

FEDERAL RESERVE BANK OF ST. LOUIS

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Anti-Inflation Process Continues

by NORMAN N. BOWSHER

THE RATE OF INFLATION has accelerated since 1965, until in the past year overall prices have risen more than 5 per cent. Progress in reducing inflation has been very slow, both because the inflation was permitted to develop momentum from 1964 through 1968, and because a gradual approach has been applied in correcting it in 1969 and 1970.

Growth in total spending has been slowed to about the estimated growth in productive capacity since the third quarter of 1969. Production and employment have been affected adversely, but the adjustment has been much less than in previous periods of economic correction. Construction has been cut back, and bond and stock prices have fallen.¹

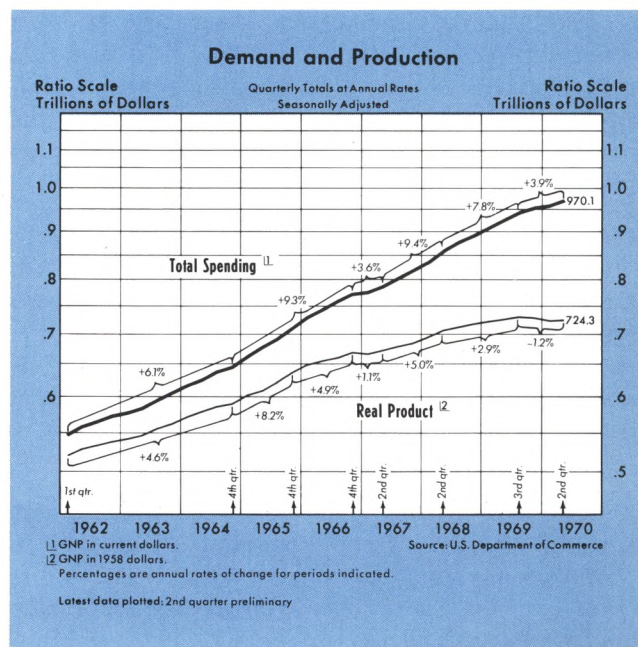
This article reviews the recent growth trend of the money stock. To evaluate this trend and possible future trends, the article examines some evidence bearing on the current growth rate in the amount of money demanded. It also examines some credit and regulatory developments that might affect the Federal Reserve System's control of the money stock in the near future.

Appropriate Growth in Spending

Two crucial questions for current stabilization policy are: (1) What rate of growth of total spending is most desirable to keep downward pressure on inflation and expectations of inflation? (2) What rate of monetary expansion is consistent with such a growth of total spending?

Studies conducted by this bank indicate that a moderate 6 to 7 per cent rate of growth of total spending would gradually reduce the rate of increase in overall prices from 5.3 per cent a year in the first half of 1970 to about 3.5 per cent a year in the first

¹An article in this *Review* last month ("Inflation and Its Cure," pp. 2-7) concluded that many of these costs probably resulted from the public adapting to the higher rates of anticipated inflation, and the downward pressure on prices remained light.



half of 1972.² According to these estimations, total real output would rise about 1 per cent in the next twelve months and nearly 4 per cent in the following year.

Appropriate Monetary Growth

Total spending for goods and services may accelerate or decelerate as a result of any one of a number of disturbances. One such disturbance is a change in the money stock initiated by the monetary authorities relative to the amount of money demanded by the public. Important factors affecting amount of money demanded are spending, income, wealth, prices of goods and services, and interest rates. The amount of money demanded is little affected in the short run by those factors which determine the supply.

²Calculated using the model discussed in "A Monetarist Model for Economic Stabilization," Leonall C. Andersen and Keith M. Carlson, April 1970 issue of this *Review*, pp. 7-25. For current simulations, see the "Quarterly Economic Trends" release of this Bank.

If the money stock is greater (or less) than the equilibrium amount demanded at prevailing economic conditions, the resulting discrepancy tends to cause the rate of spending on goods, services, and financial assets to increase (or decrease). The process will continue until, with new levels of spending, income, prices, wealth, and interest rates, the amount of money demanded equals the amount supplied.

The equilibrium amount of money demanded at a point in time can only be measured indirectly. Some evidence can be obtained on whether it is greater or smaller than the amount supplied by observing whether the general trend of spending is accelerating or decelerating. When the rate of growth of spending remains unchanged for a prolonged period, the amount of money demanded is evidently rising at about the same rate as the money stock.

Some insight into the rate of monetary growth which would be most conducive to a moderate growth of total spending may be obtained from past experience. From the 1957 high in business activity to the high in 1965, when the money stock grew at an average 2.2 per cent a year, the trend growth in total spending was 5.7 per cent a year.

Since economic conditions were similar in 1957 and 1965, the amount of money demanded also rose at roughly a 2.2 per cent trend rate from 1957 to 1965. However, the amount of money demanded is probably rising at a faster rate now, requiring a more rapid injection of money to avoid having a depressing effect on total spending. Prices are now rising more rapidly than from 1957 to 1965 and are expected to continue to rise for some time, requiring more money for transactions. Interest rates generally rose in the earlier period, increasing the alternative cost of holding nonearning cash balances. If interest rates now stabilize or decline, as seems likely, this incentive to reduce cash holdings will no longer exist. Also, many may feel that their overall liquidity has been reduced beyond desired levels, especially in view of recent declines in security prices, insolvency of some corporations, and talk of a money squeeze. To the extent that attempts are made to conserve and build up cash balances, growth in spending slows unless offset by a more rapid growth in money stock.

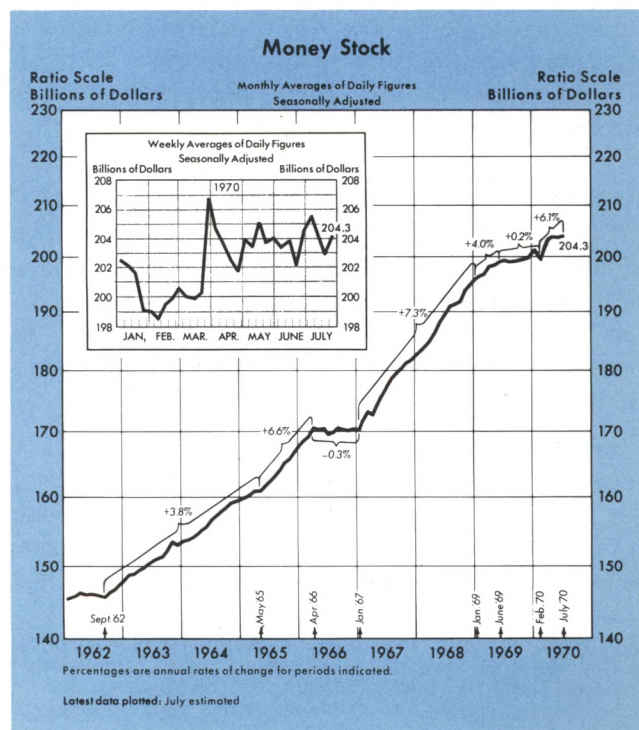
Relationships between estimated growth rates of money stock and total spending, formulated using this Bank's model, suggest that the amount of money demanded now may be rising about 6 per cent a year. To reduce inflation and inflationary expecta-

tions, however, it is necessary for the stock of money to grow less rapidly than the amount demanded in order to restrain growth in total spending. Calculations at this Bank indicate that a fairly steady 5 per cent growth rate of money would be most likely to succeed in the current situation in fostering a moderate 6 per cent rate of growth in total spending in the next twelve months.

Recent Money Growth

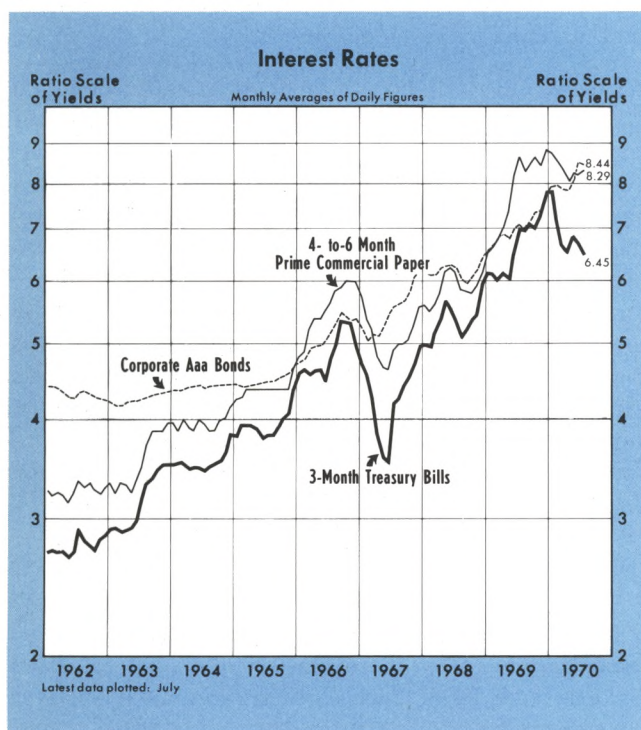
During the spring of 1970 there was a sizable injection of money, and from the first to the second quarter, the money stock rose at a rapid 6 per cent annual rate. Moreover, it is likely that in the remainder of the year the Treasury will be a large net borrower of funds, both to meet seasonal needs and to finance an expected deficit resulting from a reduced rate of tax collections as growth of incomes slows. When the Treasury borrows heavily, growth in money stock frequently is expanded rapidly by the Federal Reserve to accommodate market demands and ameliorate the higher interest rates that might otherwise result temporarily if funds have to be diverted from other uses.

Since early May, however, growth in money has been moderated. The slowing has occurred despite some money market developments which might have caused the System to continue to expand money rapidly. In late April, terms of a Treasury security



offering became unattractive in light of the sudden Cambodian invasion. To obtain sufficient buyers, the Federal Reserve expanded the money stock by injecting member bank reserves. The money and capital markets became unsettled as a result of a marked decline in stock and bond prices, the uncertain financial condition of some security dealers, the social unrest accompanying the Cambodian affair, talk of liquidity squeeze, and the insolvency of some firms, particularly the large Penn-Central Transportation Company. In addition, the Treasury borrowed about \$7 billion of new funds in July and August.

Despite the slower growth in money and unsettled money market conditions, interest rates generally declined after early May. Three-month Treasury bill



rates, which reached 8 per cent early this year and averaged 6.83 per cent in May, continued to decline and averaged about 6.50 per cent in early August. Rates on Federal funds declined from an 8.5 to 9 per cent range in the June 1969 to February 1970 period to an average 8 per cent from March to early June, and to about 7 per cent during early August.

Demand For Credit

How was it possible for short-term interest rates to decline in view of a slower growth in money after early May? The demand for bank credit in the private sector moderated. Since the period is still short,

the relaxation may prove to be merely a respite. But recent economic developments are similar to those during other postwar periods when we witnessed a general decline of demands for credit and of interest rates. With demands for credit less vigorous, interest rates drifted lower. Limiting growth of money, in turn, becomes easier when money market conditions are not strained.

A brief review of selected key developments indicates how credit demands may be relaxing. During 1967 and 1968 the money stock, increasing at a 7 per cent annual rate, grew more rapidly than the amount demanded by the public. As a result, total spending on goods and services and credit demands were continuously and excessively stimulated. Subsequently, the more moderate 3 per cent average rate of expansion in money since early 1969 has probably been less than growth in the amount demanded, which had been accelerating with the higher actual and expected prices.

For a time after the growth of money moderated, the stock of money held probably continued to exceed the overall amount demanded, and spending continued to be stimulated. Some individuals and businesses began to feel that their money balances were relatively low as early as the summer of 1969 and began taking actions to conserve cash, but most of the public probably continued to consider their cash balances adequate. If their balances were less than desired, the difference was small, as evidenced by the mildness of the correction in spending growth in late 1969.

With the amount of money demanded continuing to rise faster than the quantity supplied (except possibly for a brief period this spring), a growing portion of the public began taking actions to conserve and build cash balances. Individuals and businesses may undertake to improve their cash positions in many ways. Although there is reluctance to change consumption patterns or business plans, some less essential projects are trimmed or postponed in an effort to bolster cash balances, as evidenced by the moderated growth in total spending. Some individuals may have bought fewer stocks and bonds, or even liquidated some securities, in an attempt to correct a cash shortage. Although these efforts build cash holdings for some economic units, others find their cash balances declining since the total stock of money is little affected by these adjustments. At the same time, the resulting slower business conditions, and sharp declines in security prices, as well as the talk of a

money squeeze and the widespread publicity regarding financial problems of particular firms, may have caused some to revise upward the amount of money they desired to hold.

When the growth rates of the money stock were permitted to vary much more than in recent decades, so-called money panics occurred. The amount of money demanded at times greatly exceeded the amount supplied, and short-term interest rates rose sharply as the public scrambled for the limited funds. In such periods, severe interruptions in economic activity occurred. For example, in the spring of 1920, money, which had been expanding at a 17 per cent annual rate, suddenly began contracting at an 8 per cent rate. Yields on prime 4- to 6-month commercial paper jumped about 60 per cent within a few months, and industrial production dropped about one-third from early 1920 to early 1921.

Since the early Fifties, rates of growth in the amount of money supplied have fluctuated over a much narrower range, and the stock of money has more nearly approximated the amount demanded. When amounts of money demanded exceeded the amount supplied, some financial strains occurred for a brief time, such as during the "credit crunch" in the early fall of 1966. The adjustments, however, were relatively mild. Rather than a widespread desperate bidding for funds in the market, driving up short-term interest rates, actions were taken to conserve cash balances, such as trimming or postponing expansion plans, policing inventories, reducing expenditures, and shortening and upgrading investment holdings. As a result, credit demands and interest rates, particularly those on short-term instruments, began declining during these postwar periods of financial stress.

Conditions during the spring and early summer of 1970 appear to be similar to other recent periods when, with the advantage of hindsight, it can be concluded that the amount of money demanded exceeded the amount supplied. If so, investment plans may have become less ebullient, and the demand for credit may have passed its peak of intensity.

Control of Money Growth

If the demand for credit continues to be less intense in the future than it was last winter, interest rates may stabilize or decline somewhat further even though the rate of growth of money stock is restrained. Under such conditions it is much easier for the monetary authorities to limit growth of bank reserves and money than when interest rates are rising rapidly

and market pressures are increasing. While moderation of growth of the money stock may in the short run keep interest rates somewhat higher than they otherwise would be, this is a necessary step to lower interest rates in the future.

Another recent development has contributed to keeping monetary growth moderate. In January the Regulation Q interest rate ceilings on time deposits were raised slightly. Effective June 24, the ceiling rate was completely suspended on large CD's maturing in 30 to 89 days, permitting banks to offer yields competitive with other instruments. In the fifteen months before ceilings were relaxed in January, time deposits decreased at a 3 per cent annual rate. From January to June, time deposits increased at a 12 per cent rate, and weekly data since late June indicate another marked acceleration.

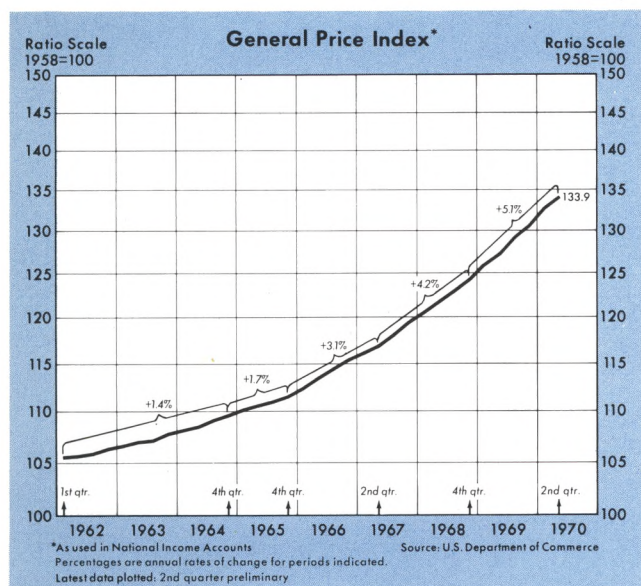
This reintermediation through banks of funds which had been flowing through commercial paper or other credit channels has little overall effect on total spending or total credit outstanding. However, since CD's and other time deposits must be supported by reserves, banks have fewer reserves available to support demand deposits (money). The additional reserves to support time deposits can be provided by the Federal Reserve. However, there has been less money market pressure to provide them with banks expanding their credit at a faster rate, since a given amount of reserves permits more bank loans and investments when liabilities are in the form of time deposits than in demand deposits.

Conclusions

Inflation continues as a serious domestic economic issue, deriving from the excessive total spending from 1965 through 1968. Since early 1969 monetary actions have been directed toward dampening total spending and inflation, while holding the social and economic costs of adjusting to lower price expectations to tolerable levels.

Very restrictive monetary actions might eliminate inflation quickly, but at the expense of sharp cutbacks in production and employment. With very expansive monetary actions, inflation could not be eliminated — it would accelerate.

According to calculations of this bank, a steady moderate growth of money would reduce inflationary pressures while holding the costs in terms of production slack to reasonable levels. With a 5 per cent annual rate of growth of money, it is estimated that



the rate of overall price increase would slow gradually from the 5.3 per cent average rate in the first half of 1970 to about a 3.5 per cent rate in the spring of 1972. Real product would expand as price rises moderate, increasing from the recent little net change to nearly 4 per cent in the twelve months ending in mid-1972.

Money has on the whole risen moderately since last December, namely, at an average 4.1 per cent annual rate, despite a rapid injection this spring. Rapid increases in the money stock may be easier to resist in the near future than from 1965 through 1968. In contrast to the earlier period, private demands for credit seem to be moderating. Also, the relaxation of Regulation Q has permitted a faster growth of time deposits and bank credit and more comfortable bank reserve positions, even though total reserves and money have expanded at a moderate rate.

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The Federal Budget and the Economy

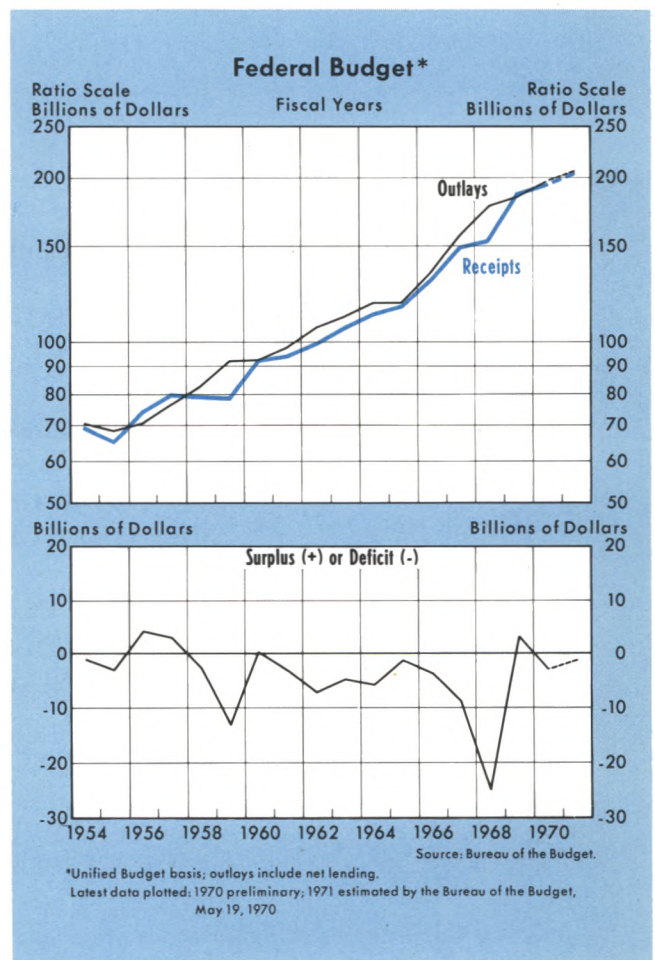
by DENIS S. KARNOSKY

The typical problems involved in formulating a budget for the Federal Government are compounded this year by concern about persistent inflation in the face of rising unemployment and falling production. The Administration considers fiscal restraint essential in order to continue the fight against inflation and has proposed that the budget for the fiscal year ending next June be approximately balanced. Congress has acted on only a small portion of the proposed budget program, but many analysts believe that a substantial budget deficit will develop.

The prospect of a large Federal deficit in fiscal 1971 stems from three factors. There is a possibility that Congress will enact legislation which will result in Government spending in excess of that requested by the Administration. Second, there is some doubt as to whether several proposed tax programs will be adopted. The third factor is the pattern of economic activity in the coming year. Moderation in growth of total spending since late 1969 caused tax revenue to fall significantly short of projections in fiscal 1970 and, similarly, revenue growth in fiscal 1971 is expected to be moderate.

The Proposed Budget in Perspective

The actual Federal budget in fiscal 1971 will not be known for about a year. At the moment the main clue to current and forthcoming fiscal action is the budget report submitted by the President to Congress in February and revised on May 19. Although the actual budget is often quite different from the proposed budget, that report can be used as a point of departure, in that it indicates the thrust of fiscal actions advocated by the Administration.



Outlays

The President's proposed budget for fiscal 1971 calls for total outlays of \$205.6 billion, an increase of 4.5 per cent from fiscal 1970. This plan would con-

Table I

ANNUAL RATE OF CHANGE OF FEDERAL OUTLAYS
(Fiscal Years)

	1960-65	1965-68	1968-70*	1970-71*
Total Outlays	5.1%	14.7%	4.9%	4.5%
Defense	1.6	17.5	-0.1	-8.3
Nondefense	8.2	12.6	8.9	13.3
Human Resources	6.9	17.5	12.5	15.0
Physical Resources	7.5	10.9	4.0	-0.5
Interest Payments	4.6	9.6	15.6	2.7

*Fiscal 1970, preliminary; fiscal 1971 based on Bureau of the Budget data, May 19, 1970.

tinue the pattern of relatively moderate growth in spending which has been followed since enactment of the Revenue and Expenditure Control Act in mid-1968. Total outlays increased at about a 15 per cent average rate during the three-year period from fiscal 1965 to fiscal 1968, but grew at a reduced 5 per cent rate in the last two budget years.

A reduction in defense spending is planned for fiscal 1971, and outlays for nondefense programs are projected to continue increasing rapidly. Defense spending is projected to decline by \$6.7 billion in this fiscal year, to \$73.6 billion, only slightly higher than in fiscal 1967. Other spending is planned to increase \$15.5 billion, a 13 per cent increase over last year.

A net decline in spending for national defense since fiscal 1968, coupled with rapid expansion of other budget outlays, has resulted in a sharp decrease in the portion of the budget devoted to the military.

Table II

COMPOSITION OF FEDERAL OUTLAYS
(Fiscal Years)

	1960	1965	1968	1970*	1971*
Defense	49.8%	41.9%	45.0%	40.8%	35.8%
Nondefense	50.2	58.1	55.0	59.2	64.2
Human Resources	27.5	29.9	32.1	36.9	40.6
Physical Resources	11.0	12.2	11.1	10.9	10.4
Interest Payments	9.0	8.8	7.7	9.3	9.1

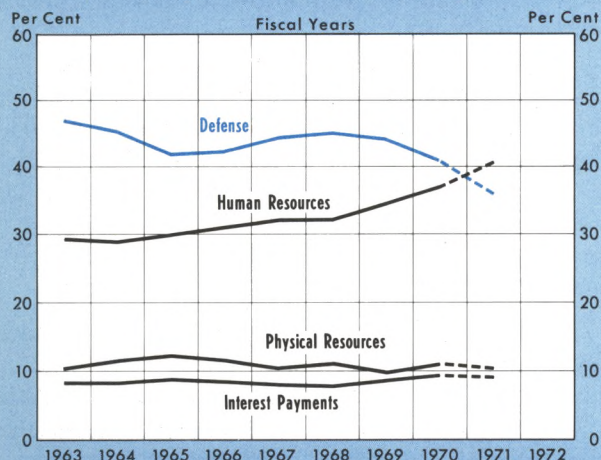
*Fiscal 1970, preliminary; fiscal 1971 based on Bureau of the Budget data, May 19, 1970.

Defense spending, as currently projected, would account for 36 per cent of the budget in fiscal 1971. During the period of military buildup in Vietnam, defense spending increased at a 17.5 per cent average annual rate, from \$49.6 billion in fiscal 1965 to \$80.5 billion in fiscal 1968. This rapid rate of growth was almost matched, however, by expansion of non-defense spending. As a result the military's share of the budget did not change substantially, increasing from 42 per cent of total outlays in 1965 to 45 per cent in 1968.

Nondefense spending increased at an 11 per cent average rate from fiscal 1965 to 1970 and would account for 64 per cent of all outlays in fiscal 1971. Programs devoted to human resources have shown the greatest expansion in recent years and, as currently projected, would account for almost 41 per cent of the budget in fiscal 1971, significantly greater than the 32 per cent allocated in fiscal 1968. Almost all of this increased share represents growth of spending for Social Security and health programs. Other nondefense outlays would be increased 11 per cent in fiscal 1971 and be essentially unchanged as a proportion of total outlays. Physical resource projects, which include housing, urban development and transportation programs, would represent about 10 per cent of budget outlays in fiscal 1971, a share which has not changed substantially since 1960.

In fiscal 1970 about 21 per cent of total spending (GNP) in the economy reflected some form of Federal spending, either directly, through Government purchases of goods and services, or indirectly, through transfers of income to the private sector. The proposed 4.5 per cent increase in budget outlays in fiscal 1971 implies that this relationship probably would not change significantly this year, but would be somewhat larger than in fiscal 1960 when the ratio was about 19 per cent.

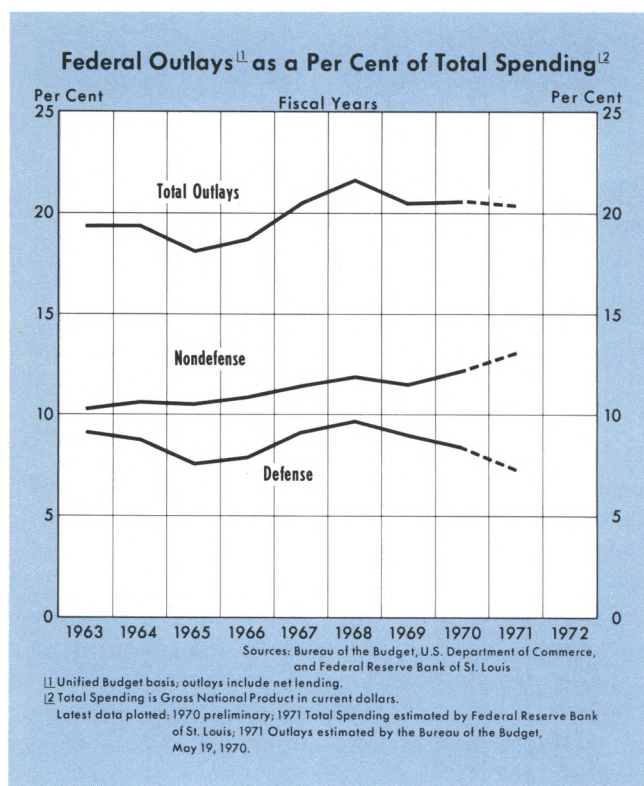
Composition of Federal Outlays*



Sources: Bureau of the Budget and Federal Reserve Bank of St. Louis

*Unified Budget basis; outlays include net lending.

Latest data plotted: 1970 preliminary; 1971 estimated by Federal Reserve Bank of St. Louis based on Bureau of the Budget data, May 19, 1970.



The relationship between Government outlays and total spending in the economy increased substantially from 1965 to 1968, rising from 18 to about 22 per cent. During that period Government outlays for defense increased from 7.6 per cent to 9.7 per cent of total spending. The decline in defense outlays since 1968 has resulted in a sharp reduction in the portion of total spending associated with national security programs, and defense-related spending accounted for 8.4 per cent of total spending in fiscal 1970. This share promises to decline further this year. Government spending for nondefense purposes has generally increased faster than total spending in the economy since 1960. From fiscal 1960 to fiscal 1970 the ratio of nondefense outlays to total spending rose from 9.3 per cent to 12.2 per cent. This proportion is expected to increase further in fiscal 1971.

While budget data for state and local governments are not directly comparable with the Federal budget used here, it is possible to make some approximate comparisons.¹ State and local expenditures have apparently increased slightly faster than total spending since fiscal 1960. As a per cent of total spending,

¹Budget data for state and local government forming a consistent series over time are available only on a National Income Accounts basis.

Table III

**GOVERNMENT EXPENDITURES
AS A PER CENT OF TOTAL SPENDING*
(Fiscal Years)**

	1960	1965	1968	1970
State and Local	8.3%	9.2%	10.1%	10.7%
Federal	18.4	18.1	20.8	20.8
All Government	26.7	27.3	30.9	31.5

*Total spending is GNP in current dollars; expenditures are on a National Income Accounts basis. Federal grants-in-aid are excluded from state and local government expenditures.

state and local expenditures increased from 8.3 per cent in fiscal 1960 to 10.7 per cent in fiscal 1970. This suggests that the portion of total spending in the economy which reflects some form of government expenditures has generally increased in the past decade, and probably accounts for approximately 30 per cent of spending.

Receipts

Taxable income tends to rise and fall with the pace of economic activity, and consequently the Federal budget tends toward deficit in periods of moderated growth of total spending. In the absence of new revenue legislation, total budget receipts in fiscal 1971 are expected to be approximately \$3 billion higher than in the previous year. This is a relatively slow increase and is due to the combined effects of an expected moderate rate of increase in economic activity, and the tax changes incorporated in the Tax Reform Act of 1969, including termination of the income tax surcharge on June 30, 1970. The tax reform provisions and elimination of the surcharge are expected to cost the Government about \$3 billion in revenue in fiscal 1971. In order to bolster revenue the Administration has proposed several new programs: a tax on leaded gasoline (\$1.6 billion), a postal rate hike (\$1.5 billion), and speeded collection of gift and estate taxes (\$1.5 billion). With adoption of these proposals, receipts in fiscal 1971 are estimated to be about \$8 billion higher than last year.

The Deficit

The Federal budget for fiscal 1971, as reviewed in May, was projected to show a deficit of \$1.3 billion. This was based, however, on an estimated deficit of \$1.8 billion in fiscal 1970, an estimate which has since proved to be too low. The actual budget was in deficit by \$2.9 billion in fiscal 1970. In January of this year the Administration had projected a budget sur-

plus of \$1.5 billion for fiscal 1970. This estimate was revised in May to a deficit of \$1.8 billion, with almost all of the change due to a shortfall in estimated receipts from the corporate profits tax. However, actual corporate and individual income tax receipts fell short of expectations, and total budget receipts in fiscal 1970 amounted to \$193.8 billion, compared with the May estimate of \$196.4 billion.

The Administration has not yet revised its budget projections for 1971 in light of the actual 1970 budget; however, there is now little prospect that the deficit of \$1.3 billion projected in May is realistic. For example, the Administration projected in May that revenue would increase by \$7.9 billion over fiscal 1970. Since actual revenue in 1970 was \$2.6 billion less than estimated in May, fiscal 1971 receipts would tend to be lower by the same amount. This implies that the Administration's proposed budget would be in deficit by at least \$4 billion this fiscal year. The budget deficit would be significantly larger than \$4 billion if Congressional actions result in expenditures beyond those requested by the Administration or if Congress is not receptive to the proposed new revenue programs.

Impact on the Economy

Table IV summarizes the pattern of economic activity which has been observed since the Government enacted restrictive, anti-inflationary fiscal policy in mid-1968. Inflation has accelerated, production growth has slowed and has been negative since last fall, and unemployment has increased. Interest rates, which many analysts expected to fall, have remained high.

This pattern of activity has led to suggestions that Government actions have had little effect on inflation and stimulative actions (both fiscal and monetary)

Table IV

THE PATTERN OF ECONOMIC ACTIVITY (Half-year Averages)

	1968		1969		1970
	1st	2nd	1st	2nd	1st
Annual rate of change of prices*	3.9%	4.3%	4.8%	5.3%	5.3%**
Annual rate of change of real product	6.5	3.5	2.4	.9	-1.3**
Unemployment rate	3.7	3.5	3.4	3.6	4.5
Interest rate on corporate Aaa bonds	6.2	6.2	6.8	7.3	8.0

*GNP price deflator

**Preliminary

are now required in order to bolster real economic activity. However, the Administration wants a budget close to balance in order to pursue the fight against inflation. In the May 19, 1970 revision of its February proposal, the Bureau of the Budget stated:

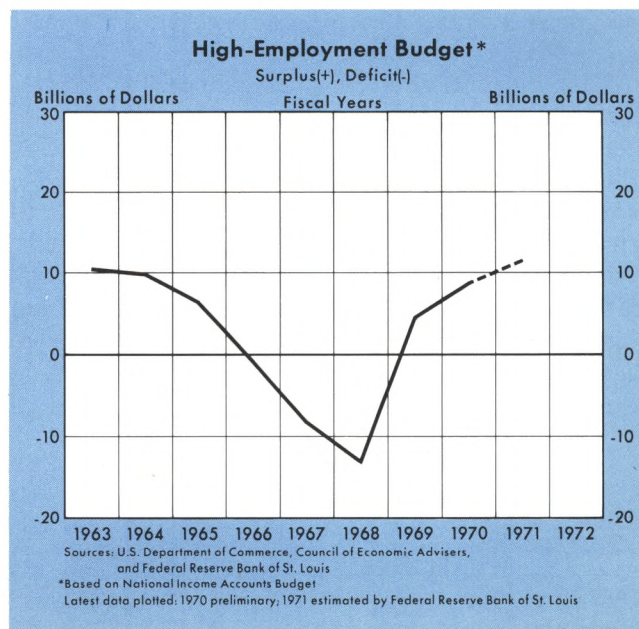
If the Congress votes higher appropriations, or does not approve the taxes proposed by the President, it should match these with specific cuts in other spending programs or increases in other taxes.

Continued fiscal restraint is essential to further progress toward the objectives stated in the President's budget message. Relaxation of that restraint now would risk the danger of permitting the economy to climb too fast as it begins to pick up in the months ahead. Too rapid an advance could nullify the progress made to date toward bringing inflation under control

Since there is a growing belief that the budget deficit actually will be substantially larger than the President requested, it is important to analyze the probable impact of a large deficit on the economy.

Measuring Fiscal Influence

The high-employment budget, an often-used measure of fiscal influence, indicates that the budget for fiscal 1971, as proposed by the Administration, would be restrictive in its impact on economic activity. The high-employment measure of the budget eliminates most of the effects of changes in real economic activity on the budget and attempts to measure changes in the budget due solely to legislative action. Thus the growth of the tax base is held at its high-employment rate and the effects of varia-



tion in economic activity on the budget are significantly reduced. If the budget is enacted as proposed, the high-employment budget would be in surplus by about \$12 billion in fiscal 1971, about \$3 billion larger than in fiscal 1970. If the proposed revenue programs are not adopted or spending exceeds the projected level, the change in the high-employment surplus would be much smaller and the influence of fiscal actions would be less restrictive.

Financing Expenditures

A key element which must be considered in analyzing the impact of the budget on the economy is the method the Government uses to finance its expenditures. The Government has three financing alternatives: taxing, borrowing from the public sector, or borrowing from the Federal Reserve, which is the same as creating money. The effect of Government spending on economic activity can vary depending on the type of financing employed.

The amount of borrowing the Government will do in fiscal 1971 will be determined by the outlay and revenue programs adopted by Congress. From whom the Government borrows will determine the impact of the budget on the economy. Borrowing from the public, that is competing with individuals and businesses for credit funds, would tend to put upward pressure on interest rates. There would be little net increase in total spending in that the Government spending would supplant private spending programs that were unable to get credit.

If the Federal Reserve chose to alleviate some of this pressure on credit markets, however, the impact of Government borrowing would tend to be different. Monetary actions directed at increasing bank reserves and thus the supply of credit, could ease the immediate upward pressure on interest rates and contribute to a smaller restrictive effect on private borrowing. The Government essentially would be financing the deficit by money creation, and unlike taxing or borrowing from the public, money creation involves no crowding-out of private spending.² Thus, Government borrowing in conjunction with accommodative monetary action would tend to have a more stimulative effect on total spending.

The budget deficits of the 1965-68 period are gen-

erally believed to have been a major source of the current inflation. These deficits were due primarily to accelerated growth of Federal spending and since the economy was essentially fully employed in 1965, the expansion of Government spending resulted in strong competition with the private sector for the output of the economy.

The Government chose not to increase taxes and thereby reduce private demand and release resources for Government use. Instead, the Government sought to borrow funds to finance its spending programs and had to compete for credit with the private sector. The expanded demand for credit put strong upward pressure on interest rates. Early in 1967, the Federal Reserve began to increase the money supply at a rapid rate and from January 1967 to January 1969, the nation's money stock increased at an average rate of 7.3 per cent. This growth of money was excessively rapid and contributed to an acceleration of total spending in the economy.

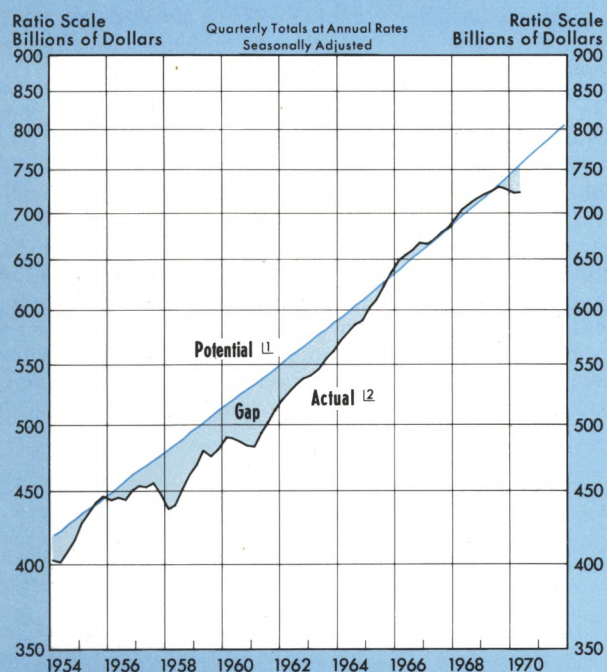
Price increases were generated by excessive demand as the Government competed with the private sector for the output of the economy. After rising at a 1.4 per cent average annual rate from 1960 to mid-1965, prices increased at an average rate of 3.2 per cent from mid-1965 to mid-1968. After-tax income of individuals rose at an accelerated 8.2 per cent average annual rate from mid-1965 to mid-1968, compared with a 6.4 per cent rate in the previous five years. However, consumer purchasing power (after-tax income adjusted for price increases) increased at a 4.8 per cent rate from mid-1965 to mid-1968, unchanged from a 4.9 per cent rate of increase in the earlier period.

Conclusion

The Federal budget prospects are not now so ominous as they were three years ago in terms of immediately contributing to excessive total demand. The most expansionary type of budget deficit, one accompanied by rapid monetary growth, would surely stimulate total spending in the coming year but would probably have less of an effect on prices than in the 1965-68 period. The acceleration of Government spending in 1965 and the rapid rate of monetary expansion from early 1967 to late in 1968 contributed to growth of total spending far in excess of productive capacity, and prices increased sharply. Currently, however, production in the economy is significantly below potential and could be expanded somewhat in response to an increase in total spending. With some idle capacity in the economy, an increase

²Several studies, in this *Review* and elsewhere, have concluded that Government expenditures not accompanied by money creation have only a temporary effect on total spending. Over a longer period of time such spending is believed simply to crowd out private spending.

Actual and Potential Real Product



Sources: U.S. Department of Commerce, Council of Economic Advisers, and Federal Reserve Bank of St. Louis

¹ Potential GNP in 1958 dollars, as originally formulated by the Council of Economic Advisers. Base period is mid-1955. Rate of growth from IV/1953 to IV/1962 is 3.5%, IV/1962 to IV/1965 is 3.75%, IV/1965 to IV/1969 is 4%, IV/1969 to IV/1970 is 4.3%, IV/1970 to IV/1971 is 4.4%.

² Actual GNP in 1958 dollars.

Latest data plotted: Potential GNP projected through 4th quarter 1971; Actual GNP, 2nd quarter 1970 preliminary

in total spending would tend to bolster production and employment in the coming year.

A resurgence of spending, however, could strongly affect the degree of downward adjustment in cost-push factors two and three years from now. For example, rapid increases in total spending would alleviate some of the pressure on corporate profits and remove some of the incentives for cost-cutting programs currently underway. Increased production might also decrease some of the employment uncertainty in the labor force and contribute to strengthening of wage and salary demands. Thus while a large budget deficit may appear to be an attractive means of alleviating some of the current employment and production pains, the relief could be very expensive if it caused rapid inflation to last longer than necessary, or to actually accelerate in later years.

The budget as proposed by the Administration would have little, if any, effect on total spending in the coming year. There is a possibility that the deficit would be somewhat larger than the Administration estimated in May, but the larger deficit would be due to a shortfall of tax revenue, reflecting a moderate pace of total spending through this winter. In contrast, the deficits of the 1965-68 period were due to rapid expansion of Government spending at a time when the economy was essentially at full employment. Also a \$4 or \$5 billion deficit would not contribute to a rapid expansion of the money stock. If adopted, it would be a budget consistent with easing inflationary pressures over the next few years.



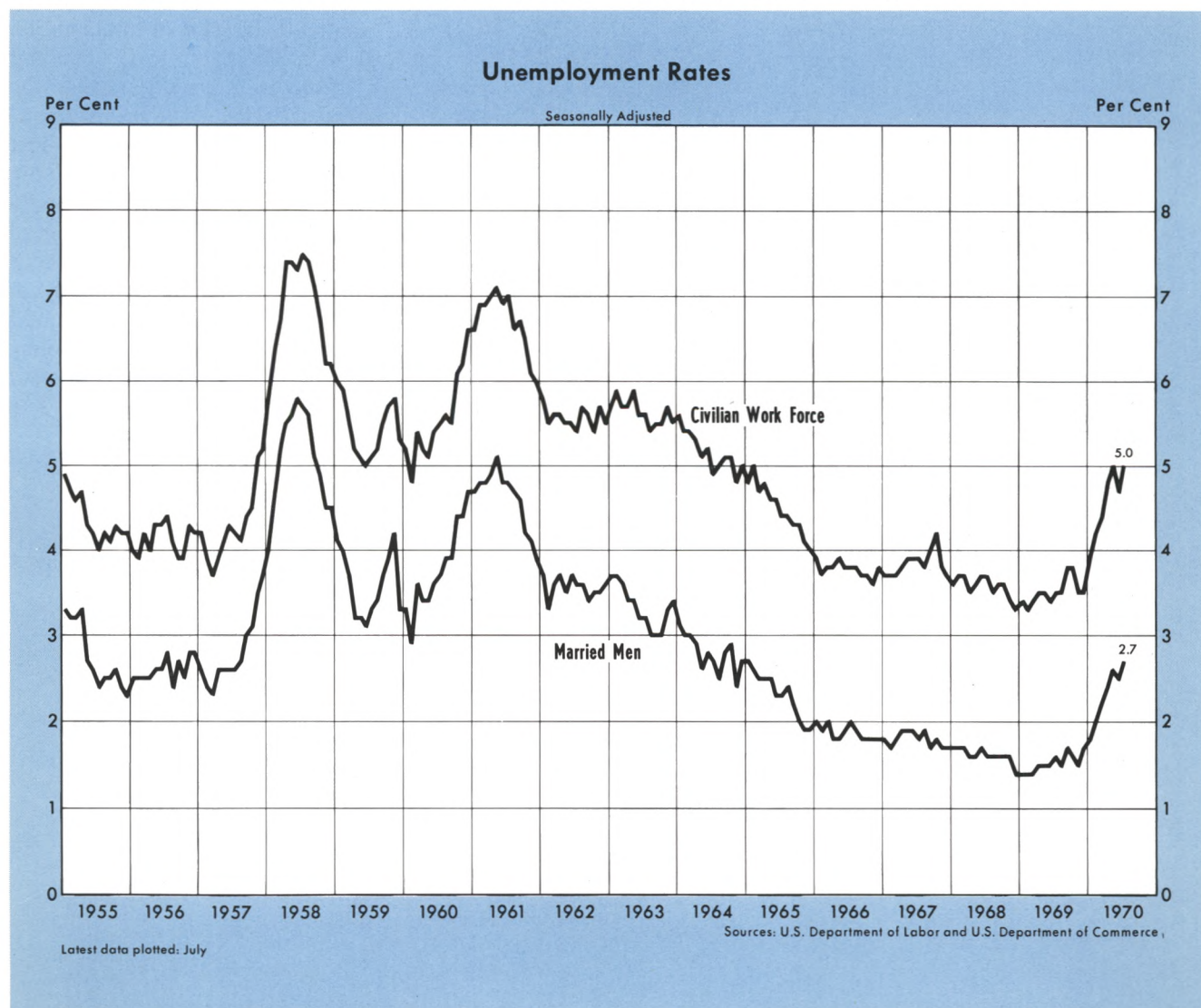
Current Utilization of Labor

Unemployment has averaged about 5 per cent of the civilian labor force since May. This rate is up from about 3.5 per cent in late 1968 and 1969, and has been given much attention as an indication of an underutilization of labor and accompanying hardship.

Some unemployment is unavoidable when workers are free to leave jobs in search of better opportunities, when some positions are seasonal, when some people are incapable of working, and when businesses are forced to cut back or close because they are no longer competitive. Estimates vary as to what level of unemployment would develop with total spending rising at the fastest rate consistent in the long run with price stability or a constant rate of inflation. Unemployment has on occasion fallen below such a minimum, but only

as a temporary effect of an excessive amount of spending which also has caused an acceleration of price increases.

In evaluating the unemployment situation, some comparisons with previous periods may be helpful. The average 5 per cent unemployment rate since May is slightly below the 5.2 per cent rate in 1964, generally considered a year of high economic activity and the last year with a relatively moderate price trend. In the 1962-63 period, the unemployment rate fluctuated between 5.5 and 6 per cent, and in the interval between the 1958 and 1960 business cycle troughs, the rate fell to about 5 per cent. During these two periods when downward pressure was applied to the rise in prices, unemployment rose to 7 per cent and above.



Total Civilian Employment Per Cent of Total Population of Working Force Age (16-64)



As a measure of hardship or of unemployment conditions among those most seriously seeking work, unemployment among married men may be better than the overall unemployment rate. As can be seen in the chart, the current level of about 2.7 per cent is even more favorable than the overall rate compared with other periods since early 1955.

Another measure of utilization of labor resources relates the total number of people actually working to the civilian population of working force age. The July level of 64.2 per cent on this measure is down from the peak but is still higher than at any time between 1952 and 1967.

Another indication of utilization of labor is the duration of unemployment. In July, the average length of unemployment was 9.3 weeks. This is up from about 8 weeks in 1969, but down substantially from the 12 week

or longer periods from 1958 to early 1965. Unemployment insurance and other benefits reduce the social costs of such temporary idleness, and may increase the average length of "hunting" time between jobs as people are better able to reject less desirable alternatives.

With present market restraints and inefficiencies, it is not a sustainable situation to hold the unemployment rate at 1969 levels by stimulating total spending, since price increases are thereby accelerated. A level of unemployment above 5 per cent may develop temporarily while spending is restrained to reduce inflation and inflationary expectations. A fundamental attack on the unemployment problem might focus on the inefficiencies and restrictions in this market, by providing better information on job opportunities, increasing mobility of labor, providing more education, training of skills, and removing restrictions on employment.

Average Duration of Unemployment *



* Duration of unemployment represents the average length of time (arithmetic mean) during which those classified as unemployed have been continuously looking for work.

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