SHADOW OPEN MARKET COMMITTEE

Policy Statement and Position Papers

September 19, 1977

1. Shadow Open Market Committee Policy Statement, September 19, 1977
2. SOMC Members – September 19, 1977
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    Projections for the Economy – Jerry L. Jordan, Pittsburgh National Bank

    Economic Prospects through 1978 – Robert J. Genetski, Harris Bank

    Weekly Federal Reserve Report – H. Erich Heinemann, Morgan Stanley & Company

    Memo from Homer Jones – Homer Jones, Federal Reserve Bank of St. Louis

    The Federal Budget – Rudolph G. Penner, American Enterprise Institute

    Financing the Government Deficit – Robert H. Rasche, Michigan State University

    Briefing for the Shadow Open market Committee – Wilson E. Schmidt, Virginia Polytechnic Institute and State University

    The Dilemma of Inflationary Policies – Karl Brunner, University of Rochester

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Policy Statement
Shadow Open Market Committee
September 19, 1977

The policies that produced sustained recovery, rising employment and lower inflation have ended. The growth rate of money – currency and demand deposits – has returned to the high levels of 1968, 1972 and early 1973. Government spending is growing again at a faster rate than the economy. The budget deficit is rising.

Prospects for the economy in 1978 and 1979 as a result appear less attractive than when this Committee met last March. Inflation is expected to increase next year and the growth of real output is expected to fall. The reasons for slower growth and higher inflation differ, however. Capacity utilization is high in many industries, and real growth must slow to the trend rate of capacity growth – three to four percent per year. Accelerating inflation and an enhanced risk of recession are mainly the result of the inappropriately expansionary monetary policy that the Federal Reserve pursued during the past two years, and particularly during the past six months.

Increased money growth in 1977 has restricted the choice of policies for 1978 to three principal alternatives. None of the three is attractive, but there are important differences. At its meeting today the Shadow Open Market Committee discussed these differences and recommended that the Federal Reserve return to a policy of eliminating inflation gradually, while minimizing the risk of a large recession.

Three Options

The Federal Reserve has three options. (1) It can continue on the path of rapid money growth that has prevailed in 1977. (2) It can accept the errors of the past year while immediately restoring the policy of slowing inflation. (3) Or in some measure it can correct for the excessive money growth of the past year, and once again restore a policy of ending inflation.

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The first option minimizes the risk of recession in 1978, but would result in increased inflation. By maintaining the recent high rate of money growth, real growth might temporarily be higher than otherwise, but at the cost of higher inflation later. As inflation increases, the demands to do something about inflation increase. Controls on wages and prices would become more likely. But controls, if adopted, would ultimately prove to be useless against inflation. Shortages of goods, services, and materials used in production would be the inevitable result. Sooner or later money growth would be reduced as part of a new, anti-inflation policy. This option adds to real growth in 1978 at the cost of higher inflation. This policy would squander the progress that has been made in restoring stability. The benefits of this option seem small when compared to the costs.

The second option would be to accept higher inflation as an unavoidable, but temporary, consequence of excessive money growth. Money growth would be reduced to an annual rate of 4% starting from present levels. This policy means that the Federal Reserve's summer errors would be translated into a recession. Output growth under this policy would probably be less than the trend rate.

The third option is to partially correct the summer bulge in the money stock. This bulge can be partly eliminated without severe consequences for real growth because the economy has not yet adjusted to the higher level.

At the previous meeting of this Committee, in March 1977, we recommended that the growth rate of money be held between 4% and 4-1/2% during the year ending in the first quarter 1978. The growth rate of money for the second and third quarter has been over twice the rate we recommended. The annual rate of money growth is far above the 5-1/4% midpoint of the target chosen by the Federal Open Market Committee, November 1976, and reaffirmed at subsequent meetings. By their standards, as well as ours, the growth rate of money has been excessive.

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This Committee has affirmed repeatedly that stable growth, lower inflation, and recovery from recession can be achieved together if proper policies are chosen. The Federal Reserve's 1977 excesses may mean that a recession will once again follow when it attempts to reduce inflation.

Recommendations

The inordinate growth of money in the last six months stemmed from two episodes. In March and April, Federal Reserve credit was increased rapidly to keep interest rates from rising; consequently the money stock jumped. But this only postponed the rise in interest rates to the end of April.

Again in June and July, Federal Reserve credit growth was accelerated to keep short-term interest rates from rising and the stock of money rose rapidly. But the rise of interest rates was only postponed one month.

The Federal Reserve has not been able to prevent a rise of short-term interest rates this year. It has only been able to obtain slight delays of rate rises. And it has done this only at the expense of losing control of the amount of Federal Reserve Credit and the money stock.

The failure of the Federal Reserve to reach its targets is not an accident. Excessive money growth has been the result of inappropriate procedures for controlling the stock of money. The Federal Reserve has continued to concentrate on short-term changes in interest rates and has ignored the movements of the monetary base and other determinants of the stock of money. The result has been excessive money growth in periods of expansion, and insufficient money growth in recession.

This Committee has warned repeatedly that current procedures for controlling money are inadequate. The result of those procedures is that stable high output has not been achieved; inflation has increased; price and wage controls have become more likely; and the risk of returning to a stop and go economy is greater.

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In addition to the change in procedures, the Shadow Open Market Committee recommends that the summer bulge in money be removed by reducing the current level of the money stock by $4-billion, the reduction to be accompanied by an announcement that the step has been undertaken to return the money stock to the level it would have reached if the most recent error in monetary policy had not occurred. Subsequent to the correction, money growth should resume at a constant annual rate of 4-1/2%.

A stop-go monetary policy is not inevitable. We urge, again, that the Federal Reserve refrain from trying to control short-term interest rates. It should not take the Federal Funds rate as its operating target. Instead, it should adopt procedures to directly control money. If it does so, the Federal Reserve is fully capable of achieving its announced targets for money growth.

The return to stability with rising real income cannot be achieved by monetary policy alone. The growth rate of government spending is high and rising. A rising share of resources absorbed by government means fewer resources for private investment, slower growth of private output and fewer jobs in the private sector.

We project that the budget deficit for fiscal 1978 and the borrowing by off budget agencies will require the private sector to absorb about $60-billion in new government securities. This amount is much larger than appropriate under current conditions. We recommend that nothing further be done to increase the budget deficit and government borrowing in 1978 and that the budget deficit be reduced in 1979. The Congress and Administration should adopt a program to limit the growth of government spending, so as to achieve and maintain the balanced budget promised by the Administration for fiscal 1981.

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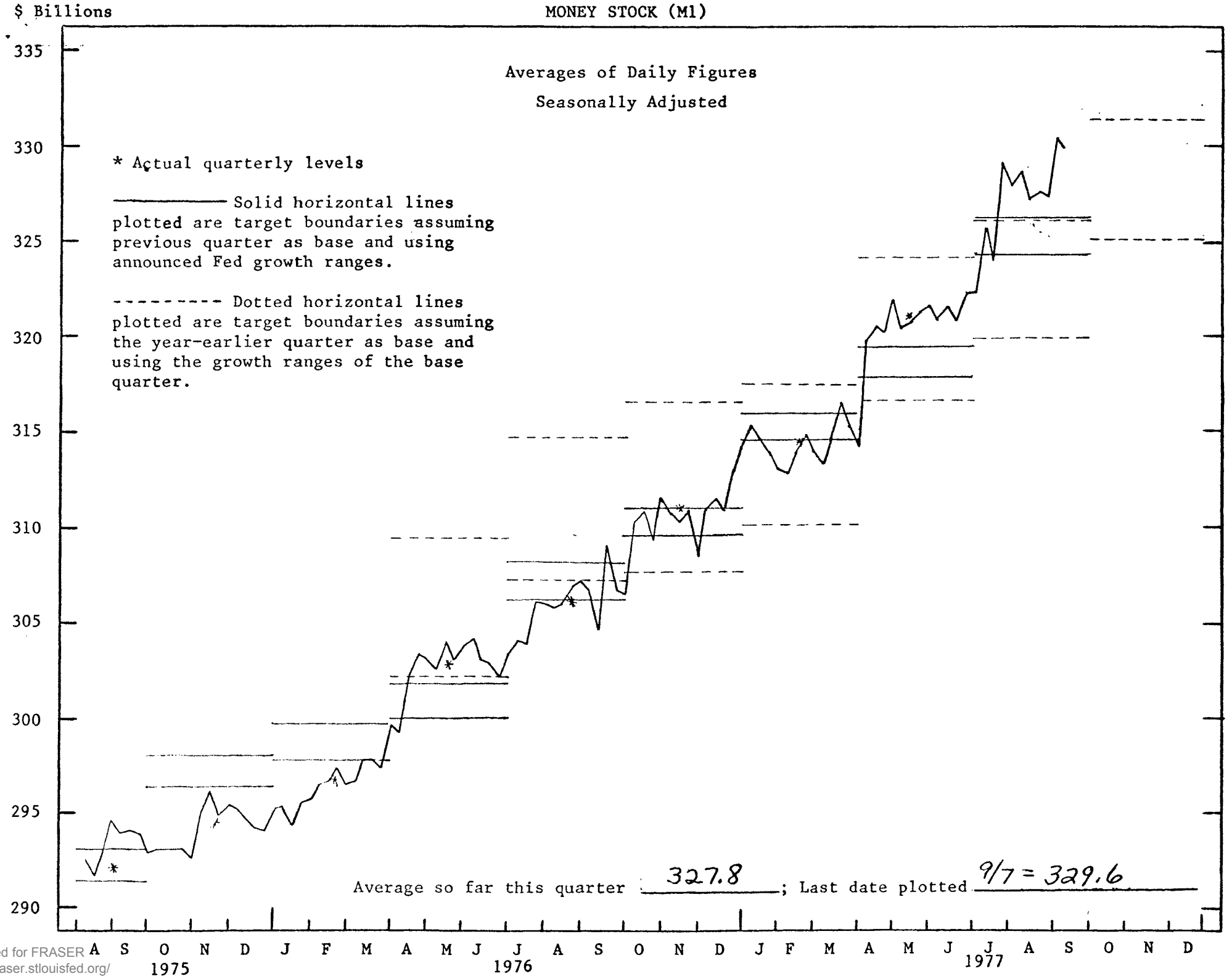

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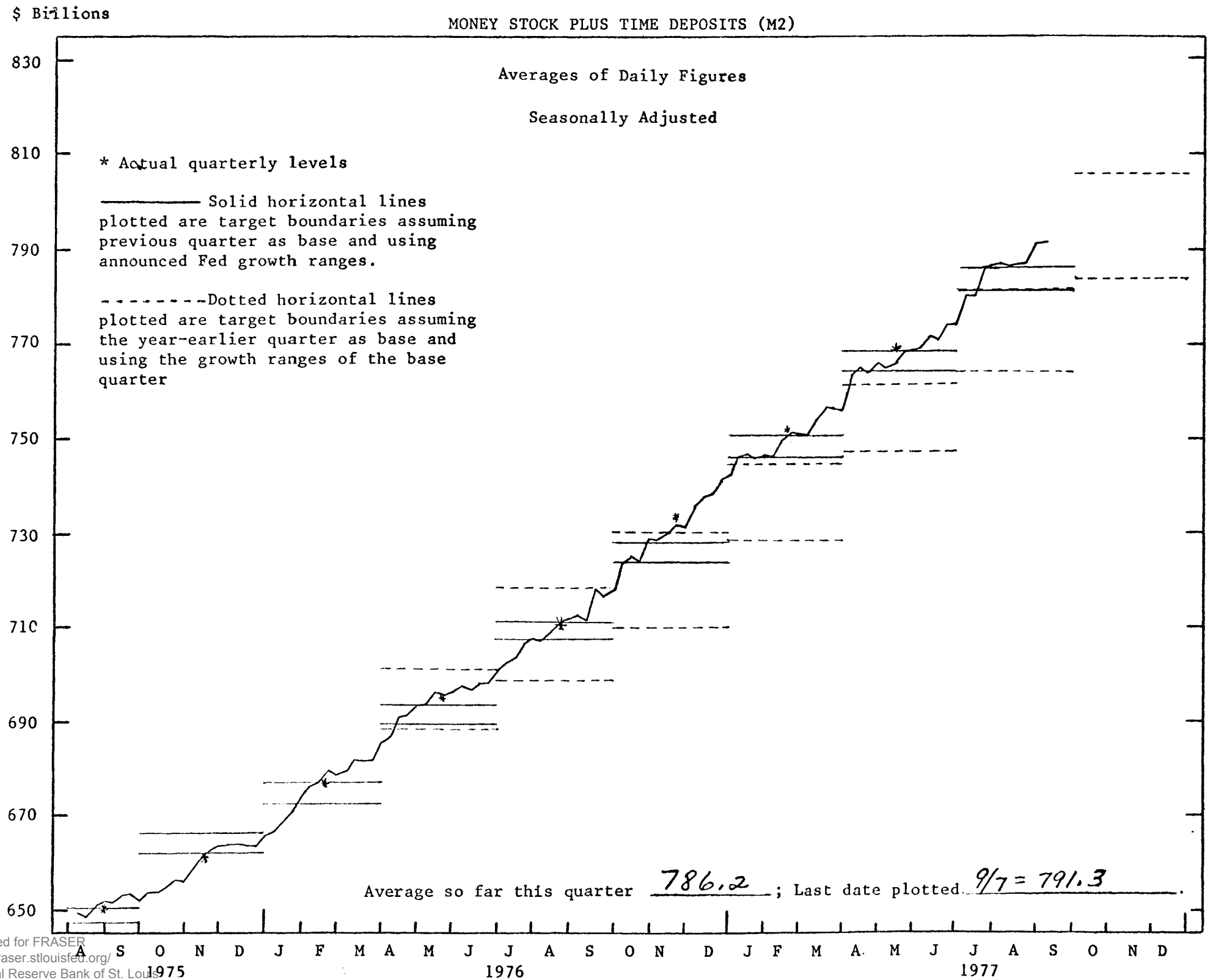

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abrupt move to "desired" monetary growth path would bring about recession or "mini recession".

Prospects for 77IV: (for Fed hitting M. growth targets)
(Treas borrowing $ 19-20 billion in 77IV) ⇒
(strong private credit demands)
slowing only to upper end of target ranges.

PROJECTIONS FOR THE ECONOMY

PREPARED FOR THE

SHADOW OPEN MARKET COMMITTEE MEETING

September 8, 1977

By
JERRY L. JORDAN
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PITTSBURGH NATIONAL BANK

SHADOW OPEN MARKET COMMITTEE

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

BJECT ECONOMIC PROJECTIONS DATE September 8, 1977

1) At the March 7, 1977 S.O.M.C. meeting the following assumptions for money growth and velocity were presented:

	M^1	M^2	V^1	V^2
Q4/76-Q4/77	6.0%	9.0%	4.0%	1.2%
1976 - 1977	6.0%	9.9%	3.6%	-0.02%

Based on actual results for the first 8 months, money growth is expected to be one percentage point greater by year-end, and also velocity growth is likely to be somewhat greater, as follows:

	M^1	M^2	V^1	V^2
Q4/76-Q4/77	6.9%	10.0%	5.1%	2.1%
1976 - 1977	6.5%	10.6%	4.2%	0.3%

The above figures assume that growth of M^1 and M^2 slow to 6% and 9% respectively in Q4/77.

2) At the March 1977 meeting real output growth was projected to be 5.9% by year-end, and that projection is maintained. Prices were projected to rise only 4.2% by year-end, and that is now revised to 5.9%. Corresponding to the more rapid monetary growth and inflation than earlier projected, nominal income

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growth is expected to be somewhat over 12%, compared with the March projection of 10.3%.

3) For 1978 M^1 and M^2 growth are <u>assumed</u> to be 6% and 9%, respectively from Q4/77 to Q4/78.

Projections for the economy are:

	GNP	REAL OUTPUT	PRICE DEFLATOR
Q4/77-Q4/78	9.7%	3.5%	6.0%
1977 - 1978	10.5%	4.3%	6.0%

Implied velocity growth is:

	V^1	V^2
Q4/77-Q4/78	3.5%	0.6%
1977 - 1978	3.7%	1.0%

4) (a) Monetary growth in 1977 has been excessive by almost any standard, and the slowing assumed above for 1978 is only that necessary to get back down to the upper limits of the Fed's announced target ranges.

(b) At the March 1977 meeting, the S.O.M.C. recommended money growth of 4 to 4.5%, or a level of M^1 of $326 billion for Q1/1978. Since the level of M^1 for Q3/1977 is expected to be about $328 billion, a decline in the money stock of $2 billion would be necessary to hit the S.O.M.C. target. A decline in the money stock during Q4/77 and Q1/78, following an average growth of 8.7% in Q2 and Q3/77 would

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produce at least a mini-recession in 1978.

(c) If the S.O.M.C. were to accept the Fed approach of "bygones are bygones" and recommend a 4 to 4.5% growth of M^1 from Q3/77 foreward, a significant slowing in nominal income growth and real output could be expected.

(d) If monetary growth continues into 1978 at rates similar to the past two quarters, inflation in 1978 could be expected to be in the range of 7 - 8%.

(e) Since monetary growth over the past two-and four-quarter periods (ending Q3/1977) is the most rapid since 1972 there are no good alternatives available for monetary policy. The appearance of a trade-off between inflation and real output growth next year should be put into the context of a level of prices and real output three to four years from now. Policies to maintain output growth in 1978 at the expense of continuing high inflation would imply eventual adoption of more restrictive policies and most likely a recession in 1979 or 1980. A curtailment of M^1 growth in Q4/77 and 1978 to the 4 to 4.5% range would imply a few quarters of real output growth below the long-run potential, but would halt the acceleration of inflation and provide an environment for greater real growth with less inflation in 1978 and 1980. On balance, output and employment would be greater, and price levels lower, in 1980 if the recent acceleration in mone-

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tary growth is halted before the "whites-of-the-eyes" of re-accelerating inflation are in sight.

JLJ

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Enclosures

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MONEY GROWTH RATES
(% Change from Previous Year)

FROM:	TO:	M_1	M_2	MONETARY BASE
1971/Q1	1972/Q1	6.8	10.9	7.1
Q2	Q2	6.3	9.7	7.1
Q3	Q3	6.7	10.4	7.0
Q4	Q4	8.4	11.2	8.3
1972/Q1	1973/Q1	8.5	10.5	9.0
Q2	Q2	8.0	10.0	8.8
Q3	Q3	7.2	9.2	9.0
Q4	Q4	6.2	8.8	8.1
1973/Q1	1974/Q1	5.9	8.9	8.0
Q2	Q2	5.6	8.7	8.6
Q3	Q3	5.3	8.3	8.4
Q4	Q4	5.1	7.7	9.0
1974/Q1	1975/Q1	3.6	6.6	8.3
Q2	Q2	4.1	7.3	7.7
Q3	Q3	4.8	8.3	8.0
Q4	Q4	4.4	8.3	7.6
1975/Q1	1976/Q1	4.9	9.4	8.1
Q2	Q2	5.2	9.6	8.8
Q3	Q3	4.5	9.3	8.4
Q4	Q4	5.6	10.9	8.6
1976/Q1	1977/Q1	6.0	10.9	8.2
Q2	Q2	6.0	10.6	7.8
* Q3	Q3	7.1	11.0	8.9

* Projected by Pittsburgh National Bank

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TWO-QUARTER COMPOUNDED ANNUAL RATES OF CHANGE

	Monetary Base	M_1	M_2
Q1/71 - Q3/71	8.1	8.6	11.7
Q2/71 - Q4/71	6.6	9.6	8.0
Q3/71 - Q1/72	6.2	5.1	10.0
Q4/71 - Q2/72	7.7	7.9	11.4
Q1/72 - Q3/72	7.8	8.3	10.8
Q2/72 - Q4/72	8.9	8.9	11.0
Q3/72 - Q1/73	10.2	8.6	10.2
Q4/72 - Q2/73	8.8	7.0	9.0
Q1/73 - Q3/73	7.8	5.9	8.2
Q2/73 - Q4/73	7.5	5.5	8.7
Q3/73 - Q1/74	8.2	5.8	9.7
Q4/73 - Q2/74	9.7	5.8	8.8
Q1/74 - Q3/74	8.6	4.8	7.0
Q2/74 - Q4/74	8.4	4.3	6.6
Q3/74 - Q1/75	8.0	2.5	6.2
Q4/74 - Q2/75	7.0	3.9	8.1
Q1/75 - Q3/75	8.1	7.2	10.4
Q2/75 - Q4/75	8.2	4.9	8.5
Q3/75 - Q1/76	8.2	2.7	8.4
Q4/75 - Q2/76	9.4	5.6	10.6
Q1/76 - Q3/76	8.6	6.4	10.2
Q2/76 - Q4/76	7.8	5.6	11.2
Q3/76 - Q1/77	7.9	5.5	11.7
Q4/76 - Q2/77	7.7	6.5	10.0
* Q1/77 - Q3/77	10.0	8.7	10.3

* Projected by Pittsburgh National Bank

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HARRIS BANK

HEROS
Harris Economic Research Office Service

6-7%

August 3, 1977

ECONOMIC PROSPECTS THROUGH 1978

Slower economic growth and some moderation in inflation are forecast for the balance of the year. For 1978, real growth is expected to rise moderately while the inflation rate renews its upward march.

Monetary Growth and the Outlook

The significance of monetary growth was once again apparent in economic developments during the first half of the year. Total spending rose at a rapid 13% annual rate following a strong increase in the money supply in the last half of 1976. M_2 (currency plus most bank deposits) increased at a 12½% annual rate from June to December of 1976. For the first half of 1977, M_2 growth slowed to a 9% annual rate. This development is a major factor underlying the forecast of a 9% - 9½% annual rate rise in total spending or GNP for the balance of the year. Inflation as measured by the GNP price deflator is expected to moderate to the 5% - 6% range during the next six months, following the 6% pace in the first half of the year.

For 1978, the speed of the economic advance will depend critically on monetary growth rates for the balance of this year--and here lies the dilemma. Monetary growth at the top end of the Federal Reserve Board's targets would allow for only a 3% increase in real growth in 1978. Examined from a different perspective, if the Administration wants to realize its own forecast for a 5% real growth rate in 1978, then M_2 would have to increase by about 12%. If continued, such an increase would send inflation into the double digit range by 1979. Given these choices, the forecast assumes M_2 will grow at a 10% rate through the remainder of this year and into 1978. This would be one-half percentage point above the upper end of the Federal Reserve's targeted range and would lead to real growth in the 3½% - 4% range during 1978.

Inflation

Although some moderation in inflation is anticipated during the balance of the year, it merely offsets the effect of the sharp price increases earlier in the year. The key determinant of inflation is past monetary growth. For the past two years money supply growth has been fairly high. M_2 growth has averaged 9.7% at an annual rate over the past two years, and this implies an inflation rate of 6% - 7% for 1978.

Consumer Expenditures

Consumer spending is expected to be fairly weak in the latter half of 1977 and to provide only a moderate boost to the economy through 1978. The strong pace of auto sales in the second quarter is not likely to be sustained in the months ahead. Also, the saving rate, which reached 5½% of disposable income in the second quarter, is expected to rise as the year progresses. This will be reflected in the generally moderate advance in consumer spending.

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Investment Expenditures

Plant and equipment expenditures are forecast to increase in the 13% - 15% range for both the balance of this year and for 1978. Strong profit gains in 1975 and 1976 combined with approaching capacity limitations in certain industries should provide the main ingredients for sharp gains in business fixed investment.

Financial Markets

The federal deficit for fiscal 1978 is estimated by the Administration at close to $60 billion compared to approximately $50 billion in the current fiscal year. Increased federal borrowing combined with greater economic activity in the private sector and an underlying inflation rate of 6% will serve to boost short-term interest rates. The 4 to 6 month commercial paper rate (currently 5½%) is forecast to average 7% in 1978. The general direction of long-term rates is also likely to be up, but the slower pace of business activity anticipated in the fall could delay the increase. As a result, new issue rates on AA industrial bonds are expected to average 8% in the current quarter before climbing to the 9% area by the end of next year.

Corporate Profits Revised Upward

A major revision in the GNP numbers going back to 1974 now indicates that after-tax profits were much stronger than previously reported. The revisions which are based on more complete corporate income tax report indicate that after-tax profits adjusted to exclude inventory profits and allow for depreciation at replacement cost were up 25% in 1976 from the previous high in 1972. Moreover, preliminary estimates of second quarter profits show an additional 7% gain over the average for 1976. Although the slower economic growth expected in the third quarter will adversely affect reported profits, the moderation in inflation will increase the quality of those profits. For 1978, continued moderate rates of expansion in the economy should lead to gains in after-tax profits of approximately 10%.

Summary

A slower expansion is anticipated for the last half of 1977, leading to growing political pressures for faster monetary growth. The forecast assumes that to some extent these pressures are held in check and that monetary growth comes in slightly above the upper end of the Federal Reserve's targeted range while interest rates continue to rise. This result leads to an uneasy compromise of moderate real growth along with 6% - 7% inflation for 1978.

Robert J. Genetski
Economist

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

1403.9
1355.
48.8

	ACTUAL			FORECAST						YEARS			
	1976:4	1977:1	1977:2	1977:3	1977:4	1978:1	1978:2	1978:3	1978:4	1975	1976	1977	1978
GROSS NATL PRODUCT	1755.4	1810.8	1869.0	1910.0	1954.0	2003.0	2052.0	2100.0	2152.0	1528.8	1706.4	1886.0	2076.8
%CH	6.7	13.2	13.5	9.1	9.5	10.4	10.2	9.7	10.3	8.2	11.6	10.5	10.1
CONSTANT DOLLAR GNP	1287.4	1311.0	1331.6	1342.7	1355.1	1368.4	1380.7	1391.3	1403.9	1202.1	1274.7	1335.1	1386.1
%CH	1.2	7.5	6.4	3.4	3.7	4.0	3.6	3.1	3.7	-1.3	6.0	4.7	3.8
PRICE DEFLATOR	1.3635	1.3813	1.4036	1.4225	1.4420	1.4637	1.4862	1.5094	1.5329	1.2714	1.3386	1.4124	1.4981
%CH	5.4	5.3	6.6	5.5	5.6	6.2	6.3	6.4	6.4	9.6	5.3	5.5	6.1
CONSUMPTION EXPENDITURES	1139.0	1172.4	1194.0	1217.0	1242.7	1271.7	1301.0	1330.6	1361.6	980.4	1093.9	1206.5	1316.2
%CH	14.0	12.3	7.6	7.9	8.7	9.7	9.5	9.4	9.6	10.2	11.6	10.3	9.1
DURABLES	166.3	177.0	179.1	181.4	185.5	190.8	195.5	200.0	205.0	132.9	158.9	180.8	197.8
%CH	18.8	28.3	4.8	5.2	9.4	11.9	10.2	9.5	10.4	8.9	19.6	13.8	9.4
NONDURABLES	458.8	466.6	475.3	483.6	492.3	501.9	511.9	522.1	532.7	409.3	442.8	479.4	517.2
%CH	13.3	7.0	7.7	7.2	7.4	8.0	8.2	8.2	8.4	8.8	8.2	8.3	7.9
SERVICES	513.9	528.8	539.6	552.0	564.9	579.0	593.6	608.5	623.9	438.2	492.3	546.3	601.3
%CH	13.2	12.1	8.4	9.5	9.7	10.4	10.5	10.4	10.5	12.0	12.3	11.0	10.1
INVESTMENT EXPENDITURES	243.4	271.8	293.0	300.9	307.0	315.9	324.1	330.3	338.9	189.1	243.3	293.2	327.3
%CH	-16.1	55.5	35.0	11.2	8.4	12.1	10.8	7.9	10.8	-11.9	28.7	20.5	11.6
NONRES FIXED EXPEND	167.6	177.0	183.3	190.3	196.7	203.7	210.9	217.9	225.1	149.1	161.9	186.8	214.4
%CH	6.7	24.4	15.0	16.2	14.1	15.0	14.9	14.0	13.9	-1.0	8.6	15.4	14.8
PRODUCERS DUR EQUIP	110.6	119.2	123.1	127.5	131.7	136.0	140.5	145.0	149.5	96.3	106.1	125.4	142.8
%CH	6.0	34.9	13.7	15.1	13.8	13.7	13.9	13.4	13.0	0.1	10.2	18.2	13.9
BUSINESS STRUCTURES	57.0	57.9	60.2	62.8	65.0	67.7	70.4	72.9	75.6	52.9	55.9	61.5	71.7
%CH	7.3	6.5	16.9	18.4	14.8	17.7	16.9	15.0	15.7	-2.9	5.7	10.0	16.6
RES FIXED EXPEND	76.7	81.0	90.0	93.5	95.7	97.5	98.0	97.0	95.0	51.4	68.0	90.0	96.9
%CH	63.8	24.4	52.4	16.5	9.7	7.7	2.1	-4.0	-8.0	-6.6	32.3	32.3	7.6
INVENTORY CHANGE	-0.9	13.8	19.7	17.1	14.6	14.7	15.2	15.4	18.8	-11.4	13.3	16.3	16.0
NET EXPORTS	3.0	-8.2	-8.1	-6.1	-6.2	-5.6	-2.6	1.8	2.5	20.3	7.8	-7.1	-1.0
GOVT PURCHASES	370.0	374.9	390.1	398.2	410.5	421.0	429.5	437.3	449.0	338.9	361.4	393.4	434.2
%CH	7.9	5.4	17.2	8.6	12.9	10.6	8.3	7.5	11.1	12.0	6.6	8.9	10.4
FEDERAL	134.2	136.3	143.3	146.7	154.0	159.0	162.0	164.3	170.5	123.3	130.1	145.1	163.9
%CH	12.9	6.4	22.2	9.8	21.4	13.6	7.8	5.8	16.0	11.0	5.5	11.5	13.0
MILITARY	88.4	89.7	94.2	96.0	100.5	104.5	106.5	108.0	112.0	83.9	86.8	95.1	107.8
%CH	9.6	6.0	21.6	7.9	20.1	16.9	7.9	5.8	15.7	9.0	3.4	9.6	13.3
OTHER	45.8	46.7	49.1	50.7	53.5	54.5	55.5	56.3	58.5	39.4	43.3	50.0	56.2
%CH	19.6	8.1	22.2	13.7	24.0	7.7	7.5	5.9	16.6	15.5	10.0	15.3	12.4
STATE & LOCAL	235.8	238.5	246.7	251.5	256.5	262.0	267.5	273.0	278.5	215.6	231.2	248.3	270.3
%CH	5.4	4.7	14.5	8.0	8.2	8.9	8.7	8.5	8.3	12.5	7.2	7.4	8.8

NOTE: PERCENTAGE CHANGES AT ANNUAL RATES; PRELIMINARY DATA FOR 77:2

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

	ACTUAL			FORECAST						YEARS			
	1976:4	1977:1	1977:2	1977:3	1977:4	1978:1	1978:2	1978:3	1978:4	1975	1976	1977	1978
PRETAX PROFITS*	154.8	161.7	168.6	179.9	174.1	189.3	186.2	192.9	198.5	123.5	156.8	168.8	189.3
%CH	-12.2	19.1	18.2	5.6	7.7	15.9	13.7	13.1	14.2	-2.7	27.9	7.6	12.1
TAX LIABILITY	63.9	64.4	67.3	68.2	69.1	71.6	73.9	76.2	79.2	59.2	64.8	67.2	75.2
%CH	-11.6	3.2	19.1	5.6	5.6	15.9	13.7	13.1	16.6	-4.2	29.9	3.9	11.9
AFTER TAX PROFITS	90.9	97.2	101.3	102.7	105.0	108.7	112.3	115.8	119.3	73.4	92.1	101.6	114.0
%CH	-12.6	30.7	18.1	5.6	9.1	15.9	13.7	13.1	12.7	-1.6	25.5	10.3	12.3
AFT TAX PROF ADJ[1]	59.2	61.0	67.6	72.8	69.8	72.1	74.0	75.9	77.4	49.1	63.3	67.8	74.8
%CH	-41.2	12.7	51.1	34.4	-15.6	14.1	10.7	10.7	8.3	57.5	29.0	7.1	10.4
PERSONAL INCOME	1432.2	1476.8	1520.1	1553.5	1590.0	1630.0	1669.0	1710.0	1751.0	1253.4	1382.7	1535.1	1690.0
%CH	11.5	13.1	12.3	9.1	9.7	10.4	9.9	10.2	9.9	8.5	10.3	11.0	10.1
TAX & NONTAX PAYMENT	209.5	224.4	224.9	225.4	232.5	234.6	242.4	254.1	262.4	169.0	196.9	226.8	248.4
%CH	19.0	31.6	0.9	0.9	13.2	3.7	14.0	20.7	13.7	-0.8	16.5	15.2	9.5
DISPOSABLE INCOME	1222.6	1252.4	1295.2	1328.1	1357.5	1395.4	1426.6	1455.9	1488.6	1084.4	1185.8	1308.3	1441.6
%CH	10.2	10.1	14.4	10.6	9.1	11.6	9.2	8.5	9.3	10.1	9.4	10.3	10.2
PERSONAL OUTLAYS	1166.3	1201.0	1223.6	1247.1	1275.8	1306.1	1336.7	1367.3	1398.7	1004.2	1119.9	1236.9	1352.2
%CH	14.1	12.4	7.7	7.9	9.5	9.8	9.7	9.5	9.5	10.0	11.5	10.4	9.3
PERSONAL SAVINGS	56.3	51.4	71.6	81.0	81.7	89.3	89.9	88.6	89.9	80.2	66.0	71.4	89.4
%CH	-43.0	-30.5	276.5	63.8	3.4	42.6	2.7	-5.6	6.1	11.9	-17.7	8.3	25.2
SAVING RATE(%)	4.6	4.1	5.5	6.1	6.0	6.4	6.3	6.1	6.0	7.4	5.6	5.4	6.2
EMPLOYMENT	88.133	88.998	90.370	90.800	91.200	91.700	92.300	92.800	93.400	84.768	87.488	90.342	92.550
%CH	1.5	4.0	6.3	1.9	1.8	2.2	2.6	2.2	2.6	-1.3	3.2	3.3	2.4
LABOR FORCE	95.711	96.067	97.186	97.600	98.100	98.500	99.000	99.400	99.900	92.631	94.790	97.238	99.200
%CH	1.9	1.5	4.7	1.7	2.1	1.6	2.0	1.6	2.0	1.8	2.3	2.6	2.0
UNEMPLOYMENT RATE(%)	7.900	7.367	7.000	6.967	7.034	6.904	6.768	6.640	6.507	8.483	7.708	7.092	6.704
PRODUCTIVITY*	14.607	14.731	14.735	14.788	14.858	14.923	14.959	14.992	15.031	14.180	14.569	14.778	14.976
%CH	-0.3	3.4	0.1	1.4	1.9	1.8	1.0	0.9	1.0	0.1	2.7	1.4	1.3
INDUSTRIAL PRODUCTION	1.318	1.335	1.375	1.395	1.410	1.428	1.444	1.459	1.475	1.178	1.298	1.379	1.452
%CH	2.6	5.4	12.4	6.0	4.4	5.2	4.6	4.2	4.5	-8.9	10.1	6.2	5.3
MONEY SUPPLY-(M1)	311.067	314.400	321.067	327.000	332.500	338.000	343.500	349.000	355.000	289.475	304.192	323.742	346.375
%CH	6.6	4.4	8.8	7.6	6.9	6.8	6.7	6.6	7.1	4.2	5.1	6.4	7.0
VELOCITY OF M1	5.643	5.760	5.821	5.841	5.877	5.926	5.974	6.017	6.062	5.279	5.609	5.825	5.995
%CH	0.1	8.5	4.4	1.4	2.5	3.4	3.3	2.9	3.0	3.8	6.2	3.8	2.9
MONEY SUPPLY-(M2)	732.833	751.033	768.367	787.000	806.000	825.000	844.000	863.500	884.500	640.958	703.833	778.100	854.250
%CH	13.1	10.3	9.6	10.1	10.0	9.8	9.5	9.6	10.1	7.7	9.8	10.6	9.8
VELOCITY OF M2	2.395	2.411	2.432	2.427	2.424	2.428	2.431	2.432	2.433	2.384	2.425	2.424	2.431
%CH	-5.7	2.7	3.6	-0.9	-0.4	0.6	0.6	0.1	0.2	0.5	1.7	-0.1	0.3

NOTE: PROFITS FOR 77:2 ARE ESTIMATES; PRODUCTIVITY IS CALCULATED AS CONSTANT DOLLAR GNP PER WORKER
1) AFTER TAX PROFITS ADJUSTED TO EXCLUDE INVENTORY PROFITS AND ALLOW FOR DEPRECIATION AT REPLACEMENT COST

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	ACTUAL			FORECAST						YEARS			
	1976:4	1977:1	1977:2	1977:3	1977:4	1978:1	1978:2	1978:3	1978:4	1975	1976	1977	1978
INTEREST RATES													
NEW ISSUE AA INDUS BONDS	7.85	7.88	7.92	8.00	8.25	8.50	8.70	8.75	9.00	8.91	8.25	8.01	8.74
PRIME RATE	6.543	6.250	6.470	6.750	7.000	7.500	7.750	8.000	8.000	7.863	6.841	6.617	7.813
COMMERCIAL PAPER 4-6 MOS.	4.990	4.810	5.237	5.750	6.000	6.500	7.000	7.250	7.500	6.318	5.345	5.449	7.063
AUTO SALES 1)	10.167	11.233	11.667	11.113	11.232	11.432	11.500	11.444	11.510	8.675	10.125	11.311	11.471
DOMESTIC	8.467	9.400	9.300	9.300	9.400	9.603	9.660	9.613	9.668	7.100	8.633	9.350	9.636
IMPORTS	1.700	1.833	2.367	1.813	1.832	1.829	1.840	1.831	1.842	1.575	1.492	1.961	1.836
HOUSING STARTS 1)	1.770	1.758	1.889	1.857	1.831	1.835	1.766	1.669	1.650	1.162	1.541	1.834	1.730

1) IN MILLIONS OF UNITS--SEASONALLY ADJUSTED ANNUAL RATES

6.76
3325 | 22500
19950
25500
23275
22250

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MORGAN STANLEY & CO.
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Weekly Federal Reserve Report

September 9, 1977

The chickens of August may be coming home to roost. Following two months during which the Federal Reserve has been pumping up the total of high-powered money in the economy at an excessive rate, participants in the financial markets should not be surprised to see outsized increases in the money supply. We will admit to having been taken aback a bit by the timing of the $3-billion jump in M-1 that was announced late yesterday afternoon. Our estimates had suggested demand deposits in the banking system (which account for almost all of the volatility in the money supply) would rise about $1-billion before seasonal adjustment in the week of August 31, in contrast to the central bank's initial estimate of a $3.1-billion increase. But the fact that growth in the money supply has once again spurted ahead is a natural consequence of the monetary policy that the Federal Reserve has actually implemented since late June. For the past 10 weeks, the four-week to four-week annual rate of increase in the monetary base has averaged 11.6%. This is not only far above a level that would be consistent with the money managers' announced objective of gradually restoring general price stability, but also has had the effect of actually injecting reserves into the banking system faster than banks have been able to make efficient use of them.

As we commented in our Weekly Federal Reserve Report dated August 19, "the Federal Reserve System has not yet succeeded in bringing monetary expansion under control." The fact is, time is growing short for the central bank to take effective action to restore monetary stability. If the rate of growth in the money supply is not reduced quickly, the fabric of improved inflationary expectations -- so painfully woven over the past four years -- will begin to disintegrate. Such a development would of course pose a serious threat to financial markets, but, in addition, it would also foreshadow new and dangerous instabilities in the real economy as well.

Speaking to the graduating class at Jacksonville University last month, Arthur F. Burns, chairman of the Federal Reserve Board, rightly observed that "in a period of rising demands for funds, a determined effort by the System to keep interest rates down could quickly turn the Federal Reserve into something akin to the engine of inflation that it was during the early Korean War

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period...Actually, the consequences now would almost certainly be far worse than they were a quarter-century ago because the public has become far more sensitive to inflation. Long-term interest rates, in particular, tend to respond quickly nowadays to changing inflationary expectations. Once the financial community perceived that the Federal Reserve was pumping massive reserves into commercial banks with a view to creating monetary ease, fears of a new wave of inflation would

Federal Reserve Data

(Weekly Averages of Daily Figures; in Millions of Dollars)

	Latest Week	Change From Prev. Week	Rates of Change Over 3 Months	6 Months	1 Year
Money Supply (M-1)* (1)	$330,400	$+3,000	+ 9.3%	+ 9.2%	+ 7.0%
Money Supply Plus Comm'l Bank Time Deposits Other Than Large CDs (M-2)* (1)	791,200	+4,000	+10.5	+10.0	+10.8
Monetary Base* (2)	126,500	- 300	+10.4	+ 9.5	+ 8.4
Adjusted Federal Reserve Credit* (2)	106,900	- 600	+12.0	+10.9	+ 8.7
Total Member Bank Reserves* (2)	35,500	- 260	+11.2	+ 7.6	+ 4.7
Member Bank Borrowing (2)	637	- 755	NA	NA	NA
Wednesday Figures					
Short-Term Business Credit* (1)	192,720	- 114	+ 7.6	+ 8.9	+ 7.9
Total Commercial Paper Outstanding* (1)	60,843	- 20	+30.8	+31.2	+17.5
Business Loans:					
All Large Banks* (1)	119,795	+ 281	+ 6.1	+ 4.6	+ 6.5
New York City Banks* (2)	34,063	--	+ 4.0	+ 1.3	+ 4.2
Chicago Banks* (2)	11,117	+ 23	- 4.8	- 5.3	+ 2.4

*Seasonally Adjusted NA = Not Applicable

Rates of change are compound annual rates except for total reserves. Short-term business credit includes commercial and industrial loans at large banks plus loans sold to affiliates less bankers' acceptances plus loans at large banks to finance companies and nonbank financial institutions plus nonbank commercial paper. Loan reclassifications and mergers at New York City banks increased the reported total of commercial and industrial loans at these banks by $684-million at year-end 1976.

(1) August 31 (2) September 7

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quickly spread...Heightened inflationary expectations would soon overwhelm markets in today's inflation-conscious environment by actually causing long-term interest rates...to rise. The policy of seeking lower interest rates by flooding banks with reserves would thus be frustrated. And I need hardly add that adverse effects on production, employment, and the dollar's purchasing power would follow."

Dr. Burns averred that "the Federal Reserve System, I assure you, will not be deterred by the drumbeat of dubious propositions concerning money and interest rates. We are determined to continue on a path of further gradual unwinding of the inflationary tendencies that have become so deeply embedded in our economic life." For ourselves, we find Dr. Burns' stirring rhetoric to be ironic, for if the central bank had not been seeking to peg short-term interest rates at an inappropriately low level during the summer months, then clearly expansion of the monetary base would not have accelerated to an average of more than 11%.

The importance of steady, even-handed, longer-range policies to deal with the symptoms of stagflation that appear to be troubling the world economy was stressed by the International Monetary Fund in its 1977 annual report, which was published this weekend:

> "Economic policies in the industrial countries, and in most other countries as well, are now placing a primary emphasis on medium-term objectives. The central aim is to combat inflation and, where necessary, strengthen the external position during the next few years, in the firm belief that such an approach will yield the best results for economic growth and employment in the longer run.
>
> "Implementation of policies with an emphasis on medium-term objectives--involving a gradual approach to reduction of inflation, absorption of the unemployed, and adjustment of the external position--is likely to prove difficult. It will require skill, patience, and courage on the part of the authorities, together with a substantial measure of continuity. However, despite the problems that might attend the gradual or moderate approach that has been generally adopted, it would not appear that any better or more promising approach is available....
>
> "From this and other behavior in the recent period, it would appear that (the industrial) countries have adopted a rather patient and even-handed approach to the short-term conduct of fiscal and monetary policies, in contrast to the frequent changes of policy undertaken in the late 1960s and early 1970s. More than in the past, the current approach involves the steering of a general course toward medium-term growth objectives judged to be compatible with objectives for employment and prices and with the strength of the balance of payments. It is this apparently greater tendency to gear short-term demand management to a set of interrelated objectives over the medium term that distinguishes current practice from that of the earlier period, when the primary emphasis was on short-term growth targets that frequently proved to be overly ambitious."

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In this context, it would be disappointing indeed if the Federal Reserve System were to fail to follow its own policy prescription.

MONEY MARKET DEVELOPMENTS

Federal Reserve member banks responded in predictable fashion to the too-long-delayed increase in the discount rate to 5 3/4% that the Reserve Board finally implemented in the last week of August. Borrowing at the discount window dropped by $755-million on a daily average to a total of $637-million. This more than offset a contra-seasonal jump in Federal Reserve "float" (central bank credit automatically extended on cash items in process of collection), and allowed the money managers overall to reduce both the monetary base and Federal Reserve credit during the week. Even so, the monetary base is continuing to expand at a rate well above that implied by the money managers' official targets. The monetary base averaged $126.5-billion a day during the four weeks ended on September 7, up at a 9.2% seasonally adjusted, compound annual rate from the average of $125.65-billion during the four weeks ended on August 10. (These data, of course, refer to the monetary base as recently revised by the Federal Reserve Bank of St. Louis. See our Weekly Federal Reserve Reports dated August 12 and August 19 for an extensive discussion of this revision.)

Demand for short-term credit from the business sector has been moderate in recent weeks, continuing a trend that first began to be apparent around midyear. The Morgan Stanley proxy for total short-term business credit outstanding--which declined slightly during the week ended August 31 (see the table on page 2)--averaged $192.96-billion during the four weeks ended on that date, up at a compound annual rate of 7.8% from the average of $191.8-billion outstanding during the four weeks ended on August 3. This was well under the rate of gain in short-term borrowing by business that was typical in the first part of the year. The Treasury has recently announced its first net borrowing of new money in the short-term bill market (three- and six-month maturities) in quite some time. This announcement came somewhat earlier than many analysts had assumed, but as an offset to this demand--which is moderate in any event--foreign buyers of Treasuries have been aggressive recently. According to the Federal Reserve Bank of New York, marketable Treasury securities held in custody by the central bank for official foreign holders rose by almost $1.5-billion during the week ended September 7 to a total of $62.2-billion. This gain--in large part reflecting the regular monthly transfer of funds to the main oil exporting nations--brought the total increase in these holdings from the comparable date a year earlier to $12.7 billion.

TARGETS FOR MONETARY POLICY

We have argued many times in these letters that the Federal Reserve's standard operating procedure of trying to manage the monetary aggregates by manipulating short-term interest rates is fraught with operational and economic problems. In effect, the central bank attempts to peg the price for a commodity (namely, short-credit) in a market where demand is very unstable. In order for the market to clear, the authorities are compelled to use their powers to produce substantial variations in the supply of funds. The problem is that apart from the ministerial function of offsetting daily swings in the availability of bank reserves caused by such factors as changes in Treasury balances at the Federal Reserve banks, changes in Federal Reserve "float", and changes in the public's demand for currency, the authorities have continuously to probe the market to determine through ad hoc experimentation what the demand for funds actually is.

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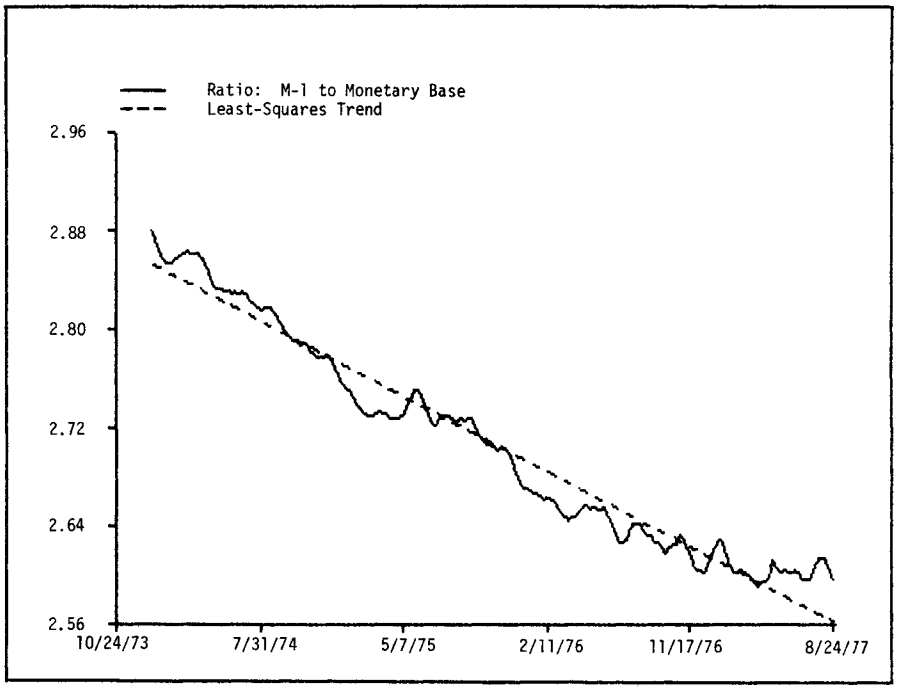
Figure 1

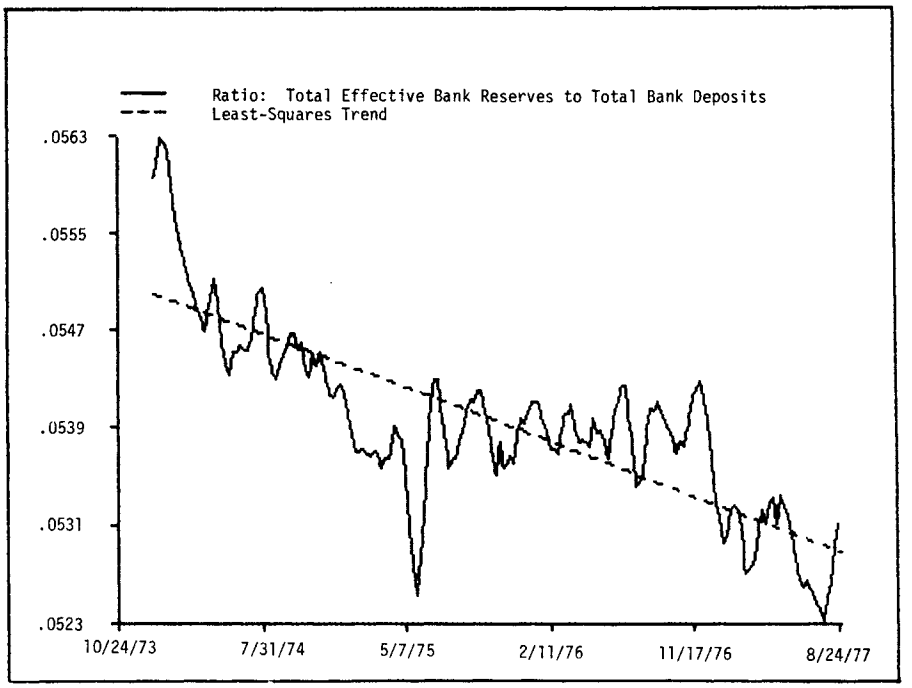
The Money Multiplier



Sources: Chase Econometric Associates Data Base; Morgan Stanley Research

Figure 2

The Reserve Ratio



Sources: Chase Econometric Associates Data Base; Morgan Stanley Research

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Errors in central bank judgment about the underlying equilibrium rate in the money markets--of the sort, we would submit, that has developed this summer--have helped to produce much of the instability in central bank policy in recent years. As we have stated many times in the past, we would prefer that the Federal Reserve seek explicitly to manage the monetary base, which in the long run accounts for most of the change in the money supply. There remains, then, the problem of identifying an appropriate target rate for the expansion of the monetary base. Plainly, as Figure 1 shows, the ratio of the money supply to the monetary base is not one, but rather shifts in response to changes in the public's portfolio decisions concerning the form in which money assets are held. The key relationships that determine these changes in money multiplier are shown in Figures 2, 3, and 4. Each of these ratios bears an inverse relationship to the money multiplier--a higher ratio means a lower multiplier. (We have discussed the reasons for these associations repeatedly in our regular monthly analyses of the relationship between Federal Reserve action and monetary growth, most recently on August 19.)

In effect, this method of analysis seeks to separate the money stock into two components: that portion which is determined by central bank policy (namely, the monetary base) and that portion which is determined by actions of the public, the banking system and the Treasury (namely, the money multiplier). Obviously, the policy maker must have some notion of the interaction of these external factors in making a decision about the target band within which growth in the monetary base should be contained. We have done considerable analysis--both short- and long-run--of the behavior of the factors that determine the money multiplier. We have concluded that, despite the substantial short-run volatility in the reserve ratio (which on a week-to-week basis is an approximate measure of the efficiency with which banks are using reserves supplied by the central bank), there are basic trends which are evident that can be useful for policy purposes.

For instance, from 1956 through mid-1977, the average quarter-to-quarter rate of change in M-1 was 4.18%, while the average rate of change in the monetary base was 5.23%. This difference of 1.05 percentage points was accounted for by a mean positive contribution of 98 basis points from the reserve ratio (largely reflecting the secular increase in time deposits relative to demand deposits, since time deposits have a lower reserve requirement than demand); a negative contribution of 46 basis points from the increase of currency relative to demand deposits; a negative contribution of 143 basis points from the rise of time deposits relative to demand deposits (rising time deposits absorb reserves otherwise available to support demand deposits, the principal component of M-1); and a negative contribution of 14 basis points from the Treasury deposit ratio.

The postwar history has been that the monetary base has grown on average at about 25% faster than the narrowly defined money supply. This, it would seem to us, should be an outer constraint on the permissible rate of expansion of the base. In other words, if the desired rate of growth of the money supply is 5.5%, then the monetary base should in general not expand faster than 6.875%. This should be the maximum, for there is evidence (as the charts show) that the rate of increase in both the currency ratio and the time deposit ratio has been slowing down in recent months, which, in turn, has led to a slower rate of decline in the money multiplier.

If the implications of this analysis are correct, then there is no question that the monetary authorities have been following a high-risk course this summer. The

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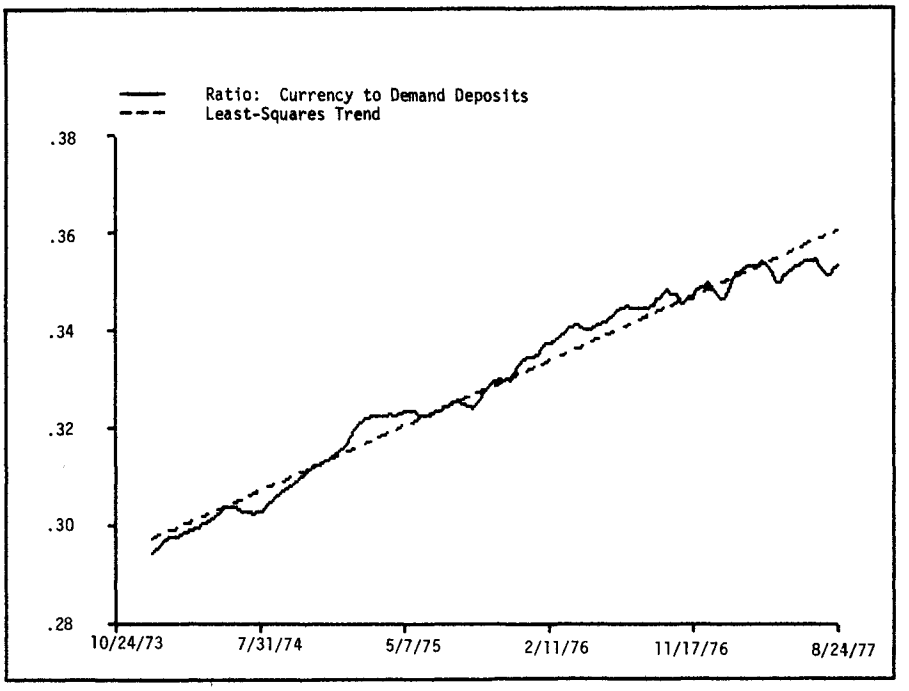
Figure 3

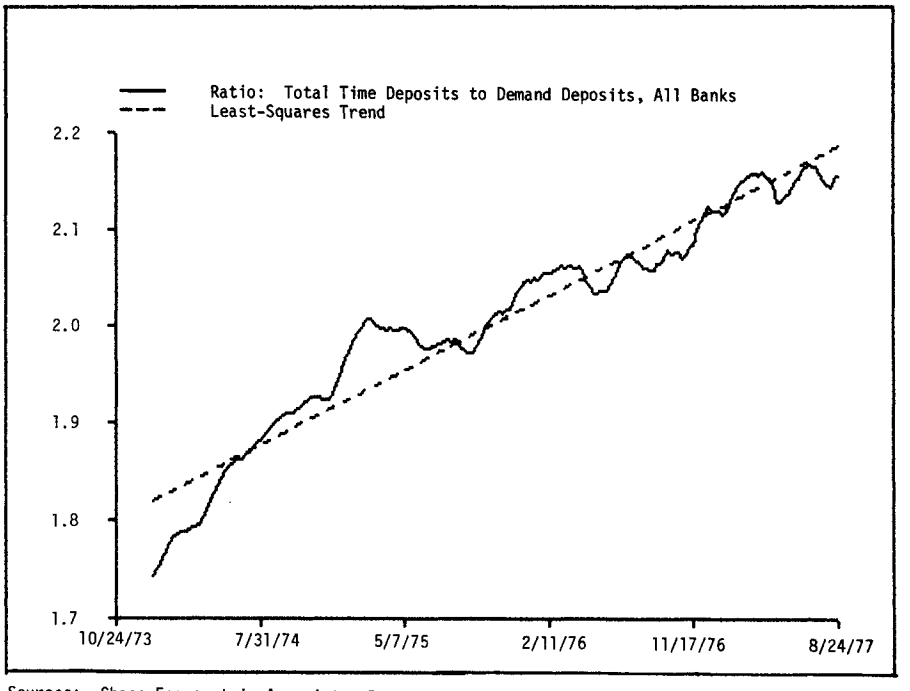
The Currency Ratio



Sources: Chase Econometric Associates Data Base; Morgan Stanley Research

Figure 4

The Time Deposit Ratio



Sources: Chase Econometric Associates Data Base; Morgan Stanley Research

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recent increases in the monetary base may well be translated into very large rises in the money supply.

The interest rates regularly monitored by the Federal Reserve were as follows:

Rate	Daily Average Week Ended August 31	Daily Average Week Ended September 7	Change in Basis Points
Federal Funds	6.02%	5.97%	- 5
90-Day Treasury Bills	5.56	5.57	+ 1
90- to 119-Day Commercial Paper	5.88	5.88	--
90-Day CDs (Secondary Market)	5.98	5.97	- 1
90-Day Eurodollars	6.30	6.26	- 4
20-Year Governments	7.53	7.51	- 2

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September 9, 1977

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STATISTICAL APPENDIX - CAPITAL MARKET ACTIVITY 1976-1977

Table 1

Bond Market Volume 1971-1977*

Publicly Offered Nonconvertible Debt
($ Millions)

	1971	1972	1973	1974	1975	1976	1977
January	$ 2,017	$ 2,849	$ 1,231	$ 2,532	$ 3,680	$ 2,670	$ 2,964
February	2,116	1,855	611	2,060	3,759	2,323	1,371
March	3,925	1,918	1,678	2,307	3,684	3,267	2,652
Total 1st Quarter	8,058	6,622	3,520	6,899	11,123	8,260	6,987
April	1,822	1,901	1,635	2,149	2,866	2,713	2,263
May	2,004	1,616	996	2,288	3,844	2,425	1,496
June	1,924	1,470	1,524	1,917	4,150	3,610	2,890
Total 2nd Quarter	5,750	4,987	4,155	6,354	10,860	8,748	6,649
July	1,684	1,905	1,200	2,065	3,112	1,681	3,053
August	1,438	1,495	986	2,018	1,287	1,746	1,825
September	2,158	1,313	656	1,025	1,569	2,264	
Total 3rd Quarter	5,280	4,713	2,842	5,108	5,968	5,691	
October	2,307	2,015	1,800	3,565	2,345	2,857	
November	1,895	1,952	1,936	3,066	2,292	2,423	
December	1,502	1,532	2,138	2,701	2,537	2,687	
Total 4th Quarter	5,704	5,499	5,874	9,332	7,174	7,967	
Total	$24,792	$21,821	$16,391	$27,693	$35,125	$30,666	

*Excludes Federal, state, and local issues as well as tax-exempt pollution contral financing; includes a limited number of underwritten offers by Federal agencies

Source: Morgan Stanley & Co. Incorporated

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Table 2

Public Bond Sales; 1975-1976 and Year-To-Date 1977
By Type of Issuer
($ Millions)

	Banks & Fin.	For & Provinc.	Indus-trials	Tele-phone	Trans-port.	Utility	Misc.	Total
1976								
January	$ 590	$ 455	$ 850	--	$ 77	$ 548	$ 150	$ 2,670
February	300	410	900	$ 100	193	320	100	2,323
March	510	400	1,320	335	107	595	--	3,267
Total 1st Quarter	$ 1,400	$ 1,265	$ 3,070	$ 435	$ 377	$ 1,463	$ 250	$ 8,260
Percent	16.9%	15.3%	37.2%	5.3%	4.6%	17.7%	3.0%	100.0%
April	$ 600	$ 428	$ 775	$ 450	$ 93	$ 217	$ 150	$ 2,713
May	768	350	715	--	62	530	--	2,425
June	1,650	315	497	540	23	525	60	3,610
Total 2nd Quarter	$ 3,018	$ 1,093	$ 1,987	$ 990	$ 178	$ 1,272	$ 210	$ 8,748
Percent	34.5%	12.5%	22.7%	11.3%	2.0%	14.5%	2.4%	100.0%
July	$ 210	$ 400	$ 310	--	$ 136	$ 525	$ 100	$ 1,681
August	380	367	580	$ 175	84	160	--	1,746
September	470	400	380	125	169	620	100	2,264
Total 3rd Quarter	$ 1,060	$ 1,167	$ 1,270	$ 300	$ 389	$ 1,305	$ 200	$ 5,691
Percent	18.6%	20.5%	22.3%	5.3%	6.8%	22.9%	3.5%	100.0%
October	$ 745	$ 235	$ 862	$ 150	$ 185	$ 680	--	$ 2,857
November	500	810	220	150	84	655	4	2,423
December	670	250	885	150	252	380	100	2,687
Total 4th Quarter	$ 1,915	$ 1,295	$ 1,967	$ 450	$ 521	$ 1,715	$ 104	$ 7,967
Percent	24.0%	16.3%	24.7%	5.6%	6.5%	21.5%	1.3%	100.0%
Total 1976	$ 7,393	$ 4,820	$ 8,294	$ 2,175	$ 1,465	$ 5,755	$ 764	$30,666
Percent	24.1%	15.7%	27.0%	7.1%	4.8%	18.8%	2.5%	100.0%
1977								
January	$ 800	$ 300	$ 825	$ 50	$ 379	$ 610	--	$ 2,964
February	265	433	200	280	46	87	$ 60	1,371
March	475	125	635	755	142	420	100	2,652
Total 1st Quarter	$ 1,540	$ 858	$ 1,660	$ 1,085	$ 567	$ 1,117	$ 160	$ 6,987
Percent	22.0%	12.3%	23.8%	15.5%	8.1%	16.0%	2.3%	100.0%
April	$ 750	--	$ 580	$ 275	$ 98	$ 560	--	$ 2,263
May	561	$ 260	150	135	40	250	$ 100	1,496
June	915	800	5	370	118	682	--	2,890
Total 2nd Quarter	$ 2,226	$ 1,060	$ 735	$ 780	$ 256	$ 1,492	$ 100	$ 6,649
Percent	33.5%	15.9%	11.1%	11.7%	3.9%	22.4%	1.5%	100.0%
July	$ 1,180	$ 185	$ 860	$ 42	$ 331	$ 395	$ 60	$ 3,053
August	682	150	400	45	208	340	--	1,825
Percent	37.4%	8.2%	21.9%	2.5%	11.4%	18.6%	--	100.0%
Total Year to Date	$ 5,628	$ 2,253	$ 3,655	$ 1,952	$ 1,362	$ 3,344	$ 320	$18,514
Percent	30.4%	12.2%	19.7%	10.5%	7.4%	18.1%	1.7%	100.0%

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Table 3

Public Bond Sales; 1975-1976 and Year-To-Date 1977
By Rating of Issuer
($ Millions)

	Moody's Rating				Unrated	
	Aaa	Aa	A	Baa	or Lower	Total
1976						
January	$ 850	$ 1,037	$ 578	$ 175	$ 30	$ 2,670
February	715	994	352	60	202	2,323
March	1,125	797	890	455	--	3,267
Total 1st Quarter	$ 2,690	$ 2,828	$ 1,820	$ 690	$ 232	$ 8,260
Percent	32.6%	34.2%	22.0%	8.4%	2.8%	100.0%
April	$ 1,225	$ 451	$ 894	$ 95	$ 48	$ 2,713
May	615	766	370	195	479	2,425
June	1,640	603	820	465	82	3,610
Total 2nd Quarter	$ 3,480	$ 1,820	$ 2,084	$ 755	$ 609	$ 8,748
Percent	39.8%	20.8%	23.8%	8.6%	7.0%	100.0%
July	$ 463	$ 233	$ 387	$ 475	$ 123	$ 1,681
August	192	436	390	325	403	1,746
September	542	1,125	447	150	--	2,264
Total 3rd Quarter	$ 1,197	$ 1,794	$ 1,224	$ 950	$ 526	$ 5,691
Percent	21.0%	31.5%	21.5%	16.7%	9.2%	100.0%
October	$ 544	$ 871	$ 1,110	$ 140	$ 192	$ 2,857
November	1,075	761	350	180	57	2,423
December	337	585	1,165	355	245	2,687
Total 4th Quarter	$ 1,956	$ 2,217	$ 2,625	$ 675	$ 494	$ 7,967
Percent	24.5%	27.8%	32.9%	8.5%	6.2%	100.0%
Total 1976	$ 9,323	$ 8,659	$ 7,753	$ 3,070	$ 1,861	$30,666
Percent	30.4%	28.2%	25.3%	10.0%	6.1%	100.0%
1977						
January	$ 1,709	$ 655	$ 475	$ 125	--	$ 2,964
February	713	173	300	50	$ 135	1,371
March	1,181	83	912	250	226	2,652
Total 1st Quarter	$ 3,603	$ 911	$ 1,687	$ 425	$ 361	$ 6,987
Percent	51.6%	13.0%	24.1%	6.1%	5.2%	100.0%
April	$ 1,175	$ 546	$ 278	$ 140	$ 124	$ 2,263
May	505	210	230	280	271	1,496
June	1,250	730	255	182	473	2,890
Total 2nd Quarter	$ 2,930	$ 1,486	$ 763	$ 602	$ 868	$ 6,649
Percent	44.1%	22.3%	11.5%	9.1%	13.0%	100.0%
July	$ 1,550	$ 629	$ 400	$ 50	$ 424	$ 3,053
August	250	371	520	190	494	1,825
Percent	13.6%	20.4%	28.5%	10.4%	27.1%	100.0%
Total Year to Date	$ 8,333	$ 3,397	$ 3,370	$ 1,267	$ 2,147	$18,514
Percent	45.0%	18.4%	18.3%	6.8%	11.5%	100.0%

Source: Morgan Stanley & Co. Incorporated

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Table 4

Public Bond Sales; 1975-1976 and Year-To-Date 1977
By Maturity
($ Millions)

	Five To Ten Years	Over Ten Years	Total
1976			
January	$ 978	$ 1,692	$ 2,670
February	750	1,573	2,323
March	1,005	2,262	3,267
Total 1st Quarter	$ 2,733	$ 5,527	$ 8,260
Percent	33.1%	66.9%	100.0%
April	$ 998	$ 1,715	$ 2,713
May	718	1,707	2,425
June	1,029	2,581	3,610
Total 2nd Quarter	$ 2,745	$ 6,003	$ 8,748
Percent	31.4%	68.6%	100.0%
July	$ 670	$ 1,011	$ 1,681
August	530	1,216	1,746
September	970	1,294	2,264
Total 3rd Quarter	$ 2,170	$ 3,521	$ 5,691
Percent	38.0%	62.0%	100.0%
October	$ 650	$ 2,207	$ 2,857
November	653	1,770	2,423
December	905	1,782	2,687
Total 4th Quarter	$ 2,208	$ 5,759	$ 7,976
Percent	27.8%	72.2%	100.0%
Total 1976	$ 9,856	$20,810	$30,666
Percent	32.1%	67.9%	100.0%
1977			
January	$ 625	$ 2,339	$ 2,964
February	478	893	1,371
March	225	2,427	2,652
Total 1st Quarter	$ 1,328	$ 5,659	$ 6,987
Percent	19.0%	81.0%	100.0%
April	$ 575	$ 1,688	$ 2,263
May	360	1,136	1,496
June	890	2,000	2,890
Total 2nd Quarter	$ 1,825	$ 4,824	$ 6,649
Percent	27.4%	72.6%	100.0%
July	$ 925	$ 2,128	$ 3,053
August	150	1,675	1,825
Percent	8.3%	91.7%	100.0%
Total Year to Date	$ 4,228	$14,286	$18,514
Percent	22.8%	77.2%	100.0%

Source: Morgan Stanley & Co. Incorporated

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Table 5

Publicly Offered Convertible Debt
1975-1976 and Year-To-Date 1977
($ Millions)

	Banks & & Fin.	Industrials	Telephone	Trans. & Utility	Total
1976					
January	--	$ 120	--	--	$ 120
February	--	90	--	--	90
March	--	120	--	--	120
Total 1st Quarter	--	$ 330	--	--	$ 330
Percent	--	100.0%	--	--	100.0%
April	--	$ 32	--	--	$ 32
May	--	15	--	--	15
June	--	426	--	--	426
Total 2nd Quarter	--	$ 473	--	--	$ 473
Percent	--	100.0%	--	--	100.0%
July	--	--	--	--	--
August	$ 4	--	--	--	$ 4
September	3	--	$ 75	--	78
Total 3rd Quarter	$ 7	--	$ 75	--	$ 82
Percent	8.5%	--	91.5%	--	
October	--	$ 15	--	--	$ 15
November	--	1	--	$ 20	21
December	--	--	--	--	--
Total 4th Quarter	--	$ 16	--	$ 20	$ 36
Percent	--	44.4%	--	55.6%	100.0%
Total 1976	$ 7	$ 819	$ 75	$ 20	$ 921
Percent	0.8%	89.0%	8.1%	2.1%	100.0%
Total 1st Quarter	--	--	--	--	--
April	--	--	--	$ 50	$ 50
May	--	--	--	--	--
June	--	$ 56	--	--	56
Total 2nd Quarter	--	$ 56	--	$ 50	$ 106
Percent	--	52.8%	--	47.2%	100.0%
July	--	$ 21	--	--	$ 21
August	--	258	--	--	258
Percent	--	100.0%	--	--	100.0%
Total Year to Date	--	$ 335	--	50	$ 385
Percent	--	87.1%	--	12.9%	100.0%

Source: Morgan Stanley & Co. Incorporated

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Table 6

Underwritten Public Common Stock Sales, 1975-1976 and Year-To-Date 1977
By Type of Issuer and Issue
($ Millions)

	Banks & & Fin.	Industrials	Telephone	Utility	Trans.	Secondary Offers	Misc.	Total
1976								
January	--	$ 31	--	$ 296	--	$ 9	--	$ 336
February	$ 36	368	--	443	--	37	--	884
March	108	452	--	774	--	111	--	1,445
Total 1st Quarter	$ 144	$ 851	--	$1,513	--	$ 157	--	$2,665
Percent	5.4%	31.9%	--	56.8%	--	5.9%	--	100.0%
April	$ 4	$ 145	--	$ 213	--	$ 282	--	$ 644
May	3	272	--	366	$ 2	70	--	713
June	--	290	$ 659	163	--	50	--	1,162
Total 2nd Quarter	$ 7	$ 707	$ 659	$ 742	$ 2	$ 402	--	$2,519
Percent	0.3%	28.1%	26.2%	29.5%	0.08%	16.0%	--	100.0%
July	--	$ 115	--	$ 295	--	$ 18	--	$ 428
August	$ 18	303	--	41	--	19	--	381
September	78	72	--	242	$ 6	20	--	418
Total 3rd Quarter	$ 96	$ 490	--	$ 578	$ 6	$ 57	--	$1,227
Percent	7.8%	39.9%	--	47.1%	0.5%	4.6%	--	100.0%
October	$ 170	$ 40	--	$ 354	--	$ 18	--	$ 582
November	--	9	--	357	--	22	--	388
December	11	6	--	407	--	26	--	45
Total 4th Quarter	$ 181	$ 55	--	$1,118	--	$ 66	--	$1,425
Percent	12.8%	3.8%	--	78.8%	--	4.6%	--	100.0%
Total 1976	$ 428	$2,103	$ 659	$3,951	$ 8	$ 682	--	$7,831
Percent	5.5%	26.9%	8.4%	50.4%	0.1%	8.7%	--	100.0%
1977								
January	--	$ 13	--	$ 257	--	$ 10	$ 9	$ 289
February	$ 36	15	$ 147	182	--	9	--	389
March	5	21	--	537	--	77	7	646
Total 1st Quarter	$ 41	$ 49	$ 147	$ 976	--	$ 96	$ 15	$1,324
Percent	3.1%	3.7%	11.1%	73.7%	--	7.2%	1.2%	100.0%
April	$ 114	$ 93	--	$ 74	--	$ 89	--	$ 370
May	3	27	--	868	--	9	--	907
June	103	312	$ 45	192	$ 2	62	--	716
Total 2nd Quarter	$ 220	$ 432	$ 45	$1,134	$ 2	$ 160	--	$1,993
Percent	11.0%	21.7%	2.3%	56.9%	0.1%	8.0%	--	100.0%
July	--	$ 88	--	$ 228	--	$ 38	--	$ 354
August	$ 105	48	--	59	--	46	--	258
Percent	40.7%	18.6%	--	22.9%	--	17.8%	--	100.0%
Total Year to Date	$ 366	$ 402	$ 192	$2,397	$ 2	$ 555	$ 15	$3,929
Percent	9.3%	10.2%	4.8%	61.0%	0.1%	14.2%	0.4%	100.0%

Source: Morgan Stanley & Co. Incorporated

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Table 7

Public Preferred Stock Sales; 1975-1976 and Year-To-Date 1977
By Type of Issuer
($ Millions)

	Utility	Trans. & Industrials	Telephone	Ins. & Banks	Total
1976					
January	$ 119	$ 20	--	--	$ 139
February	45	100(a)	$ 20	--	165
March	365	60	--	--	425
Total 1st Quarter	$ 529	$ 180	$ 20	--	$ 729
Percent	72.6%	24.7%	2.7%	--	100.0%
April	$ 10(c)	$ 21(b)	--	--	$ 31
May	135	19(d)	$ 110	--	264
June	239	50	--	--	289
Total 2nd Quarter	$ 384	$ 90	$ 110	--	$ 584
Percent	65.8%	15.4%	18.8%	--	100.0%
July	$ 85	--	--	--	$ 85
August	90	$ 50	--	$ 50	190
September	105	25(e)	--	5(f)	135
Total 3rd Quarter	$ 280	$ 75	--	$ 55	$ 410
Percent	68.3%	18.3%	--	13.4%	100.0%
October	$ 90	$ 50	--	--	$ 140
November	114	--	--	$ 76	190
December	140	100(g)	--	--	240
Total 4th Quarter	$ 344	$ 150	--	$ 76	$ 570
Percent	60.4%	26.3%	--	13.3%	100.0%
Total 1976	$1,537	$ 495	$ 130	$ 131	$2,293
Percent	67.0%	21.6%	5.7%	5.7%	100.0%
1977					
January	$ 95	--	--	--	$ 95
February	42	$ 75	--	--	117
March	270	187(1)	--	$ 10	467
Total 1st Quarter	$ 407	$ 262	--	$ 10	$ 679
Percent	59.9%	38.6%	--	1.5%	100.0%
April	$ 65	--	--	--	$ 65
May	163	$ 53	--	$ 2(m)	218
June	--	200	--	25(n)	225
Total 2nd Quarter	$ 228	$ 253	--	$ 27	$ 508
Percent	44.9%	49.8%	--	5.3%	100.0%
July	$ 22	$ 100(d)	$ 16(e)	--	$ 138
August	50	--	--	$ 100(k)	$ 150
Percent	33.3%			66.7%	100.0%
Total Year to Date	$ 707	$ 615	$ 16	$ 137	$1,475
Percent	47.9%	41.7%	1.1%	9.3%	100.0%

Notes:
(a) Includes $100-million of convertible preferred stock
(b) Includes $21-million of convertible preferred stock
(c) Includes $2-million of convertible preferred stock
(d) Includes $19-million of convertible preferred stock
(e) Includes $25-million of convertible preferred stock
(f) Includes $5-million of convertible preferred stock
(g) Includes $100-million of convertible preferred stock
(h) Includes $62-million of convertible preferred stock
(i) Includes $2-million of convertible preferred stock
(j) Includes $25-million of convertible preferred stock
(k) Includes $100-million of convertible preferred stock

Source: Morgan Stanley & Co. Incorporated

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Table 8

Private Placements by Type of Issuer
($ Millions)

	Bank	Foreign	Industrial	Telephone	Transportation	Utility	Misc.	Total
1977								
January	$ 51	$ 363	$1,174	$ 1	--	$ 57	--	$ 1,646
February	147	160	476	9	--	26	--	818
March	101	161	657	17	$ 63	15	--	1,014
Total 1st Quarter	$ 299	$ 684	$2,307	$ 27	$ 63	$ 98		$ 3,478
Percent	8.6%	19.7%	66.3%	0.8%	1.8%	2.8%		100.0%
April	$ 43	$ 45	$ 961	$ 28	$147	$392	--	1,616
May	210	248	703	21	64	40	--	1,286
June	299	--	657	89	34	112	--	1,191
Total 2nd Quarter	$ 552	$ 293	$2,321	$138	$245	$544		$ 4,093
Percent	13.5%	7.1%	56.7%	3.4%	6.0%	13.3%		100.0%
July	$ 97	$ 70	$ 889	$203	$ 37	$111	$ 75	$ 1,482
August	10	150	722	--	87	--	--	969
Total Year to Date	$ 958	$1,197	$6,239	$368	$432	$753	$ 75	$10,022
Percent	9.5%	11.9%	62.3%	3.6%	4.4%	7.5%	0.8%	100.0%

Source: Morgan Stanley & Co. Incorporated

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September 9, 1977

Memo from Homer Jones

With respect to the forthcoming meeting September 19, I fear it will of necessity be a quickie as the past ones. But possibly a groundwork could be laid for making some progress subsequent to the meeting. Possibly there could be a very small subcommittee which could examine some of the fundamental problems. The subcommittee might not need to meet physically but could make progress by post and telephone.

This is an opportune time for the Shadow Committee to look at how monetary policy gets implemented--now that we have gotten so far off the track in the last six months.

We might examine:

1. Does vestigial (and still dominant?) concern with interest rates (primarily short-term, in both senses) account for our getting off the track?

2. Should we fear a system of utterly free interest rates?

3. Would it be practical or desirable to have freedom of movement of interest rates while assuring that the movements not be "disorderly" yet avoiding getting led astray as we recently have?

4. Do we get led astray by not correcting deviations from plan and blithely wiping the slate clean and starting off from a new base every quarter?

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5. Is there any sense or is there great harm from operating on the "band" principle rather than straightforward targets?

6. Does monetary policy and the execution thereof become confused by a multiplicity of "aggregate" targets?

7. Could we profit from a simple paper examining various possible "aggregate" targets, possibly concluding that while certain ones seem preferable to others the most important thing is to follow one and not a multitude in some unspecified and indeterminate way.

The most immediate problem will be to what extent the errors of the past six months should be offset in the next three or six or twelve months and to what extent we must let bygones be bygones. Offsetting those errors in three months would require a decline in M_1, in six months would require essentially no increase, while in a year would permit slight growth over the year.

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MEMORANDUM

TO: Members of the Shadow Open Market Committee **DATE:** September 14, 1977

FROM: Rudy Penner

SUBJECT:

Enclosed is a report on the Federal Budget for the September 19th meeting.

Short-fall → 55 61.5 Penner
+ increased interest cost
+ lower nominal GNP
⇒ with 60-65 billion
+ potential GNP
unused GNP

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THE FEDERAL BUDGET

A Report Prepared for the Shadow-Open Market Committee

Rudolph G. Penner

American Enterprise Institute

Background

Table 1 shows the evolution of the 1977 and 1978 Budgets from the "lame-duck" recommendations submitted by President Ford in January 1977 through the official July 1977 estimates of the Carter Administration.

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Table 1

Budget Recommendations, Ford and Carter, Final Years

1977 and 1976

(billions of dollars)

	1976 actual	1977 Ford (Jan.)	1977 Carter (Feb.)	1977 Carter (July)*	1978 Ford (Jan.)	1978 Carter (Feb.)	1978 Carter (July)*
Outlays	$365.7	$411.2	$417.4	$406.4	$440.0	$459.4	$462.9
Receipts	299.2	354.0	349.4	358.3	393.0	401.6	401.4
Deficit	$ 66.5	$ 57.2	$ 68.0	$ 48.1	$ 47.0	$ 57.7	$ 61.5

* In the July estimates, refunds under the earned income credit which had earlier been defined as an outlay were redefined to be reductions in receipts. This has the effect of lowering 1978 receipts and outlays by $0.9 billion.

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Through the first six months of 1977, changes in the economic assumptions, technical estimating changes, and Congressional actions, all influenced the budget totals, but the most important changes were the result of shifts in Presidential policy. The most significant Presidential initiatives were as follows:

The Ford recommendations provided a major net permanent tax cut of $14.6 billion for 1978 compared to the levels implied by constant tax law. Outlays were cut $5.4 billion from current policy levels.

Prior to taking office, President Carter announced his own "stimulus package" as a substitute for the Ford tax cuts. The package consisted of minor permanent tax cuts, a major temporary tax rebate worth $11.4 billion, and increases in spending on accelerated public works, public service employment, countercyclical revenue sharing and training programs. This package was worth $15.7 billion in 1977 and $15.9 billion in 1978.

In February, President Carter submitted a more complete set of revisions to the Ford Budget. The net result was an increase in Ford's recommended 1977 deficit from $57.2 to $68.0 billion while the 1978 deficit was increased from $47.0 to $57.7 billion. The increase in the deficits was less than the value of the stimulus package primarily because of the rejection of the Ford tax cut. Carter also assumed that his package would lead to a somewhat more ebullient economy, and made other minor program changes and changes in the estimates.

In April, the re-acceleration of the economic recovery and developing Congressional hostility to the rebate proposal led to its withdrawal by President Carter.

As shown in the table, the withdrawal of the rebate combined with the net impact of the policy initiatives and re-estimates significantly reduced the

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July estimate of the 1977 deficit compared to that shown in the February Budget Revisions. However, those portions of the stimulus package that were retained have a major spending impact in 1978, and as a result the deficit increases by $13.4 billion in that year. Because the Carter estimates presume a continuing strong recovery, which would reduce the deficit significantly given constant policies, the increase in the unified deficit between 1977 and 1978 represents a strong discretionary shift toward an expansionary fiscal policy between the two years.

This shift appears somewhat less significant if national income accounting (NIA) definitions are used to compute Federal expenditures and revenues. The NIA Budgets consistent with Carter's July estimates are provided in Table 2.

Table 2

President Carter's July Budget Estimates on a National Income Accounting Basis, Fiscal 1977 and 1978

(billions of dollars)

	1977	1978
Expenditures	417.2	469.3
Revenues	365.4	415.3
Deficit	51.8	54.0

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It should be emphasized that although the $2.2 billion increase in the NIA Budget deficit seems small, it still represents a significant shift toward expansion in discretionary policy. One can get a highly imperfect measure of discretionary shifts using revenues and expenditures calculated as if the economy were at full employment. Official full employment estimates have not been provided by the new Administration, but my own crude estimates suggest that the full employment deficit rises by more than $15 billion between 1977 and 1978 on an NIA basis.

All of the above is based on the Administration's July estimate of the Budget. No forecast of Budget totals is completely reliable. The following section explores some of the most important estimation problems in order to develop somewhat more precise forecasts of the Budget's likely impact over the next few quarters.

Estimating Problems

While monitarists, fiscalists, and rational expectations theorists can engage in lively debates regarding the impact of the budget on the economy, there is no denying that the economy has a major impact on budget totals. On the outlay side, changes in the unemployment rate have a major impact on unemployment benefits; changes in interest rates alter the cost of the national debt; and changes in the rate of inflation have a major impact on outlays on indexed programs such as social security, food stamps, school lunches, etc.

The sensitivity of unified budget outlays to hypothetical changes in various economic variables is provided in Table 3 for the 1977 Budget.

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Table 3

Sensitivity of FY 1977 Budget Outlays to

Economic Assumptions

(billions of dollars)

	Addition to Outlays
Inflation (effect on indexed program only)	
One percentage point increase in CPI level by:	
First quarter, CY 1976	$1.1
Third quarter, CY 1976	0.4
First quarter, CY 1977	0.2
Interest Rates	
One percentage point increase* by:	
January 1, 1976	$2.3
July 1, 1976	1.8
October 1, 1976	1.3
January 1, 1977	0.8
July I, 1977	0.1
Unemployment Rate (unemployment assistance only)	
One percentage point increase for fiscal year	$2.5

* The increase is assumed to be for short-term rates with a somewhat smaller increase in long-term rates.

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The revenue side is even more sensitive to economic changes. A one percentage point change in the forecast of money GNP in fiscal 1977 would affect revenue estimates by more than $4 billion with the exact amount highly dependent on how the change affected personal income (for personal income taxes), corporate profits (for corporate taxes), and wages and salaries (for payroll taxes).

For the purposes of the analysis in this paper the Administration's July economic forecast will be accepted. This is shown in Appendix Table A.

Even if the economic forecast underlying budget estimates is precisely correct, there is plenty of room for error. For example, corporations have considerable discretion regarding the timing of their tax payments out of given corporate profits; one is never sure what proportion of the eligible population will claim benefits in entitlement programs; and in recent times, OMB has been bedeviled by overestimates of spending for non-entitlement programs--the so-called "shortfall" problem.

In February, the Carter Administration estimated 1977 unified outlays at $416.5 billion. Definitional changes, involving the earned income credit, and the withdrawal of the rebate lowered this figure to about $413 billion. However, the July update estimates outlays at only $406.4 billion. This reduction of more than $6 billion is primarily due to the shortfall problem. The very latest offical estimate lowers 1977 outlays further to $404 billion, and it is quite possible that actual outlays will be two or three billion lower than this figure.

There is no simple explanation for this phenomenon and the following attempt at a description of the problem must be regarded as being highly oversimplified. OMB has had a tendency to overestimate spending for a very long time, but the problem did not attract much public attention until the shortfall

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became especially large during fiscal 1976 and the transition quarter. While a large number of random events conspired against OMB in 1976 and made the problem especially serious, there are a number of continuing political and administrative factors which create a very strong bias toward overestimation.

Whenever Congress undertakes a new policy direction at the behest of an Administration there is a strong tendency on the part of the Executive Branch to claim that it will be implemented posthaste. This is especially true when the policy is aimed at some perceived national "emergency" as in energy or in fighting unemployment. For example, it was claimed that the accelerated public works program would be implemented with far greater alacrity than was assumed by most experts, but the official claims had to be duly reflected in the Budget.

Even when there are no political pressures of this type, the bureaucracy has a difficult time adjusting to policy shifts. The spending of money requires a great deal of work. Proposals have to be studied; contracts have to be negotiated and signed; etc. There is a pervasive human tendency to believe that more work can be accomplished within a certain time period than is practically possible. Typically, insufficient allowances are provided for vacations, illnesses, and the myriad of other things that can go wrong.

As experience builds with a new program direction the outlay forecasts should become more precise, and there is some evidence that this is now occuring in the defense sector. That sector had to live with severe budget stringency in the post Viet Nam era and it was slow to adjust to large increases in procurement allowed in the 1976 and 1977 budgets. While significant defense shortfalls will occur in the 1977 budget, it appears likely that the gap will be closed somewhat in 1978. However, in that year the

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the bureaucracy will still be struggling with the implementation of the relatively new stimulus programs, and a significant shortfall is likely relative to program size, particularly in the public works component of the package.

As a result of such factors, it has already been noted that 1977 unified outlays are likely to be around $401 or $402 billion. Outlays in 1978 could be seven or eight billion lower than the $462.9 estimated in July even if the Administration's economic forecast and policy stance remains constant.

However, because both 1977 and 1978 outlays will fall short of the July estimates the increase in the deficit between the two years will be only slightly lower than was discussed earlier.

Short-Run Fiscal Policy Implications

In order for there to be no shortfall from the July estimates in the NIA budget for 1977, expenditures would have to soar at an annual rate exceeding forty percent in the last quarter of the fiscal year, that is, the third calendar quarter of 1977. This is clearly unreasonable and no one expects it. While quarter-by-quarter estimates of the shortfall are treacherous, to say the least, I guess that, despite the shortfall, there will be a major surge in spending during the third and fourth quarter of this calendar year as the stimulus programs get rolling--albeit behind schedule. Again, the tentative nature of any estimate must be emphasized, but it is not unreasonable to expect annual rates of growth of NIA spending between 15 and 20 percent during the last half of this calendar year with a deceleration to the seven to ten percent level in the first three quarters of calendar 1978.

It would, however, be unwise to conclude that the expansionary impact of the surge in spending over the last half of this year will be as great as is suggested by these estimates. If the acceleration occurs, it will, in large

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part, be due to extraordinary rates of growth in the grants component of the NIA budget. Virtually, the entire stimulus package is financed by grants and is implemented at the state and local level. Although the accelerated public works and public service jobs components of the package have been designed to reduce the extent to which the funds can be used to undertake projects that would have been undertaken in any case at the state and local level, considerable "substitution" is sure to occur anyway. Thus, to some degree, these programs simply reduce state and local deficits or raise surpluses at the expense of the Federal deficit. This is even more true of the counter cyclical revenue sharing component of the package. As a result, the surge in grants is unlikely to have the same expansionary impact as would a similar surge in the purchases or transfer component of the NIA budget.

Long-Run Fiscal Policy Issues

President Carter has promised to balance the Budget in fiscal 1981. Barring an economic slowdown which would cause the abandonment of this promise, he will have to adopt a fairly stringent 1979 Budget if his 1981 goal is to have any hope of realization. OMB has revealed that for planning purposes it is using a 1979 outlay figure of about $500 billion. Such planning figures seldom endure until the final Budget is presented, but if this one should happen to hold, the implied real increase in spending over the July estimates for 1978 is less than one percent. A 1978 shortfall of seven to eight billion would raise the implied rate of real growth in 1979 spending to over two percent, but still implies great stringency between the two years.

Over the longer run, the nature of the Administration's tax reform package will be of significant importance to the long-run budget outlook and to the allocation of resources. In this regard, the proposed net revenue loss associated with tax reform may be as important as the compositional changes in the tax structure.

Since the Korean War, the ratio of total Government receipts to GNP has

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been held remarkably constant. There is no clear trend in the ratio and its average since 1953 has been 18.6 percent, exactly the level achieved in fiscal 1976. To maintain relative stability in the ratio, numerous discretionary tax cuts have been necessary to offset the effect of inflation and real growth pushing income taxpayers into higher and higher tax brackets.

Because of the current high inflation rate, constant tax law implies a very rapidly increasing tax burden, because taxpayers are pushed into higher brackets at a much faster rate than they were in the past.

In 1978 the expected ratio of receipts to GNP is 19.6 percent or only slightly above the historical average of 18.6 percent. Given the Administration's economic projections it will rise to almost 22 percent by fiscal 1981 if tax laws remain unchanged. Returning the 1981 ratio to the 19.6 percent prevailing in 1978 would require a massive tax cut of over $60 billion in 1981 dollars. There is a clear conflict between the historical tendency for the Congress to keep the ratio of receipts to GNP relatively constant and the Administration's desire to obtain the revenues necessary to facilitate budget balancing in 1981.

The announced goal of the Administration is to hold outlays to 21 percent of the GNP in 1981 compared to the 22.6 implied by the July estimates for 1978. A balanced budget obviously implies that receipts will have to equal 21 percent of GNP and they have not reached this level since the Korean War--although they came close during the Viet Nam War. Whether or not the Congress will accept the implied increase in the tax burden will be one of the more interesting fiscal policy questions of the next three years. All of this, of course, accepts the relatively optimistic economic projections of the Administration. This is not the place for a detailed critique of those projections, but any slowdown in the recovery could cause the dream of a balanced budget to be postponed for many years.

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Appendix Table A

President Carter's July 1976 Economic Forecasts and Long-Run Projections

(Calendar Years: dollars in billions)

	Actual 1976	Forecast 1977	Forecast 1978	Projection 1979	Projection 1980	Projection 1981	Projection 1982
Gross national product							
Current dollars:							
Amount	1,692	1,883	2,106	2,345	2,592	2,836	3,081
Percent change	11.6	11.3	11.9	11.3	10.6	9.4	8.6
Constant (1972) dollars:							
Amount	1,265	1,330	1,399	1,468	1,545	1,621	1,690
Percent change	6.1	5.1	5.3	5.0	5.2	4.9	4.3
Incomes (current dollars)							
Personal income	1,375	1,526	1,698	1,894	2,097	2,294	2,493
Wages and salaries	890	991	1,105	1,231	1,366	1,495	1,624
Corporate profits	148	173	199	223	246	268	291
Prices (percent change)							
GNP deflator:							
Year over year	5.1	5.9	6.3	6.1	5.1	4.3	4.2
Fourth quarter over fourth quarter	4.6	6.5	6.1	5.9	4.6	4.2	4.2
CPI:							
Year over year	5.7	6.5	6.0	5.9	5.0	4.3	4.3
December over December	4.8	6.9	6.1	5.7	4.5	4.3	4.2
Unemployment rates (percent)							
Total:							
Yearly average	7.7	7.0	6.3	5.7	5.2	4.8	4.5
Fourth quarter	7.9	6.6	6.1	5.5	5.0	4.6	4.4
Insured 1/	6.4	5.1	4.2	3.7	3.2	3.0	2.8
Federal pay raise, October (percent)	4.8	6.5	6.5	6.5	6.0	5.5	5.0
Interest rate, 91-day Treasury bills (percent) 2/	5.0	4.9	5.0	5.0	5.0	5.0	5.0

1/ Insured unemployment as a percentage of covered employment; includes unemployed workers receiving extended benefits.

2/ Average rate of new issues within period. The forecast assumes continuation of current market rates.

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FINANCING THE GOVERNMENT DEFICIT

By

Robert H. Rasche
Michigan State University

The following comments are divided into essentially two parts. In Section I, an explicit financing relationship for the U.S. government is derived, which relates the deficit or surplus (unified budget) plus the deficit or surplus of off budget agencies to changes in the net source base and other factors. I have included a discussion of what items are involved in these other factors, and identified the items which must be forecast in order to make a projection of the impact of a projected deficit or surplus in the private capital markets under different assumptions about monetary policy. I welcome any comment on the appropriateness of the categories which I have devised, and/or the techniques which I propose to forecast some of the components. In addition, I would appreciate any helpful suggestions on forecasting the component of the relationship related to foreign transactions.

In Section II I have made some comments on things which I see as significant factors in recent financing, and make some rough guesses as to what the coming fiscal year may bring.

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I. Components of the Financing Identity and Some Forecasting Proposals

At various meetings in the past, I have tried a number of semi-systematic presentations of the relationship between the government deficit or surplus and various components of the financing problem. I have finally made the effort to trace down a systematic relationship between changes in the net source base and the deficit or surplus. The relationship is derived from two basic identities: the first the so called means of financing identity data for which are available in various Treasury publications, and the second the balance sheet of the Federal Reserve System which is presented in the Consolidated Statement of Condition in the Federal Reserve Bulletin. Several other minor definitions also enter into the computations. The details of the development are presented in the Appendix to this paper. The data for fiscal years 1974-1976, and quarterly thereafter, are presented in Table 1. It should be noted that all data are derived from changes in end-of-quarter stock figures and are seasonally unadjusted, hence they are not compatable with the average of daily figures, seasonally adjusted data which are usually cited.

It seems to me that the goal of this type of investigation is to be able to attempt to project the amount of financing through private credit markets which will be associated with a projected deficit and proposed (or projected) growth paths of the base. As can be seen from Table 1, in reality this does not amount to a straightforward subtraction of the change in the base from the projected deficit, as the issue is typically presented in the textbook discussion of the subject. There are a large

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number of other components in the relationship, some of which have been and can be quite important in at least short run financing developments. I shall first try to identify what is in the various groupings which I have developed and then discuss how they have affected recent financing and speculate on some future developments.

The first category is an approximation to the volume of funds raised by the Treasury in credit markets from private sources. It is the total amount of Treasury and Agency debt issued outside of the Treasury less the change in debt holdings by the Federal Reserve and Foreign official institutions. The latter is not quite accurate, as it excludes changes in holdings of agency debt by such institutions, since I have been unable to find any published source in which this information is tabulated separately. It is also possible that since this is an attempt to measure on a net basis, changes in acceptances held by the Federal Reserve System (which now appear in category VII) should be subtracted from this grouping.

The second, third and fourth categories are self explanatory. The fifth, which involves foreign transactions probably needs some explanation, particularly with respect to the treatment of "swaps." When the Fed engages in "swap" operations, the two accounts which are involved are the other assets of the Federal Reserve System (denominated in foreign currencies) and foreign deposits at the Federal Reserve. For example, when the Fed obtains foreign currencies in a "swap" operation, it increases both other assets and foreign deposits.[1] Thus, category V is unaffected by foreign currency swap operations.

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[1]See Federal Reserve Bank of New York, Glossary: Weekly Federal Reserve Statements, p. 18.

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Categories VI and VII are also fairly clear. Category VIII warrents some explanation, since a number of the items are not familiar, and the definitions are not easily available. First, other cash and monetary assets of the Treasury includes Treasury Cash and the Gold Balance as sub items. Thus, VII essentially includes net cash and monetary assets of the Treasury which involves basically time deposits, some cash items in process of collection, and some miscellaneous transit items. The other two categories which are difficult to identify are Miscellaneous Treasury Liabilities and Miscellaneous Treasury Assets. Much of what is included in these entries is of the nature of float.[2] However, there are two important exceptions which arise out of the pecularities of the book valuation of Treasury securities.

The book valuation of all government securities is at par, not at issue price. Hence, the discrepancy between the book value of the debt issue (changes in which are indicated under I above), and the actual revenue raised from a debt sale has to be accounted for somehow. This is handled in the miscellaneous asset and liability accounts. If debt is sold at a discount (as for example with a Treasury Bill auction, then the outstanding value of the debt is increased by the par value of the bills on the books of the Treasury, and the discount is entered as a miscellaneous asset account entitled "deferred interest (discount) on marketable United States Treasury securities." On the other hand, if

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[2]See the Combined Statement of Receipts, Expenditures and Balances of the United States Government.

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a note or bond is issued at a premium, then the par value of the issue is added to the value of the outstanding debt, and a miscellaneous liability item entitled "deferred interest (premium) on public debt subscriptions, United States Treasury" is increased by the amount of the premium. I have been unable to determine if these miscellaneous accounts are left unchanged until the time that the debt issue is retired, or if some schedule is used to allocate the discount or premium into interest paid over the life of the security. Judging from the accounting practices of the Federal Reserve, which also carries its government securities at par value, I suspect that the premium or discount is gradually phased out over the life of the security.[3] In any case, the changes in these categories, particularly the asset item have been substantial at times in the recent past, and their character is such that their behavior should not be the random kind of behavior that can be expected from the float type items which comprise the remainder of the entry.

The final category is that of deposit funds. Deposit funds are defined as:

> combined receipt and outlay accounts established to account for receipts that are either (a) held in suspence temporarily and later refunded or paid into some other fund of the government upon administrative or legal determination as to the proper disposition thereof, or (b) held by the government as a banker or agent for others and paid out at the direction of the depositor. Such funds are not available for paying salaries, expenses, grants, or other outlays of the government.[4]

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[3] See Federal Reserve Bank of New York, Glossary: Weekly Federal Reserve Statements, p. 13, "Other Liabilities and Accrued Dividends."

[4] Combined Statement of Receipts, Expenditures and Balances of the United States Government, 1976, p. 3.

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I have made a preliminary attempt to reconcile the identity which I have derived with the published information in the Flow of Funds data. I am rather pessimistic that the Flow of Funds source will ever prove useful in tracking down the identity. Some of the items just cannot be identified in the Flow of Funds data; some of the published categories combine items from different categories which I have defined (though this is probably surmountable with the use of unpublished data), and most troublesome of all, in places where the categories would seem to match up, the numbers frequently are completely dissimilar (even when looking at the seasonally unadjusted flows in the Flow of Funds accounts). I intend to pursue this investigation somewhat further, but it may prove that to obtain any sort of time series on the various elements of the financing process, the original sources will have to be painstakingly pulled together.

What about forecasting of the impact of the projected deficits on domestic credit markets? One category, the net source base, is close to the monetary base concept which is of major concern to this committee. We can project our desired growth of this aggregate, or we can project our best guess estimate of what actually will occur, given the existing management techniques for monetary policy. A second category which seems to warrent some consideration from the perspective of economic theory is the foreign transaction category, V. I think that this grouping comes pretty close to the concept which is referred to as the balance of payments in the literature on the monetary theory of the balance of payments, though not being an expert in that area, I may be mistaken. In any case I would like some discussion of how forecasts of this component could be developed.

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The remaining items of the identity have large random behavior about which there is very little that economic theory can tell us. It seems to me that these are things for which a pure time series approach to forecasting, such as that of Box-Jenkins is not only highly useful, but also highly appropriate.

II. Some Issues in Recent Government Financing

With the exception of the transition quarter, a common characteristic of the last several years has been the fact that the government has had to go to the private capital markets for considerably less than the total financing which it has required. In part this is due to the rapid growth of the monetary base with which we are all familiar. An additional factor which has made an important contribution is the item which I have entitled changes in Foreign Transaction Balances. In particular, over the last four quarters tabulated in Table 1, over six billion dollars of the deficit has been financed by increases in this item. For the most part this reflects increases in Foreign Official holdings of U.S. Government securities. In the two prior fiscal years, foreign official holdings of U.S. Government securities increased by four billion dollars. Thus, the recent rate of increase reflects a doubling of the rate of acquisition. I suspect that these may reflect changes in holding by the Germans and Japanese for the most part, but I have to confess that I have not tracked things down, and I shall defer to other expertise in this area. The one thing which seems clear is that there is considerable management of the float going on, and if anything it has increased substantially in recent months.

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What impact on the private capital markets can be expected in the coming fiscal year? The present official projections of the fiscal 1978 budget deficit are in the neighborhood of 60 billion dollars. In addition, something has to be added for off budget agencies. The major contributors to the off budget deficit are the postal service and the Federal Financing Bank. In the recent past, the deficit in this category has been reduced somewhat because of unexpectedly favorable experience on the part of the postal service. Judging from recent pronouncements, and the political opposition to cost cutting innovations such as the abolition of Saturday delivery and the consolidation of rural postal facilities, the recent experience cannot be extrapolated into the future. Therefore, it is likely that something of the order of 10 billion should be added for required off budget financing. If we scale down the official budget deficit estimates somewhat to account for the positive serial correlation of the OMB forecasting errors in the recent past (the so called budget underruns), then it seems appropriate to conclude that something approaching, but probably not exceeding 70 billion dollars of financing will be required over the next fiscal year.

The net source base amounted to about 120.6 billion dollars (seasonally unadjusted) at the end of June, 1977. If we assume a growth rate of the order of six percent per annum for the next fifteen months (on the assumption that this is a likely outcome, not a desirable outcome), about seven billion would be financed by increases in the base (given growth in the money stock over the last two months, this might be regarded as

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too high for a likely outcome, although care should be taken to distinguish growth in the monetary base in the last few weeks because of increases in borrowing which does not count in the net source base). If we assume that changes in foreign transaction balance increase at somewhere between the four billion annual rate of 75-76, and the eight billion rate of recent months, and further assume that the net impact of the remaining components is of the order of one billion dollars one way or the other, then the total borrowings which will be required in the private capital markets can be projected at somewhere around 55 to 60 billion dollars.

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APPENDIX

DERIVATION OF THE U.S. GOVERNMENT FINANCING IDENTITY

The basic identity and data for the financing requirement are found in the Monthly Treasury Statement of Receipts and Expenditures, and in the Federal Reserve Bulletin.[1] The first relationship is found in a table entitled "Means of Financing." This equation indicates that the

	Unified Budget Deficit(+) or Surplus (-)
plus	Transactions not applied to the current year's deficit or surplus
equals	Changes in U.S. Government and Agency Securities held by the Public (net of securities held as investments by government accounts)
plus	Change in accrued interest payable on public debt securities
plus	Changes in deposit funds
plus	Changes in miscellaneous liability accounts of the Treasury

[1]Other helpful, though not necessarily complete or accurate tables can be found in the monthly Treasury Bulletin. Additional sources of information of a fiscal year basis are the Annual Report of the Secretary of the Treasury and the Combined Statement of Receipts, Expenditures and Balances of the United States Government. The latter is the most comprehensive, informative, and probably the most accurate.

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less Changes in U.S. Treasury Operating Cash (including balances held at Federal Reserve Banks + Tax and Loan account balances + demand balances held at other depositories)

less Changes in total holdings of SDR's net of changes in SDR certificates issued to Federal Reserve Banks

less Changes in gold tranche drawing rights

less Changes in other cash and monetary assets

less Changes in miscellaneous asset accounts of the Treasury

The second identity is the balance sheet of the Federal Reserve System found in the Consolidated Condition Statement. This identity can be solved for the Treasury Balances with the Federal Reserve System and substituted into the Means of Financing identity. Two additional identities are useful:

(1) Gold Stock = Gold Certificates held by Federal Reserve Banks + Balance of Gold

(2) Treasury Cash = Federal Reserve Notes held in the Treasury + Treasury currency held in the Treasury.

Finally the definition of Transactions not applied to current year's deficit or surplus is required. This is perhaps the most elusive component of the whole problem; as far as I can discover, the only place where the data are regularly published is in the Monthly Treasury Statement. This aggregate consists of:

Deficit(+) or Surplus(-) of Off Budget Agencies (including the Federal Financing Bank in recent years)

plus Seigniorage

plus Increment on gold

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plus Net gain/loss from U.S. currency valuation adjustment

plus Net gain/loss from IMF loan valuation adjustment (starting fiscal 77)

plus Change in interest receipts on government accounts to accrual.

Manipulation of these identities gives the nine categories listed in Table 1, where the components of each category are as follows:

I. Borrowing from Private Capital Markets
- Ia. (+) Borrowing From the Public
- Ib. (-) Changes in Federal Reserve Holdings of U.S. Government Securities
- Ic. (-) Changes in Federal Reserve Holdings of Agency Issues
- Id. (-) Changes in U.S. Government Securities Held by Foreign Official Institutions (from Table 3.13, Federal Reserve Bulletin. Foreign official holdings of agency issues are not published separately)

II. Change in Net Source Base
- IIa. (+) Change in Member Bank Deposits at Federal Reserve Banks
- IIb. (+) Change in Currency in Circulation
- IIc. (-) Change in Member Bank Borrowings From the Federal Reserve

III. Change in Federal Reserve Float
- IIIa. (+) Change in Deferred Availability Cash Items
- IIIb. (-) Change in Cash Items in Process of Collection

IV. Change in U.S. Treasury Cash Balances
- IVa. (+) Change in Tax and Loan Account Balances
- IVb. (+) Change in Balances at Other Depositories (demand)

V. Change in Foreign Transaction Balances
- Va. (+) Change in Foreign Deposits at the Federal Reserve System
- Vb. (-) Change in Other Federal Reserve Assets Denominated in Foreign Currencies (swaps)
- Vc. (+) Change in U.S. Government Securities Held by Foreign Official Institutions
- Vd. (-) Change in the U.S. Gold Stock
- Ve. (-) Change in SDR Holdings
- Vf. (-) Change in Gold Tranche Drawing Rights
- Vg. (-) Change in Loans to I.M.F. (fiscal 1977 only)

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VI. Change in Interest Accruals
- VIa. (+) Change in Accrued Interest Payable on U.S. Government Securities
- VIb. (-) Conversion of Interest Receipts on Government Accounts to Accrual

VII. Change in Excess of Miscellaneous F.R. Liabilities Over Misc. Assets
- VIIa. (+) Change in Other Deposits at Federal Reserve Banks
- VIIb. (+) Change in Other Liabilities of Federal Reserve
- VIIc. (+) Change in Federal Reserve Capital Accounts
- VIId. (-) Change in Other Federal Reserve Loans
- VIIe. (-) Change in Acceptances Held by Federal Reserve Banks
- VIIf. (-) Change in Bank Premises and Operating Equipment
- VIIg. (-) Change in Other Federal Reserve Assets (excluding those denominated in foreign currencies (swaps))

VIII. Change in Miscellaneous Treasury Accounts
- VIIIa. (+) Change in Treasury Cash
- VIIIb. (+) Change in Balance of Gold
- VIIIc. (+) Change in Misc. Treasury Liability Accounts
- VIIId. (-) Change in Other Cash and Monetary Assets of the Treasury
- VIIIe. (-) Change in Misc. Treasury Asset Accounts
- VIIIf. (-) Seigniorage
- VIIIg. (-) Increment on Gold
- VIIIh. (-) Net Gain of Loss From U.S. Currency Valuation Adjustment
- VIIIi. (-) Net Gain or Loss From IMF Loan Valuation Adjustment
- VIIIj. (-) Change in Treasury Currency Outstanding

IX. Change in Deposit Funds
- IXa. (+) Change in Allocations of SDR's
- IXb. (+) Change in Other Deposit Fund Balances

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TABLE I

FISCAL YEARS

			1	2	3	4	5	6	7
			1974	1975	1976	TQ 1976	76 IV	77 I	77 II
1		UNIFIED BUDGET DEFICIT (+) OR SURPLUS	3960	43604	65605	12700	22785	18692	-8620
2	PLUS	OFF BUDGET AGENCY DEFICIT (+) OR SURPLUS	2675	9546	8016	2005	-415	4269	-106
3									
4	EQUALS	TOTAL FINANCING REQUIRED	6135	53150	73621	14705	22370	22961	-8724
5									
6		SOURCES OF FINANCING							
7									
8	I (+)	BORROWING FROM PRIVATE CAPITAL MARKETS	-2146	40422	67069	14813	15011	16495	-11269 [a]
9									
10	II (+)	CHANGE IN NOT SOURCE BASE	9890	5897	9413	-577	3403	2076	-305
11									
12	III (+)	CHANGE IN F.R. FLOAT	-249	506	-1786	580	394	-685	48
13									
14	IV (-)	CHANGE IN U.S. TREASURY CASH	-2298	-4424	1045	1258	-2842	597	-811
15									
16	V (+)	CHANGE IN FOREIGN TRANSACTION BALANCES	-3863	2805	2646	651	1325	2161	2475 [a]
17									
18	VI (+)	CHANGE IN INTEREST ACCRUALS	46	399	915	144	1201	-647	477
19									
20	VII (+)	CHANGE IN MISC. F.R. ACCTS.	214	-2202	-85	433	178	595	-138
21									
22	VIII (+)	CHANGE IN MISC TREASURY ACCTS	-35	319	-1884	-319	-2642	3582	-557
23									
24	IX (+)	CHANGE IN DEPOSIT FUNDS	-17	574	-1024	34	657	-33	-262

[a] PRELIMINARY - BASED ON TWO MONTHS DATA ON FOREIGN OFFICIAL DEBT HOLDINGS.

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September 16, 1977

Briefing for the Shadow Open Market Committee

September 19, 1977

by Wilson E. Schmidt*

There has been a great deal of excitement over our international transactions in the last six months.

There has been fear that our excess of imports over exports could not last, that it has caused or would cause a depreciation of the dollar which leads to inflation, that it causes unemployment, and that it stimulates protectionist pressure in the United States. There has been continued pressure on the part of the U.S. Government to stimulate the two other supposed locomotives of the world economy, Germany and Japan. And there has been concern about the repayment of our credits to foreigners and our ability to repay our debts.

Actually, very little of importance happened that is worth noting, with one exception.

The exception is that the International Monetary Fund in April backed off its notion of norms or zones for exchange rates for the purpose of guiding countries' exchange rate intervention over four-year periods with its implicit danger of fixing rates. Instead the new rules continue to call for intervention to prevent disorderly markets, though, as Dr. Burns has indicated, no two men can agree on what such conditions are (a view expressed in my September 1975 SOMC paper), so this is hardly a meaningful guideline but few would interpret it to be the equivalent of target zones. The new rules also call upon the members to avoid manipulating exchange rates to prevent

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effective balance of payments adjustment or to gain an unfair advantage. Again it is hard to know what this means and the Fund has said "difficult judgments will have to be made." In any event, zoning is gone.

The amount of intervention chiefly by the G-10 countries in the six months ending in July hit a record high of $7 billion per month against an average of about $4 billion since the float began. But the data do not reveal how much of this was sustained, unidirectional intervention, as against mere diddling with the rates. U.S. intervention fell from $3.2 billion in the six months ending January 1977 to $1.5 billion through August 1977, though these are crude estimates. Much more persuasive and heartening is the rise in the proportion of world trade by countries whose currencies are not maintained within relatively narrow margins in terms of any currency, group of currencies, or composite of currencies. On the basis of 1975 world imports, the proportion has risen from 43% at the end of 1975 to 52% at the end of 1976 and now to about 55%. (This figure understates the amount of trade subject to floating; all imports by countries that fix on something from countries that fix on nothing, so that the imports are subject in fact to floating, are excluded from the numerator, e.g., imports by Germany, Belgium, and the Netherlands from the U.S.).

Most attention has been given to our excess of imports over exports of $15 billion during the first half of the year. The Secretary of the Treasury reportedly has projected this to reach $25 billion or maybe a bit more for the year. Little attention has been given the inflows of capital and other transactions that must offset it under the floating exchange rate system.

During the first half of the year, the growth in foreign official assets in the U.S. was $11.4 billion, covering three-quarters of the

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trade balance. About $9.7 billion was placed in U.S. Government securities, equal to almost half of the increase in Federal debt outstanding, thereby easing the Treasury's need to finance the budget deficit from the private sector or the Fed. It is difficult to tell how much of this constitutes direct intervention in the foreign exchange markets. Not an insubstantial part of the growth in foreign official assets must be attributed to interest income on those assets - if one assumes a 6% yield, $3 billion over the first half of the year, leaving $8.4 billion to be explained otherwise during the first half of the year. In 1976, the OPEC countries accounted for somewhat more than half of the increase in our liquid foreign official liabilities. This held true for the first quarter of 1977 also. But in the second quarter, their share fell to under 15% and the portion attributable to industrial countries rose to over three-quarters. While there are no data, this sharp shift probably reflects the efforts of the UK Italy, and France to increase their gross international reserves by intervention in the foreign exchange market, buying dollars and thus preventing a depreciation of the dollar.

The trade figures have exhilarated some people, especially some in the Department of Commerce which has programs to stimulate exports that are under attack. The Department is now even talking about a basic deficit. One high Commerce official is quoted as stating that it will take us a decade to get back into equilibrium, as if equality of exports and imports implies equilibrium. It is hard to justify costly export promotion schemes when we finance a large part of our imports with loans at zero real rates of interest, that is after allowing for the effect of U.S. inflation on the nominal returns in dollars to foreigners.

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On the other hand, the trade balance has depressed others. One distinguished economist worries that we will not be able to repay our external debts. But since our interest payments to foreigners slightly more than offset our interest income from foreigners, it is hard to see that the United States is anywhere near the parlous condition of the weakest LDCs when the average LDC has a ratio of debt service to exports of 16%.

Others believe that the trade deficit has depressed the dollar which in turn causes inflation. Without accepting the proposition that depreciation of the dollar leads to inflation, we need only note that the average value of the dollar in terms of 46 main trading countries fell by six tenths of one per cent from the beginning of the year through the end of July. What seems to have caught the public's eye is the substantial appreciation of the mark and the yen, but of course those two currencies are not the whole story.

Still others are concerned with the growth of protectionist sentiment at home because of the trade balance. Labor in particular has been pressing for protection. But such efforts are likely to lead to little for labor as a whole. Though the estimates are dated, the amount of labor contained in a million dollars of our exports is just about the same as the amount of labor contained in a million dollars of U.S. production that competes with imports. The imposition of import restrictions might help labor in the protected industry but the consequent reduction in imports will lead to an appreciation of the dollar which will deter our exports by a similar amount, hurting labor in the export industries.

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Finally, there are those who complain that the trade imbalance destroys jobs and slows the growth of GNP. It is doubtful that this fear is well founded. The evidence suggests that changes in money are more important and more lasting by far than changes in the federal budget (and thus, by inference, more important than changes in the trade balance) in determining the level of aggregate demand. Since our international transactions cannot affect the stock of money and the monetary base because we are floating, the relationship between our trade balance and the state of employment is very weak and short-lived.

In another unimportant development, the Administration continues to push its locomotive theory, pressing the surplus countries, such as Germany and Japan to expand domestic demand. A 1% increase in the combined GNP of Germany and Japan would cause the rest of the world's output to rise by only $\frac{12}{100}$ of 1% with fixed exchange rates. With floating, the impact will be even smaller.

The next Administration push will be to obtain congressional support for the Witteween facility, a fund of approximately $10 billion to be loaned in almost equal shares to the International Monetary Fund by the industrial and the OPEC countries. The issue here is adjustment versus financing of deficits. The loans under the new facility to countries in balance of payments difficulty will be of longer maturity (up to seven years) than the normal Fund loans (up to five years). By and large, the world has sought to meet the challenge of the OPEC surpluses by borrowing to cover them rather than simply letting the oil producers hold and invest the currencies they have gained. The longer adjustment is delayed, the harder it is to achieve. The new facility on this test appears to be a continued step in the wrong direction.

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The Dilemma of Inflationary Policies

Karl Brunner

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Position paper prepared for the 9th meeting of the

Shadow Open Market Committee

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I. The Re-Emergence of an Old Problem

Inflation dominated over recent years official attitude and pronouncements of the Federal Reserve Authorities. This attitude was expressed by the Federal Reserve's management of new procedures developed under House Concurrent Resolution 133. The Resolution addresses the Federal Reserve Authorities to pursue a policy of monetary control conducive to longer-range stability of the price-level For two and a half years the Federal Reserve announced in quarterly Hearings before Senate or House a target range guiding monetary growth. The average money stock observed in the quarter preceding the Hearings was usually introduced as the basis of the targeted monetary growth. Monetary policy was thus formulated in terms of a target range containing the acceptable paths of the money stock.

Changes in the target range apparently reflect under the circumstances modifications in the course of policy. They seem to signal the general trend in monetary affairs to be expected over the near future. The information collected in Table 1 presents the official signals conveyed to the public since the middle of 1975. The target range guiding growth paths for M_1 and M_2 drifted generally lower. The upper boundary for M_1 was lowered from 7.5% to 6.5% and from 10.5% to 9.5% for M_2. The lower boundary of the range for M_1 was lowered from 5.0% to 4.5% and from 8.5% to 7% for M_2. At one single occurrence (in November 1976) the Federal Reserve raised the upper boundary on M_2. They simultaneously lowered, however, the upper boundary placed on M_1. The official actions can also be described by the changes in

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the mean growth between the upper and lower boundary. The mean path for M_1 was lowered over the past two years from 6.25% to 5.5% and from 9.5% to 8.25% for M_2.

The trend summarized in Table 1 apparently nudges the inherited rate of inflation to lower levels. We seem to be assured a persistent decline in the magnitude of inflation over the period 1977-79. The Shadow Open Market Committee noted this pattern in previous sessions. It also approved the generally modest rate of monetary growth maintained in the average over a 12 month period. It expressed, however, some concern about the violatile behavior of monetary growth observed within one year. It also warned that the Federal Reserve's internal procedures were ill suited to execute an effective monetary control. The traditional mode of implementing policy would remain, in the Shadow Committee's view, an uncertain and unreliable instrument for the purposes defined by House Concurrent Resolution 133. The Committee emphasized, moreover, the potential drift built into monetary growth as a result of the peculiar targeting techniques evolved by the Federal Reserve Authorities.

Table I: The Target Range on Growth Rates for M_1 and M_2

12-MONTH GROWTH RANGE TARGETS: M1

Congressional Hearing Date	Base Quarter Of the Forecast	Targeted M1 Growth Range For Next 12 Months Range	Average
5/77	Q1 77	4.5 to 6.5%	5.50%
2/77	Q4 76	4.5 to 6.5%	5.50%
11/76	Q3 76	4.5 to 6.5%	5.50%
7/76	Q2 76	4.5 to 7.0%	5.75%
5/76	Q1 76	4.5 to 7.0%	5.75%
2/76	Q4 75	4.5 to 7.5%	6.00%
11/76	Q3 75	5.0 to 7.5%	6.25%
7/75	Q2 75	5.0 to 7.5%	6.25%
5/75	3/75	5.0 to 7.5%	6.25%

12-MONTH GROWTH RANGE TARGETS: M2

Congressional Hearing Date	Base Quarter Of the Forecast	Targeted M2 Growth Range For Next 12 Months Range	Average
5/77	Q1 77	7.0 to 9.5%	8.25%
2/77	Q4 76	7.0 to 10.0%	8.50%
11/76	Q3 76	7.5 to 10.0%	8.75%
7/76	Q2 76	7.5 to 9.5%	8.50%
5/76	Q1 76	7.5 to 10.0%	8.75%
2/76	Q4 75	7.5 to 10.0%	8.75%
11/75	Q3 75	7.5 to 10.5%	9.00%
7/75	Q2 76	8.5 to 10.5%	9.50%
5/75	3/75	8.5 to 10.5%	9.50%

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The potential dangers posed by the Federal Reserve's institutional inheritance emerged this year with a sharper focus. We also possess at this stage a sufficient segment of observation in order to assess the basic trend in our monetary affairs. Table II summarizes the relevant information bearing on our problem. The crucial aspect deserving our attention is the remarkable acceleration in M_1 and M_2 maintained since the second half of 1974. The growth rate of M_1 more than doubled and the growth rate of M_2 increased by almost 70% over the past three years. Monetary growth rates computed between corresponding months in successive years, between average values of successive two-quarter periods or between shifting two-quarter intervals reveal the same basic pattern. We observe over two and a half years a positive drift persistently raising monetary growth.

Table II: Accelerations and Decelerations in M_1 and M_2

M_1 Period	% Growth	M_2 Period	% Growth
QI:72 to QII:73	8.0	QI:72 to QII:73	10.1
QII:73 to QII:74	5.7	QII:73 to QII:74	8.7
QII:74 to QI:75	3.1	QII:74 to QI:75	6.3
QI:75 to QI:76	4.8	QI:75 to QI:76	9.4
QI:76 to QII:77	6.5	QI:76 to QII:77	10.7

An inspection of the data so far available for the current calendar year confirms this pattern. Monetary growth in the second quarter exceeded substantially the upper target boundary even without the pressures to finance a tax rebate. There also exist indications of continued excessive monetary growth during the third quarter.

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Moreover, the week ending with August 17, 1977, shows a money stock 7.1% above the value in the corresponding week in 1976. We also note that monetary growth over successively shorter intervals all ending with the central week in August exhibit an accelerating pattern. An increasing growth exceeding the upper target boundary dominates the observations accruing since our last meeting in March 1977. The data in Table III effectively summarize the problem in a similar vein the growth rate of M_2 exceeded in recent months the upper target boundary for the respective magnitude.

Table III: Annual Growth Rate of M_1 Over Different Periods in 1977

	COMPOUNDED ANNUAL RATES OF CHANGE, AVERAGE OF FOUR WEEKS ENDING:							
	8/18/76	11/17/76	1/19/77	2/16/77	3/16/77	4/20/77	5/18/77	6/15/77
TO THE AVERAGE OF FOUR WEEKS ENDING:								
1/19/77	6.5							
2/16/77	5.0	3.7						
3/16/77	4.9	3.8	0.4					
4/20/77	6.1	6.0	5.4	9.6				
5/18/77	6.5	6.5	6.4	9.5	11.9			
6/15/77	6.0	5.8	5.4	7.5	8.5	5.2		
7/20/77	6.8	7.0	7.1	9.0	10.1	8.7	8.4	
8/17/77	7.1	7.3	7.4	9.2	10.1	9.0	8.9	12.5

II. The Fragile State of Anti-Inflationary Policies

In 1963/64 Allan Meltzer and I concluded in a study on Federal Reserve Policy-Making prepared for the House Committee on Banking and Currency that the negative association between actual monetary management and professed policies reflected the central problem of Federal Reserve policy-making. This negative association was produced in past decades by a systematic misinterpretation of monetary actions and the prevailing monetary state. The underlying conception about the

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monetary process governing the Reserve institution's approach for over fifty years unavoidly determined the misinterpretations of events observed during the 1930's, the 1950's, and into the 1960's.

This systematic misinterpretation seems barely the appropriate explanation of the current developments described in the previous section. The discrepancy between announced policy and actual monetary growth is probably attributable to the operation of internal implementation procedures well adjusted to the old conception prevailing until the middle 1960's centered on free reserves and money market conditions. The disposition to failure built into the traditional implementation is occasionally activated by an institutional inheritance stressing interest rate policies and emphasizing orderly money markets. This inheritance is re-enforced by regular Congressional pressure insisting that the Federal Reserve apply its resources to maintain interest rates at a low level. Lastly, we also note that the targeting technique actually practiced by the Federal Reserve Authorities offers supplementary opportunities for the built-in disposition of failure.

Our recent experience thus reveals that the execution of effective monetary control designed to lower the rate of inflation requires attention to institutional implementation beyond broad announcements. It also involves a continuous political struggle with the inflationists to Congress and the Administration. It is unfortunate in this context that the advocates of inflationary policies rarely acknowledge this implication of their proposals. The inflationary consequences are usually hidden beyond a package of worthy intentions directed towards lower interest rates, lower unemployment, or larger government

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expenditures. And once inflation emerges as a result of such endeavors, aggravated by even higher interest rates and barely lowered unemployment, there always will exist opportunities (and $ incentives) to direct public attention away from the relevant causes of the new inflationary burst. The interaction between media and political process tends to spin a web of deceit and ignorance covering the nature of the ongoing inflation. It follows that a persistent pattern of anti-inflationary policies may have a comparatively low political survival value. It certainly requires substantial courage and determination by the policy-makers involved in monetary affairs.

III. The Dilemma of Monetary Policy

What are the implications of recent monetary trends? We suppose for this purpose that monetary growth (M_1) proceeds into 1978 at an annual rate of about 7%. At this rate the underlying "permanent" inflation rate will measure around 6% p.a. The actual rate of inflation will be higher, however. The acceleration of monetary growth will raise longer-run inflationary anticipations. I expect that this revision of inflationary anticipations would add (temporarily) one to one and a half percentage points to the permanent inflation rate. The actual inflation rate observed in 1978 would thus contain a temporary acceleration component. This component raises the rate of inflation observed next year under the circumstances to about 7% - 7.5%. My estimate of the growth rate of nominal GNP for 1978 under the

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same circumstances is around 10.5% p.a. The growth rate in real GNP would therefore subside in the context of the recent monetary growth path to about 3% - 3.5%.

This estimated trend forms the basis for two alternative scenarios of monetary policy. The first scenario involves a reversal of the pattern emerging in the recent past. It would lead the Federal Reserve back to a determined anti-inflationary course. Suppose that this is expressed by a monetary growth of about 4.5% for 1978, i.e., a monetary growth along the lower boundary of the last announced target range. The growth in nominal GNP along this monetary path would be (at the most) about 8.0% and will probably be 7% - 7.5%. But the permanent inflation rate in 1978 remains in the range between 5% and 6% as a result of the past monetary acceleration. Moreover, revisions of inflationary anticipations may still be more affected by the recent acceleration and the persistent uncertainties imposed by the Carter Administration. The actual rate of inflation would probably stay above 6% under the circumstances. It follows that real growth subsides to a figure below 2%. A substantial retardation in economic activity with probably even a minor decline for about one quarter seems unavoidable in the context of this scenario. The reversal in policy to an anti-inflationary stance should thus be expected to produce a mini-recession and a corresponding increase in the rate of unemployment.

The second scenario describes a very different policy. It assumes an essentially accommodating behavior on the part of the Federal Reserve

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Authorities. Such behavior would be designed to appease Congressional pressures directed at interest rates and unemployment. It would also appease the inflationist groups within the Carter Administration. An accommodating policy could barely settle along a monetary growth path of 7% discussed above. Even along this path real growth subsides and the unemployment rate remains above 6%. Th second scenario thus foresees an acceleration in monetary growth beyond 7% to, say, 8.5%. The permanent inflation rate increases to 7% - 7.5% and the actual rate bulges along an accommodating monetary path temporarily to a range around 8% - 8.5%. The rate of real growth would thus be confined to a range of about 4% - 4.5%. An accommodating policy may thus be expected to raise somewhat the level of real growth. But inflation would definitely accelerate with corresponding increases over the whole range of interest rates.

Accommodation could, of course, continue beyond 1978. The effect on real growth rapidly declines, however, and the spillover of nominal expansion raising inflation probably increases. Inflation approaches on this course in 1979 a threshold of double digit figures. With Presidential elections less than two years away, the probability of "forceful financial leadership" increases again. At some stage accommodation will end and new efforts will be made to cope with the recent burst of inflation. The ensuing reversal in monetary policy unleashes a substantial retardation of economic activity. This retardation would probably lower output over several quarters and also raise at least one year the rate of unemployment.

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The tacit abandonment of anti-inflationary policies by Congress, the Carter Administration, and the Federal Reserve Authorities created an unfortunate but unavoidable dilemma for monetary policy. Our relevant choice is between a reversal in policy now or a reversal at a later stage. A reversal now brings forth a mini-recession in 1978 at an inflation rate of 6% - 6.5% and lower inflation rates beyond 1978. The delay of the reversal means that we eventually reap a larger recession in activity at a substantially higher rate of inflation requiring a much longer time period to tame inflation.

The ongoing debate about the proper course of financial policies offers an alternative formulation of the relevant options. It is frequently argued that the social costs associated with an anti-inflationary policy are too large. A wiser course involving a comparatively negligible social cost, it is suggested, accepts the prevalent inflation and accommodates monetary policy correspondingly. The social cost of an anti-inflationary monetary policy is well established. The assessment of the first scenario fully acknowledges this fact. The issue between the two options does not center on this acknowledgement but on the proper recognition of the social costs associated with a course of permanent and accommodating inflation. The advocates of permanent inflation argue that the social cost of this second option is quite negligible, essentially associated with the lower level of real money balances resulting from higher anticipated inflation. The argument advanced implicitly assumes that an accommodating policy of permanent

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inflation can be reasonably expected to follow a stable path. This assumption seems essentially naive and seriously faulty. It fails to appreciate the political context of financial policy-making. This context produces two sets of events which raise the social cost associated with a policy of permanent inflation to substantial levels.

The first set of conditions refers to the increasing likelihood of an erratic and unstable inflation. An accommodating policy of persistent inflation introduces pervasive incentives into the social system to explore opportunities for accelerating wage and price setting as a means of competitive wealth transfers in the expectation that the emerging price-wage policies will be validated (in the average) by an accommodating policy. Such explorations in price-wage policies tend to exploit the political process to generate an appropriate accommodating stance in financial policies. It follows under the circumstances that a permanent policy of accommodating inflation will experience repeated waves of increased inflation. We also observe, moreover, that every major acceleration in price movements introduces new political opportunities and raises political rewards for the supply of "leadership in the fight against inflation". This pattern has been observed in many countries all over the world on repeated occasions. The resulting shifts in financial policies unleash the unavoidable retardation of economic activity expressed by a decline in output and rising unemployment. A policy of permanent inflation very likely produces, therefore, sequences of substantially accelerated price movements intermittently interrupted by declines in output and higher

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unemployment. An accommodating inflation policy may thus easily produce two or three recessions, combined with continued inflation, over a ten-year span. The current value of the costs determined by the future series of recessions forms a first component in the relevant social cost of permanent inflation.

The first set of conditions still yields another cost component in our tabulation. The increasing uncertainty bearing on the course of financial policies over the next two or three years affects the price-wage contracting on labor and output markets in a manner probably raising the natural level of unemployment. The current value of the future stream of social costs associated with a higher natural level of unemployment forms the second strand in the total social cost to be considered.

The second set of conditions fostered by a policy of accommodating permanent inflation determines two more cost components. The experiences of many countries indicate the rising probability of price-wage controls, or controls over interest rates, as inflation accelerates. Such controls occur in a variety of shifting forms. They usually affect the quality and volume of output and longer-range investment programs. They lower incentives to produce and dampen the willingness to expand productive facilities. The magnitude of these effects depends on the particular controls and their mode of administration. Controls and political institutions replacing market mechanisms also raise the level of uncertainty bearing on the crucial rules of the game confronting agents in the private sector. Obscure rules with shifting interpretations

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and frequent changes in rules affecting a broad range of a firm's activities emerge from the operation of political institutions' "controlling" wages, prices, and interest rates. The combined effect operating via incentives and uncertainty lowers the level of normal output for given levels of inputs, raises the natural level of unemployment, and lowers the real rate of growth associated with any level of output. The current value of future reductions in normal output and of lowered growth in real output form the third and fourth component of the total social cost associated with an accommodating policy of permanent inflation. The social cost of persistent inflation involves thus substantially more than some "negligible esoteric consideration" based on economizing responses in the use of money induced by higher anticipated rates of inflation. At least one of the four components of the total cost resulting from an inflationary policy is of the same nature as the social cost of an anti-inflationary policy. It expresses the welfare loss associated with temporarily lower output. A crucial difference between a determined anti-inflationary policy and its inflationist alternative should be noted in this context. A single, once and for all and temporary loss occurs in the case of anti-inflationary policy. The alternative unleashes a series of repeated losses due to the inherent instability of inflationist policies. The comparative advantage of an anti-inflationary program increases with the inclusion of the three additional cost components associated with inflationist policies. A determined effort to remove inflation over the next four years will certainly involve

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some costs to our society. But I submit as my considered judgment that the social cost of an inflationist course in our financial policies substantially exceeds the cost of an anti-inflationary monetary policy.

IV. The Recommendation

Three times within the past ten years, the Federal Reserve Authorities abandoned opportunities to curb inflation. The mini-recession of 1966/67 rapidly retarded the price movements set in train in 1965. A stable course of moderate policies in 1967/68 would have brought the U.S. economy back to a stable price level. This opportunity was lost in a pronounced shift towards an expansionary policy in early 1967. This policy resulted to a major extent from intentions to moderate the incipient increase in interest rates. Thus emerged the inflationary burst observed in 1968/69.

The shallow recession of 1970 broke the momentum of price movements. This opportunity was not exploited by the Federal Reserve Authorities. A continuous acceleration of monetary growth from early 1970 to the middle of 1971 contributed to maintain the inherited rate of inflation. An anti-inflationary course was initiated by the Federal Reserve Authorities with President Nixon's "New Economic Policies" and again abandoned in the spring of 1972. The consequences became visible several months before the Opec-Eclat in the fall of 1973.

And now looms a fourth opportunity lost. Monetary growth drifted increasingly towards the wrong track. We inherited thus a situation which precludes an easy and comfortable solution. All our options

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involve more or less unpleasant consequences. The Shadow Committee should certainly urge that the Federal Reserve Authorities return to a moderate growth path along the lines suggested in our previous recommendations. These recommendations were determined by our objective to restore over several years a stable price level. The return to our original growth path may be executed in two distinct modes. In one case the Federal Reserve Authorities follows a growth path of 4.5% until the end of 1978 based on the observed average for the third quarter of 1977. In the other case the Federal Reserve Authorities moves the money stock until the first quarter 1978 back to the growth path implicit in the Shadow Committee's proposal made in March 1977 and proceeds subsequently along this growth path. I submit at this stage without further discussion the first mode to the Shadow Committee's attention. The Committee's attention should also be directed, once more (remember Cato's Ceterum censco...), in view of recent developments, to the proper implementation of an effective monetary control.

The social cost of the recommendation is immediately visible. But the public should recognize the larger cost of a permanent drift into inflation. The cost of the Latin-Americanization of the U.S. economy is substantial indeed. This cost is distributed over the future, however, and policy-making appears to operate with a pronounced myopic bias. The disregard of future costs will not exorcise them and most of us would still experience the unfortunate consequences of an inflationist policy. The U.S. economy and our welfare would be better

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served with a determined program initiated now and maintained over four years to lower monetary growth to a level compatible with a stable price level. This was, at some occasion, the intention of House Concurrent Resolution 133.

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