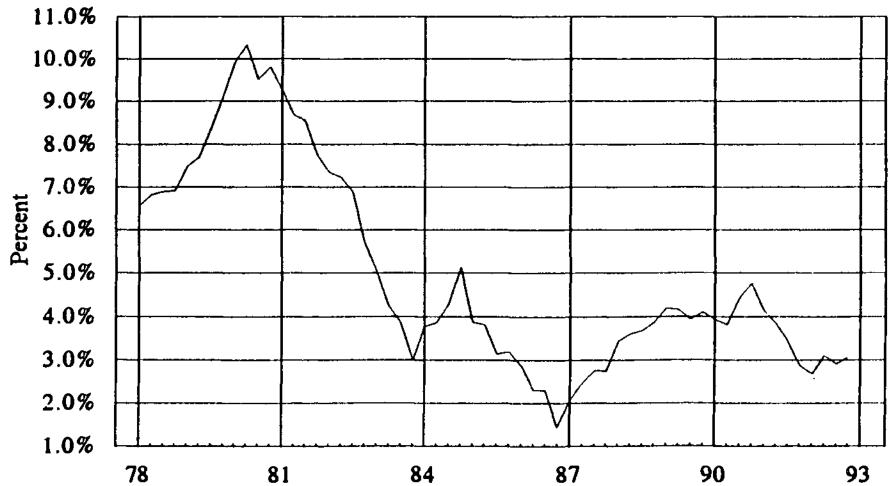
Implicit GDP Deflator



— GDP Implicit (Yr/Yr)

Fixed Weight GDP Deflator

1978 - Present



— Fixed Weight GDP (Yr/Yr)

Chart 6

MEASURES OF MONEY SUPPLY

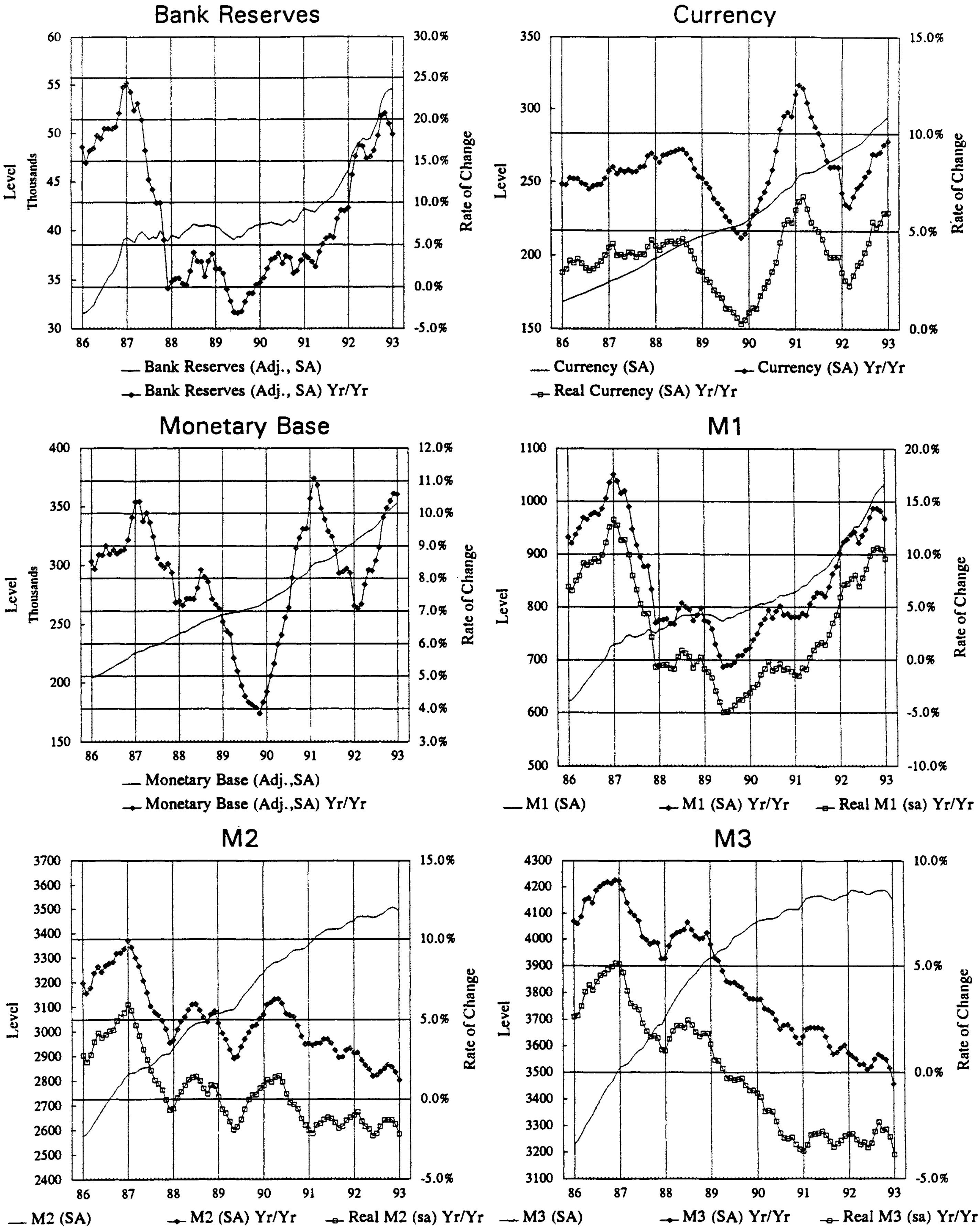


Chart 7

MONEY VELOCITY

04-Mar-93

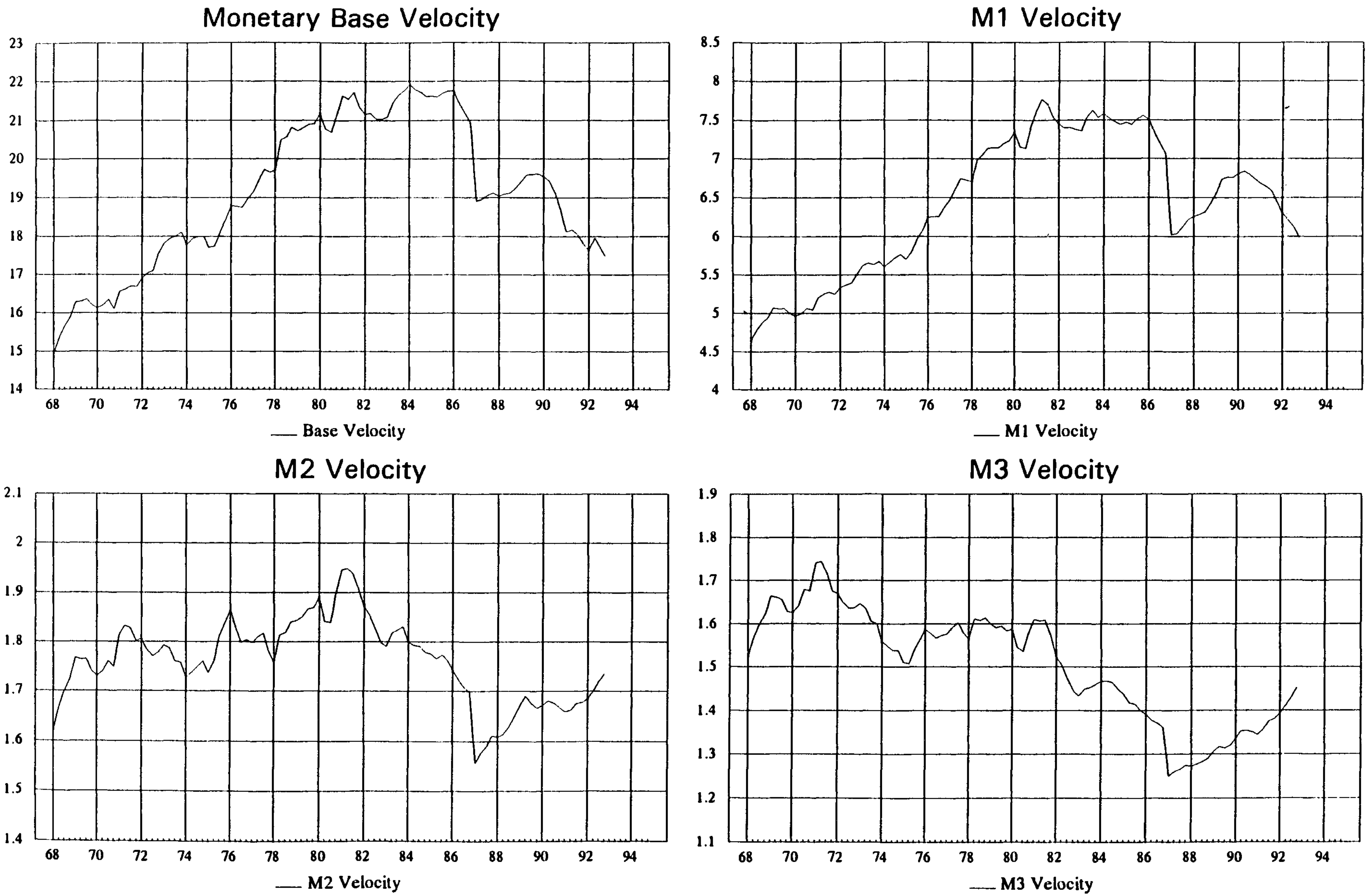
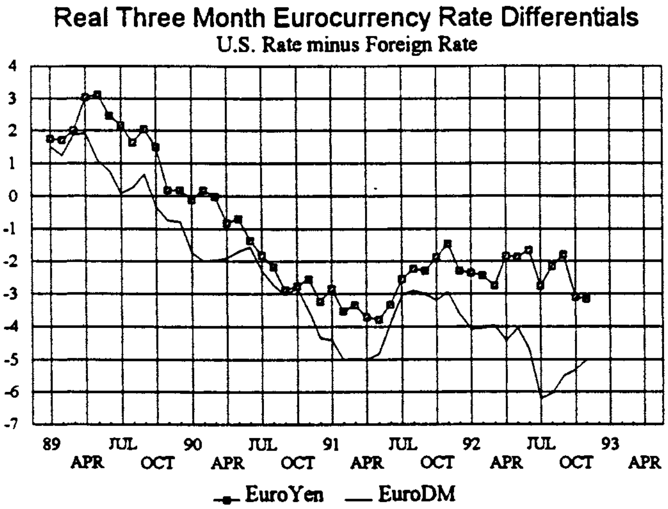


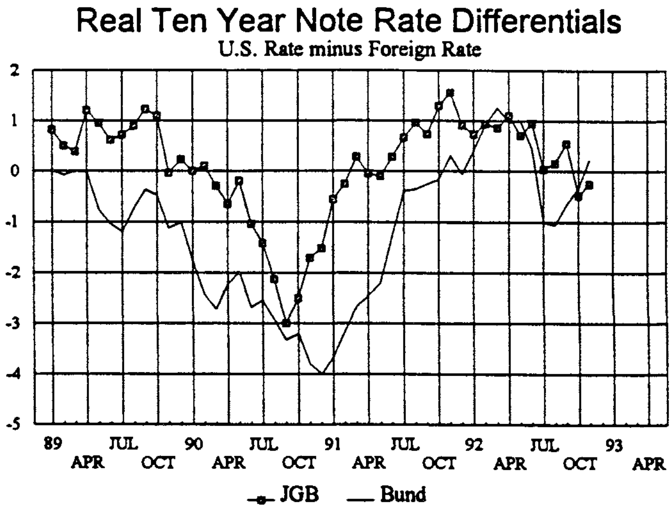
Chart 8

INTERNATIONAL FINANCIAL TRENDS

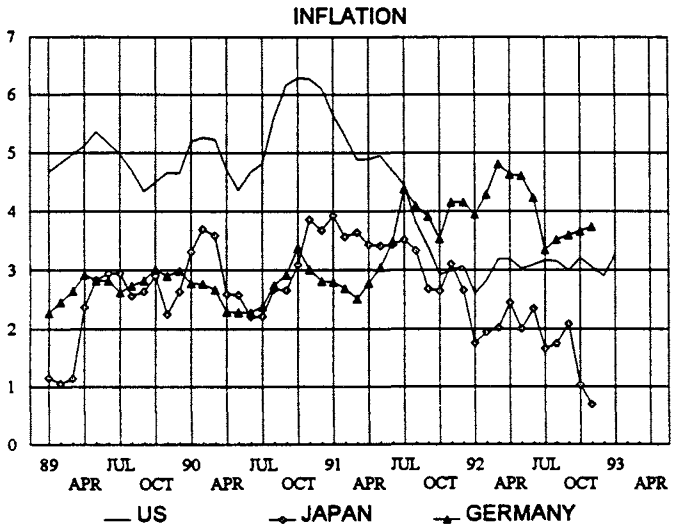
04-Mar-93

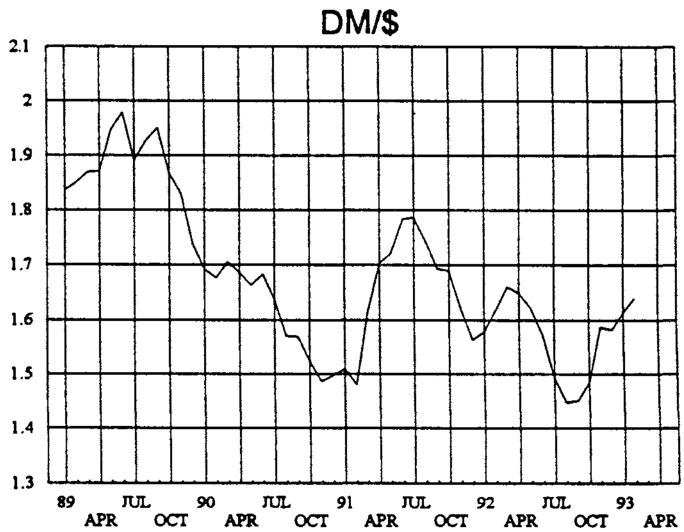


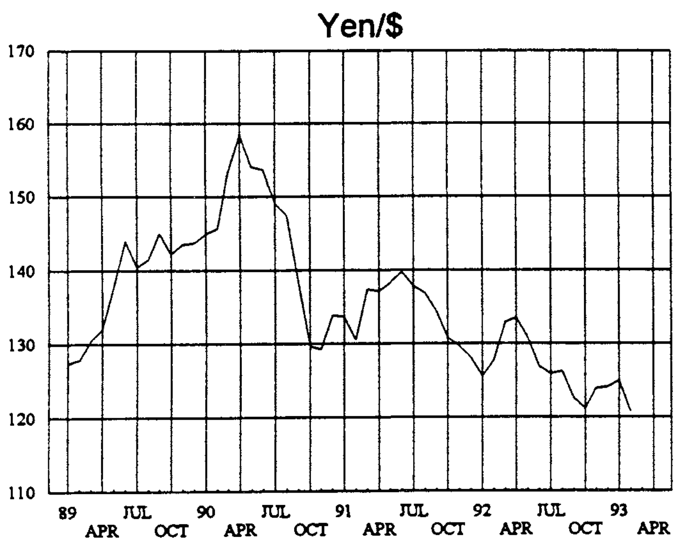
Nominal rates deflated by year-to-year CPI rate.

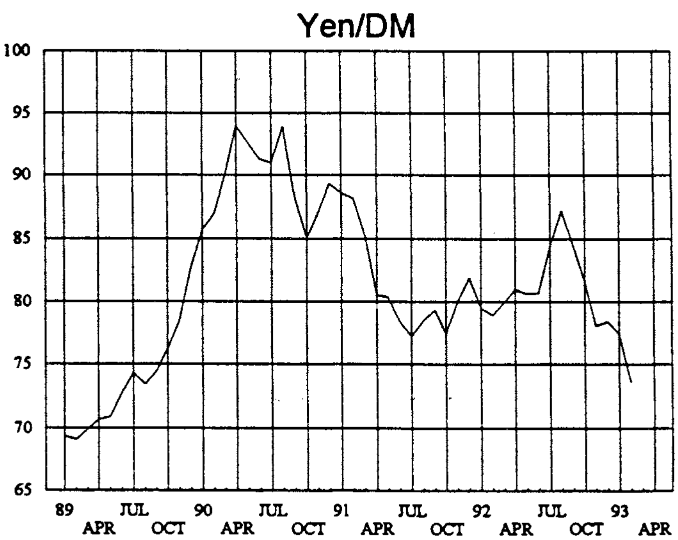


Nominal rates deflated by year-to-year CPI rate.









SOME OBSERVATIONS ON MONETARY BASE GROWTH DURING RECOVERIES

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William E. Simon Graduate School of Business Administration
University of Rochester

There is continuing pressure on the Federal Reserve to further ease monetary policy to promote economic recovery. Since the peak of this most recent business cycle in July 1990, short-term interest rates have fallen by almost 500 basis points and the monetary base has grown at an average rate of almost 11 percent per annum. By almost any measure, the Federal Reserve has been very aggressive with the instruments under its control to promote economic recovery.

Growth in the monetary base, however, is the principle engine for generating inflation and historically had little impact on real economic growth. Figure 1 illustrates that annual growth rates in the base have little or no association with real GDP growth. (Allowing for a lag of up to two years does not significantly alter the picture.) On the other hand, higher monetary base growth is systematically associated with higher rates of inflation. Partitioning annual base growth into periods in which it was less than 5 percent and periods in which it was greater than 5 percent is summarized in Table 1 and tells a similar story. The table shows that between 1960 and 1992 when the monetary base grew faster than 5 percent year over year it averaged 7.3 percent and that real GDP growth averaged 2.8 percent and inflation averaged 5.2 percent. When the monetary base growth was less than 5 percent, year over year real GDP still averaged 2.8 percent while the average inflation rate fell to 2.9 percent.

Figure 2 reproduces Figure 1 except that it only plots the three years following an economic trough. Once again, the qualitative picture is the same: faster base growth appears unrelated to real economic growth but positively related to inflation rates. The graphs of Figure 3 plot the path of real GDP, the price level and the monetary base for each recovery since 1960. Each variable is indexed to 100 in the quarter of the trough and its evolution is plotted for 12 quarters or 3 years. In five of the six recoveries, high base growth has resulted in higher price growth while lower base growth has been associated with lower price growth.[1] The only exception appears to be the current recovery to date. Extremely rapid base money expansion has occurred since the trough in 1991-I yet prices have only grown modestly. History gives cause for alarm regarding the prospects for inflation if the Federal Reserve does not bring a stop to this very rapid expansion in the monetary base. Since January 1st of this year, the monetary base has grown at an annual rate in excess of 25 percent!

We also continue to hear reports from Washington and the business press that either more economic growth causes inflation or that inflation is good for economic growth. Neither story has much evidence to support it. Figure 4 plots the annual growth rate in real GDP against the annual inflation rate along with the least squares regression line over the 1960-1992 period. There appears to be no indication that high economic growth is systematically associated with higher rates of inflation. If anything, the picture indicates that higher inflation rates are more frequently associated with lower rates of real economic growth.

Table 2 partitions the sample into those periods of annual inflation greater than 5 percent and less than 5 percent. When annual inflation was greater than 5 percent, real GDP grew at an average rate of 2.9 percent. When annual inflation was less than 5 percent, real GDP grew at an average rate of 3.3 percent. Neither the Federal Reserve nor the Administration should attempt to resurrect the Phillips Curve as basis for policymaking.

Since the announcement of Clinton's economic program there has been a drop in long-term interest rates. Most commentators have interpreted this as indicating support for the President's economic proposals and confidence that the deficit will be reduced some time in the future. It is worth noting that long-term rates have been falling since early December. Long-term Treasuries have fallen 80-90 basis points. The term spread has declined from over 400 basis points in December to about 360 basis points in late February. Nevertheless, since Clinton's announcement of his economic program, long-term rates have continued to fall and short-term rates have stabilized.

There are other interpretations one may wish to consider depending on whether one views the fall as a reduction in expected future short-term real rates or only in nominal rates. One possible explanation is that tax increases that reduce the future deficit may reduce the pressure on the Federal Reserve to monetize the debt and thus create inflation. If so, then the reduction in long-term nominal rates is simply a reduction in expected inflation and not a reduction in real rates. Another explanation is less charitable to the Clinton economic plan. It is well-known that the slope of the yield curve is a valuable predictor of future real economic growth. Thus another interpretation is that the flattening of the yield curve is signaling that real rates are expected to be lower in the future because the tax proposals of the new Administration will act to reduce economic growth in the longer term. It is dangerous, therefore, to be too sanguine regarding the behavior of the bond markets and its response to the current economic proposals.

NOTES

[1]Also plotted for the last three recessions is the domestic base which nets out foreign holdings of U.S. currency. The message remains the same even for the current episode.

Table 1

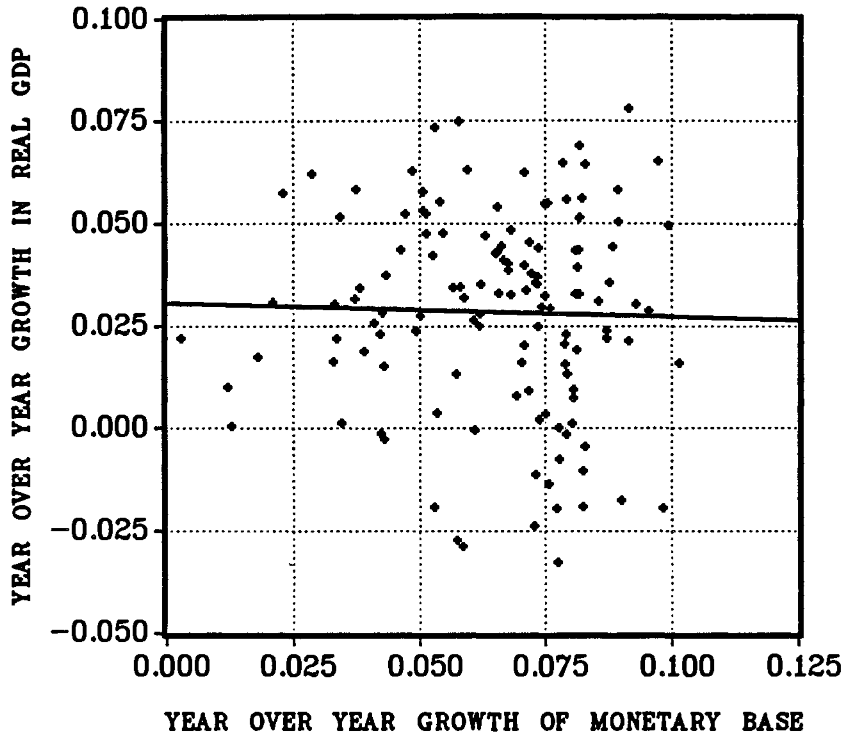
	Annual Growth Rate of Monetary Base	
	< 5.0%	> 5.0%
Average Base Growth Rate	3.4%	7.3%
Average Real GDP Growth Rate	2.8%	2.8%
Average Inflation Rate	2.9%	5.2%

Table 2

	Annual Inflation Rate	
	< 5.0%	> 5.0%
Average Base Growth Rate	6.0%	7.5%
Average Real GDP Growth Rate	3.3%	2.9%
Average Inflation Rate	3.2%	5.3%

REAL GDP, INFLATION AND THE MONETARY BASE 1960 – 1992

REAL GDP AND MONETARY BASE GROWTH



INFLATION RATE AND MONETARY BASE GROWTH

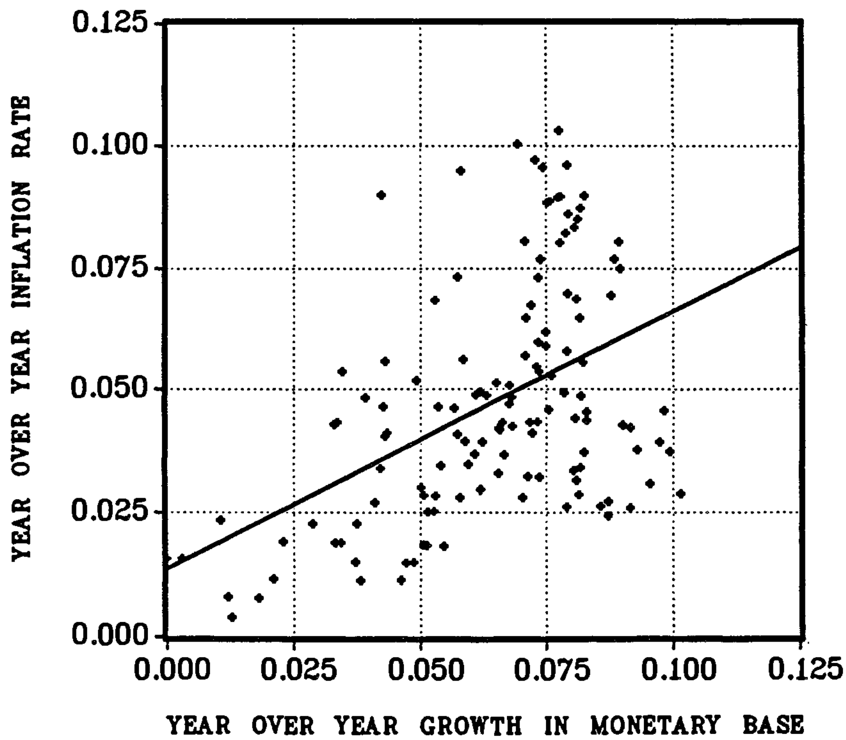
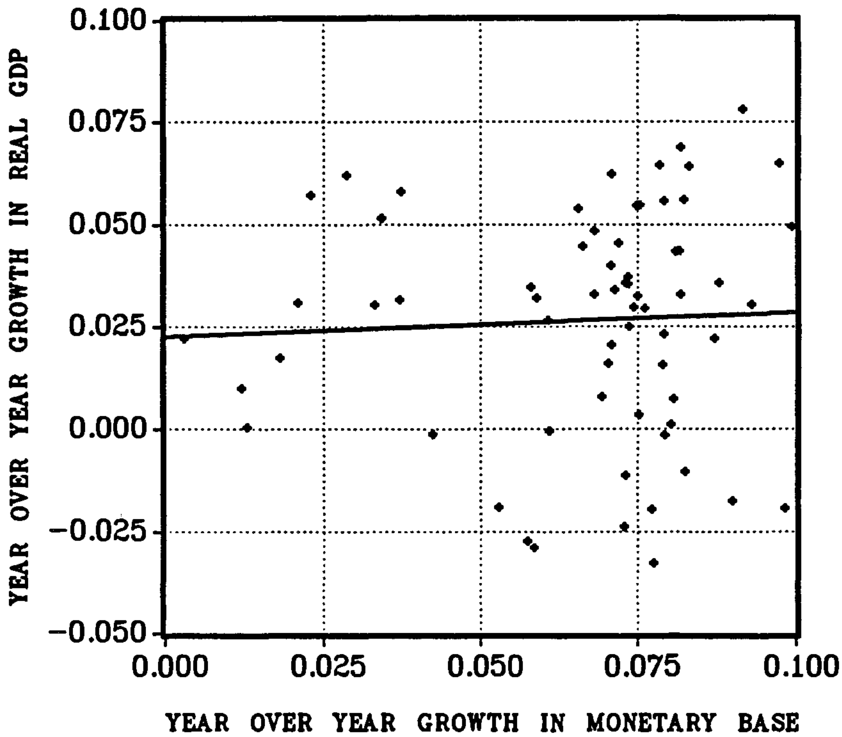


FIGURE 1

REAL GDP, INFLATION AND THE MONETARY BASE DURING ECONOMIC RECOVERY

REAL GDP AND MONETARY BASE GROWTH



INFLATION RATE AND MONETARY BASE GROWTH

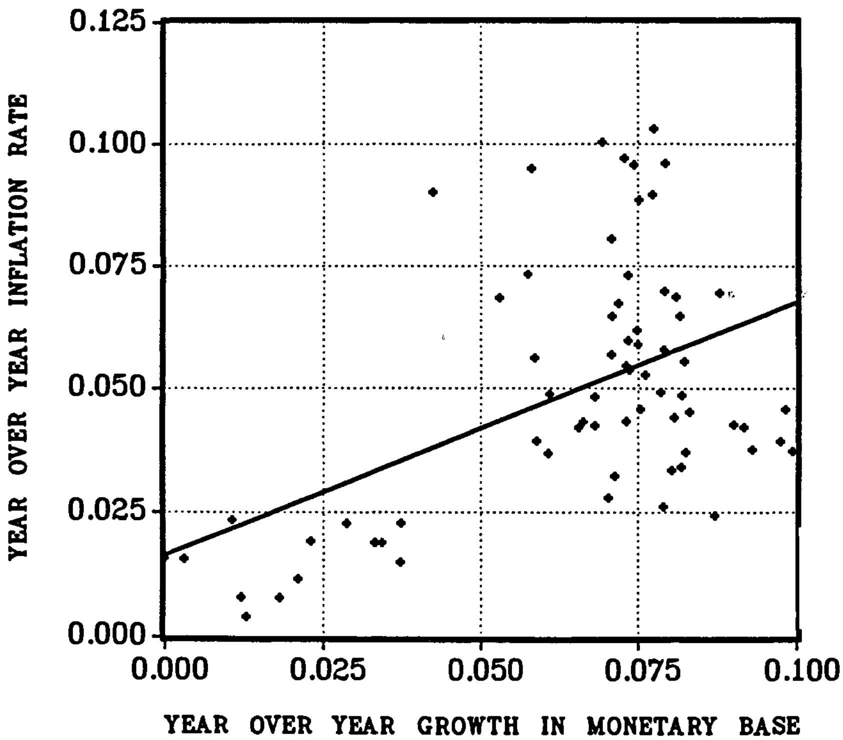


FIGURE 2

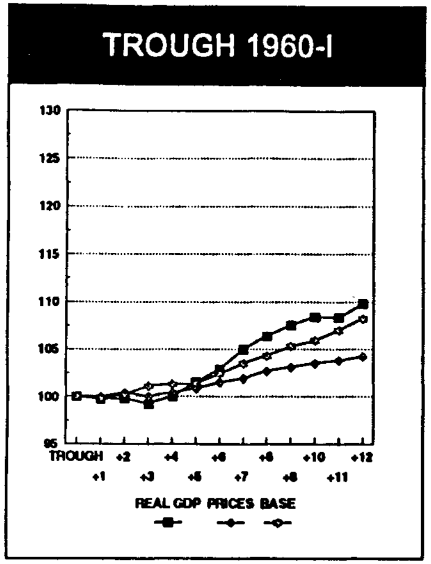


Figure 3.1

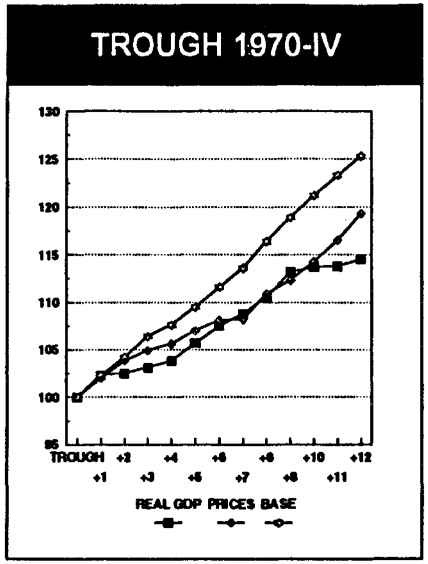


Figure 3.2

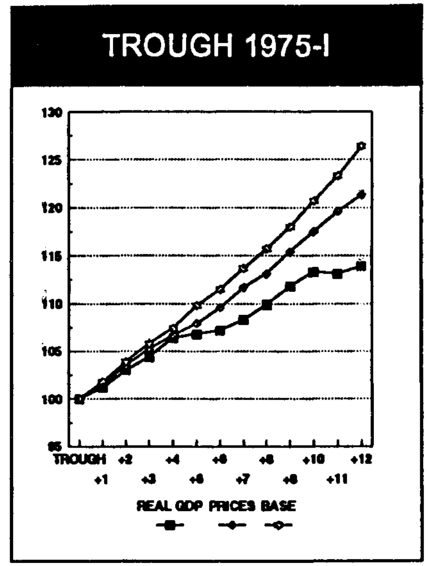


Figure 3.3

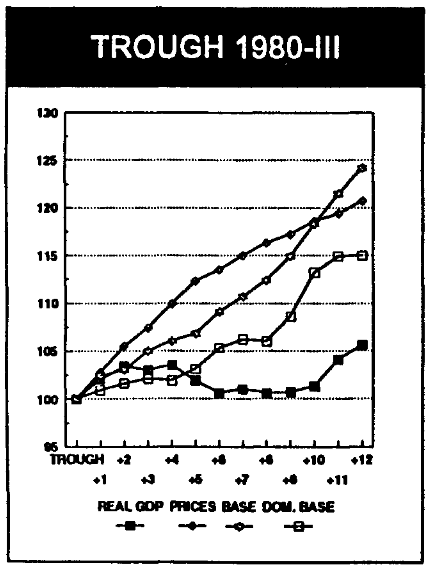


Figure 3.4

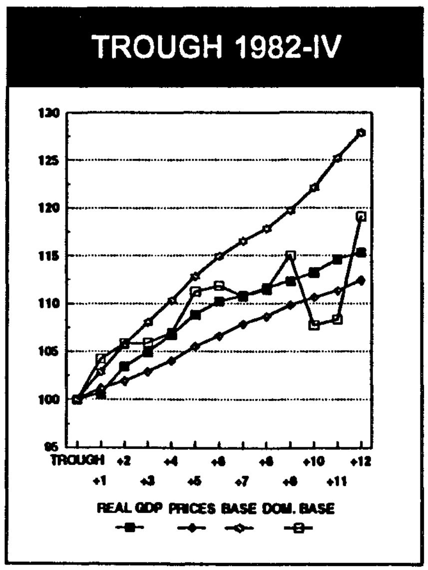


Figure 3.5

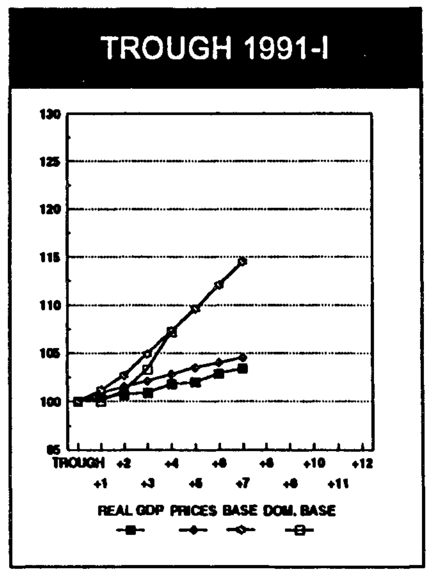


Figure 3.6

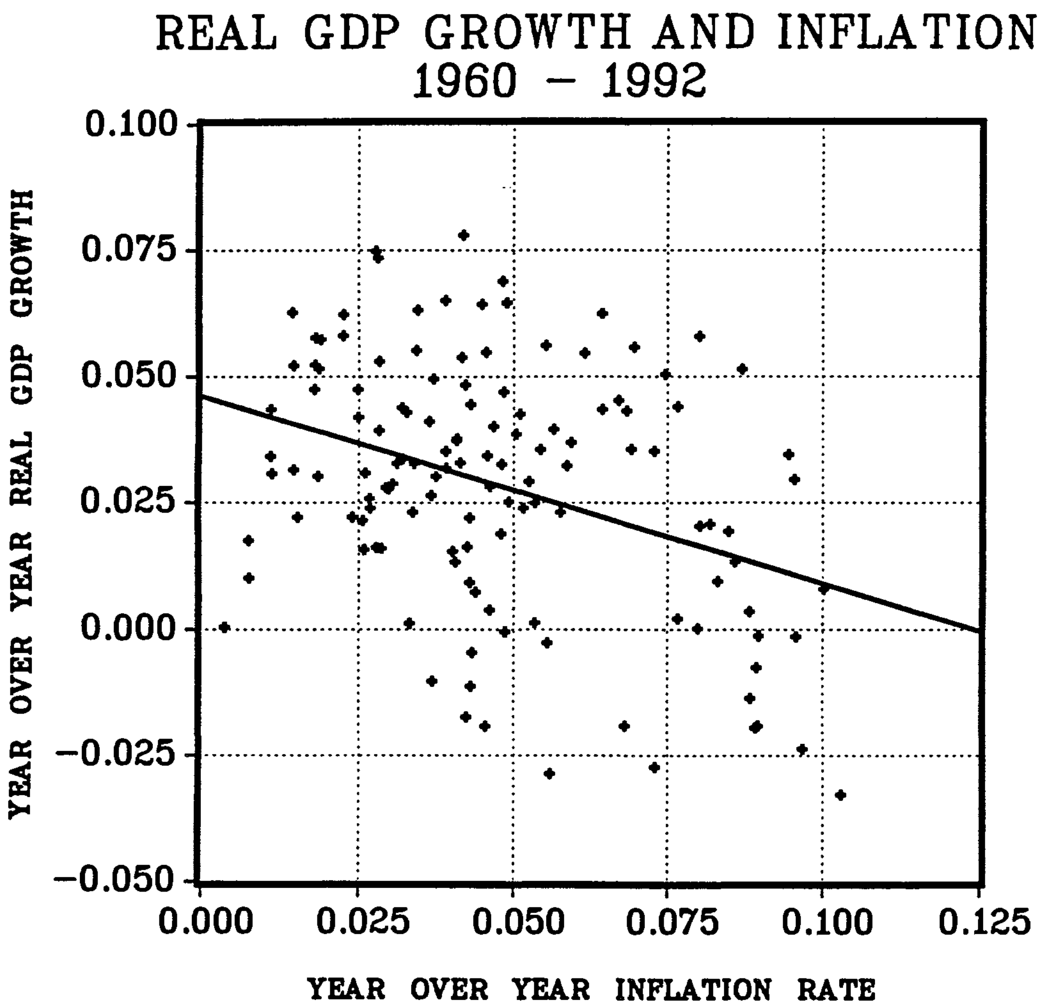

REAL GDP GROWTH AND INFLATION
1960 – 1992
YEAR OVER YEAR REAL GDP GROWTH
0.100
0.075
0.050
0.025
0.000
−0.025
−0.050
0.000
0.025
0.050
0.075
0.100
0.125
YEAR OVER YEAR INFLATION RATE

Figure 4

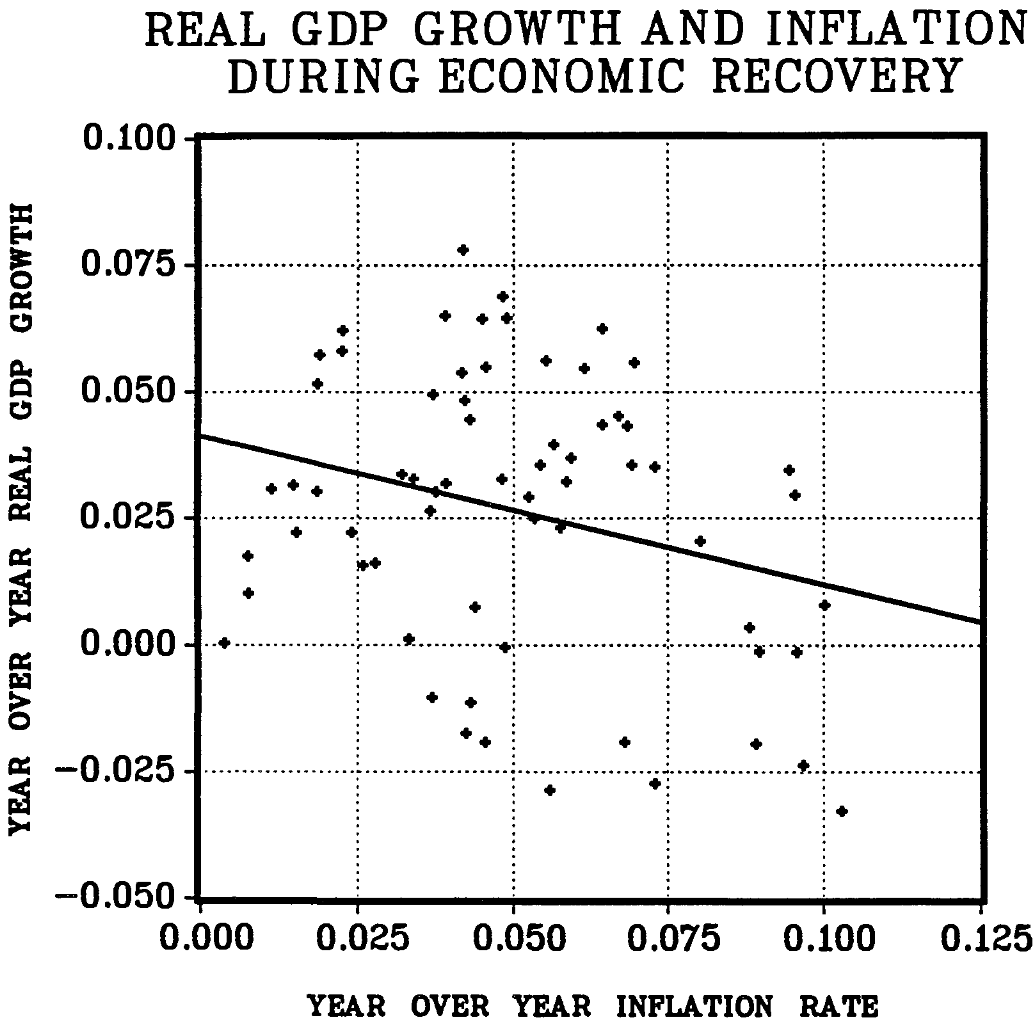

REAL GDP GROWTH AND INFLATION
DURING ECONOMIC RECOVERY
YEAR OVER YEAR REAL GDP GROWTH
0.100
0.075
0.050
0.025
0.000
−0.025
−0.050
0.000
0.025
0.050
0.075
0.100
0.125
YEAR OVER YEAR INFLATION RATE

Figure 5

THE COMPETITIVE POSITION OF THE UNITED STATES IN THE INTERNATIONAL ECONOMY

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Brown University

What was the international competitive position of the United States at the outset of the Clinton Administration? What can we learn from recent performance and policies of other major economies around the world? These are big questions, but a relatively few graphs can go a long way in providing a sense of where the U.S. economy stands.

PRODUCTIVITY AND UNIT LABOR COSTS

Figure 1 shows what has happened to unit labor costs in manufacturing since 1987 for the United States and a handful of other countries. The black bar shows the data in local currencies, and the gray bar the data converted to a common currency using 1992 exchange rates. U.S. unit labor costs in manufacturing have risen by only 4 percent since 1987. With the exception of France, our major competitors have done worse, and in some cases much worse. Taking account of exchange rate changes since 1987, the U.S. has done far better than any of its major competitors; U.S. unit labor costs have fallen 23 percent. We should not be surprised that U.S. net exports have risen substantially over this period; the U.S. balance-of-payments current account was -$163 billion in 1987 and only -$3.7 billion in 1991.

Figure 2 shows the long-term record of U.S. unit labor cost and productivity in the private business sector. The figure shows the private business sector rather than just manufacturing because trade in services is growing rapidly, and trade in agricultural products has long been important to the United States. The dramatic improvement over the last several years is clearly evident. Over the four quarters ending 1992:IV, compensation rose by 3.69 percent, output per hour by 3.26 percent, and unit labor cost by only 0.67 percent. In manufacturing, over the four quarters ending 1992:IV, compensation rose by 2.49 percent, output per hour by 3.26 percent, and unit labor cost fell by 0.73 percent.

OUTPUT

Figure 3 shows what has happened to industrial production since 1987. The United States has only just recently seen its industrial production surpass its peak in 1990. Production in OECD Europe as a whole flattened out in 1990, but has now fallen below U.S. production, relative to the base year of 1987. Japan's production rose to a much higher peak in 1991 than did U.S. production, but the decline in Japan has been much steeper than it was in the United States. Canada reached a peak in 1989, and is still far from recovering to its peak level of production. Overall, the performance of the United States is at least comparable to that of its major competitors. A rosier view would note that the United States has enjoyed a sustained increase in production since late 1991, whereas many other countries have flat to falling production.

Figure 4 shows the longer-term growth record as measured by real GDP. The data in the figure were drawn from the World Bank, *World Development Report 1992,* which has the virtue of reporting a very large number of countries but the disadvantage of not being totally up to date. In Figure 4, the United States and the United Kingdom are the only two countries to show higher growth over the 1980-90 period compared to the 1965-80 period. For the United States, growth averaged 2.2 percent 1980-92, down from 2.7 percent 1965-80. Still, given that most countries in the developed world suffered low or negative growth 1991-92, the relative improvement of U.S. growth after 1980 still stands. On an absolute level, U.S. growth 1980-90 was 3.4 percent, which was higher than any other country in the figure except for Japan, at 4.1 percent. (Australia, Canada and Finland also came in at 3.4 percent growth.)

THE LABOR MARKET

The politics of economic performance often center on unemployment issues. Figure 5 shows U.S. performance on this front. Between 1970 and 1980, unemployment rose in every country shown in the figure, except for Norway which was unchanged.[1] Unemployment again rose in every country between 1980 and the latest available data, which refer to 1992:III, except for the United States and Belgium. On an absolute basis, U.S. unemployment was below that in many of our international competitors.

The unemployment rate only scratches the surface of employment conditions. Figure 6 shows unemployment of six months and longer as a percentage of total unemployment in 1990 (latest data available to me in readily accessible form). Relative to other countries, U.S. unemployment is short-term. In 1990, when the U.S. unemployment rate was 5.4 percent, only 12.4 percent of that unemployment, or 0.67 percent of the labor force, was six months and over. In contrast, Germany, for example, had an unemployment rate of 4.9 percent in 1990, but 64.5 percent of that unemployment, or 3.16 percent of the labor force, was six months and over. The U.S. labor market is much more flexible than labor markets in most other countries.

Figure 7 reflects my interest in a growing problem in the United States, that of early retirement of men aged 55-64. (I think it is a problem because people in this age group have valuable accumulated skills.) Of men in that age group, 34.7 percent were either not in the labor force or unemployed, a concept the OECD calls the "inactivity rate." In fact, the United States compares reasonably well to other countries on its inactivity rate for men 55-64, with the exceptions of Japan and Sweden. In terms of the employment of women, shown in the figure for the age group 25-54, the United States does better than most other countries (the U.S. inactivity rate is lower). Sweden is the only country in the figure with a lower inactivity rate for women 25-54.

I put Sweden in these figures not because it is a large economy, which it obviously isn't, but because by many measures it does very well on the employment-unemployment front. Figure 8 provides a hint as to how Sweden can accomplish this result. Sweden spends 0.2 percent of its GDP on subsidized employment and 0.8 percent of its GDP on training programs for unemployed adults. In 1990-91, unemployed adults entering training programs amounted to 1.7 percent of the labor force in Sweden, compared to 0.9 percent for the United States.[2] Given that Sweden spends much more as a percentage of GDP on these programs than does the United States, it is presumably the case that unemployed adults remain in training programs longer in Sweden than in the United States. Training programs reduce reported unemployment, but in Sweden's case have not been successful in achieving a high rate of growth of real GDP, judging from Figure 4.

An interesting feature of Figure 8 is the large differences among the countries shown in unemployment compensation as a percentage of GDP. It is well-known that unemployment compensation tends to reduce the incentive for unemployed persons to find new jobs; part of the problem of high unemployment is that many OECD countries pay people too much for too long to remain unemployed.

TAXES

President Clinton has proposed that the United States embark on a program of substantial tax increases with the stated aim of reducing the federal budget deficit. It seems appropriate to ask whether there is evidence that high-tax countries have smaller budget deficits than low-tax countries.

Figure 9 shows the data on taxes and budget deficits for OECD countries in 1990. Government is defined here as general government—central and lower levels of government combined. There is no evidence in Figure 9 that countries with higher taxes as a percentage of GDP have lower budget deficits.

Figure 10 explores the question of whether countries that increased their taxes the most over the 1972-90 period were successful in reducing their budget deficits. Here again, the verdict is negative. With the exceptions of Japan and Ireland, budget deficits have grown everywhere, independently of whether countries increased their taxes a lot or a little. Given this evidence, given that President Clinton is planning substantial increases in federal spending, and given the likelihood that the increases in tax rates will yield less revenue than estimated at this time, I see no reason to believe that the federal budget deficit will in fact fall to any appreciable extent.

Figure 11 provides information on top marginal personal tax rates for 1980 and 1990 (updated to 1992 where I had information readily available). Almost all countries reduced tax rates in the 1980s, but as of 1992 the United States still had the lowest top rate of the countries shown in the figure with the exceptions of Canada, Norway, Sweden, and Switzerland.

Figure 12 provides information on capital taxation. Many countries have a zero tax on capital gains, but most tax dividends at a higher rate than does the United States. There is much to be said for taxing dividends and capital gains at the same, relatively low rate.

I believe that it is no accident that countries with high tax rates in the 1980s experienced higher unemployment and slower growth, on the whole, than did the United States.

CONCLUDING COMMENTS

The performance of the U.S. economy was certainly less than robust 1990-92, but relative to other nations the United States has not done badly. The impatience of the Clinton Administration and its desire to raise taxes to finance new spending programs promises to damage U.S. economic prospects. The fiscal program of stimulus now and higher taxes later is 1940s Keynesianism. In fact, the depressing effects of future tax increases will arrive in 1993; the combination of fiscal stimulus and restraint at the same time is equivalent to driving with one foot on the accelerator and one on the brake. This policy is just as bad for the economy as it is for a car.

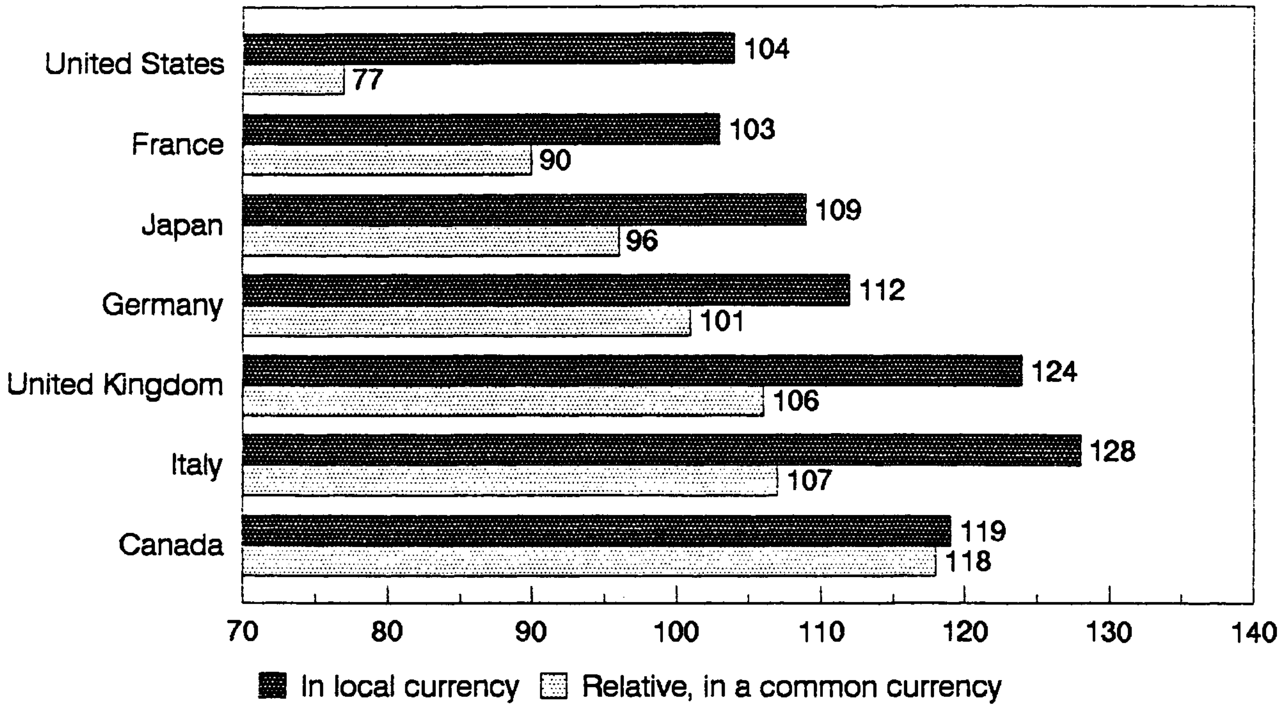
NOTES

[*]I thank Data Resources, Inc. for providing access to its data bank, from which I drew the data for Figures 2 and 3.

[1]The data in the figure refer to OECD standardized unemployment rates, which adjust for differences in national definitions to maintain comparability across countries.

[2]OECD Employment Outlook, July 1992, Table 2.B.2.

Figure 1 - Unit Labor Costs in Manufacturing, 1992
Selected Countries
Index, 1987 = 100



Source: OECD Economic Outlook, Dec. 1992, Table 18

Figure 2 - U.S. Productivity and Unit Labor Cost
Business Sector
Four-Quarter Change, 1947 - 1992

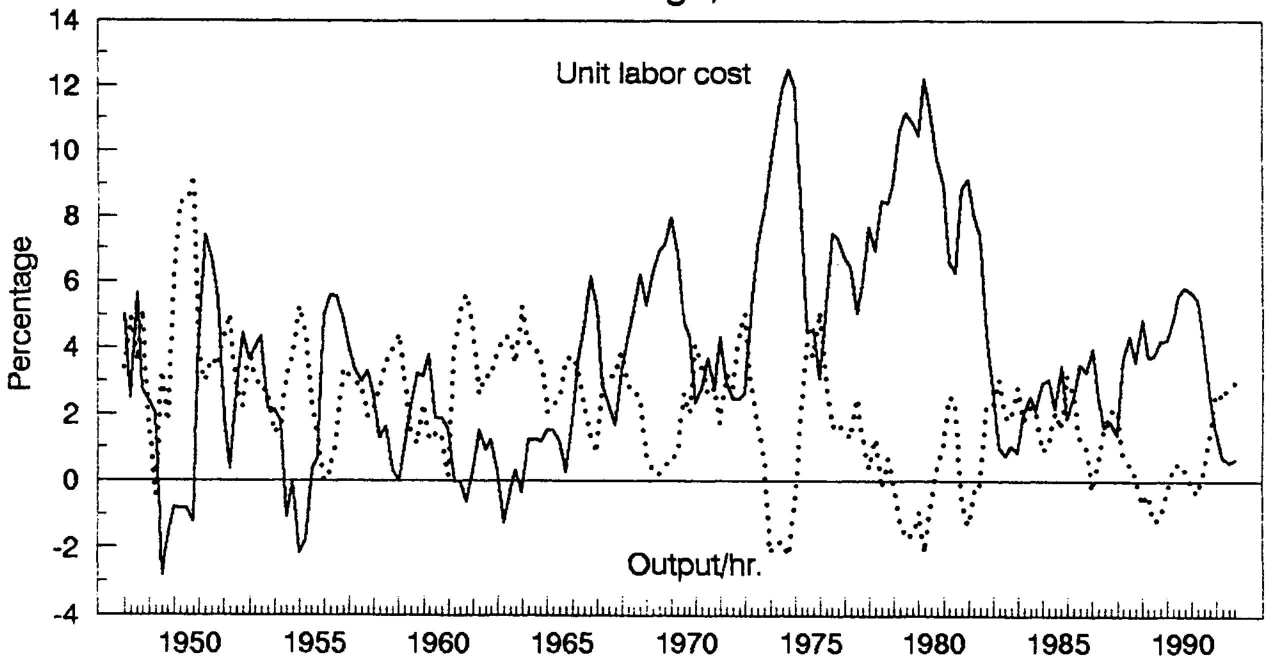


Figure 3 - Industrial Production, Monthly
United States, OECD Europe, Japan, Canada
1987 - 1992

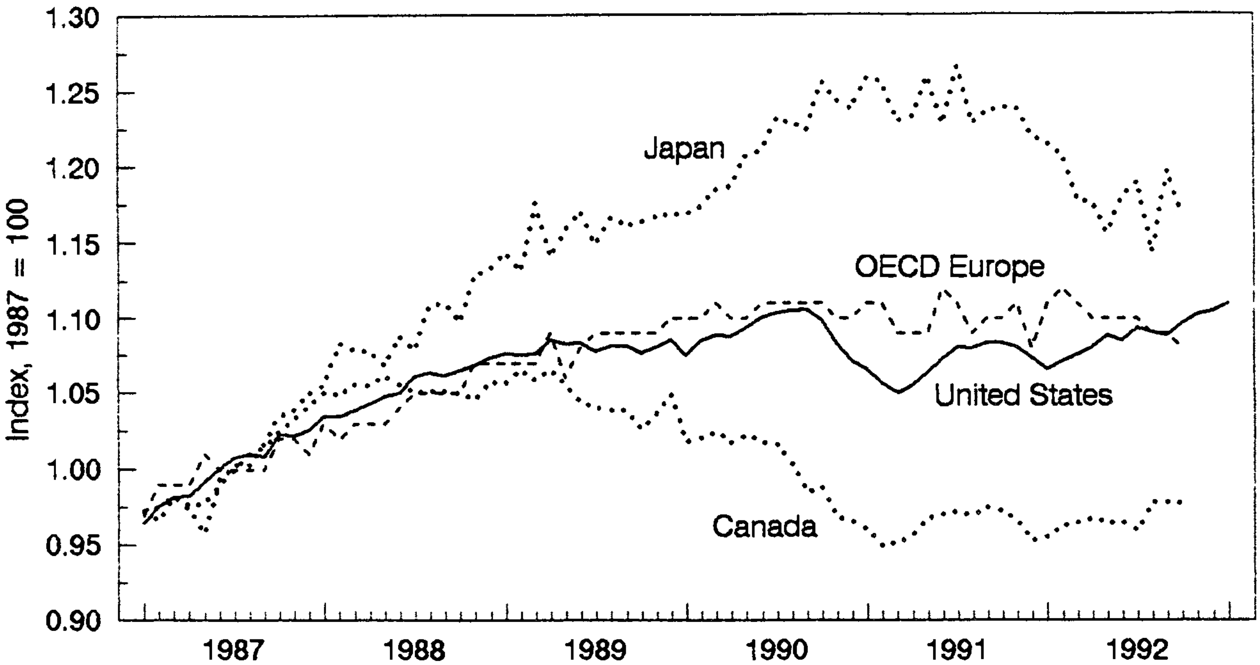
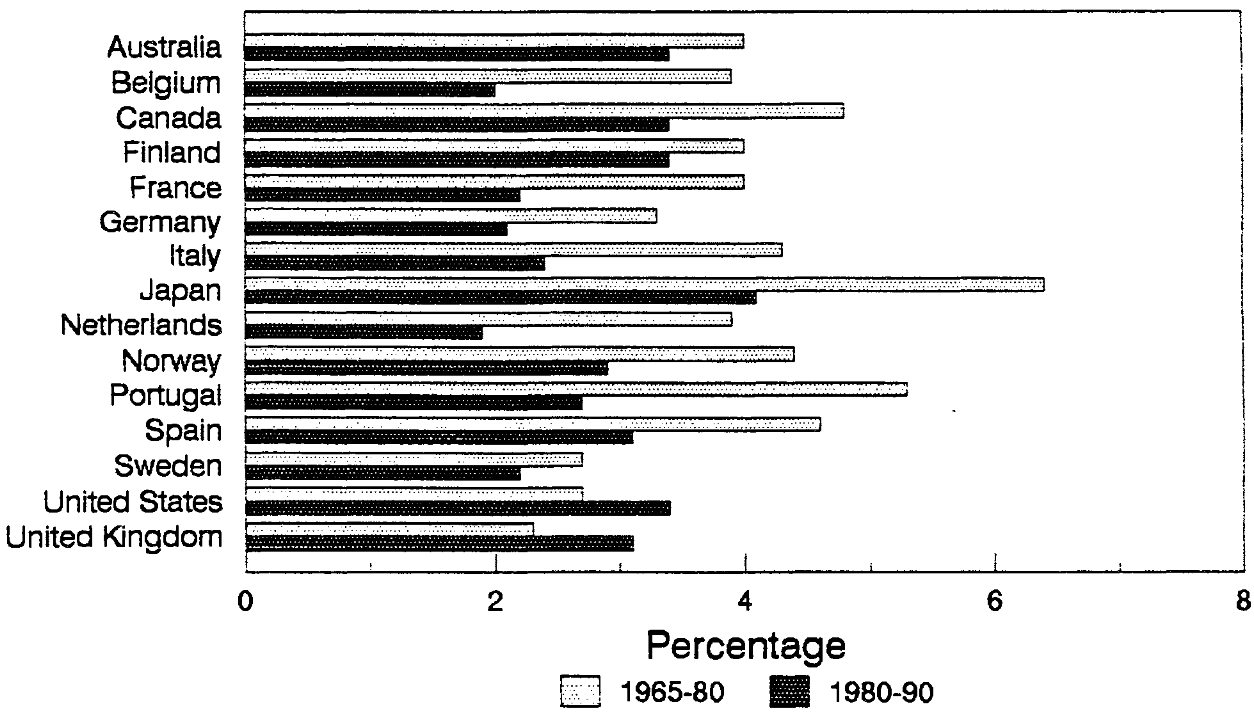
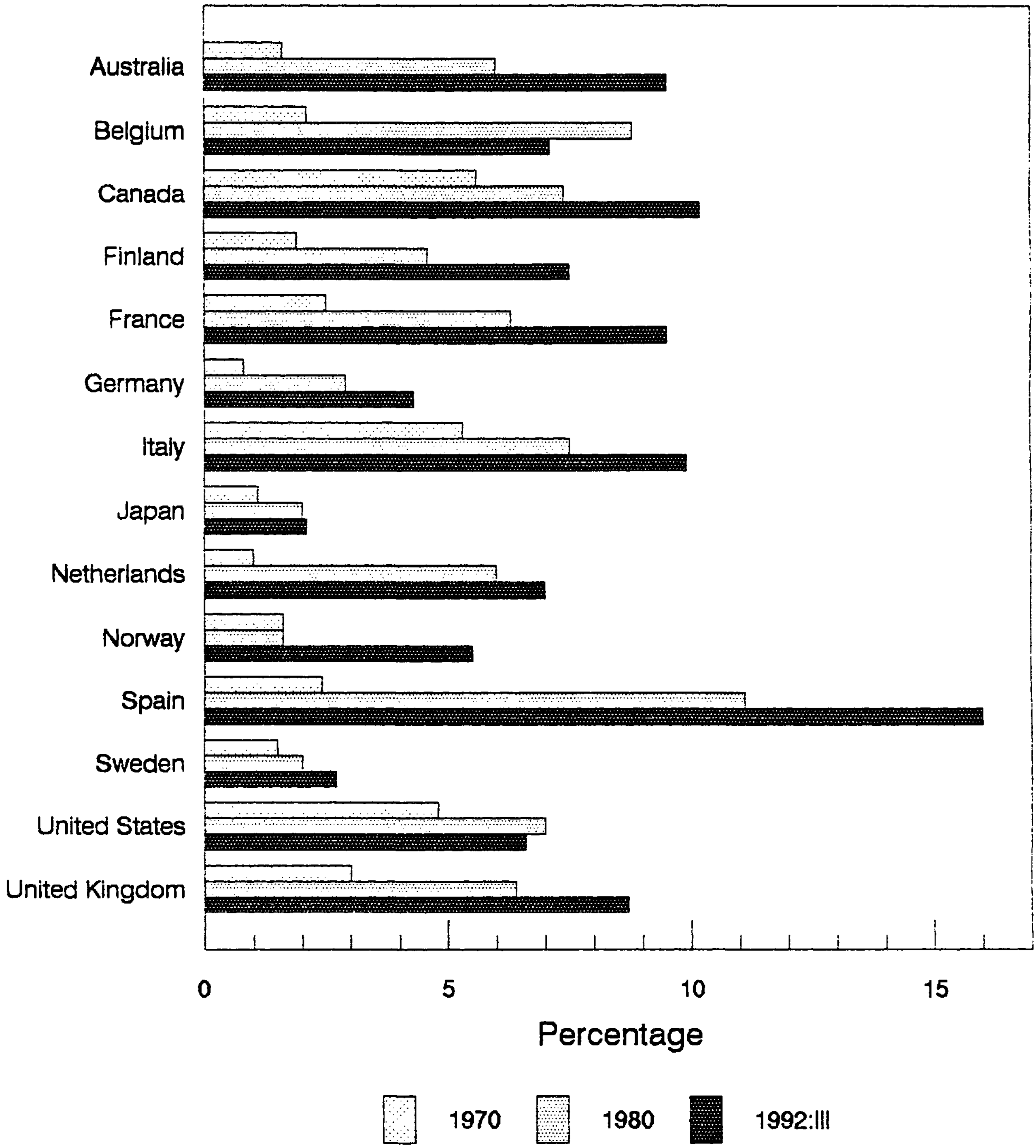


Figure 4
Growth Rate of Real GDP, 1965-80 and 1980-90
Selected Countries



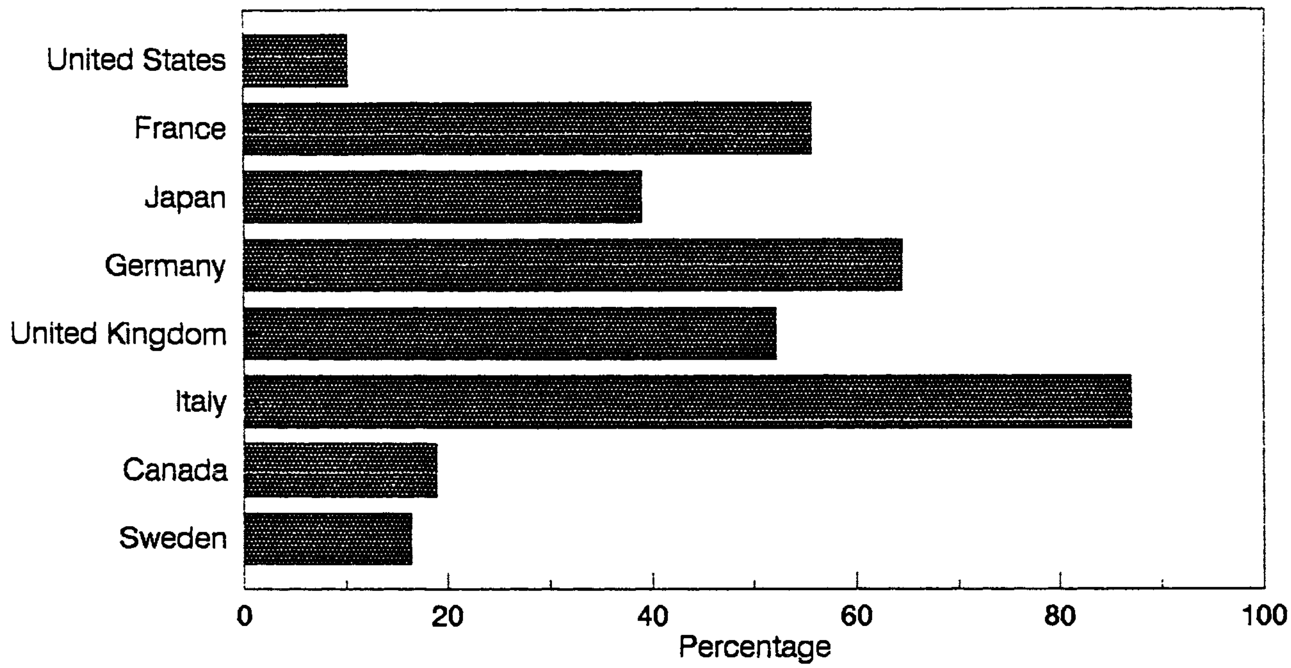
Source: World Bank, World Development Report 1992, Table 2.

Figure 5
Unemployment Rate, 1970, 1980, and 1992:III
Selected Countries



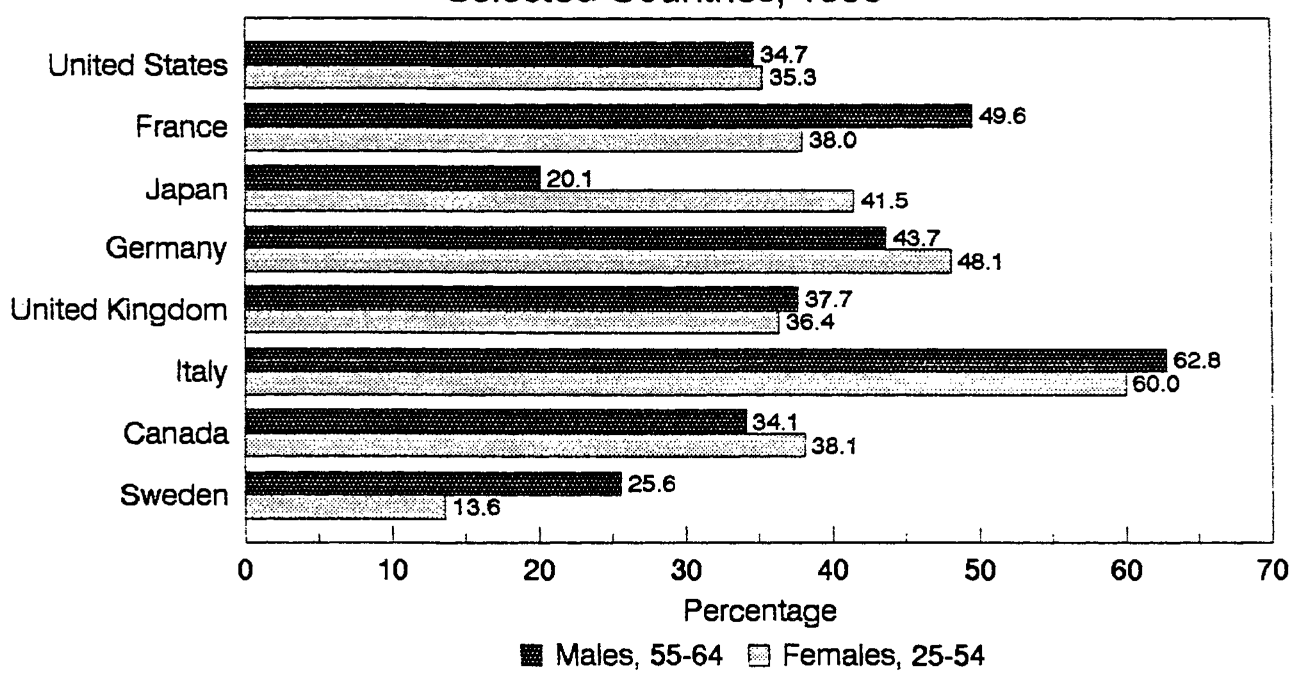
Sources: OECD Economic Outlook June, 1990 and December 1992, Table R 18.
OECD Main Economic Indicators, December 1992, p. 22.

Figure 6 - Unemployment Six Months and Over
As Percentage of Total Unemployment
Selected Countries, 1990



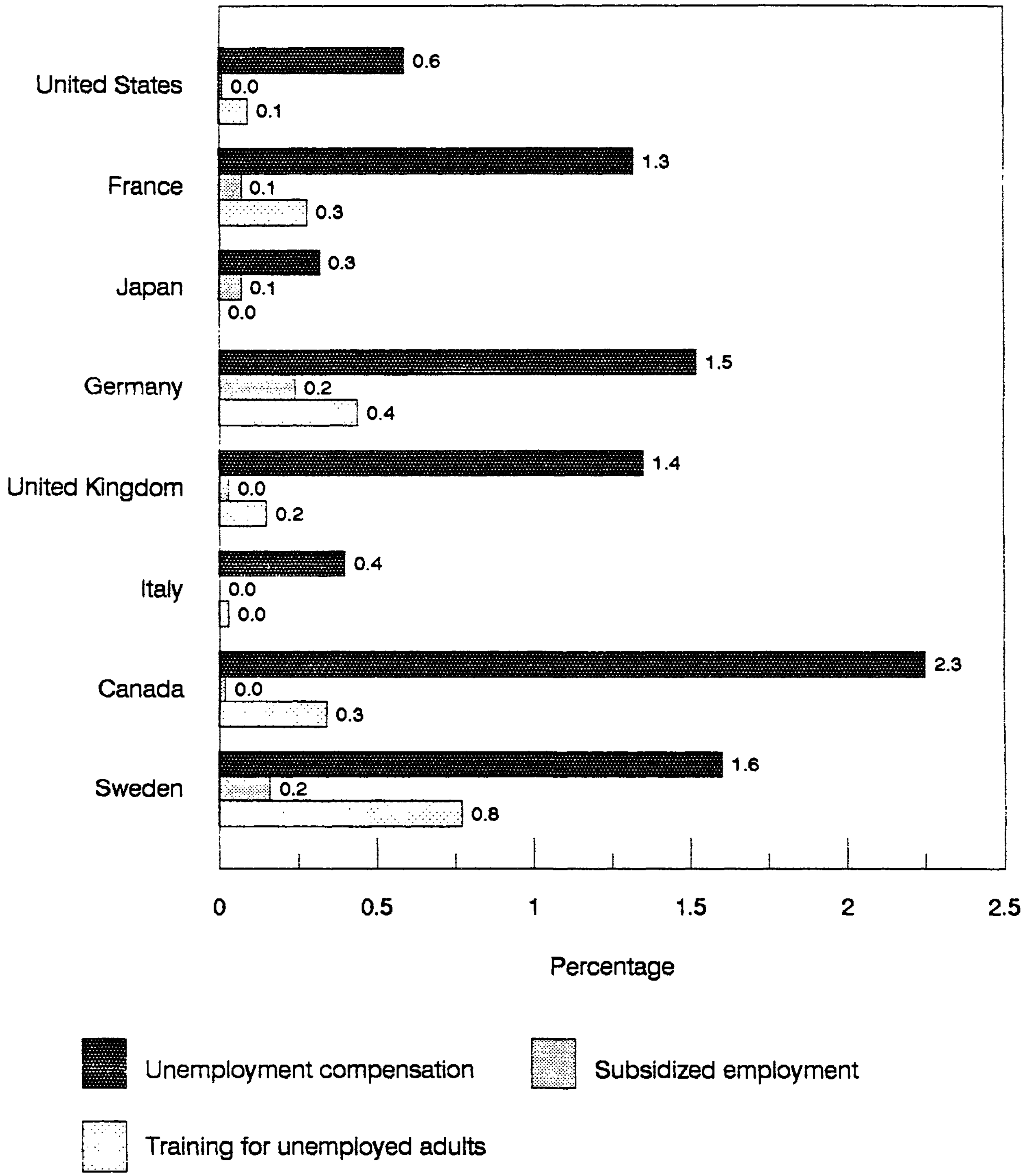
Source: OECD Employment Outlook (July 1992), Table N

Figure 7 - Inactivity Rates
(Percentage of Group Not Employed)
Selected Countries, 1990



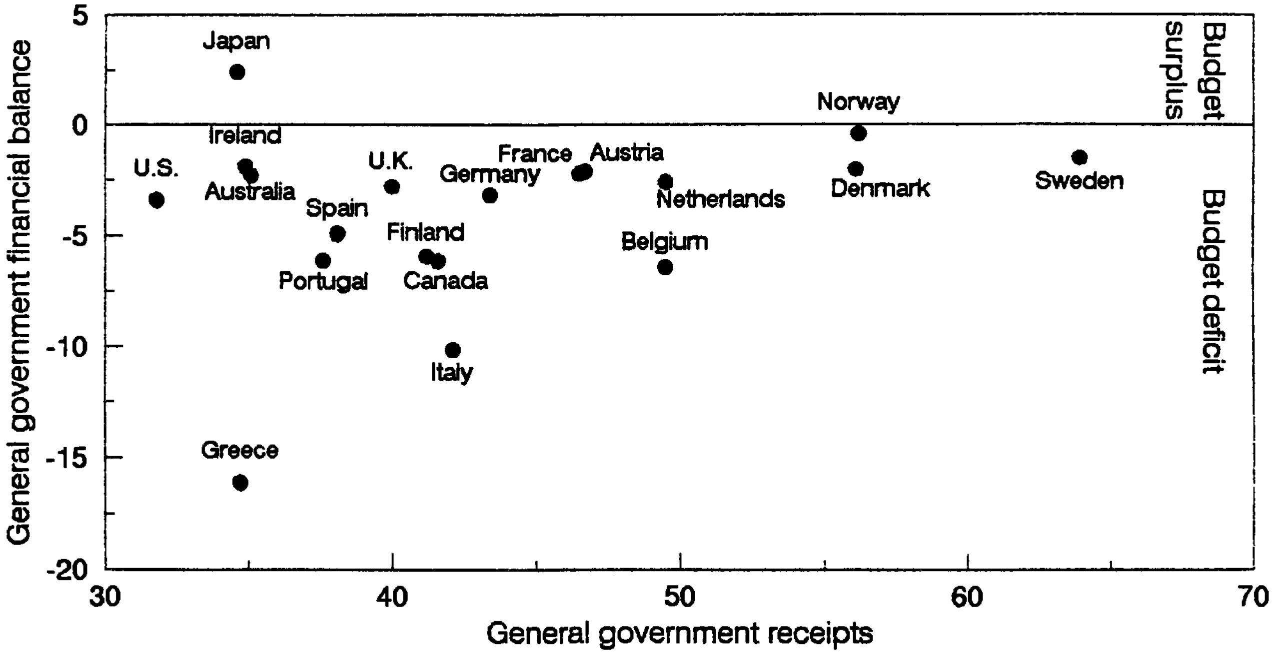
Source: OECD Employment Outlook (July 1992), Table 2.7

Figure 8 - Labor Market Programs, Selected Countries
1991 (or latest year available)
Percentage of GDP



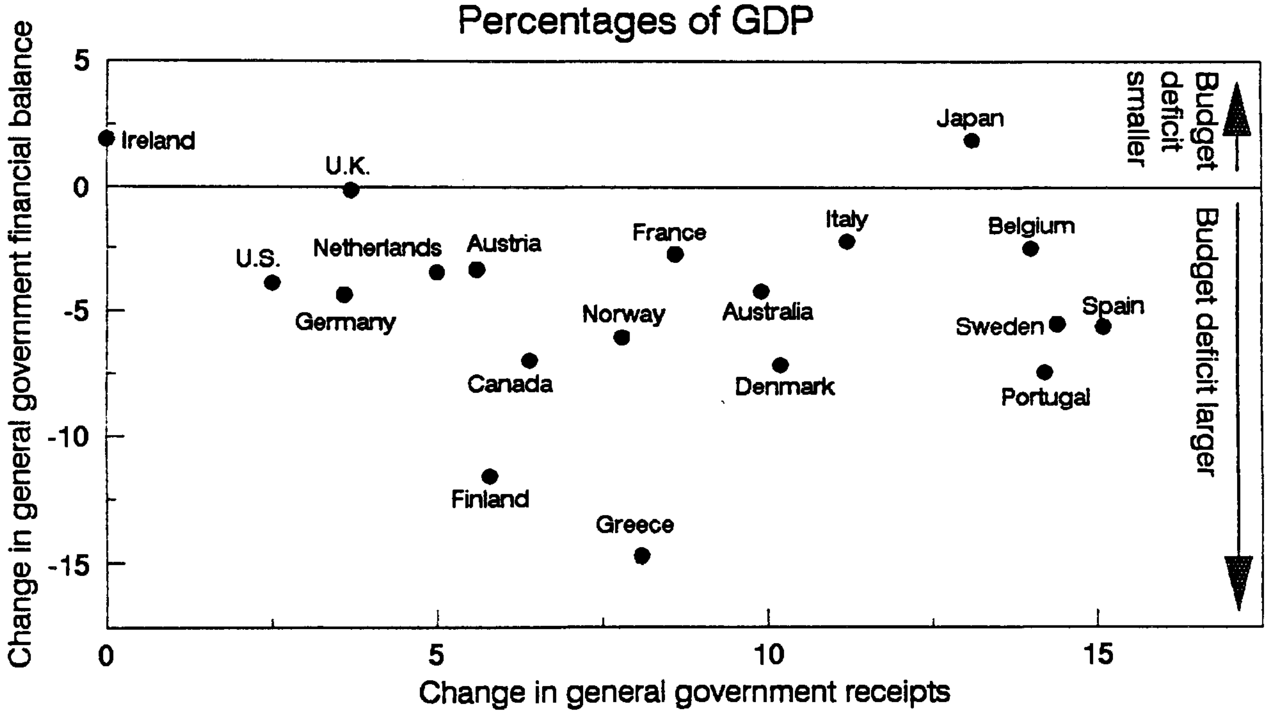
Source: OECD Employment Outlook (July 1992), Table 2.B.1

Figure 9 - General Government Receipts and Balance
OECD Countries, 1990
Percentages of GDP



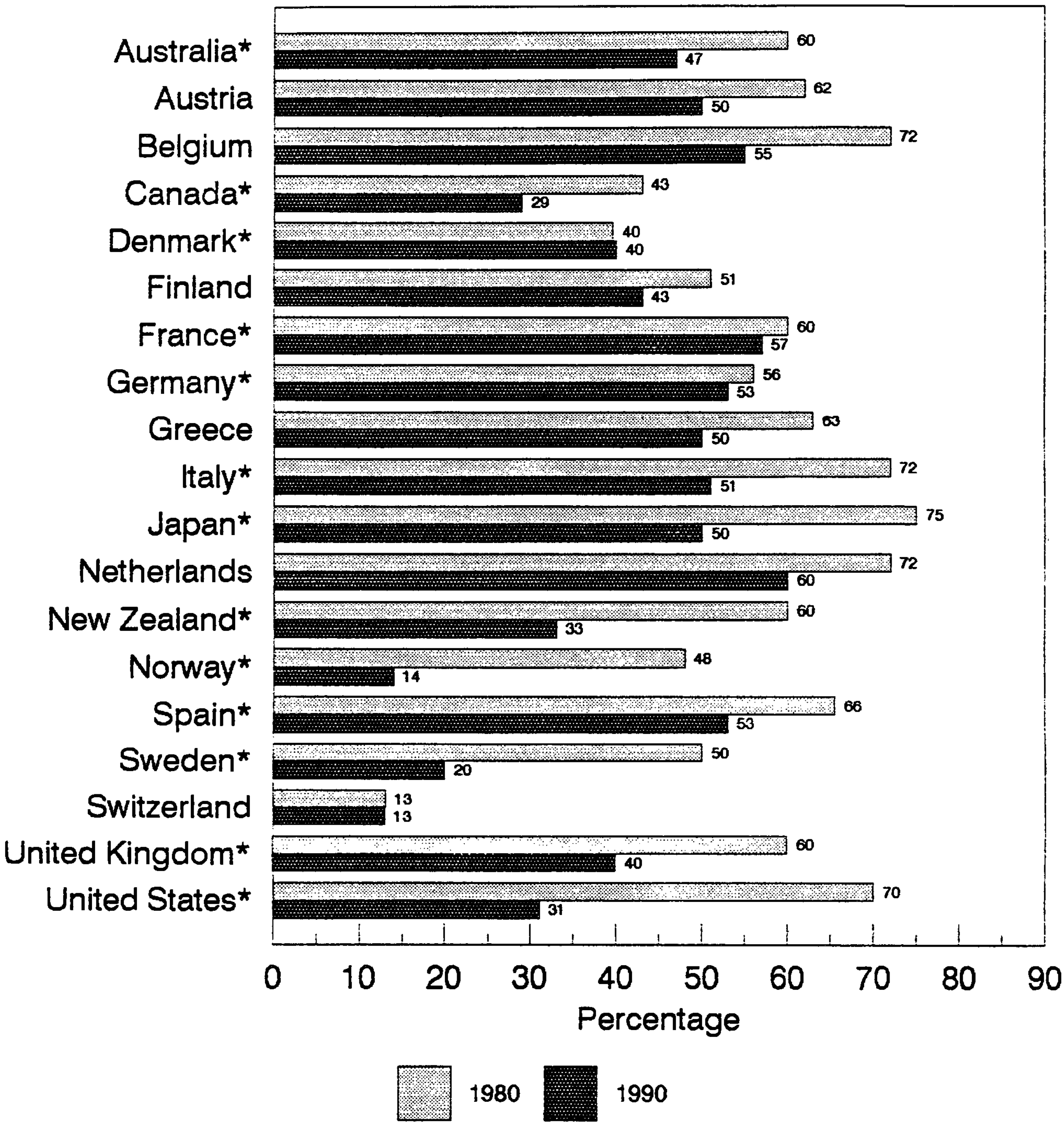
Source: OECD Economic Outlook 1992, Tables R14, R16

Figure 10 - Changes in General Government Receipts and Balance
OECD Countries, 1972 - 1990
Percentages of GDP



Source: OECD Economic Outlook 1992, Tables R14, R16

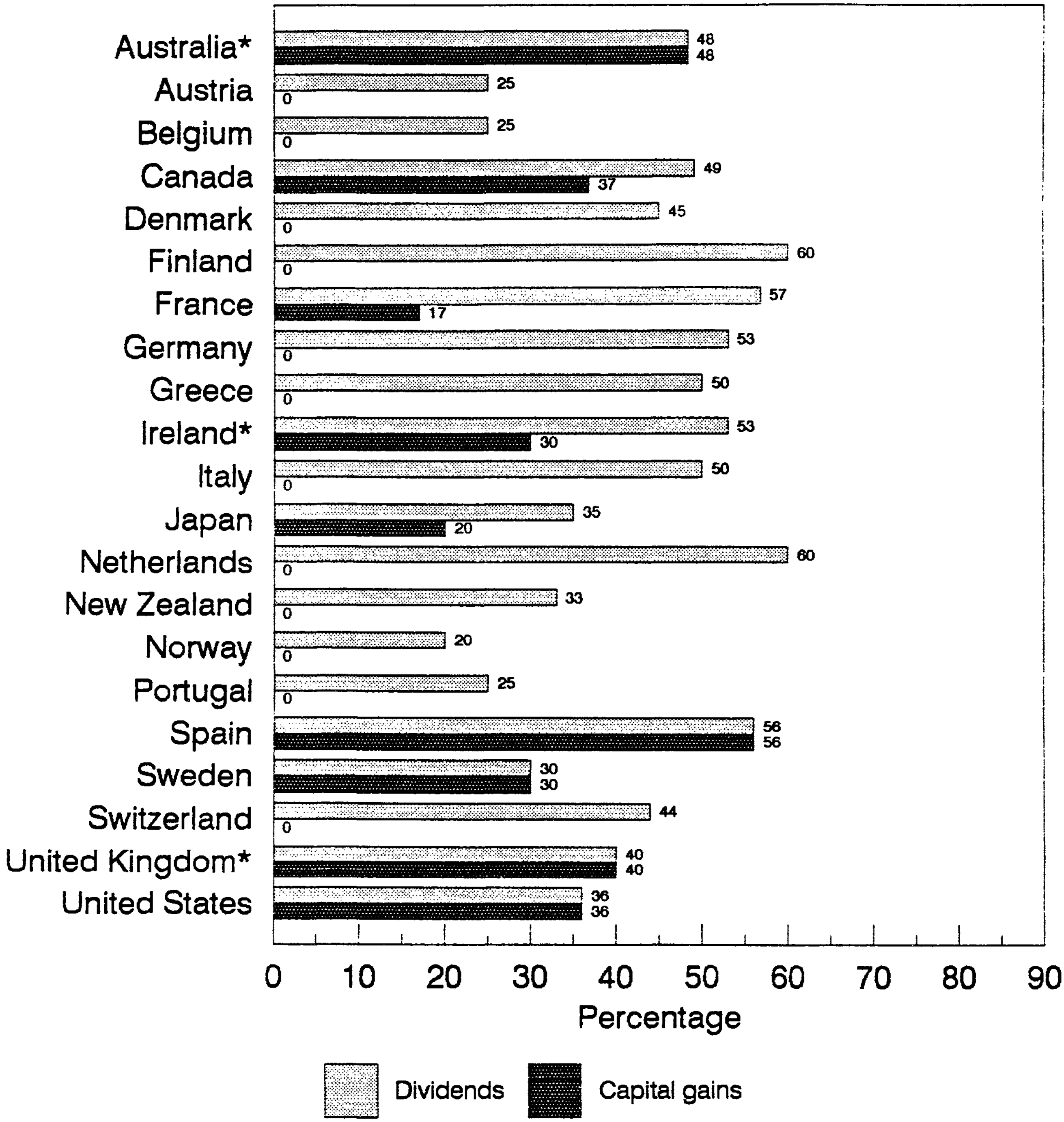
Figure 11 - Top Marginal Personal Tax Rates
(Central Government)
Selected Countries, 1980 and 1990



Source: David Carey, Jean-Claude Chouraqui, and Robert P. Hagemann, "The Future of Capital Income Taxation in a Liberalized Financial Envoronment," OECD Economics Dept. Working Papers No. 126, Paris, 1993, Table 1.

* Updated to latest data in "Tax Deform," Wall St Jour, 3 Feb. 1993, p. A14.

Figure 12 - Top Marginal Personal Tax Rates on
Capital Income (Central and lower levels of Goverment)
Selected Countries, 1990



Source: David Carey, Jean-Claude Chouraqui, and Robert P. Hagemann, "The Future of Capital Income Taxation in a Liberalized Financial Envoronment," OECD Economics Dept. Working Papers No. 126, Paris, 1993, Table 2.

* Real capital gains taxed.

U.S. FOREIGN EXCHANGE MARKET INTERVENTION IN 1992

Anna J. SCHWARTZ
National Bureau of Economic Research

Quarterly reports on Treasury and Federal Reserve foreign exchange operations ending three months earlier than the date of publication in the *Federal Reserve Bulletin* are available through October 1992 (issues of April, July, October 1992, and January 1993). These reports provide information on purchases and sales during the quarter, if any, of which foreign currency as well as realized net profits of losses and changes in market valuation of the preceding quarter and that of the current quarter. The reports provide no information on the size or the composition of each authority's portfolio.

International Financial Statistics gives end-of-month data on the combined foreign exchange portfolio of the Federal Reserve and the Treasury. The figure for December 1992 is $40.01 billion. The corresponding year earlier figure for December was $45.93 billion. The combined foreign exchange portfolio during the year moved within a narrow range, the peak of $45.93 billion having been registered in December 1991, and the low point in December 1992.

INTERVENTION OPERATIONS

Why did the portfolio change as it did? One concern of the U.S. authorities was to resist episodes of either weakness of the dollar vis-a-vis the mark or strength vis-a-vis the yen, however futile the resistance. In January 1992, for example, U.S. monetary authorities intervened in an operation coordinated with Japanese monetary authorities. The Federal Reserve and Treasury Exchange Stabilization Fund shared a $50 million yen purchase equally.

The U.S. authorities also intervened on July 20 in several rounds of sales of marks totaling $170 million, shared equally by the Federal Reserve and the ESF. The authorities repeated the exercise in August, selling $500 million in marks on the 7th and 11th, and an additional $500 million on the 21st and 24th.

Some of the transactions in 1992 represented operations initiated in June 1991 to reduce D-mark and dollar foreign exchange held by the U.S. authorities and the Bundesbank, respectively. About $1.1 billion of D-marks was sold for dollars in November and December 1991, 60 percent for the account of the Federal Reserve and 40 percent for the ESF. Another $200 million of marks was sold to another foreign monetary authority in November. In this reporting period, the ESF also purchased SDRs for marks from the IMF and sold them to other foreign authorities. In a series of transactions with the Bundesbank in the third quarterly reporting period in continuation of the June 1991 agreement, the U.S. authorities sold $6.2 billion marks for dollars.

In transactions in the quarterly period ending April 1992, the ESF repurchased $2 billion equivalent in foreign exchange that it has warehoused with the Federal Reserve. No balances now remain in the warehouse facility. As discussed in an earlier position paper, warehousing is a term that refers to loans, not appropriated by Congress, from the Federal Reserve to the Treasury General Fund as well as the ESF. The Treasury has used these funds to acquire foreign currencies. Reversing policies of 1988-90 that gradually increased authority of the Federal Reserve to warehouse holdings of foreign currency for the Treasury to as much as $25 billion, the two agencies agreed that the Treasury should repay the loans, and that the Federal Reserve would not eliminate its authority to warehouse but reduce it to $5 billion.

SWAP ARRANGEMENTS

The Federal Reserve has reciprocal currency swap arrangements with 14 central banks and the BIS. In late January 1992 the ESF initiated a special swap facility with Panama, which repaid in the following quarterly period the $143 million it had borrowed.

In January 1993 a wire report noted that the Federal Reserve had bought Australian dollars, which had come under pressure as the ruling Labor party lost in election. Until the quarterly report for the period ending January 1993 is available, neither the amount of the intervention nor on whose account it was made can be known. Australia does not have a swap line with the Federal Reserve. It will be interesting to learn whether the purchase was for the account of Australia or for the account of the ESF. Intervention can be a means of exchanging political favors.

FINANCIAL RESULTS

A record of calendar year 1992 financial results of intervention will not be available until the Federal Board and ESF publish their annual reports, about June 1993. In the meantime, the quarterly results ending in October 1992 of net realized profits and changes in valuation profits or losses for the Federal Reserve and the Treasury ESF can be summarized.

No realized profits or losses were reported in the second quarterly period ending April 30, 1992, but in the first, third and fourth quarterly periods net profits for the Federal Reserve totaled $769 million, for the ESF $238 million. These results should be representative of what the full calendar year figures will show.

The quarterly valuation results, however, are not applicable to the calendar year results. The quarterly results, as noted above, measure the change in the market valuation of the portfolio on the last day of the preceding and the last day of the current quarter. Losses on valuation were reported in the second and fourth periods that did not erase positive valuation gains in the first and third periods for each authority.

The quarterly results, however, cannot be used to measure the change in valuation from December 31, 1991 to December 31, 1992. We can project a large loss in valuation over the year from the knowledge that the exchange value of the dollar was low at the end of December 1991, hence marks and yen, assuming these were the main currencies in the portfolio, would have had a high valuation, and the substantial increase in the exchange value of the dollar at the end of December 1992, hence the portfolio, given the changes in its size and composition, would have had a lower market valuation.

Valuation losses are unrealized losses. The authorities, however, assume the risk of realized losses when they intervene in the foreign exchange market.