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ECONOMIC REVIEW

Federal Reserve Bank of Atlanta

May/June 1979

Federal Reserve Bank of Atlanta
Federal Reserve Station
Atlanta, Georgia 30303

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FEATURES:

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Editing Assistance: Adolpha Jordan
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DEPOSIT FLOWS AND THE SUPPLY OF MORTGAGE CREDIT: ARE THEY RELATED ANYMORE?

by B. Frank King

At the beginning of 1978, most housing analysts were forecasting higher interest rates and sharply lower housing production for 1978. The higher interest rates came, but the decline in housing did not. By year-end, the prime rate had moved up to nearly 12 percent and single-family mortgage rates to more than 10 percent. Yet housing starts broke two million units for the year and finished with a vigorous fourth quarter.

An important part of the standard explanation for what happened involves money market certificates. In June 1978, financial regulators allowed commercial banks and nonbank thrift institutions to sell these new liabilities. Many housing analysts have regarded that move as the equivalent of a coronary by-pass operation on housing finance that assured the flow of funds through thrift institutions into mortgages. Without the surgery, the explanation goes, rising interest rates would again have slowed that flow and produced another housing heart attack.[1]

The surgeons have gotten too much credit. Money market certificates have merits,[2] but they were not needed to rescue housing. That patient was strong and would have remained so. Open channels for the flow of funds into housing had already been assured. They were not assured by any dramatic event but by the cumulative effects of a series of treatments designed to integrate the market for home mortgages with the nation's money and capital market. More than twenty years ago, an influential group of housing economists began arguing that this integration would ease the impact of interest rate changes on housing by allowing lenders to make gradual rate adjustments, to sell existing mortgages for liquidity, and to draw mortgage funds from the capital market when demand dictated. Oliver Jones and Leo Grebler provided a classic statement of the prescription:

> "Improved marketability of mortgage loans would reduce the tendency of some of the primary lenders to make abrupt changes in the amount of new lending when portfolio adjustments are desired. Adjustments would be more fully determined by the subtle price mechanism than by quantitative restrictions or relaxations. An efficient price response to changes in supply and demand conditions would be quickly translated into changes in the cost of borrowing and changes in the value of mortgages already held. Thus, mortgage investment, as well as other long-term investments, would be responsive to changes in the market conditions through changes in price rather than volume."[3]

This integration of the money and capital market with the mortgage market has become public policy. Government and private

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[1] For examples of this argument, see David A. Levine, Jonathan E. Gray, and Neal Kaplan, "MMCs Only Postpone the Day of Reckoning," **Savings and Loan News,** Vol. 100 (January 1979), pp. 71-2; Marshall A. Kaplan, "Housing and Economic Developments: A Quarterly Review," **Federal Home Loan Bank Board Journal,** Vol. 12 (February 1979), p. 18; and R. Alton Gilbert and Jean M. Lovati, "Disintermediation: An Old Disorder with a New Remedy," **Review,** Federal Reserve Bank of St. Louis, Vol. 61 (January 1979), pp. 10-15.

[2] The article by John M. Godfrey and B. Frank King on money market certificates later in this **Review** outlines the background, growth, and implications of money market certificates at commercial banks and nonbank thrift institutions.

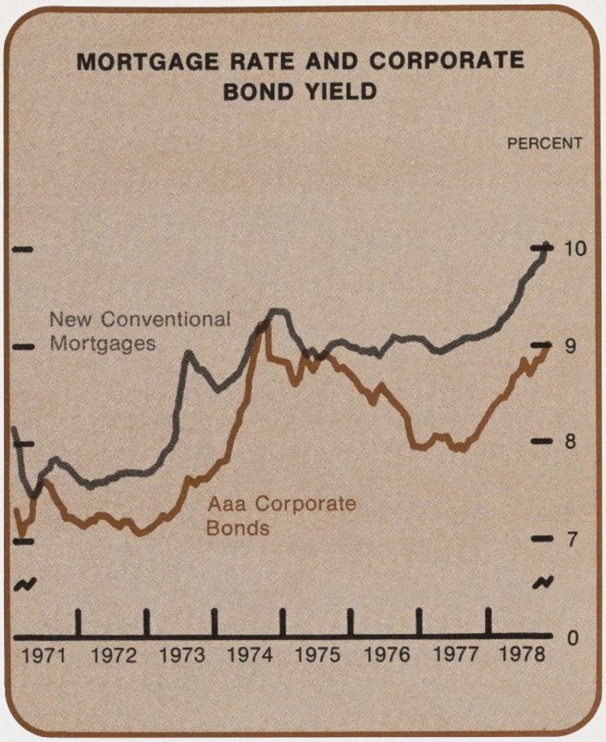
[3] Oliver Jones and Leo Grebler, **The Secondary Mortgage Market** (Los Angeles: University of California, Los Angeles, 1961), p. 25.

institutions have promoted it in many ways: through secondary markets for government-backed and conventional mortgages, mortgage-backed bonds and mortgage pass-throughs (with and without government guarantees), stand-by commitment auctions, and active borrowing by the Federal Home Loan Banks for relending to savings and loan associations. Additional methods such as savings and loan associations issuing commercial paper have continued to emerge.

The details of these arrangements vary, but their effect is the same: Mortgage lenders have direct access to the money and capital market, where they compete for funds along with corporations and governments. If mortgage borrowers are willing to pay the rates dictated by this competition, such funds are available to supplement the traditional deposits of thrift institutions. The only question for the lender is whether it can relend to home buyers at a profitable mortgage rate. In 1978, the demand for housing (thus, for high interest mortgages) was there. Demographic shifts and the perception of homes as hedges against inflation took care of that.

The dramatic introduction of money market certificates has tended to obscure the importance of the availability of funds through the other channels that have been added one by one over the past 20 years. Money market certificates did not themselves integrate mortgages into the money and capital market. The rapid adjustment of the cost of new mortgages to other long-term capital costs, demonstrated in the chart, indicates that that had already happened. Money market certificates merely provide confirmation of that integration.

What, then, is the use of regulations establishing ceiling rates limiting terms on accounts at nonbank thrift institutions and banks—Regulation Q? Are these regulations, designed to protect deposit inflows of major mortgage lenders, superfluous as far as housing is concerned?[4] So long as housing borrowers can depend on the capital market for additional funds, is there any need to worry about "availability" of funds to mortgage lenders? Since the lenders apparently



follow capital market rates when they set their mortgage rates, can ceilings on *deposit* interest hold down mortgage costs? Reason says no. Research has provided answers on both sides of the question, but the more recent the period analyzed, the more likely the research has been to find little or no effects of credit supply on housing beyond those explained by interest rates.

Despite the advances in integrating mortgage and capital markets and ambiguous evidence of the significance of deposit flows, public policy has continued to be carried out as if variation in deposit flows at thrift institutions has been the major source of instability in housing output. Public agencies, with the support of Congress, have tried to build and maintain a wall between deposits of mortgage lenders and the money and capital market with fully as much creativity as they have shown in tearing down the walls between home mortgages and this market. At the center of this policy thrust has been Regulation Q. On the periphery have been a series of measures designed to make alternatives to time and savings deposits less attractive to savers.

[4] Regulation Q can be useful for purposes other than housing, at least in the short run. These purposes are beyond the scope of this article.

Regulation Q has had three main purposes: (1) to achieve a competitive balance between commercial banks and nonbank thrift institutions. This received a major push from the application of Regulation Q-type ceilings to savings and loan associations in 1966. At that time, the nonbank thrift institutions were given a three-quarter point advantage over commercial banks on most deposits. The quarter-point rate advantage, now standard, was reached in 1970 by agreement and later by law. This differential was intended to protect the intermediaries that have higher proportions of their portfolios in home mortgages. (2) to limit the interest rates these intermediaries can pay for deposits, thus limiting the expense of raising funds for home mortgages (but, as noted before, not to limit home mortgage rates). (3) to allow the intermediaries to bid higher rates on longer term deposits, thus allowing them to obtain a closer match between the maturities of their assets and their liabilities. The gradual introduction of long-term certificates has probably provided considerable stability in deposit levels. At savings and loan associations, for example, a maturity survey conducted by the Federal Home Loan Bank Board in January 1969 found that only 5 percent of deposits at savings and loans had maturities of one year or more. By September 1973, there were 23 percent, concentrated in the one- to two-year range, and in September 1978, there were 38 percent. This percentage has reportedly fallen since that time as a result of the six-month money market certificates, a decline that disturbs some analysts of nonbank thrift institutions.[5]

The deposit insulation has been anything but complete, however. Holes were left in the wall between deposits and the money and capital market at the beginning; new holes have been made. Other investments such as short-term Treasury securities have continued to be available to savers. Some savers have moved their funds from banks and nonbank thrift institutions into these investments when market yields rose. Interest rate maxima on time and savings deposits have induced savers to look around for previously ignored higher return assets. Private financial advisers and financial columnists have aided their quest. Interest ceilings have made time and savings deposits attractive targets for financial innovators, such as money market mutual funds, tax-exempt bond funds, states and cities issuing tax-exempt, low-denomination savings bonds, large bank holding companies issuing floating-rate debentures, and credit unions with expanded powers, all seeking to gain by finding new ways to intermediate. Earlier this year, the list was extended when a large national retail concern started the process that could lead to its issuance of low-denomination savings certificates.

Over the years, such developments have induced the Congress and the regulators to react to each threat to deposit flows with a specific regulation or control on the market. They have brought state-insured thrift institutions under the savings deposit regulations, promulgated new regulations on interest compounding and premiums, regulated and threatened further regulations of subordinate liabilities of banks and bank holding companies, raised denomination minima and complicated bidding on Treasury and Federal agency securities issues, and held open the threat of further regulation of mortgage-backed securities issued by commercial banks. Failure of these controls to avoid disintermediation and the inefficiency that they foster has convinced the Board of Governors that Regulation Q should be phased out over several years.[6]

Inevitably, amendments to interest rate ceilings themselves have followed market developments, permitting costs of deposit funds to follow market interest rates and further weakening the insulation of deposits from the money and capital market. Every major Regulation Q liberalization has followed several months of rising market interest rates.

It is difficult to tell how much the attempts to insulate deposits from capital markets have reduced time and savings deposit fluctuations.[7] However, deposit growth

[5] Abraham Serfaty, "Implications of the Money Market Certificate," **Business Economics,** Vol. 14 (March 1979), pp. 22-26.

[6] Statement by J. Charles Partee, member of the Board of Governors of the Federal Reserve System, before the Commerce, Consumer and Monetary Affairs Subcommittee of the Committee on Government Operations, House of Representatives (March 22, 1979).

[7] The impact of money market certificates on deposit flows during their first 10 months suggests that deposit variation might have been reduced had Regulation Q been eliminated.

has remained quite variable. Regulation Q has become more and more complicated and less and less appreciated by the saving public.

The introduction of money market certificates last June and the more recent proposals for flexible rate certificates with longer terms, for lower certificate minima, and for higher returns on savings accounts and certificates are all admissions of failure to insulate deposits from the capital markets. If the capital market is integrated with the savings market and the mortgage market (as the evidence indicates), these changes will have little influence on potential home mortgage credit variability. In general, what people pay for mortgages will still be determined in the capital markets and how much the public borrows at that price will still depend on its demand for housing. The strength of housing over the past year was based predominantly on very strong demand, even in the face of higher mortgage rates, not on the Regulation Q change.

In summary, if the markets for mortgages and deposits at thrift institutions are substantially integrated into the money and capital market, efforts to control the volume of housing finance and output with Regulation Q are unlikely to succeed. The channels through which credit flows to housing can be changed, but the total flow is unlikely to be influenced. New regulations and modification of existing ones may well influence the portion of housing sales that nonbank thrift institutions finance, but additions of funds through their channel are likely to promote withdrawal of funds from other channels. ■

MONEY MARKET CERTIFICATES: AN INNOVATION IN CONSUMER DEPOSITS

by John M. Godfrey and B. Frank King

In May 1978, Federal regulators of savings and loan associations, mutual savings banks, and commercial banks first allowed these institutions to offer two new types of time certificates of deposit. One had a minimum maturity of eight years and a fixed maximum offering rate. Except for its longer maturity, it resembled other time certificate types. The other new time certificate was a departure from previous time deposit regulation. Its maximum offering rate changed weekly with money market interest rates. It quickly became known as the "money market certificate." This innovation may well be a model for future evolution of regulation of time and savings deposits. An analysis of its background and development should help our understanding of the forces driving this evolution.

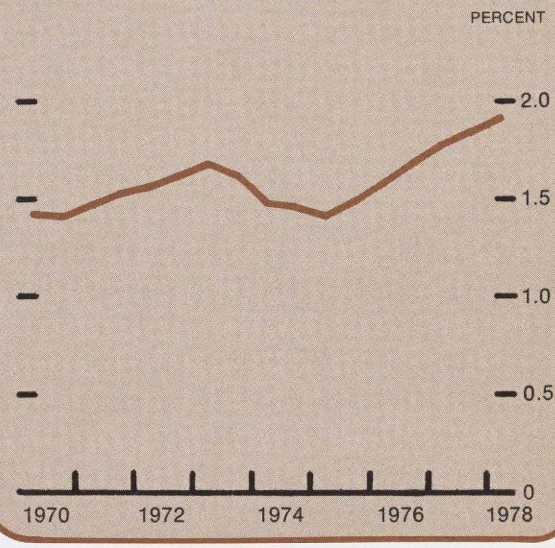
WHY A MONEY MARKET CERTIFICATE?

The regulators' money market certificate innovation came in a set of circumstances that was all too familiar to them and to the institutions that they regulate. Interest rates had been rising for more than a year and had reached levels that had begun to cause weakness in deposit inflows, particularly at savings and loan associations and mutual savings banks—the nonbank thrift institutions. More interest rate increases looming on the horizon threatened to begin a period of disintermediation similar to those that plagued financial intermediaries in 1966, 1969-70, and 1973-74. Concern for the thrifts' problems was accompanied by worries about the maintenance of housing production. These were magnified by a low rate of housing starts in the first quarter of 1978 and the widespread belief among housing analysts that starts would be lower in 1978 than they had been in 1977.

Against this background, the regulators sought ways to allow "financial institutions to compete for funds to assure an adequate flow of credit into housing and to meet other borrowing needs."[1] They were aided in their choice of methods by the cushion of earnings that the thrift institutions had developed during the preceding period of low short-term interest rates and relatively high mortgage rates. For example, savings and loan associations' average returns on mortgages minus their average yield on deposits had risen from 1.43 percentage points during the first half of 1975 to 1.93 during the first half of 1978 (see Chart 1). That net return was .33 percentage points above their average for the 1970s.

CHART 1

SAVINGS AND LOAN SPREAD BETWEEN RATE OF RETURN ON MORTGAGES AND AVERAGE INTEREST RATE ON DEPOSITS



[1] Board of Governors of the Federal Reserve System, press release, May 11, 1978, p. 1.

The regulators reacted to their concerns and the thrifts' good fortune with an innovative time certificate. It had a term of six months, with a substantial penalty for early withdrawal; its minimum denomination was $10,000; it was not negotiable; and, most importantly, its contract rate was tied to the auction rate on the six-month U.S. Treasury bills (thrifts were allowed to pay one quarter of a percentage point more than the six-month bill rate; commercial banks were allowed to go only as high as the bill rate).

These money market certificates (MMCs), with their $10,000 minimum, were designed to retain those deposits that financial institutions were most likely to lose during periods of high interest rates. The new powers allowed the institutions to adjust the interest rates they paid for these deposits to those on competing savings instruments without raising the interest cost of all savings deposits.

HOW WELL DID THE INNOVATION WORK?

As a marketing venture, money market certificates were quite successful. Most institutions began to issue them soon after they were allowed to. Most chose to pay the maximum permissible rate. As short-term rates increased until early in 1979, the volume of MMCs outstanding rose. By the end of March 1979, it had reached $136 billion, a volume equal to more than twice the year-end 1978 assets of all credit unions in the U. S. (see Chart 2).

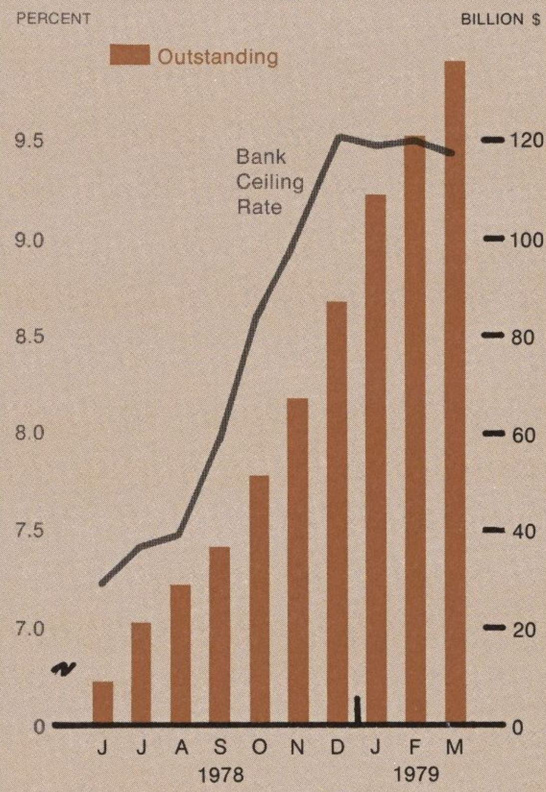
Nonbank Thrift Institutions. Because they are considerably more likely to suffer disintermediation than are commercial banks, the nonbank thrift institutions had more at stake in the MMCs. They used their new powers aggressively, taking on $95 billion in MMCs—70 percent of the total outstanding—by the end of March. MMCs made up more than 16 percent of their deposit liabilities at that time.

Thrifts' use of money market certificates did considerably more than avoid the type of disintermediation that had been experienced during other periods of high nominal interest rates.[2] Outflows from accounts other than MMCs between June 1978 and March 1979 were about $48 billion—one-half of MMC inflows. In only three months during that ten-month period were there net inflows to other categories of deposits, but the thrift institutions did not suffer net outflows in any month.

On the asset side of the balance sheet, the nonbank thrift institutions suffered much less than they had during other periods of high interest rates. Although mortgage lending was off in late 1978 and early 1979, it declined much less sharply than it

CHART 2

MONEY MARKET CERTIFICATES OUTSTANDING AT COMMERCIAL BANKS, SAVINGS AND LOAN ASSOCIATIONS, AND MUTUAL SAVINGS BANKS



Source: Board of Governors of the Federal Reserve System and United States League of Savings Associations.

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[2] For a cogent analysis of deposit behavior at thrift institutions during the last half of 1978 and other high interest rate periods, see R. Alton Gilbert and Jean M. Lovati, "Disintermediation: An Old Disorder with a New Remedy," **Review**, Federal Reserve Bank of St. Louis, Vol. 61, January 1979, pp. 11-14.

had in previous periods of high interest rates. Whether this lending actually added strength to housing demand or merely displaced mortgages that would have been made through other channels is debated. The article at the beginning of this issue of this **Review** argues that MMCs probably contributed little to housing demand.

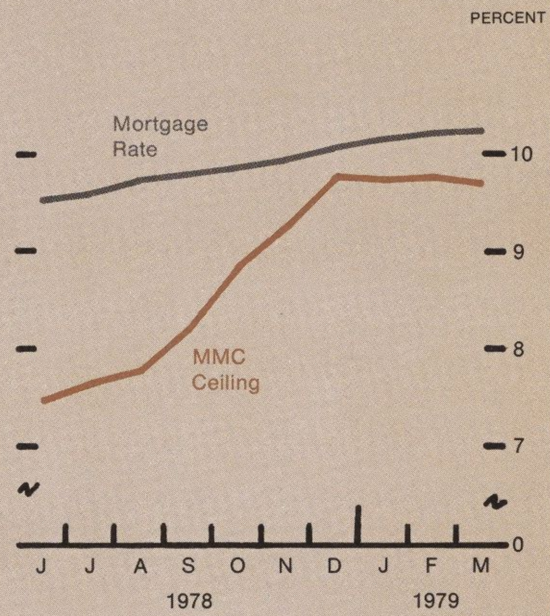
The rousing popularity of MMCs brought problems along with it. These showed up most clearly and painfully in nonbank thrift institutions' net interest margins. MMC ceilings rose much faster than mortgage rates after June 1978, cutting the spread between the cost of this source of new funds and the return on new mortgages from a little more than 2 percentage points to less than one-half of one percentage point by early 1979 (see Chart 3). This reduction of the net return on new thrift assets decreased their average margins. Rising MMC inflows late in the year and the need to roll over maturing MMCs at higher rates after November magnified the squeeze.

The amount of this squeeze is difficult to document with precision. A minimum estimate of its effect is a reduction of the average net return by at least a quarter of a percentage point, which ate up most of the cushion that the nonbank thrifts had in June 1978. Certainly, evidence of the squeeze can be seen in the narrowing rate spread, the complaints of the thrift institutions, their trade associations and their regulators, and the proposals of these groups for liberalizing terms and rates on other, less costly time certificates. According to the regulators' statement, this squeeze on thrifts was also a key consideration in the March decision to forbid interest compounding on MMCs and to eliminate the quarter point interest rate advantage for the thrifts when the Treasury bill rate exceeds 9 percent.[3]

In sum, the nonbank thrift institutions chose to issue a large volume of money market certificates to an enthusiastic public. Their choice avoided almost certain disintermediation and allowed them to continue to add mortgages to their portfolios at a pace that was faster than usual in high interest periods. Issuing the certificates in large volume also put a cost

CHART 3

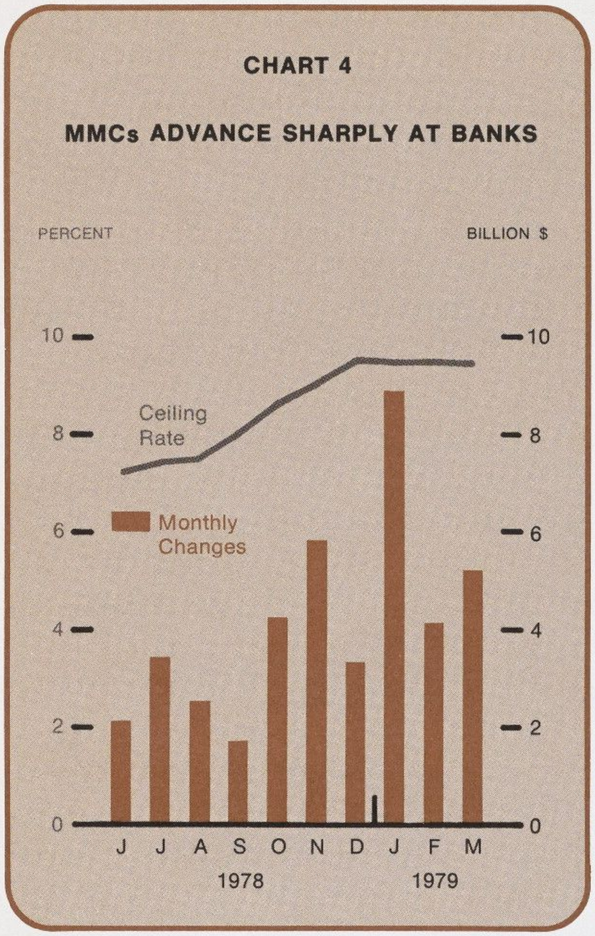
NONBANK THRIFT INSTITUTIONS' MAXIMUM MMC RATE AND SAVINGS AND LOAN ASSOCIATIONS' EFFECTIVE RATE ON NEW MORTGAGES



squeeze on these institutions and, in March, resulted in a modest retreat from the original conditions but, significantly, not from the tie to Treasury bills.

Commercial Banks. But thrift institutions were not alone in offering MMCs. Commercial banks also have availed themselves of the opportunity provided by the Regulation Q amendments. Their experience with money market certificates has been similar to that of the nonbank thrift institutions (see Chart 4). Commercial banks began issuing MMCs in June 1978 and, by March of this year, had $41.2 billion in MMCs outstanding. MMCs now comprise about 8 percent of banks' consumer time and savings deposits. Most of the growth in MMCs, however, came after September, when the ceiling rate moved up above 8 percent. Banks have issued over three-quarters of their total volume of MMCs outstanding since September. The availability of 8-percent

[3] Board of Governors of the Federal Reserve System, press release, March 8, 1979, p. 2.



MMCs EXPAND BANK DEPOSITS

(billion $)

	May 1978	Feb. 1979	Change
Total Time and Savings Deposits	572	619	+47
Passbook Savings	223	216	- 7
Time Deposits under $100,000			
MMCs	0	41	+41
Other	169	152	-17
Time Deposits over $100,000	180	210	+30

interest rates seemed to be a "magic" number that attracted a large amount of consumer deposits. (Eight percent is the highest rate that banks can pay on their longer maturity consumer time deposits.)

The heavy volume of MMCs has precipitated a significant change in the structure of bank time and savings deposits (see table). Between May 1978, immediately before the introduction of MMCs, and March 1979, total bank time and savings deposits advanced $47.5 billion. During this time, however, there were significant changes in several deposit categories. Passbook savings deposits declined $6.5 billion, and small-denomination time deposits, excluding MMCs, fell $17.4 billion. At the same time, large-denomination time deposits rose $30.1 billion.

To what extent did consumers shift funds out of bank passbook savings and other small-denomination time deposits into bank MMCs and, therefore, cause the weakness in the other deposit categories? To what extent did banks' ability to offer MMCs allow them to attract additional deposits? There are several reasons to believe that not all of the declines in other bank consumer deposits were necessarily associated with shifts of funds into bank MMCs. However, even if the entire decline in passbook savings and other small-denomination time deposits were attributable to MMCs, the MMCs would have resulted in net deposit gains for banks of about 40 percent.

However, passbook savings on a seasonally adjusted basis continued to advance through September 1978 while the volume of MMCs outstanding at banks reached nearly $10 billion. Therefore, during the first four months that MMCs were offered, they did not appear to have resulted in any net outflows from passbook savings. Since then, the decline in savings accounts and other small-denomination time deposits undoubtedly has reflected the movement of some funds into bank MMCs. However, at least part of the deposit loss at banks stemmed from shifts of funds into MMCs at nonbank thrift institutions and other financial instruments. It seems reasonable to conclude that 50 percent or more of the funds in MMCs represented a net gain in deposits for commercial banks.

To the extent that banks were able to attract additional funds through MMCs, they did not have to rely as heavily on more expensive large-denomination CDs and other forms of managed liabilities. Thus, MMCs helped stabilize bank deposit flows and provide a means of retaining the funds of many existing customers. The banks' ability to serve existing depositors in the face of strong competition from nonbank financial institutions is an important consideration in their ability to maintain customer relationships.

The benefits of MMCs to banks and thrift institutions have been greater than just the net gain in deposits. MMCs very clearly prevented considerable disintermediation from taking place as interest rates rose above Regulation Q ceilings. The types of funds that MMCs attracted—deposits of $10,000 and over—are the very ones that would have most likely left these financial institutions as market interest rates approached current levels. To persons with $10,000 to invest, there are several instruments available which carry higher rates of interest than banks and thrifts could pay on short (and even the longer) maturity deposits before MMCs were authorized. For example, Treasury bills can be purchased in denominations of $10,000; and Treasury notes and bonds, in denominations as low as $5,000 and $1,000, respectively. Also, a number of money market mutual funds are available with initial deposits as low as $1,000 or $2,000. Even commercial paper is offered in amounts slightly above the MMC minimum. Clearly, the majority of funds currently in MMCs would not have remained in the financial institutions, given recent levels of interest rates, if banks and thrifts had not been able to offer money market certificates. Nor would these institutions have been able to attract additional funds. By these measures, the MMCs have been highly successful for banks and thrifts.

FURTHER INNOVATIONS?

With interest rates of 9 to 10 percent on money market certificates receiving wide publicity, consumer groups, and especially retired persons, have been quite vocal in asking Federal regulators to increase their interest-bearing deposit options. In particular, there has been pressure to obtain (1) higher interest rates, (2) deposits with lower minimum denominations, and (3) deposits of greater liquidity, i.e., reduced penalties for early withdrawals. While banks and nonbank thrifts are authorized to pay as much as 8 percent on certain long-term deposits, these deposits carry substantial interest penalties if they are redeemed prior to maturity. What consumers want are deposits with higher interest rates without excessive withdrawal penalties in affordable denominations.

The Federal financial regulatory agencies must conform to congressional intent and law in framing deposit interest rate controls. These regulators recognize that congressional "objectives protecting the thrift industry and sustaining mortgage credit plans appear to have overshadowed the desire to provide small savers with a market-oriented rate of return."[4] As pointed out above, thrifts cannot afford to offer interest rates that approach current short-term market rates on a substantial portion of their deposits because their earning assets are primarily in long-term, fixed-rate mortgages. Therefore, the perceived viability of the thrift industry, not commercial bank earnings that can adjust more quickly to fluctuations in market rates, is of prime importance in regulators' consideration of liberalization of interest rate ceilings.

To these ends, the Federal bank and thrift regulatory agencies have made four proposals that would meet the objectives of consumers and ensure that thrifts will not experience severe earnings pressures.[5] The first two proposals involve entirely new types of time deposits, and the other two would change the restrictions on existing deposits. All these proposals would apply to both banks and thrift institutions except credit unions. Nothing in the proposals would require the banks and thrifts to offer all of these options, even if they are approved. An institution's own judgment and competitive conditions would determine whether or not they would actually be offered.

One new deposit would be a "rising-rate certificate" that would pay an increasingly higher rate of return the longer it is held. For example, during the first year, banks could pay a 6-percent rate of return; by the fifth through eighth years, they could

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[4] J. Charles Partee, statement before the Subcommittee on Financial Institutions of the Committee on Banking, Housing and Urban Affairs, United States Senate, April 11, 1979.

[5] Board of Governors of the Federal Reserve System, press release, April 3, 1979.

pay as much as 8 percent. Compounding of interest would be allowed, so that over the eight-year period, the simple rate of return would average about 7¼ percent. The thrift industry would retain its traditional and one-quarter of a point rate advantage, a differential that is legally mandated for types of deposits in existence in 1975. The withdrawal penalties of this deposit would go a long way toward meeting demands for greater liquidity: Three months' interest would be foregone if the deposit were redeemed during the first year, but any redemptions after one year would not carry any interest penalty at all.

The other proposed new deposit would be a "five-year certificate" on which the contract rate would be tied to the preceding month's average yield on five-year Treasury securities (the rate paid would *not* change during the five-year period, however). Commercial banks could pay a maximum of 125 basis points less than that average, and thrifts, a maximum of 100 basis points less. If this deposit had been available in April, its rate of return would have been linked to the average five-year Treasury note rate in March, which was 9.2 percent; banks could thus have paid 7.95 percent. This deposit has the advantage, of course, that its contract rate would vary with a market-determined rate. It would also offer considerable liquidity; the penalty for premature withdrawal would be the loss of six months' interest.

The regulatory agencies have also proposed two changes to existing accounts. One would be a "bonus savings account" on which financial institutions could pay an extra ½ percent on the minimum balance held in a passbook savings account for the preceding 12 months. Another proposal would lower the minimum denomination on longer maturity time certificates. Nonbank thrift institutions currently have a $1,000 minimum denomination on all time certificates; banks have a $1,000 minimum on all certificates maturing in four years or more. The proposal would lower the minimum denomination to $500, which would apply only to those certificates maturing in four years or over. The proposed changes to existing deposits will not likely attract a great deal of additional funds for financial institutions, but they will allow the small depositor to receive higher interest rates and to purchase some of the longer maturity certificates. The combination of proposals represents an attempt to formulate an acceptable compromise of diverse interests in the matter of the payment of higher interest on consumer deposits. The proposals were offered for public comment in order to obtain the views of these interests.

Regulatory Changes. In late May, Federal bank and thrift regulatory agencies jointly adopted four measures to become effective July 1 that incorporated many of the above proposals.[6] The maximum rate on passbook savings accounts was increased ¼ of 1 percent (to 5¼ percent at banks and 5½ percent at nonbank thrifts). Both banks and thrifts will be allowed to offer a four-year savings certificate, with the ceiling rate based on the yield on four-year maturity Treasury securities. (Banks may pay 125 basis points less and thrift institutions, 100 basis points less.) These changes will allow savers higher rates of return, and the new certificate will provide returns more in line with comparable market interest rates.

To permit small savers to purchase these deposits, all legal minimum denominations on consumer time deposits will be eliminated (except for the $10,000 required for MMCs). Financial institutions, however, may still establish their own minimum denominations. To provide greater liquidity, required early withdrawal penalties will be eased for deposits issued or renewed after July 1. For deposits maturing in more than one year, the minimum penalty will be the loss of six months' interest, while for those deposits maturing in one year or less, the penalty will be three months' interest.

These changes in Regulation Q are a small step toward offering consumers higher interest rates, increased liquidity, and, through lower minimum denominations, an enhanced ability to purchase the deposits. The regulatory agencies plan to consult again later this year to determine whether further adjustments in deposit interest rate ceilings are appropriate. ■

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[6]Board of Governors of the Federal Reserve System, press release, May 30, 1979.

THE OUTLOOK FOR FOOD PRICES

by Gene D. Sullivan

A major continuing problem in the national economic outlook is inflation. During 1978, food prices were a prime contributor to the rapid rise in inflation. Many projections have indicated that climbing food prices will continue to be troublesome in 1979, and the data confirm that large increases occurred in the first quarter.

Forecasting food prices is a hazardous business. Past forecasts often have not sparkled with accuracy. The errors have not been entirely attributable to the incompetence of forecasters. Food prices result from a complicated set of influences and interrelationships, not all of which are foreseeable at any given time. Unusual weather has often been a major disruptive force that cannot be taken into account in advance.

Here, we hope to provide insight into a number of major factors that influence food prices. Specifically, we will (1) show the relationship between changes in food prices and changes in the Consumer Price Index; (2) compare the importance of food prices to other expenditure groups making up the CPI; (3) examine and compare the major components of food expenditures; (4) project price changes for these major components; and, finally (5), project the price change in the food component of CPI in the year ahead.*

Reports of price data so often mention food prices as a major cause of price inflation that one might expect that the consumer price level is largely determined by retail food prices. That, however, is not the case.

CHART 1

CONSUMER PRICE INDEX
(Percent Change Over 12-month Span)

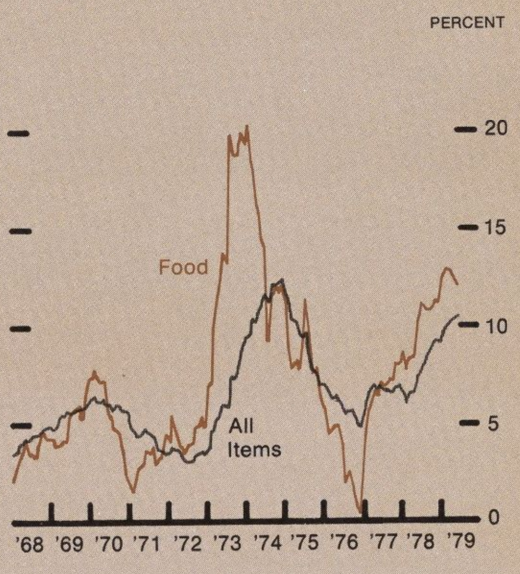

Chart 1 compares percentage changes in food prices and the overall Consumer Price Index from 1968 forward. Food prices are clearly more volatile than the index for all items, having risen a great deal more rapidly at times and considerably more slowly at other times.

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*Both the content and format of this article reflect heavy borrowing from a presentation made at the November 1978 Agricultural Outlook Conference by Dr. J. B. Penn, economist with the U. S. Department of Agriculture. We have adjusted the price forecasts in areas where our opinions differ from Penn's and where subsequent information has led us to different conclusions.

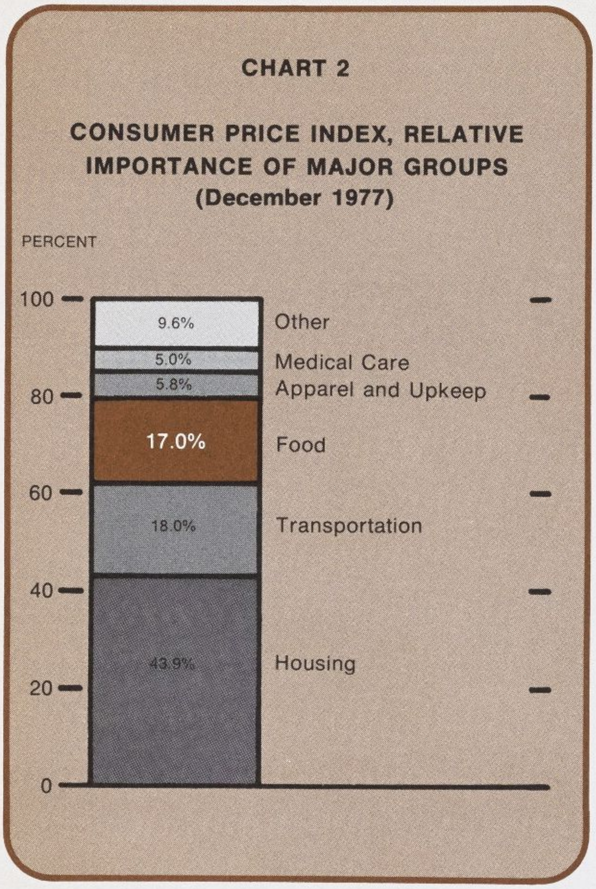


Chart 2 shows the relative importance of food and other major components of the CPI. Housing accounts for nearly 44 percent of the total, and food, at 17 percent, ranks in third place. Thus, food prices account for less than one-fifth of the CPI.

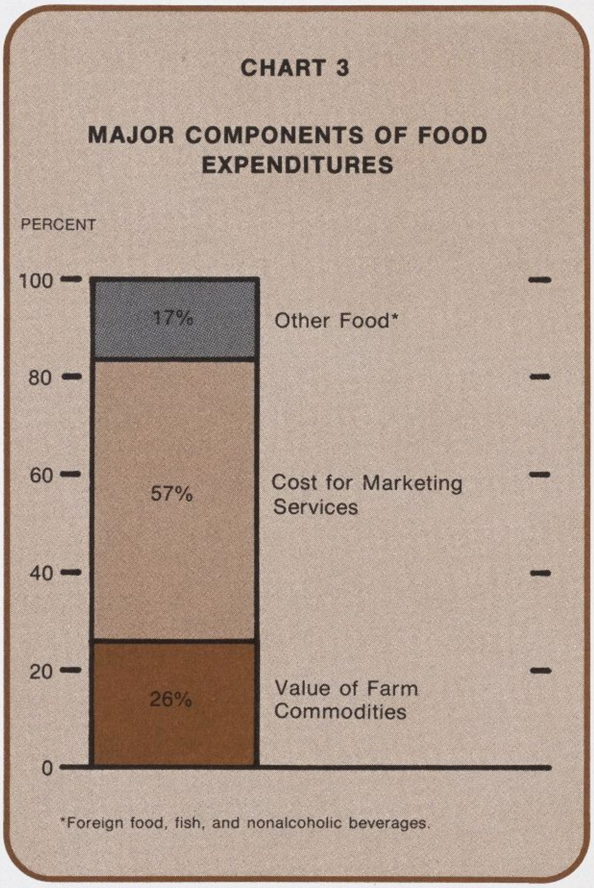
Chart 3 depicts the components of food expenditures and reveals that the value of raw farm commodities (domestically produced) accounts for 26 percent of the total. The cost of marketing services accounts for over half of food expenditures. The remainder, 17 percent, is spent for foods of foreign or nonfarm origin.

Marketing services exert the major influence on food prices. As shown in Chart 4, labor is the largest single component of marketing services, with packaging and transportation charges making up smaller identifiable segments. Insurance, financing, advertising, and overhead charges comprise the relatively large category labeled as "other" expenses.

Labor and transportation costs are expected to increase most rapidly in 1979. Labor costs will rise an estimated 10 percent. Workers receiving wages of $4 or less per hour, who are exempt from the Administration's wage restraint program, are prevalent in food retailing. Retailing, including eating and drinking places, accounts for three-fourths of all production workers involved in processing and marketing food. Therefore, labor costs in the food sector are likely to advance faster than in the rest of the economy.

Transportation costs are strongly influenced by energy prices. Recent announcements of price increases for imported petroleum products lead to expectations of rapid rises in transportation costs, perhaps as much as 15 percent in 1979. Packaging costs, also heavily dependent on oil prices since a number of food products are packaged with materials derived from petroleum, may be expected to increase about 10 percent this year.

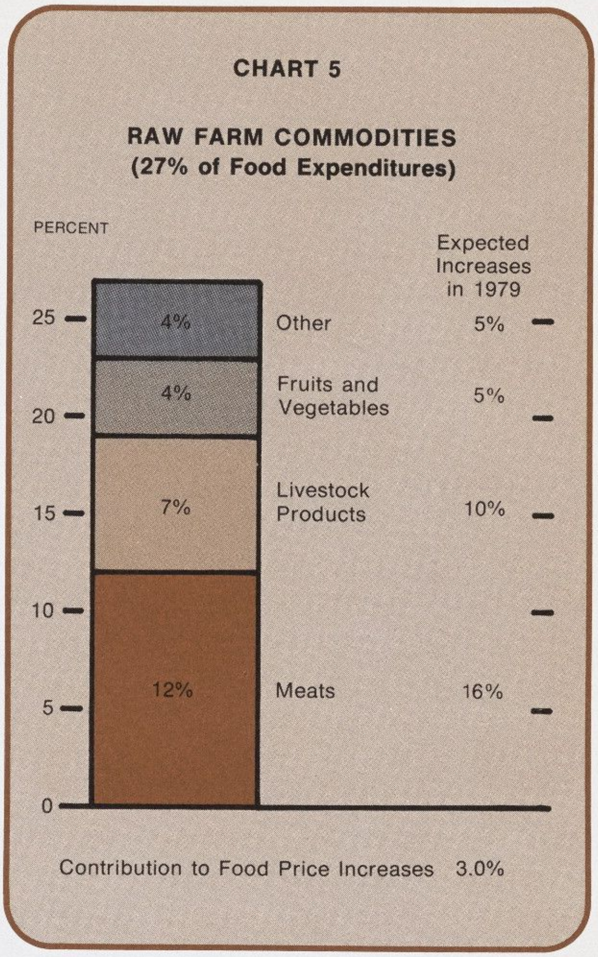
The high cost of inventory financing is likely to maintain at least an 8-percent rise

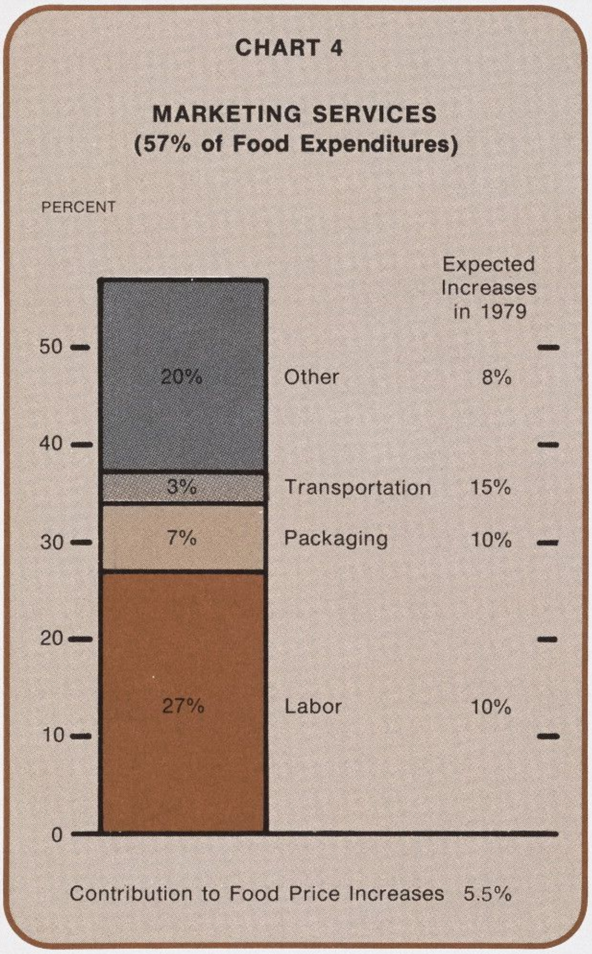


in other marketing costs in the year ahead. Thus, if we weight these projected price increases by their shares of total food costs, we can expect marketing services to contribute about 5.5 percent to the total rise in food prices in 1979.

Important components of raw farm commodities are shown in Chart 5. Meats and livestock products account for the lion's share of the total. Crop products, including fruits and vegetables, claim a relatively small percentage of total food outlays. Fruits and vegetables were a major source of food-price inflation in early 1978, but more plentiful supplies of all crops in 1979 are expected to hold down price increases for food crops in the year ahead.

The major threat of increased food-price inflation comes from the livestock sector. A continuing shortage of meats is expected to result in rapid price inflation that will spill over to all livestock products as consumers attempt to substitute eggs and dairy products for high cost meats. The combined impact of inflation in raw farm commodities is expected to add 3.0 percent to the boost in food prices in 1979.

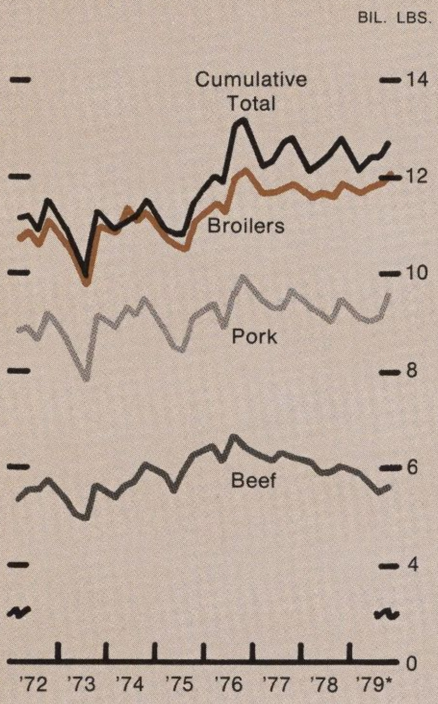




The shrinking meat supply (see chart 6) is primarily attributable to the liquidation of cattle herds that farmers began when prices plunged in 1974. However, recent surveys show that pork producers will boost pork output by 15 percent during the second half of this year. That will counteract the expected further decline in beef production, but even with broilers and other types of meats added in, 1979's total meat output is still unlikely to reach the level that occurred during 1976 at the height of the liquidation of cattle herds. With consumer demand continuing to rise rapidly in the face of stable or dwindling meat supplies, rapid price increases are the way the market equates supply with demand.

CHART 6

U.S. COMMERCIAL MEAT PRODUCTION



*Estimated.

SOURCES OF FOOD PRICE INCREASES IN 1979

	Percent
Raw Farm Commodities	3.0
Marketing Services	5.5
Other Food Products	1.5
Total Expected Increase	10.0

The table shows the summation of the expected food price increases during 1979. Marketing services will contribute 5.5 percent, raw farm commodities will add 3.0 percent, and other food products are likely to account for another 1.5 percent. The total projected increase amounts to 10.0 percent. That is higher than the USDA's most likely forecast, but it is below the rate that may result if weather problems should again severely restrict crop output.

The long-run hope for bringing food-price inflation under control is expanded meat supplies. Prospects for increasing meat output are assessed in the next article appearing in this issue. ■

PROSPECTS FOR MEAT PRODUCTION

by Gene D. Sullivan

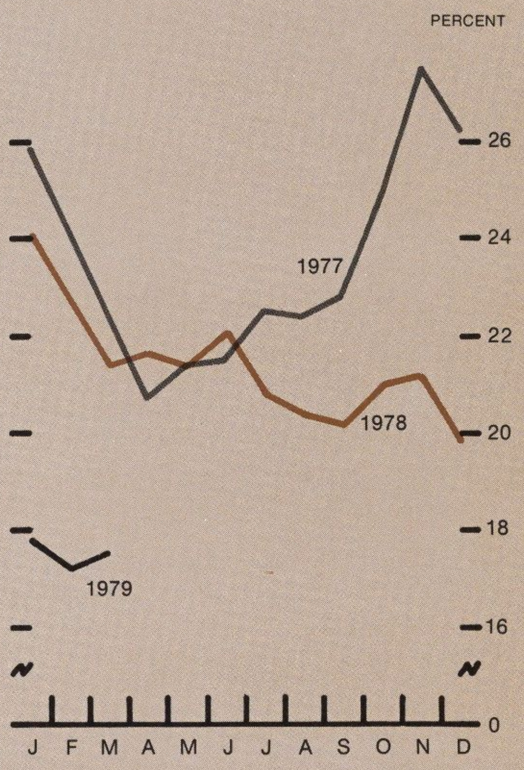
The major reason for the rapid increase in food prices in recent months has been reduced beef production. Before inflation of food prices can be significantly reduced, meat output must expand. Beef production, which usually makes up more than half of the meat supply, will not grow materially until breeding herds are rebuilt. Recent reductions in cow marketings suggest that cattle herds have stopped declining and may have at last begun to rise, but increased beef supplies are at least three years away. In the meantime, solid gains in pig numbers promise to raise pork output enough to offset the shortfall in beef supplies by the end of this year. With continuing brisk growth in poultry output, total meat supplies should exceed the year-earlier level by the final quarter of 1979.

Why Beef Output Declined. In response to returns sagging well below production costs ever since 1974, farmers have sent their breeding stock to market and sharply reduced their herds of mature cattle. The nation's calf crop, the source of future beef supplies, has been reduced each year since 1975 and, by 1978, was 15 percent below its peak. Nevertheless, the total beef supply continued to increase through 1977 because production was boosted by the slaughter of breeding stock. Total beef output did not fall significantly until late 1978.

The reductions in cattle numbers were somewhat offset in 1977 and 1978 by the feeding of more animals to heavier weights prior to slaughter. Specifically, more calves were fattened in feedlots in lieu of being slaughtered at lighter weights directly from pasture. In addition, heavy marketings of breeding stock continued during the early part of 1978. In some areas, drought shriveled pastures and forced livestock to market. But throughout the country, a widespread sell-off of mature cows continued in spite of a strong increase in prices that, by most accounts, had returned profitability to the cow-calf enterprise for the first time since 1973.

CHART 1

COWS AS A PERCENTAGE OF TOTAL U.S. CATTLE SLAUGHTER



Before beef production can increase sufficiently to arrest the rise of retail prices, herd liquidation must cease and net additions must be made to the breeding stock, i.e., heifer calves must be withheld from the market to be used for herd replacements. A comparison of the volume of animals moving to market with year-earlier levels could provide an early sign that a turnaround in cattle numbers has begun.

Chart I shows the percentage of cows in U. S. total cattle slaughter from 1977

TABLE 1

MARKETINGS OF CATTLE AND CALVES IN DISTRICT STATES*

(thousand head)

	1977	1978	1979	Percent Δ Year Ago
January-June	1,295	1,457	-	+12.6
July-December	1,885	1,548	-	-17.9
January-April	-	808	688	-14.9

*The sum of marketings reported weekly in Florida, Georgia, Alabama, and Mississippi.
Source: Federal-State Market News Service.

through March 1979. A substantial reduction, beginning in the summer of 1978 and continuing through the first quarter of 1979, is evident.

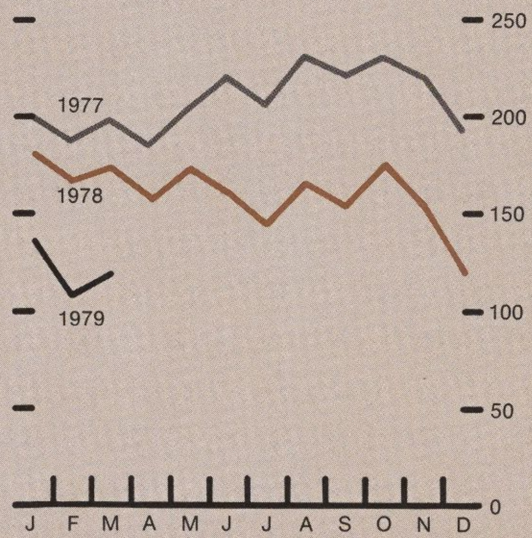
Weekly marketings of cattle and calves within the Southeast provide additional insights into intentions of producers within this traditional cow-calf area (see Table 1). In four reporting states in the Sixth Federal Reserve District, marketings began to drop below the year-earlier level in early summer 1978 and have continued to lag year-ago levels ever since.

Monthly slaughter data in the Southeast may be even more revealing of breeding intentions, since most of the animals slaughtered at local facilities are mature cows rather than steers or calves. A significant reduction in cow slaughter would be stronger evidence that farmers may, in fact, have begun to rebuild cattle herds. Chart 2 shows that District cattle slaughter declined in 1978. By March 1979, slaughter in Georgia had dropped to nearly one-half of the year-earlier level. Similar declines, though not quite so extreme, have been evident in other District states.

CHART 2

COMMERCIAL CATTLE SLAUGHTER, SIXTH DISTRICT STATES

(thousand head)



Although reduced marketings and slaughter are encouraging signs, the evidence is not sufficient to determine that herd rebuilding has, in fact, begun. Since the calf crop has declined, numbers marketed would have to drop as soon as net herd liquidation ceased or even slowed. The cattle inventory at year-end 1978 revealed that the District's cattle population had fallen another 12 percent during the year. Decreased marketings, at least until that time, signified only a slowing in herd liquidation.

Conclusive information as to whether herd rebuilding has begun more recently must await the July 1 inventory of cattle population. An increase is expected, particularly in animals held for herd replacement. Even so, higher beef production from domestic herds is probably at least three years away. That would be the minimum time required to produce a market-ready animal from a calf borne by a heifer entering the breeding herd this spring.

Help from Expanded Pork Output. Hog production offers the best promise of near-term expansion of meat output in view of the dim prospects for beef. A rise in pork output has been expected for some time. Surveys of hog producers indicated plans for increased production in the fall of 1977, but that expansion did not occur. Subsequent surveys and actual marketings during 1978 revealed that pork production was little changed from year-earlier levels until moderate growth began to appear in the latter part of the year.

Why pork production did not expand as anticipated in 1978 is a matter of some conjecture. The fact that Canadian producers did increase output at about the same rate that U. S. producers had initially intended raises doubts as to whether unusual disease and cold weather problems, the reasons commonly cited, adequately explain the shortfall in U. S. output.

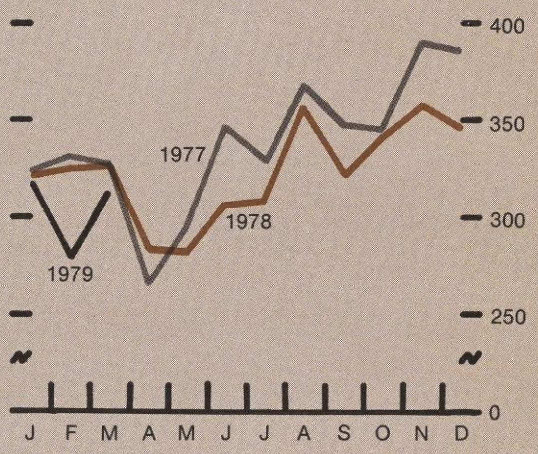
There is reason to believe that U. S. hog producers did, in fact, plan to expand output as reported but subsequently changed their minds. Marketings of sows (mature female breeding stock) can be a clue to production intentions. During periods of planned expansion in hog numbers, producers not only retain larger numbers of young females for breeding but also may slow their marketing of sows. The fastest way to increase pig production is to hold a sow in the breeding herd longer than normal to produce one or more additional litters of pigs. Similarly, an unusually heavy rate of sow marketings would indicate that producers are cutting back production potential and a reduction in hog numbers is on the way.

During September and October of 1977, the number of sows slaughtered declined, as shown by Chart 3, but then rose again to relatively high levels in November and December. It would appear that producers changed their minds about expansion in late 1977 and sold the female animals they

CHART 3

NUMBER OF SOWS SLAUGHTERED, UNITED STATES

(thousand head)



would have used to expand pork output in 1978.

Sow marketings returned to relatively low levels in early 1978, suggesting that producers were again planning to expand pork output. It was not until the late summer and fall of 1978 (about the minimum time required) that actual marketings of hogs began to increase. Even then, production expansions were relatively moderate, amounting to only a one-percent increase in pork production for the year as a whole. By December, however, the beginnings of a bulge in pork output appeared, as production of commercial pork rose to 2 percent above the same month in 1977. In the following month, January of 1979, pork output climbed to 9 percent over the year-ago level. Further, surveys indicated that the number of hogs on hand in March 1979 was 13 percent larger than the year-earlier count.

Producers reported plans for a further sharp expansion in pig production during 1979. The pig crop during the winter quarter (December 1978-February 1979) was 17 percent larger than in 1978, and herdsmen anticipated an average increase of about 20 percent in the number of sows farrowing

TABLE 2

INVENTORY OF HOGS AND PIGS IN THE FOURTEEN PRINCIPAL PRODUCING STATES[1]

(thousand head)

	1977	1978	1979	1979 as Percent of 1977	1979 as Percent of 1978
Inventory Number - March 1					
All Hogs and Pigs	44,020	44,680	50,511	115	113
Kept for Breeding	7,003	6,946	8,344	119	120
Market	37,017	37,734	42,167	114	112
Sows Farrowing					
December[2] - May	5,197	5,155	6,207[3]	119	120
Pig Crop					
December[2] - February	15,586	15,626	18,260	117	117

[1]Georgia, Illinois, Indiana, Iowa, Kansas, Kentucky, Minnesota, Missouri, Nebraska, North Carolina, Ohio, South Dakota, Texas, and Wisconsin.
[2]December of preceding year.
[3]Intended.
Source: U. S. Department of Agriculture.

during the spring and summer quarters (see Table 2).

Hog marketings should average at least 15 percent above the year-ago level during 1979, adding 2.0 billion pounds or more to total pork output. Such an increase in pork supplies would offset the expected decline in beef production.

Poultry Will Expand the Total Meat Supply. Production of broilers and turkeys, while not included in the red meat supply, is, nevertheless, an increasing component of the consumer's meat diet. Broiler production has been growing rapidly to fill the void left by shrinking beef output. Annual output was 7 percent, or 650 million pounds, larger in 1978 than in 1977. Production could grow an additional 800 million pounds in 1979.

Turkey production, though a smaller proportion of the total meat supply, is growing even more rapidly and will probably contribute an additional 200 million pounds to the total meat supply by year-end. Even though poultry traditionally has not been a close substitute for red meat, the extra supply seems likely to provide an attractive alternative to expensive beef products for grocery store shoppers in 1979.

In summary, the total meat supply is nearly certain to increase in 1979. The expansion will provide some relief from price pressures that have been building with the contraction in meat output since 1976. If consumers prove willing to substitute pork and poultry for beef in sufficient quantities during the next two years, food price pressures should abate considerably. If consumers insist on buying beef, however, prices are certain to continue to rise until larger beef supplies can be made available. ■

CONSTITUTIONAL LIMITATION OF THE FEDERAL BUDGET

by William N. Cox

The idea of amending the National Constitution to limit the Federal budget is now on the national agenda. Diverse concerns have put it there. Many of these concerns—probably most of them—are not economic. But at least one economic concern is obviously on the list: inflation.

The Federal deficit in the '70s has become more frequent and larger, in relation to the size of our economy, than it was in the '50s and '60s. This statement holds up even if we combine the deficits of state, Federal, and local governments. These larger and more frequent deficits have contributed somewhat to the inflation we have today. We economists disagree as to whether the deficits have contributed to inflation directly, through the debt-financed spending involved, or, indirectly, through the quicker monetary growth accompanying higher deficits. One way or the other, however, higher deficits have contributed to our inflation.

The Federal Government's budget outlays have claimed about a one-fifth share of total spending since Vietnam. A higher share of government budget activity contributes to inflation in two distinct ways. First, it tends to raise total spending (public plus private). Second, a growing Federal share means a bigger tax bite, which adds to productivity disincentives in terms of innovations, additions to productive capacity, and perhaps in terms of hours worked.

Whatever else the deficits and the Federal share of national activity have done for us, both of them have contributed to the inflation we face. This is particularly interesting as we address the constitutional proposals for limiting the Federal budget today because these proposals deal with eliminating the Federal deficit, with limiting the share of Federal spending in our economy, or with limiting the share of Federal taxation.

THE THREE PROPOSALS:

"BALANCED BUDGET" AMENDMENT

Elimination of the Federal deficit; Federal revenues must at least equal expenditures.

SPENDING CAP AMENDMENT

Federal expenditures could not exceed some specified proportion of GNP.

REVENUE CAP AMENDMENT

Federal tax collections could not exceed some specified proportion of GNP.

The so-called "balanced budget" amendment is the most talked-about proposal. This is what more than one-half of our state legislatures, including all of those within our Sixth District boundaries, have resolved for a constitutional convention to propose. "Balanced budget" is a misnomer; the proposal calls for the elimination of deficits but not necessarily for the elimination of surpluses.

The spending cap amendment would limit Federal spending to some stipulated proportion of our Gross National Product. That proportion is now about 21 percent. Tennessee added such an amendment to its State Constitution two years ago.

The third proposal, the revenue cap amendment, would do much the same thing on the taxation side, restricting the share of our income devoted to Federal taxes—now just under 20 percent. An example of the revenue cap idea at the local level comes to us from California: Proposition 13.

Here we discuss the economic implications of these proposals. Our purpose is not to urge either support or opposition to any of these proposals, implicitly or otherwise. It is simply to give you a fair idea of the economic consequences. With a couple of exceptions, noted below, there is general agreement among economists about the likely effects.

Balanced Budget Amendment. Let's look first at the so-called balanced budget amendment.

"BALANCED BUDGET" AMENDMENT

- *would eliminate deficits;*
- *would enhance antiinflation policies;*
- *would probably encourage non-budgetary actions such as regulations;*
- *would be difficult to implement;*
- *would not directly affect the share of government activity in our economy;*
- *would weaken the government's general antirecession capabilities; and*
- *would not permit as much targeting of antirecession policies toward particular areas, sectors, and groups.*

It would eliminate deficits; this is what it is designed to do. In the process, it would preclude further additions to our national debt and to the existing supply of Treasury securities. Our national debt now totals about $800 billion, $500 billion of which is owed to creditors outside the government itself. This represents a little less than one-quarter of our Gross National Product, about the same proportion as ten years ago. Of that $500 billion, one-quarter is now owed outside the U. S. This proportion has risen dramatically in recent years. Debt owned outside the U. S. is, of course, beyond the reach of U. S. taxing power.

The *"balanced budget" amendment would enhance antiinflation policies* of the Federal Government, providing a fairly obvious discipline against spending increases and tax cuts.

Third, *it would probably encourage non-budgetary actions such as regulations* by the Federal Government. The proposition here is simple: If we continue to ask the Federal Government to respond to all sorts of problems while restricting its budgetary ability, then congresses and administrations will look for other ways to respond, probably with regulations and with off-budget financing methods like loan guarantees.

This amendment would be difficult to implement. Reducing the deficit from its current level of about $35 billion per year to zero would require some combination of tax increases, spending cuts, and unaccustomed good fortune with the business cycle. The deficit reacts to business conditions; if the real growth rate of our economy slows down by 3 percent (equivalent to about a 1-percent increase in the unemployment rate), the deficit tends to go up by about $20 to $25 billion. Most of this response is on the revenue side, as tax revenues slow along with income growth. One-fifth of the deficit increase comes from the expenditure side as more people become entitled to unemployment and public assistance benefits. Putting the same notion another way, we have cut the deficit roughly in half during the past three years. About 60 percent of this improvement has come from economic expansion itself rather than from overt taxing or spending changes enacted by the Congress or the Administration. This is why the perennial forecasts of "a balanced budget three or four years from now," made by almost every Administration, are always conditioned on an expectation of no recession: Recessions drive the deficit up.

Implementation, by pushing the deficit to zero, could *cause* a recession. The question is whether monetary policy, which would move into the center ring with all the spotlights on it, could and would offset the elimination of Federal deficit spending. If the credit which would have been borrowed by the Treasury remained available to the private sector and if these funds were indeed borrowed and spent by the private sector, implementation would go smoothly. Otherwise, implementation would slow the economy down.

The balanced budget amendment would not directly affect the share of government activity in our economy; it relates to balance, not to the level at which balance would be achieved. *A balanced budget amendment would weaken the government's antirecession capabilities.* The traditional response of governments to recession, as we well know, is to cut taxes and add to spending. A balanced budget amendment would mandate the opposite—tax increases and spending cuts to offset the built-in tendency of the deficit to go up in response to recession. Would this work? Economists disagree what would happen here. Monetary policy, again, would be in the spotlight. Recessions could be fought successfully under a balanced budget amendment if two things happened again: (1) The credit which would have been used to finance the Federal deficit would have to remain available to the private sector—that would be up to the Federal Reserve—and (2) the private sector—businesses and consumers largely—would have to borrow that credit and spend it or invest it in an amount equal to the deficit spending that the Federal Government otherwise would have done. Worries that this would not happen have led to discussion about "escape-hatch" language which might be attached to a balanced budget amendment, providing for relief during recessions.

Recessions tend to be uneven in their impact, as we in the Southeast can recall from the experience of four years ago. One of the traditional responses of government to recessions has been to try to target some of the tax cuts and some of the spending increases to the particular areas, sectors, income groups, occupations, and so forth most heavily affected by the recession. *A balanced budget amendment, if implemented, would weaken the government's ability to target antirecession policies.* Targeted spending or tax cuts would have to be matched somewhere else in the budget by spending cuts or tax increases.

Spending Cap Amendment. Now let's look at the implications of the spending cap proposal which would restrict the share of Federal Government spending to some stipulated percentage of our Gross National Product.

The spending cap would not eliminate deficits. It deals with the level of spending only, not with the relationship between spending and revenues.

SPENDING CAP AMENDMENT

- ***would not eliminate deficits;***
- ***would enhance antiinflation policies somewhat;***
- ***would restrict the share of government activity;***
- ***would probably encourage regulations and targeted tax incentives;***
- ***would not be difficult to implement;***
- ***would weaken our general antirecession capabilities somewhat; and***
- ***would not permit quite as much targeting of antirecession policies.***

The spending cap would enhance antiinflation policies somewhat. During the '70s, the economy has grown at about a 9½-percent annual rate, whereas Federal spending has grown at about 10½ percent. The spending share has grown. This would not have been possible under a spending cap amendment. With one, inflation probably would have been lessened.

A spending cap amendment would restrict the share of government activity by definition. However, *it would probably encourage regulations and targeted tax incentives.* Cuts on the tax side would be permitted under a spending cap and might serve as substitutes for spending increases.

This amendment would not be as difficult to implement as the balanced budget amendment. Difficulty would depend on the percentage level at which the cap was set. Clearly, the lower the cap—there has been discussion of levels from 21 down to 18 percent—the more difficult to implement and the more lead time required.

The spending cap amendment would weaken our general antirecession capabilities somewhat. Unlike the balanced budget situation, however, tax cuts would still provide some response to recession.

Finally, *the spending cap amendment would not permit quite as much targeting of antirecession policies* to distressed areas, industries, or income groups. Tax cuts would be permissible, but it is obviously difficult to help unemployed people or bankrupt businesses with tax cuts.

Revenue Cap Amendment. Third, let's look at the revenue cap amendment, which would restrict the share of Federal taxation to some stipulated proportion of Gross National product.

REVENUE CAP AMENDMENT

- ***would not eliminate deficits;***
- ***would weaken antiinflation policies somewhat;***
- ***would not encourage regulatory activity;***
- ***would restrict the share of government activity somewhat;***
- ***would be easy to implement;***
- ***would not weaken our general antirecession capabilities; and***
- ***would not affect targeting of antirecession policies.***

The revenue cap would not eliminate deficits; it deals with revenue levels, not balance.

It would weaken antiinflation policies somewhat. In the course of inflation, our progressive tax structure tends to raise Federal tax revenues more quickly than either the growth of the general economy or the inflation rate. Under a revenue cap, the government would be required to cut taxes in response to inflation. There is another side to this, however—a factor which has not been satisfactorily quantified: A reduction in the Federal share of taxation might provide incentives for innovation, for production, and for additions to productive capacity, strengthening the ability of the economy to produce and removing some inflationary pressure that way. Which of these two tendencies would prevail is uncertain.

The revenue cap amendment would not encourage regulatory activity. After all, tax incentives and additional spending would not be precluded. *It would restrict the share of government activities somewhat,* although it is interesting to note that if we had imposed a revenue cap at the beginning of the '70s, at the then-prevailing share, it would not have "bit" since then. The economy has grown at a 9½-percent rate, and Federal spending has grown at 10½ percent, but Federal revenues have grown at 8½ percent. Tax cuts in the '70s have more than offset the impact of our progressive tax structure, in other words.

A revenue cap would be easy to implement, would not weaken our general antirecession capabilities, and would not affect the targeting of antirecession policies, again, because there would be no restriction of the ability to implement either tax cuts or spending increases in response to recession.

Such are the broad economic implications of these three proposals. It would be natural, perhaps, to conclude by comparing these consequences and saying "This one is best"; or "This one is worst." But different individuals are apt to put different weights on the various consequences. Some may think some of the items discussed here are irrelevant; some may view them as vital. Much more importantly, though, the question of constitutional limitation of the Federal budget is not entirely an economic one. Clearly, there are political, social, and, indeed, philosophical implications and concerns involved. We have tried to give an idea of the economic implications so each reader can combine them with his own values and concerns and can come to his own conclusions about whether to support or to oppose any of these three proposals or whether to check the box marked, "None of the above." ■