SHADOW OPEN MARKET COMMITTEE

Policy Statement and
Position Papers

March 24-25, 1985

PPS-85-1

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1. Shadow Open Market Committee Members - March 1985
2. SOMC Policy Statement, March 25, 1985
3. Position papers prepared for the March 1985 meeting:

   Confusion of Language and the Politics of Uncertainty, Karl
      Brunner, University of Rochester

   Guidelines for Deficit Policy, Mickey D. Levy, Fidelity Bank

   Economic Outlook, Jerry L. Jordan, First Interstate Bancorp

   Forecasts of the M1 - Adjusted Monetary Base Multiplier for 1985,
      Robert H. Rasche, Michigan State University

   International Trade Policy: The Two Main Tasks, Jan Tumlir, GATT,
      Switzerland

Shadow Open Market Committee

The Committee met from 2:00 p.m. to 7:30 p.m. on Sunday, March 2, 1985.

Members of SOMC:

PROFESSOR KARL BRUNNER, Director of the Center for Research in Government Policy and Business, Graduate School of Management, University of Rochester, Rochester, New York.

PROFESSOR ALLAN H. MELTZER, Graduate School of Industrial Administration, Carnegie-Mellon University, Pittsburgh, Pennsylvania.

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*On leave from the SOMC, currently Under Secretary of the Treasury for Monetary Affairs.

POLICY STATEMENT

Shadow Open Market Committee Meeting
March 25, 1985

Economic recovery continues despite the absence of coherent economic policies. The Federal Reserve concentrates on short-term policy decisions and lurches from excessive money growth to slow money growth and back to excessive money growth, with no long-term program to achieve non-inflationary money growth. It is disappointing that the Administrtion projects essentially no change in the inflation rate in the rest of the decade. The Congress concentrates on short-term budgetary adjustments and avoids developing a long-term fiscal program to maintain growth and increase economic stability. It is counterproductive that the Federal Reserve and members of the Administration favor currency market intervention, since it does not achieve its intended effect and destabilizes the exchange market. These actions increase uncertainty and reduce efficiency. They make private planning more difficult.

During the last five years, the United States has made important progress in improving economic fundamentals -- lower inflation, lower interest rates, increased output and productivity growth. These gains should not be squandered. To maintain and extend these gains, present fiscal and monetary policy uncertainties must be resolved.

Fiscal Policy

The central fiscal issues are the degree to which the government shifts resources toward current consumpiton and away from investment and the way the budget is financed. A rising share of government

spending typically means that the government is shifting resources toward current consumption and away from investment. The result is lower investment and eventually lower output. If higher government spending is financed by increasing money growth, inflation rises. If spending is financed by higher income taxes, the government's spending for consumption crowds out private spending and saving. Investment and future output are reduced.

Excessive attention to the size of the deficit draws attention away from these central issues. Misleading and incorrect statements about the relationship of the budget deficit to the foreign trade deficit misinform the public. There is no simple connection between the current exchange rate and the budget deficit. There is no valid reason for believing that a reduction in the budget deficit will be followed by a fall in the dollar exchange rate. In fact, a reduction in government spending for consumption that shifts resources toward investment and lowers the risk of future inflation may be followed by further appreciation of the dollar against other currrencies. This should not be an excuse for failing to act on the deficit.

The effects of budget policy depend on the details of the fiscal package. All reductions in spending do not have the same effect. Current use of price controls on medical services to reduce expenditures under medicare is a short-term stop-gap that reduces efficiency. It is not a part of, or a substitute for, a long-term fiscal policy to reduce spending. Reduction in defense appropriations often are followed by reductions in manpower that reduce efficiency by reducing the labor available to operate planned or available equipment. Reductions in spending for maintenance of highways and other social capital postpone spending to a later date.

2

Discussion of fiscal policy puts too much emphasis on the size of projected budget deficits and too little emphasis on the efficient use of resources. We urge Congress to support the Administration's proposed spending cuts and indeed enact additional cuts. We propose five principles of budget policy to contribute to growth and stability and reduce uncertainty.

1. Congress should reduce the ratio government spending to total output, initially, at least 2 percent below current levels and thereafter maintain the ratio as part of a long-term fiscal plan.

2. Spending reductions should take precedence over tax increases. These reductions should not be at the expense of public goods such as defense in order to maintain transfer outlays. Both must be reduced.

3. Spending reductions should be made in ways that increase efficiency in the use of resources.

4. Short-run action to reduce the deficit should be consistent with long-term structural reform of spending programs. Postponements masked as reductions should be avoided.

5. Any revenue increases agreed upon as part of a budget compromise should fall on consumption spending. Full indexation of the income tax should be retained. To make a fundamental change in the government's fiscal policy, it is essential to put a cap on total federal spending.

Monetary Policy

The Federal Reserve cannot change the government's fiscal policy. The responsibility of the monetary authorities is to maintain stable monetary conditions consistent with a return to full price stability.

Unfortunately, confusion and uncertainty surround monetary policy. The Federal Reserve announces targets for monetary aggregates and, at the same time, urges more intervention in the exchange market. They seem unaware that, if they achieve their monetary targets, the only

3

effect of exchange rate intervention is to shift the risk of exchange rate changes from private speculators to the Federal Reserve and ultimately, to the taxpayers. Further, the Federal Reserve uses control procedures that increase the variability of money growth. As long as current procedures are used, interest rates, exchange rates and output will vary excessively.

At our last meeting, we praised the Federal Reserve for keeping average money growth near the mid-point of the target range. We urged them to reduce the uncertainty created by erratic money growth and to announce a program to end inflation by the end of the decade.

The Federal Reserve, instead, announced a very modest reduction of 1/2 percent in average money growth for 1985 and increased the short-term variability of money growth. Although they talk about reducing inflation, they have postponed or abandoned any effort to reduce inflation. This is a mistake. There is no better time than the present to adopt a long-term policy to reduce the trend rate of inflation.

A year ago the FOMC set a target for 1984 money growth centered on 6 percent. The Shadow Committee preferred a lower target for 1984 but emphasized the paramount importance of instituting a long-run policy of achieving non-inflationary money growth. Actual M1 growth in 1984 was 5.2 percent, below the center of the Fed's target.

In order to eliminate "base drift" and establish a coherent framework for steady progress towards lower money growth, the SOMC urges the Federal Reserve to increase M1 in 1985 by 5 percent from the mid-point of the original target range for 1985. This policy would result in an increase of 5.75 percent over the four quarters of 1985, or a 5.5 percent average increase for 1984 and 1985 taken together.

4

In the event that money growth in 1985 exceeds this target, as we think highly likely, the target for 1986 would still be based on the target level for year-end 1985, rather than the actual level of fourth quarter 1985.

Chairman Volcker acknowledged to Congress that the present method of announcing monetary targets is unsatisfactory. His statement neglected the two most unsatisfactory aspects -- the uncertainty generated by the use of multiple targets and a shifting base for announced monetary growth.

Eliminating base drift is one component of a long-run monetary policy plan. A second key component is to announce a multi-year projection for expected money growth. The rate of money growth should not shift about haphazardly but should decline regularly. A credible long-term strategy reduces uncertainty, particularly in an era of large budget deficits. Reducing uncertainty lowers interest rates and raises real output.

Many countries announce montary targets or projections. Most announce a single target, and some achieve the target more reliably than the Federal Reserve. The reason is that the Federal Reserve's procedures are archaic and inefficient. The Fed is unjustifiably complacent about the intra-year volatility that results.

The third step in developing a monetary policy to achieve stability and end inflation is to require the Federal Reserve to choose a single monetary target and improved control procedures. We again urge the Congress to require the Federal Reserve to announce a multi-year strategy for reducing inflation.

Exchange Rates

The recent interventions by the Federal Reserve and foreign central banks have been counterproductive, destabilizing exchange markets.

The Federal Reserve cannot simultaneously control the growth rate of money and manage the exchange rate. Proposals for massive intervention or coordinated intervention are misguided. The expected short-term response to slower money growth is a rise in short-term market rates and a rise in the exchange rate. The longer-term effect will be lower market interest rates on short- and long-term assets and no effect on the real exchange rate -- the exchange rate adjusted for differences in anticipated rates of inflation at home and abroad. The only way that the Federal Reserve, or other central banks, can have a lasting effect on the exchange rate is by changing their country's expected rate of inflation. Efforts to change the exchange rate without changing the rate of money growth and the expected rate of inflation fail. This is the finding of every careful study of exchange rate policy.

There are many factors affecting the exchange rates between the dollar and other currencies, but two principal forces are unmistakable. First, the expected rate of inflation inthe United States has fallen relative to other countries, particularly Germany and Japan, during the past four years. Second, the expected after-tax return to capital has increased in the United States both in absolute terms and relative to other countries. This is a real change that cannot be offset by Federal Reserve actions.

Proponents of exchange rate intervention mislead the public. The dollar has risen because holders anticipate a higher return from

6

holding dollar assets than from holding foreign assets. The principal change in U.S. international capital movements in recent years has been a shift by U.S. citizens and financial institutions from investment abroad to investment in the United States. Americans are repatriating their foreign assets to take advantage of the improvement in investment opportunities at home. Foreigners are investing more in the United States for the same reason. As a result, the net capital flow to the United States is high relative to previous periods. The current account deficit is the counterpart of the capital inflow and will remain as long as the capital inflow continues.

Many people view this process as a means of financing the budget deficit. This view is misleading. The flow of capital to the United States is the result of many private decisions to invest in dollar-denominated assets. Unlike the 1960s and 1970s, when foreign central banks supported a weak dollar, U.S. government debt held by foreign central banks has fallen.

We urge the Administration to reject the policy of exchange market intervention. The Administration and Congress should demand that the Federal Reserve ignore exchange market fluctuations and institute a stable policy of controlling money growth to end inflation.

CONFUSION OF LANGUAGE AND THE POLITICS OF UNCERTAINTY

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I. Confusion of Language

Interest rates fell throughout the second half of last year. They dropped by the middle of January 1985 below the level from which they started to rise early in 1984.   The Federal Funds rate fell about 300 basis points and the discount rate was lowered in repeated steps late last year.   So "Wall Street" and the media decided   that monetary policy turned "increasingly easy".   Once again we observe the apparently endless repetition of an old story. The experts of the public arena persist in interpreting the stance of policy in terms of the prevailing movements of interest rates.   Declining interest rates reveal an "easy policy" and rising rates a "tight policy".   These expressions are moreover not just meant to summarize the observed movements of interest rates.   These movements are understood as a signal indicating that monetary policy conveys a stimulative ("easy") or retarding ("tight") effect on economic activity.

This story has a long history. During the first year of the Great Depression in 1930 the Fed assured itself and the public that it had done everything possible to stimulate the economy.   Interest rates, after all, were falling.   There was nothing more to be done. Events had moved beyond the control of the Fed.

Early in the year 1960 the Fed announced a shift toward easier policy.   Free reserves rose and the Federal Funds rate fell. But the apparent stimulus failed to affect the economy.   It still slid into a mild recession.   Naturally, voices were heard claiming that the

9

economy had moved beyond the influence of the Fed. In particular, the money stock declined throughout this period in spite of an "easy policy".

More examples could be collected from old or more recent experiences. But the point requires no further elaboration and we had better examine its basic fallacy. We note first that the Fed exerts in the short-run a very limited influence on market rates of interest. These interest rates are dominated by market forces. The Fed's actions operate on market rates to a large extent via the signal effect these actions convey to the market about the future course of policy. But contrary to widely held beliefs among politicians the Fed cannot persistently lower interest rates with an expansionary policy against prevailing market forces. The longer-run consequences of such a policy have been clearly demonstrated for many years. They produce inflation and correspondingly *high* interest rates adjusted to the ongoing inflation. It follows that *over the longer run* the Fed *can* indeed substantially shape interest rates. It can produce *high* interest rates with *large monetary expansion* and *low* interest rates, as in the early part of the 1960s, with a *credible non-inflationary* policy of *low monetary expansion*. Mr. Volcker understood this fact very clearly and made this point repeatedly during the first years of his stewardship.

The first point made above thus emphasizes that over a *shorter* horizon interest rates cannot be effectively manipulated against market forces and the market's dominant evaluation. And over longer horizons the Fed's influence on the broad contours of interest rate behavior is just the reverse of the belief expressed by many

politicians.   Interest rates provide thus very poor information about the thrust of monetary policy.

A wide range of experience drawn from many different times and countries informs us that economic activity responds to the variations in monetary growth.   In particular, monetary accelerations or unexpected monetary expansions stimulate activity for a few quarters. Monetary decelerations or unanticipated monetary contractions retard on the other hand activity for a short period. We note thus with some interest that the phase of rising interest rates last year was accompanied by a strong monetary acceleration.   The subsequent monetary deceleration was accompanied by a large decline of interest rates. This behavior is not consistent with an explanation attributing the changes in interest rates to a "restrictive policy" in the first half and an "easy policy" in the second half.   This linguistic regulation would otherwise mean that policy is "tight" whenever the Fed _increasingly expands_ the money stock and the supply of credit. It would also mean that policy is "easy" whenever the Fed _lowers_ monetary growth and credit supply.

The change in monetary growth experienced last year is worth noting.   Monetary growth dropped from the first to the second period

Period	M-1	Monetary Base
1/11/84 - 7/11/84	8.1%	10.3%
7/11/84 - 1/ 9/85	3.0%	4.6%

by more than half. We also note that the deceleration of the monetary base was the major cause of the monetary retardation. It seems hardly sensible to describe this shift from the first to the second half of 1984 as a move toward "easier policy".   The monetary retardation and

11

the associated slower supply of bank credit reflected to a large extent the Fed's behavior.

The same pattern prevailed in 1930 and 1960. The fall in interest rates was accompanied throughout 1930 by lowered growth of the monetary base and the money stock. The apparently "easy policy" was actually a policy fostering continued economic contraction. And in 1960 "Wall Street" and the media just concentrated on free reserves and the federal funds rate. They failed to notice the actual behavior of the Fed expressed by the persistent decline of the monetary base. Contrary to an opinion voiced at the time in the media, the money stock did not become uncontrollably disconnected from the Fed's (actual) policy. It effectively reflected this policy imitating the recession.

The annual reports of the Fed for 1949 and 1950 also offer some instructive examples. The report for 1949 advises us that the Fed essentially pursued an "easy policy", but open market operations were dominated by sales. Massive open market purchases in 1950 raising monetary growth and credit supply were represented in the annual report for that year as an expression of a "tighter" policy. The history of the Fed exhibits thus a singular phenomenon. More than 20 years ago Allan H. Meltzer and I emphasized in a detailed study on Federal Reserve Policymaking prepared for Congress that the Fed's rhetoric and actions were negatively correlated. The problem still persists today, but mostly located in the media and "Wall Street".

II. The Creation of Uncertainty as a Matter of Policy

Monetary policy has been riding a roller coaster over the past six years. In 1979 until the fall of that year monetary growth spurted at 10.2%. It dropped to 2.2% from the fall 1979 to the spring of 1980.

12

This slow phase was followed until the spring of 1981 by another go-phase with a growth rate of 10.1%. A slowdown to 5.4% emerged from the spring of 1981 to the late summer of 1982. There appeared at this time a go-go episode until the fall of 1983 with a monetary growth of almost 13%. This rapid acceleration ultimately subsided to a lower growth of 5.6% over most of the winter 83/84 well into 1984.

This behavior of monetary growth reveals the basic problem of the Fed's strategy and tactics. It did manage in the average over the past five years to lower inflation. But the record summarized above conveys the erratic and uncertain sense of our monetary policy. This uncertainty was reenforced by contradictory statements intermittently supplied by various Fed officials. Monetary policy thus appeared more and more as a "random walk through history". The prevaiing uncertainty contributed to the high level of the real rate of interest and most particularly to the remarkable variance of nominal interest rates observed over the past five years. It is noteworthy that the variance of both monetary growth and interest rates increased over this period. Table I shows the large increase in the standard deviation of monetary growth over the levels observed in the 1950s, the 1960s and the 1970s.

Standard Deviations of the First Difference of the Logarithm
of the Percentage Change in Velocity and M1
(Quarterly Data, Seasonally Adjusted)

Period	VBase	VM1	MB	M1
1952.3-1960.1	1.333'	1.196	0.462	0.534
1960.2-1970.1	0.759	0.734	0.502	0.608
1970.2-1979.3	0.931	0.904	0.287	0.504
1979.4-1984.4	1.286	1.475	0.576	1.157
1952.3-1984.4	1.072	1.050	0.771	0.849

Table I

13

There seemed to be no anchor to our monetary affairs which would provide a stable and predictable performance.

It is important to recognize that this uncertainty follows unavoidably from the Fed's tactical procedures and institutional choices expressed most particularly by the nature of reserve requirements. Policy implementation involves a shifting game guided in varying combinations by the federal funds rate, the Fed's perception of the economy, its views about recent monetary growth and the magnitude of borrowed reserves. The emergence of this borrowed reserve conception revived in recent years old views and procedures guiding Fed policymaking during the 1920s. The Fed sets under this conception a target for borrowed reserves and proceeds subsequently with open market operations designed to adjust the actual volume of borrowed reserves to its target level. It follows under the circumstances that whenever borrowed reserves exceed their target level the monetary base tends to be accelerated. The monetary base is decelerated in the opposite case. We need to recognize at this stage that short-run changes in borrowed reserves are dominated by an evolution of random shocks affecting credit markets and banks' positions. The "borrowed reserves tactic" thus converts these random shocks modifying borrowed reserves into erratic and unpredictable movements of monetary growth. A similar argument extends to the case of federal funds targeting. A reliable assessment of the future course of monetary policy is further impaired by the shifting combination of guide posts noted above which are used by the Fed.

A policy of uncertainty is not innocuous. It affects the evolution of output and investment. The pronounced uncertainty contributed to higher real rates of interest. It also explains the remarkable

14

volatility of interest rates which accompanied our roller coaster policy over the past six years. This result was shown in studies prepared by Bomhoff, Mascaro-Meltzer and others. But a policy of uncertainty produces some more pervasive consequences. Agents operating in the economy confront under the circumstances a serious information problem. They must set prices and plan their activities facing an uncertain course of monetary affairs. This context influences a price setting behavior which effectively establishes a causal link between monetary shocks and real variables. Prices do not respond in general to all the passing variations in market conditions. Many prices adjust to more permanent changes in the underlying state. A policy of uncertainty obscures however the recognition of the actual conditions. Perceptions guiding price setting behavior are thus unavoidably erroneous to some extent. Agents find it in particular impossible to distinguish between transitory and permanent aspects of our monetary affairs. Comparatively more permanent conditions are partly misinterpreted as transitory events barely justifying major adjustments of prices. They affect under the circumstances output and employment. A politics of uncertainty thus produces misinterpretations of current and expected monetary conditions which foster short-run variations in output and employment.

These shorter run patterns do not exhaust the consequences of the uncertainty created by the monetary authorities. The longer-run prospects of prices are difficult to assess in such a regime. The evaluation of costs and returns of projects with a long payoff period suffers therefore even greater risks. The resulting increase in risk lowers the incentive to invest in such projects.

Recent discussions revealed additional consequences of the uncertainty associated with some monetary regimes. The general characteristics of the regime, expressed for instance by the uncertainty it imposes, conditions trend and variability of output over the longer run. It appears that the properties of the stochastic process characterizing the regime contribute to determine the properties of the stochastic process governing output. Different regimes with different levels of built in uncertainty thus produce different patterns for the evolution of output.

A preliminary and still crude examination of this important issue may be useful. A recent study by Kormendi and Meguire in the Journal of Political Economy listed data from 47 countries describing standard deviation and mean of monetary and real income growth based on annual values over twenty years. These data were explored with the aid of some simple regressions presented in table II. Regression 1 attends to a question frequently discussed in recent years. It confirms the view that a larger average monetary growth is systematically associated with a higher standard deviation. The regression coefficient is highly significant. The constant term is non-significant which suggests that the standard deviation of monetary growth SM is proportional to average monetary growth MM. This implies a constant coefficient of determination equal to the regressive coefficient. We also note that 73% of the cross-country variation in SM is associated with variations in MM.

The association between the standard deviation SY of real income growth and its average MY is in contrast quite weak. The regression coefficient is barely significant at standard levels. The low correlation also suggests absence of any systematic connection. Only 4.5%

16

of the variation in SY is reducible to the variation in MY. The standard deviation of real growth appears, *relative* to the mean real growth, as a constant plus a random term.

Correlation Between Mean and Variance of Money Growth and GNP

MM = Mean Growth Rate M1 for 47 Countries
SM = Standard Deviation Growth Rate M1
MY = Mean GNP Growth Rate for 47 Countries
SY = Standard Deviation Growth Rate GNP

<u>Regressions</u>

1. SM = 0.008   +   0.665 MM
         (.822)   (11.13)

         (.)=T-Value   Adjusted R-Square=0.73
         F=123.84   DW=2.07
         Standard Deviation Residuals .03711

2. SY = 0.021   +   0.201 MY
         (3.68)   (1.78)

         (.)=T-Value   Adjusted R-Square=0.045
         F=3.18   DW=2.04
         Standard Deviation Residuals .011278

3. SY = 0.024   +   0.07 SM
         (9.15)   (3.22)

         (.)=T-Value   Adjusted R-Square=0.17
         F=10.36   DW=2.10
         Standard Deviation Residuals .010521

Table II

The last regression is of particular interest for our purposes. It regresses the standard deviation SY of real growth on the standard deviation SM of monetary growth. Both constant term and regression coefficient are quite significant. It is noteworthy that the constant terms in regressions 2 and 3 are not significantly different. The correlation coefficient in the last regression is however modest. Only 17% of the total variation in SY is associated with corresponding

17

cross country variations in SM or ultimately in MM. This implies that real shocks and real conditions dominate the pattern of real growth. Even an average monetary growth of 100% p.a. would raise SY only by about 20% from .024 to approximately .029.

Some further interpretation is needed at this stage. The "real shocks" reflected in the constant and random term of regression 3 include the real effects of the realizations generated by the stochastic process controlling monetary growth discussed above under the shorter run aspects. The regression coefficient associated with SM reflects on the other hand regime characteristics. The total "monetary effect" on SY consists thus of two components, one operating via the regression coefficient and the other via portions of the random term.

An issue emerging in monetary analysis in recent years also requires our attention. It has been argued that the larger the perceived aggregate shocks relative to allocative shocks the smaller are the real effects of monetary shocks. This analysis and result depend crucially on the existence of a substantial information lag for aggregate information relative to allocative or local information. This information lag hardly exists in the USA but may operate with substantial force in most of the 47 countries used in the sample. But an alternative interpretation underlying our short run analysis is available. We obtain the same conclusions with the assumption that larger monetary shocks are perceived to contain a higher permanent proportion. This assumption forms essentially a hypothesis about the stochastic characteristics of prevailing monetary regimes. Either one of the two interpretations implies that the relation between SY and SM is non-linear involving a decreasing sensitivity of SY with respect to

18

SM as SM increases. Such a non-linear relation would imply that a linear approximation seriously underestimates the regression coefficients in the lower levels of monetary growth. The regression in table III including the square of SM examines this issue. The

Non Linear Regression of SY on SM

$$SDY = .013 + .257 \; SDM - .524 \; SDM \; Squared$$
$$\quad (2.7) \quad (3.2) \quad \quad (-2.4)$$

R-Squared = .251 F = 8.7 Standard Deviation Residual=.00998

Table III

coefficient of SM^2 is significantly negative and thus implies a negative second derivative of SY with respect to SM. This result supports the contention advanced above. The coefficient of SM is moreover substantially raised from .07 in table II to .257. An average monetary growth of .1 (i.e. 10% p.a.) would raise SY in the average to about .031 which is more that double the level of .013 associated with a zero level of SM. We note finally that the constant term is still significant but smaller than in the linear regression. The "explanatory power" has also been raised from 17% to 26% of the total variation in SY.

III. Excuses

The results support prior and ongoing studies which reveal the occurrence of real consequences associated with a politics of uncertainty. The Fed typically justifies its policies however with an argument which denies such consequences. It asserts that monetary accelerations or decelerations over less than three quarters are innocuous. Variations in monetary growth need be maintained over more than two quarters before a monetary shock operates on the output

market. The potential real effect of a shorter run monetary shock can always be offset under the circumstances by a suitable reversal. Such shorter-run variability may indeed generate no serious uncertainty and corresponding inference problem for agents whenever they occur in the context of a well understood and generally believed pre-committing policy. The case of Switzerland offers some interesting experience in this respect. But uncertainty unavoidably mounts with short run variability of monetary growth in the absence of any constraining and credible institutions pre-committing the behavior of the Central Bank. Agents setting prices and planning activities confront in this case a burdensome problem of interpreting monetary evolutions. Misconceived inferences affect the economy and so does the recognition of the inherent risk.

The immunization of established discretionary policymaking against its critics does not rely on a single argument. A wide variety of objections has been addressed to a policy of pre-committing monetary control. The idea that "nobody knows what money is" was discussed in a previous position paper and is really embarrassingly silly. It is noteworthy that it circulates mostly among non-economists. The irrelevance of this idea is easily recognized by the falsehood of its central implication. If people would not know what money is then they would randomly select objects to settle obligations arising from transactions. This clearly has not happened. Others maintain that monetary control is technically not feasible. But the examination of this issue pursued by James Johannes and Robert Rasche over the past six years demonstrates that control of monetary growth over one year within a 2% band centered on the target level is quite feasible. This

conclusion is confirmed by studies prepared by the staff at the Board of Governors of the Federal Reserve System. The control level over one year indicated is quite sufficient for all practical purposes of policymaking.

The potential errors associated with the measurement of the nation's money stock raises a more respectable issue. It is noteworthy however that a similar concern about publicly used data with probably larger measurement error is not voiced (e.g. trade deficit, current account deficit, price indices as inflation measure, etc.). Concern was particularly voiced whether the measurement error has increased or especially become more volatile. The implications of this event coincide with the consequences of another problem I wish to address with my final comments.

A chorus of voices stresses potential effects of deregulation and financial innovation. These effects are expected to "loosen" *somehow* the relation between monetary policy and monetary growth, and the latter's relation with aggregate nominal demand or national income. A paper recently published in the Review of the Federal Reserve Bank of Boston exemplifies the typical thrust of this literature. Two more ambitiously designed papers were published over the past years in the Brookings Papers on Economic Activity. The general content and nature of the argument offers however no additional material.

The general sense of the "deregulation cum innovation" critique can be discerned from the following quote:

> As a result of recent banking deregulation and continuing innovations in communication and data processing technology, the relationship between the growth of money stock and the course of economic activity may become less dependable in the future. Therefore, forecasters may discover that the growth of the money stock is a less reliable indicator of GNP growth. Furthermore, policymakers may find that smooth

21

targets for the growth of monetary aggregates, which change slowly over the years, are less reliable guides for monetary policy unless perhaps the funding strategies of depository institutions can be anticipated well in advance.

A detailed examination of the papers mentioned above conveys a pervasive sense of inconclusiveness and vagueness. It is not clear what the nature of the problem precisely involves. There is moreover no logical link between negative conclusions bearing on monetary policy and the discussion of financial innovations. The discussion remains an exercise in impressionisms. There seems to be little perception that financial innovations proceeded over the centuries and shaped monetary evolution over a long time. Gurly and Shaw argued more than twenty years ago that the explosive growth of savings and loan associations during the 1950s erodes the potency of monetary policy. The subsequent evolution discredited such fears or hopes.

The consequences of deregulation and financial innovation can be usefully organized for our purposes in one or the other (not exclusively) of two groups. In order to condition the relevant process under consideration (i.e. the link between policy and nominal gross national product) they must modify the behavior of the monetary multiplier or velocity. These two magnitudes fully define the relation between monetary policy and nominal gross national product. Here we encounter a difficult obstacle however for any serious investigation. A general assertion that deregulation cum innovation modifies behavior of multiplier and velocity *somehow* yields no assessable implications. This remains an empty but politically suggestive exercise. A variety of modifications in behavior are moreover quite compatible with a continued effective application of monetary control policy.

Consider first the monetary multiplier. The Shadow statement include since 1979 the statistical analysis and forecasts of the multiplier prepared by Johannes-Rasche. The statistical analysis reveals a remarkable stability of the process governing the multiplier. Changes in monetary regime from the 1979-82 episode to the subsequent interest targeting phase of deregulation and innovation did not modify the tracking record of the analysis. Similarly, the stochastic properties of forecast errors hardly changed over the six years. There is simply no evidence of "loosening" or lessened reliability in this portion of the overall relation linking monetary policy with nominal gross national product.

Monetary velocity describes the second portion of the link Much verbal noise has indeed been addressed to it over the past three years. We indeed observed, as indicated in the graph, the most pronounced decline in velocity ever recorded in the postwar period. But this reflects probably the large decline in the inflation rate which occurred over this period. We also observe in table IV that the rate of increase in velocity (for both V_o and V_1) over the first eight quarters of the cyclic recovery proceeded at the lowest level recorded over the postwar period in spite of the rigorous upswing. The increase of the standard deviation of ΔV_1 (i.e. of the first difference in M-1 velocity) since 1979 noted in table I appears to support the idea of a "loosened connection". The standard deviation of V_o (i.e. in the first difference of base velocity) also listed in table I denies however this conclusion. The link between monetary policy and national income did not deteriorate in the past six years relative to the 1950s. More importantly, the arguments advanced never make clear whether deregulation and innovation raise or lower the level, the

23

trend, or the variance of the velocity innovation. The observations noted above yield so far little information about a reliable imputation to the three possible components of velocity behavior. Some arguments emphasizing a wider menu of interest bearing money substitutes appear to suggest a *rise* in level or trend, or both. But our observations are difficult to reconcile with such implications and their underlying notions. Perhaps more important is the circumstance that modification of trend or level does not impair the quality of the link. Changes in level pose at most a transition problem and changes in trend can be incorporated into the non-inflationary benchmark for monetary growth.

Changes in the variance of velocity innovations do indeed modify the quality of the link. the nature of the problem may be presented with the aid of the following relation

$$m_{t-1} + \mu + \nu_t + v_{t-1} + \beta(L)\Delta v_{t-1} + \varepsilon_t = Y_t$$

where y = level of nominal GNP, m_{t-1} = money stock in $(t-1)$, μ = the current desired rate of increase in m, v = white noise in money supply process, v_{t-1} = past value of velocity, $\beta(L)\Delta v_{t-1}$ = an autoregressive process in Δv and ε = a white noise component in current velocity change. All the level data (i.e. y, m and v) are in log form. Suppose first that velocity is approximated by a random walk. The first log difference Δv coincides thus with ε and $\beta(L)\Delta v_{t-1}$ = 0. Monetary growth can be set at a level $\bar{\mu}$ expected to realize a target level $\bar{y}$ where $\bar{\mu} = \bar{y} - m_{t-1} - v_{t-1}$.

The variance of the error $(y-\bar{y})$ is then given by

$$E(y-\bar{y})^2 = \text{variance } \nu + \text{variance } \varepsilon + \partial \text{ covariance of } \varepsilon \text{ and } \nu.$$

This variance is also the minimum achievable under the circumstances.

24

There exists no strategy for setting μ which will lower this variance. Arguments developed in detail on other occasions determine a constant μ as an optimal solution. It remains optimal even if the variance substantially increased. But consider now the case when velocity is not a random walk. Serial correlation of Δv offers potential opportunities to forecast current velocity changes with the aid of an autoregressive scheme. Knowledge of this scheme allows the monetary authorities to set $\bar{\mu}$ in response to the optimal prediction of Δv. This assures again a minimum variance around the target level irrespective of the deterioration of "the link" expressed by a rise in the variance of velocity or its innovation (i.e. its random noise component). A constant setting of μ would not be optimal under the circumstances. But we do not know the autoregressive scheme and we need to estimate it. The reliability of this estimate is moreover highly questionable. There is consequently no assurrance that setting $\bar{\mu}$ based on such estimates yields a smaller variance of nominal GNP than a constant μ. It is just as likely to raise the variance. Advocates of an activist period by period adjustment of would have to show that the forecast error of velocity based on an estimated serial correlation scheme possesses a smaller variance than the change Δv. They would also have to show some good grounds to expect some persistence of this pattern over time. The crucial conclusion is however independent of activist or non-activist setting of monetary growth. In either case the advantage of a monetary control policy is not destroyed by a deterioration of "the link" expressed by a higher variance of the random component in velocity.

25

Growth Rates of Velocity After a Recession
Over the First Eight Quarters
(Per Quarter in Percentage)

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Y(r) = Growth Rate Real GNP
Y(n) = Growth Rate Nominal GNP
M1   = Growth Rate M1
VM   = Growth Rate Velocity M1
B    = Growth Rate Base Money
VB   = Growth Rate Velocity Base Money
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Recession Year	Y(r)	Y(n)	M1	VM	B	VB
1954.2(7)	1.38	1.82	0.62	1.20	0.24	1.58
1958.1(6)	1.47	1.95	0.64	1.31	0.56	1.39
1960.4(8)	1.20	1.51	0.51	1.00	0.59	0.92
1970.4(8)	1.20	2.15	1.54	0.61	1.62	0.53
1975.1(8)	1.09	2.28	1.27	1.01	1.64	0.64
1980.2(6)	0.72	2.54	1.76	0.78	1.40	1.14
1982.4(8)	1.33	2.18	1.76	0.42	1.90	0.28

- -

Percentage Growth Per Quarter   (.)=# of Quarters Used

Table IV

VELOCITY (1947.2-1984.1)

quarterly data, seasonally adjusted

V
_____
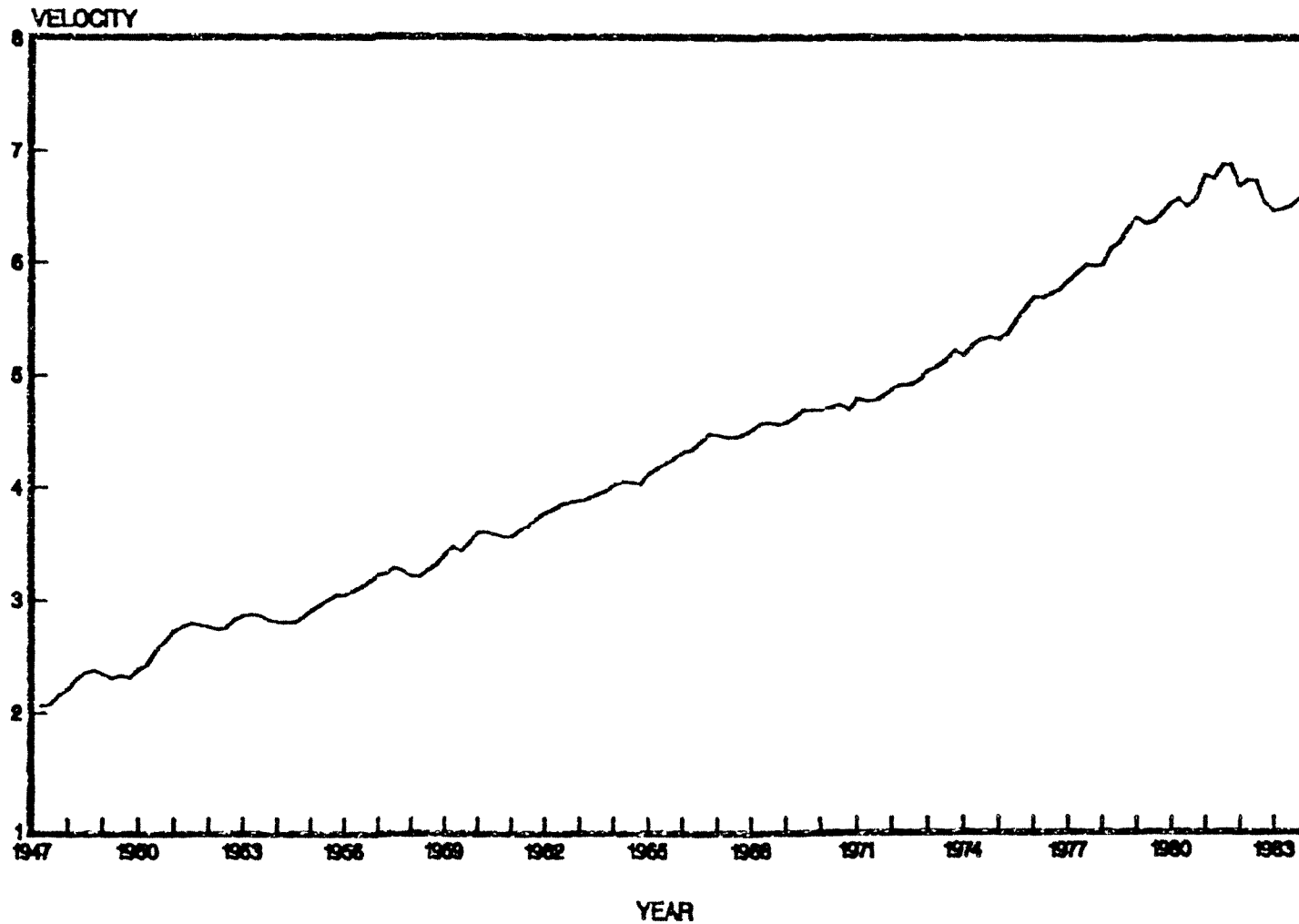
YEAR

VELOCITY=NOMINAL GNPSA/M1SA   SOURCE; FEDERAL RESERVE BULLETIN

27

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Federal Reserve Bank of St. Louis

GUIDELINES FOR DEFICIT POLICY

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According to the *Budget, Fiscal Year 1986*, on a current services basis the FY1985 deficit now will be $223.6 billion and the FY1986 deficit approximately $230.3 billion. This is sharply higher than the estimates in the Administration's *Mid-Session Review* of the FY1985 Budget (August 1984), which forecast deficits of $172.4 billion in FY1985 and $174.2 billion in FY1986. The higher estimated deficit in FY1985 reflects in part the slowdown in economic growth in the second half of 1984 and in part the impact of the shift to on-budget accounting of HUD loans. Given the heightened sensitivity of federal outlays to changes in interest rates, deficit projections would be even higher if actual and projected interest rates had not declined from mid-1984 levels.[1] Nevertheless, the projected rise in outlays (7.7% average annually from FY1985 to FY1988), the climb in deficits to the $250 billion area, and the associated sharp rise in the federal debt-to-GNP ratio are striking. In response, the Administration has proposed spending cuts of $50.8 billion in FY1986, $82.7 billion in FY1987, and $105.3 billion in FY1988. The Administration forecasts that these cuts would reduce the deficit in FY1988 to $144.4 billion or 2.9 percent of GNP.

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[1] Aided by faster-than-forecast economic growth and a shortfall in spending, the year-to-date deficit (October 1984 to February 1985) is consistent with a FY1985 deficit below $200 billion. However, interest rates have risen recently, economic growth should moderate from its current pace, and the shortfall in spending outlays will probably narrow, and the FY1985 deficit should end out close to the Administration's estimate.

The Administration's long-run budget forecast is based on 4 percent real GNP growth through 1988 and somewhat slower growth thereafter (see Table 1).

TABLE 1

Economic Assumptions Underlying Administration's Budget Forecast

	1985	1986	1987	1988	1989
GNP (% chg. 4th Qtr-4th Qtr)					
Real $	4.0	4.0	4.0	4.0	3.8
Nominal $	8.5	8.5	8.3	7.9	7.4
CPI (% chg. Year-over-Year)	4.1	4.3	4.2	3.9	3.6
Unemployment Rate (%, annual average)	7.0	6.9	6.6	6.3	6.1
Interest Rates (%, annual average)					
90-day Treasury Bill	8.1	7.9	7.2	5.9	5.1
10-year Treasury Note	11.0	10.3	9.3	7.3	5.7

Source: *Budget, FY1986.*

According to Administration estimates, a permanent one percent slower-than-expected annual rate of real growth beginning in January 1986 would reduce receipts dramatically, and increase the deficit by $4.1 billion in FY1986, $16.9 billion in 1987, and $33.4 billion in 1988. Perhaps more troublesome to the budget outlook are the Administration's interest rate assumptions, particularly for 1987 and beyond. The Administration assumes the 3-month Treasury bill rate will average 7.2 percent in 1987, 5.9 percent in 1988, and 5.1 percent in 1989. In contrast, CBO budget projections (*The Economic and Budget Outlook: Fiscal Years 1986-1990*, February 1985) assume the 3-month Treasury bill rate to average 8.2 percent each year after 1986. The Administration's assumptions of healthy economic growth, little change in expected inflation, and continuously declining real interest

30

rates, may be inconsistent.[2] Higher-than-expected interest rates would have a dramatic impact on interest outlays and would exacerbate the difficulty of stabilizing the federal-debt-to-GNP ratio. Based on the Administration's proposed deficit forecasts, one percentage point higher-than-projected interest rates would raise net interest outlays and deficits by $8.2 billion in FY1986, $11.7 billion in FY1987, and $14.8 billion in FY1988.

Guidelines for Deficit Policy

Deficit cutting efforts should be guided by several principles. First and foremost, budget proposals should be conceived and debated within a context of a fiscal (deficit) policy whose primary goal is to create an environment conducive to long-run economic growth. Given past failures of fiscal policy in managing aggregate demand, short-run stabilization goals should not be the focus of fiscal policy. While there is substantial uncertainty about the impact of fiscal policy on the short-run pattern of economic activity, there is a growing consensus about the long-run adverse consequences of rising government spending and debt. The reallocation of resources from private sector activity to the public sector generated by higher

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[2] Under these circumstances, a decline in nominal interest rates, given what appears to be little change in inflationary expectations (the Administration projects the percentage change in the CPI to recede from 4.3 percent in 1986 to 3.9 percent in 1988 and 3.6 percent in 1989), implies a sizeable decline in real interest rates. There does not seem to be sufficient changes in the capital stock, nor is there any proposed change in tax policy, that would substantiate a decline in real rates. If, however, real rates were to fall as the Administration's budget projections assume, one could expect a decline in the exchange value of the U.S. dollar, which would drive up inflationary expectations (and nominal interest rates).

government spending tends to reduce private investment, regardless of how it is financed. Also, the sharply rising federal debt-to-GNP ratio eventually will constrain the availability of credit for private investment, although the timing of this impact is uncertain.

A long-term growth-oriented fiscal policy requires stabilizing the federal debt-to-GNP ratio. Empirical research does *not* indicate at what level or when the debt ratio should be stabilized in order to achieve an investment/economic growth goal. However, substantial cuts are necessary merely to stabilize the federal debt-to-GNP ratio. The Administration's proposed spending cuts would stabilize the federal debt-to-GNP ratio at slightly above 40 percent, but only if those cuts were accompanied by the Administration's anticipated declines in real and nominal interest rates. In stark contrast, the CBO baseline budget projection, which assumes 3.4 percent real GNP growth after 1987, 4.2 percent annual rise in the CPI after 1986, and a 3-month Treasury bill rate of 8.2 percent after 1986, forecasts the federal debt-to-GNP ratio to climb to 49.7 percent by 1990.

Second, to preserve production incentives, spending cuts should take the lead in any deficit-cutting effort. From 1983 through the end of the decade, all of the rise in the cyclically-adjusted deficit as a percent of benchmark GNP is attributable to the rise in cyclically-adjusted outlays. Cyclically-adjusted revenues in 1989 are projected to be nearly the same percent of benchmark GNP as in 1983. Many spending programs are well intended, but in some case their projected sharp increases in outlays are due to structural flaws that require corrective action. This is particularly true of non-means tested entitlement programs, which have grown dramatically and, in general, have been spared from recent budget cutting efforts.

32

Third, as a practical matter, all government spending programs should be considered candidates for budget cuts. In particular, social security and other non-means tested entitlement programs, and defense, cannot be excluded from the outlay-trimming exercise. These programs constitute 62.5 percent of total budget outlays. The composition of government spending has evolved from a series of subjective preferences, and is not derived from economic analysis. However, simple arithmetic takes us a long way toward the conclusion that "everything should be on the table." Allowing non-means tested entitlement outlays to remain sacrosanct severely constrains efforts to stabilize the debt-to-GNP ratio. Also, these transfer programs are a source of economic inefficiency to the extent that they reduce labor supply and/or savings. The defense program must be analyzed in terms of national security as well as budget goals; nevertheless, it is doubtful that a judiciously chosen, modest slowing of scheduled growth in defense outlays would severely hamper national security. Ultimately, resolving the thorny issue of the composition of spending cuts, for example, as between defense and non-defense programs, rests on the ability of elected officials to compromise. Therefore, common-sense suggests that all budget programs should come under close scrutiny in an efficient and fair effort to slow the growth of spending and debt.

Fourth, short-term deficit-cutting efforts should be consistent with long-run program reform. Enacting a "quick fix" deficit-cutting package is not necessarily good public policy if it does not generate long-run savings or if it fails to address, or precludes addressing, some of the structural flaws of government spending programs.

33

Temporary reductions in the armed forces would not generate permanent long-run savings in defense outlays if military readiness requires that those discharged must be rehired in the future. A one-year freeze on social security COLAs may preclude much needed program reform. And, attempts to limit Medicare outlays by strictly limiting doctors' compensation would generate some short-run saving but would increase long-run costs *and* perpetuate inefficiencies in the health industry. (Providers would respond by restricting services to Medicare participants. Meanwhile participants may respond by seeking less efficient and more costly types of medical care, i.e., substituting in-patient care for a routine ailment that normally would require an out-patient visit. Instead, phasing in changes in financial incentives for hospitals and Medicare recipients would be an important step toward Medicare reform, even though it may not generate any short-term cost-saving.)

The fifth principle concerns the fact that since the deficit cuts required to stabilize the federal debt-to-GNP ratio are very large, political compromise may result in some increases in tax revenues. Therefore, any tax increases should abide by two rules: (1) they should be assessed on consumption so that there are no further disincentives to save and invest, and (2) the indexing of personal income taxation, which is now in place, should not be delayed or eliminated. These rules reflect the fact that a deficit-cutting package that suppresses productive output would be counterproductive to the effort to stabilize the debt-to-GNP ratio. The real difficulty with this guideline for taxation is practical in nature: once taxes are considered "open game" in deficit-cutting efforts, it would be difficult politically to limit tax increases only to higher taxes on

34

consumption. So while the rule to avoid higher taxes on investment or saving stands as an important guideline, the key point is that slowing the rise in federal debt should be accomplished largely by slowing spending growth.

FY1986 Budget Proposals

The Reagan Administration's proposed substantial spending cuts would reduce outlay growth to 1.5 percent in FY1986, and 4.5 percent annually from FY1985 to FY1988. If enacted, they would be the largest in recent history. However, the cuts would be small relative to what eventually must be done to correct the current unstable situation. Nevertheless, the size of the proposed cuts represents a major step in the right direction. Importantly, the *FY1986 Budget* did not recommend tax increases, and Congress's current primary deficit-cutting focus is on spending cuts rather than tax increases.

The most striking characteristic of the proposed cuts is that they are imposed largely on programs whose outlays constitute a small portion of the total spending budget (see Table 2). Specifically, no cuts are proposed for social security (OASDI), whose cash outlays of $199.8 billion in FY1986 and $641 billion during the three years FY1986 to FY1988 constitute nearly one-fifth of total current services outlays.   Cuts of $5.4 billion in FY1986 and $25.5 billion in FY1986 to FY1988 are proposed for all non-means tested entitlement programs (social security; Medicare; railroad, military, federal employee, and other retirements and disability; and unemployment compensation), whose $345.5 billion outlays in FY1986 and $1,112.1 billion in FY1986 to FY1988 constitute over one-third of all current services spending. Proposed cuts in defense outlays also are small relative to total

35

defense outlays. A disproportionately large portion of the proposed
cuts would be imposed on the broad range of non-defense, non-
entitlement programs, with the largest chunks coming out of farm price
supports, general revenue sharing, civilian agency pay raises, and
strategic petroleum reserves.

TABLE 2

Composition of Administration's Proposed Outlay Cuts for
the Combined Three Year Period FY1986 to FY1988

	Current Service Outlays ($ bil)	Portion of Total (%)	Proposed Saving ($ bil)	Saving as a portion of	
				Total Proposed Saving (%)	Current Service Outlays (%)
I. Defense	993.5	29.8	28.2	11.8	2.8
II. Entitlements:					
A. Non-Means Tested	1112.1	33.4	25.6	10.7	2.3
Social Security	(641.0)	(19.2)	(0.0)	(0.0)	(0.0)
All Other[a]	(471.1)	(14.1)	(25.6)	(10.7)	(5.4)
B. Means-Tested[b]	216.0	6.5	11.0	4.6	5.0
III. Other Non-defense, Non-entitlement outlays[c]	660.8	19.8	134.3	56.2	20.3
IV. Offsetting Receipts	-213.7	-6.4	9.6	4.0	4.5
V. Debt Service	565.4	17.0	30.2	12.6	5.3
Total	3,333.9	100.0	238.8	100.0	7.2

NOTES: [a] Includes railroad, military and federal employee
retirement,   other   retirement   and   disability,
Medicare, and unemployment insurance.

[b] Includes Medicaid, AFCD, foodstamps, child nutrition,
guaranteed student loans, SSI, earned income tax
credit, and veterans pensions.

[c] Includes programs identified in *Budget FY1986* as
other mandatory outlays, dedicated funding and
business operations, outlays for forward-funded and
related programs, outlays for slow-spending and fast-
spending discretionary programs, and discretionary
loan outlays.

36

Considered in terms of the fiscal policy guidelines mentioned above, the Administration's proposals in general are admirable: they would modify spending programs and in many ways eliminate sources of inefficiency (for example, the farm subsidies) and address the rising costs of certain pension programs (for example, civil service retirement), they would generate substantial immediate savings, and they avoid tax increases. As expected, the deficit-cutting package is controversial. By cutting some programs and not others, and eliminating some programs altogether (for example, general revenue sharing), the proposal effectively redefines the role of government in certain types of economic activity. Whether these proposed cuts are "fair" is largely subjective; cutting spending in some programs and not others is not necessarily unfair. Similarly, the "fairness" of an across-the-board freeze on all government spending programs depends on whether the current size and distribution of government spending is considered "fair". On the other hand, the skewed distribution of the proposed cuts does point to the enormous *potential* cuts in spending that could be achieved if all government programs, including the non-means tested entitlements, were part of a comprehensive spending cut package. The following recommendations are samples of the type of program reforms that deserve consideration.

Social Security. The Administration proposed a one year COLA freeze in retirement benefits for former military and civilian employees and the industrial pension component of railroad retirement benefits. This provision should be extended to social security benefits.

Social security participation should be extended to all new state and local government employees, the only major group of workers still

37

excluded from the program. Extending coverage for this redistributive program would reduce a source of inequity between participants and non-participants.

Currently, half of social security benefits are taxed for recipients whose total income, including social security and income from tax exempt bonds, exceeds $25,000 for individuals and $32,000 for married couples filing jointly. Instead, social security and railroad retirement benefits that exceed household lifetime contributions should be taxed, similar to tax treatment of private pensions. For equity reasons, households with total incomes below $12,000 would be excluded. This tax treatment would not affect the lower income elderly and would tax other recipients roughly in proportion to their income and marginal tax rates. It also would reduce some of the intragenerational inequities caused by spouse benefits, and narrow the wide differential between after-tax rates of return on household contributions received by current and future retirees.

Three other social security changes should be implemented that would generate *no* additional short-term saving: (a) the social security benefit structure should be modified so that beginning in 1990, persons who retire between ages 62 and 65 should receive actuarially reduced benefits, (b) average indexed monthly earnings (AIME) should be calculated by indexing for inflation rather than average wage growth (this provision would be complemented by liberalizing IRA and Keogh provisions, by raising maximum limits and reducing penalties for withdrawal), and (c) the current spouse benefit provision should be replaced by an earnings sharing arrangement whereby spouses would divide evenly covered household earnings and

38

benefits would be based on his or her own earnings base. These three recommended changes would be part of a broader social security reform that must be implemented gradually and would not generate any short-term savings.

Medicare. Medicare Supplementary Medical Insurance (SMI) premiums paid by beneficiaries currently cover 25 percent of average benefits for an elderly enrollee (they are estimated to be $17.30 per month in 1986) and their increases after 1985 are limited to increases in the CPI. These premiums should be increased and graduated as a function of income, so that by 1990 the average premium would equal 35 percent of average costs, with higher income elderly paying premiums up to 50 percent and lower income elderly having their premiums remain tied to increases in the CPI.

Medicare Part A should be redesigned to include a catastrophic hospital feature and an adjusted cost-sharing arrangement based on ability to pay. Currently, participants pay for the first day of a hospital stay, incur zero costs for days 2 through 59, and then co-pay 25 percent of costs after 59 days. A catastrophic plan would place a "stop-loss" limit on out-of-pocket costs incurred by long-term care patients. Short-stay patients would pay more than they do currently, through a modest (15 percent) co-payment schedule, which would be graduated with income, for in-patient care for days 2 through 15.

An additional reform for Medicare involves transforming the current prospective payment system to hospitals and HMOs more toward a medical insurance voucher system by: (1) relaxing some of the burdensome eligibility requirements for HMO and hospital participation in Medicare, (2) allowing hospitals and HMOs to rebate cost savings to Medicare participants (rather than being only able to offer more

39

services), and (3) allowing individuals to take actuarial equivalent values of premiums and choosing the private health plan that best suits their needs. These reforms would encourage more innovative and cost-effective medical delivery systems and also provide financial incentive to participants to be more cost-conscious in their choice of medical provider.

Military Retirement. Currently, military employees may retire with approximately half-pay after 20 years of service (the initial benefit is 2 1/2 percent of final base pay per year of service). With this financial incentive, it is not surprising that the average retirement age for non-disability, active-duty service members is 43 years old. Military pensions should be modified so that benefit schedules are a function of years of service *and* age of retirement, with younger retirees receiving reduced pensions.

Unemployment Insurance and Workers Compensation. Currently, a portion of unemployment insurance is taxed only if a taxpayer's threshold income exceeds $12,000 for individuals and $18,000 for married couples filing jointly, while workers compensation benefits are tax exempt. All unemployment insurance and workers compensation benefits should be taxed as ordinary income.

These proposals would generate substantial additional savings in the non-means tested entitlement programs -- over $60 billion during FY1986 to FY1988. Combined, these modifications would encourage work effort and saving, and to discourage excessive and unnecessary uses of medical services by the elderly. The recommended phased-in changes in social security and Medicare are not geared to generate short-run cost savings but instead form the basis for necessary long-run reform.

Prospects for Responsible Fiscal Policy

The Administration has recommended sizeable spending cuts for FY1986, and Congress has taken initial steps to broaden the scope of sources for potential spending cuts. For example, postponing the COLA for social security has emerged as one possible cost-cutting measure, although its eventual acceptance is highly questionable. While current political maneuvering around the budget issue in Congress seems to be following the same path as previous unsuccessful efforts, a note of optimism can be found in the perceived immediacy of the need to cut deficits. Nevertheless, the magnitude of the budget imbalance is staggering, and sharply rising interest costs constrain efforts to stabilize the debt-to-GNP ratio. A note of caution is appropriate: a spending cut package close in total size to the Administration's proposal would be a major first step toward fiscal responsibility, even if it is *not* large enough to eliminate the primary deficit and stabilize the federal debt-to-GNP ratio. Remember, it has taken a long time to lay the foundation for such large deficits -- importantly, the recent growth of the non-means tested entitlements was generated by legislation enacted in the late 1960s and early 1970s. The unwinding process may be equally as long.

ECONOMIC OUTLOOK

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It appears that the FOMC has assumed that M1 velocity will rise 2 to 2 1/2 percent in 1985, given their intention to increase the money stock by 5 1/2 percent by year end. However, they have emphasized that money would grow faster if velocity appears to be growing slower, or money would grow slower if velocity is growing faster. That could be taken to imply that there is a current year target for nominal GNP that is more important than the M1 target.

Table I shows the various "official" numbers for this year:

TABLE I

1985 Projections
(Fourth Quarter to Fourth Quarter)

	Administration	Congressional Budget Office	FOMC	
			Range	Central Tendency
GNP	8.5%	7.7%	7 - 8 1/2%	7 1/2 - 8%
Output:	4.0	3.4	3 1/4 - 4 1/4	3 1/2 - 4
Prices:	4.3	4.2	3 - 3 3/4	3 1/2 - 4
Unemployment:*	6.9	7.0	6 1/2 - 7 1/4	6 3/4 - 7

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*Year end

All of these projections compare with actual results for 1984 as follows:

1984

GNP:	9.7%
Output:	5.9
Prices:	3.6
Unemployment:	7.1

Since actual M1 growth for 1984 was 5.2 percent, the Fed's central target for 1985 is slightly faster, which is hard to understand. As long as there is supposed to be a long-run policy objective of

43

reducing monetary growth to a non-inflationary rate, there is little justification for targeting monetary growth that is faster than the previous year.

It is worth noting that the Administration's inflation assumption is higher than the CBO and the Fed. That is undoubtedly due to the desire on the part of the Administration to show a smaller deficit (as a percent of GNP) that is associated with faster nominal GNP growth. For the second year in a row, the Fed has a lower inflation projection than just about anyone else inside or outside government.

Current thinking by the Fed is more optimistic than last summer. The comparison of projections for 1985 is shown on Table II.

TABLE II

1985 Projections
(Fourth Quarter to Fourth Quarter)

	July '84 Projections		February '85 Forecast	
	Range	Central Tendency	Range	Central Tendency
GNP	6 3/4 - 9 1/2	8 - 9	7 - 8 1/2	7 1/2 - 8
Output:	2 - 4	3 - 3 1/4	3 1/4 - 4 1/4	3 1/2 - 4
Prices:	3 1/2 - 6 1/2	5 1/4 - 5 1/2	3 - 4 3/4	3 1/2 - 4

Looking back over the past year-and-one-half, the Fed's optimism about inflation has been borne out, while the SOMC did not anticipate the favorable effects on inflation of a strong dollar and declining energy prices. While the lower inflation has been very welcome, it has been accounted for by transitional factors that cannot be expected to continue.

In both 1974 and 1979-80, the monetary approach to inflation used by the SOMC underestimated the acceleration of major price indices.

The transitory effects of the "oil shocks" were causing significant relative price shifts, and a transitory increase in the reported inflation rate. For similar reasons, the reported rates of inflation in the past two years have been less than a monetary approach suggested. Declining energy and imported goods prices cause the rate of inflation to *temporarily* fall below the monetary rate. The correct emphasis is on the long-run trend rate of inflation implied by the trend rate of monetary growth, recognizing that there will be deviations due to measurement errors and non-monetary factors.

While the FOMC's record on inflation was very good in 1983 and 1984, they underestimated real growth. Their biggest miss was in 1983 when they projected output growth of 3.5 to 4.5 percent, versus the actual of 6.3 percent. Now, for 1985 the FOMC projection for output is slightly lower than the CBO and Administration, but in line with most business economist forecast.

The SOMC was more optimistic (and more accurate) on output growth in 1983, and also projected a strong 4 to 5 percent real growth for 1984. The 10.1 percent real GNP growth recorded in Q1/84 ensured that the annual figures would be quite high even though the third quarter came in at only 1.6 percent.

Monetary growth in 1985 is destined to be very high for reasons similar to the high output growth recorded in 1984. In Q1/85, M1 growth will be 11 to 12 percent a.r., which means the remaining three quarters can average only 3 to 4 percent if money growth for the year is going to fall near the middle of the 4 to 7 percent range. The longer the rapid money growth persists, the sharper the deceleration necessary to "average out" anywhere in the target range. For illustration, if M1 growth in the first half averaged 11 percent, the

45

second half would have to be zero in order to get 5.5 percent for the year. Obviously, (to us), such sharp fluctuations are undesirable.

There may be a basic disagreement between the SOMC and the FOMC about the significance of large intra-year fluctuations of money growth. Some Fed staffers have argued that they are unimportant as long as the average is maintained. Our position should be that there are two important adverse effects of the intra-year go-stop pattern. One is that sharp accelerations and decelerations lasting for six months or more do have a significant effect on output growth, as seems to have been the case in 1984. Second, the volatile money growth creates uncertainty about the underlying trend, and market interest rates must compensate for this heightened uncertainty.

Language in the February 1985 Report of the Fed to Congress suggests that the erratic quarterly pattern is not only acceptable, but is deliberate. The FOMC is said to believe that "a somewhat higher rate of money growth than implied by straight line projections from the fourth quarter 1984 base to the targets for the fourth quarter of 1985 may be appropriate early in the year, but growth of M1 would be expected to slow, and velocity growth to rise, as the current adjustments are completed."*

Thus, the Fed has defended "front-loading," and is counting on the lagged relationship between money and GNP rising (velocity) to permit slow growth of money at a later time. If there were no effects on output of such fluctuations of money, the Fed might be able to allay the uncertainties such a policy creates for the private market

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*Page 4.

46

participants. However, especially in view of the fiscal policy impasse, it is likely that market participants will guard against the possibility that the initial rapid money growth will persist and inflation will accelerate.

In view of the 11 to 12 percent money growth in Q1/85 the probability is rising that '85 could see a repeat of '83 as far as monetary targeting is concerned. Two years ago, money growth was so far above target by mid-year the FOMC reset the base period to the second quarter and did not try to offset. Such a possibility has already been signaled by Vice Chairman Preston Martin when he acknowledged the possibility that M1 might be allowed to grow 8 to 10 percent in 1985, with the justification that velocity growth might be low.

The Outlook

The growth of nominal income and real output in the first half of 1985 will exceed the respective growth rates recorded in the second half of 1984. Most likely, money growth will be at the top end of the Fed's target range for all of 1985, so nominal GNP can be expected to grow faster than the Fed's projection. Especially in the second half of this year, inflation can not be reliably expected to remain as subdued as the FOMC has indicated. The trend growth of M1 and the monetary base have remained at historically high levels, so the reported rate of inflation will eventually rise to the underlying trend.

47

TABLE III

	M1	MB	Prices	GNP	Output
Q4/76-Q4/80	7.8	8.7	8.2	11.5	3.0
Q4/80-Q4/84	7.4	7.3	5.1	8.3	3.0
Q4/76-Q4/84	7.6	8.0	6.7	9.9	3.0
Q4/83-Q4/84	5.2	7.3	3.6	9.7	5.9
Q1/84-Q1/85*	6.4	7.4			

*estimated

The growth of MB in 1984 was the same as the four-year average for Q4/80-Q4/84. The M1 growth reported for '84 looks like a break with the trend, but so did 1981. Once the rapid Q1/85 M1 figure is recorded the year-over-year increase in M1 is half way back to the longer-term trend. By year end, it will probably be all the way back.

Since inflation can be expected to average about 1 percent slower than money and base growth, a sustained 6+ percent inflation rate is consistent with the underlying monetary trends.

The economic *projections* (but not preferences) for 1985 are:

TABLE IV

	GNP	Output	Prices	M1	V1	MB	VB
Q4/84-Q4/85	8 1/2	3 1/2	4 1/2	6	2	6	2
	to	to	to	to	to	to	to
	9 1/2	4 1/2	5 1/2	7%	3%	7%	3%

A half-year breakdown of these projections would show real growth more rapid in the first half and slower in the second half, but less of a change in 1984. The inflation rate is expected to be rising more rapidly late in the year, possibly reaching into the 6+ percent range.

48

Money growth of *no more than* 7 percent for the year requires a slowing from the first quarter's rapid pace to only about 5.7 percent for the final three quarters.

Recommendation

The slowing of the base and money from '83 to '84 should be continued into '85. This year the monetary base should not be permitted to rise by more than 6 percent. A range of 5 to 6 percent is adequate for continued real growth with sustained low inflation. An objective of reducing the growth of the base and money to the 2 to 3 percent range before the end of the decade should be adopted by the FOMC.

FORECASTS OF THE M_1 - ADJUSTED MONETARY BASE MULTIPLIER FOR 1985

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We are presently in the middle of the annual round of revisions of the monetary and reserve aggregates. The announcement of the revisions of the data for the monetary aggregates in the H.6 release of February 14, 1985 indicated a change in the levels of M_1 and M_3, but showed little change in the growth rates from the unrevised data, prior to changes in the seasonal adjustment factors (see attached Appendix Table 5 from the H.6 release). The historical data on the revised basis were released in mid-March. The Federal Reserve Bank of St. Louis has not yet revised either the Adjusted Monetary Base or the seasonal factors for the base. Thus we have a mixture of revised and unrevised data available on which to base our current forecasts.

At our last meeting, it was suggested that it would be helpful to have not only the forecasts for the coming year, but also an analysis of the source of the projected changes from the previous year. In an attempt to present this information, I have prepared Tables 1 and 2 below. The technique used to construct the forecasts in Table 1 is to use the revised not seasonally adjusted data for the monetary aggregates, the revised seasonal factors for the monetary aggregates, and the unrevised seasonal factors for the adjusted monetary base. The data for January and February are the actual data for those months as presently estimated. The forecasts suggest that we will observe a decline in the multiplier on a seasonally adjusted basis through the middle of the year from the present value estimated for February, but that this decline will be reversed during the third

51

quarter of 1985, and that in the fourth quarter the multiplier will be essentially unchanged from the February level.

In Table 2 we compare the not seasonally adjusted forecasts for the remainder of the year with the actual value of the multiplier in the corresponding month of 1984. Column 3 of Table 2 indicates the year-over-year percentage change (for January and February) or forecast percentage change (for March through December). The remaining columns of Table 2 indicate the allocation of the percentage difference between the 1985 and 1984 numbers among the various component ratios of the multiplier. These columns indicate that actual and forecast increases in the t_1 and t_2 ratios for 1985 relative to 1984 work systematically to reduce the value of the 1985 multiplier below 1984 levels. Conversely, a lower actual and forecast value of the adjusted reserve ratio works to increase the value of the 1985 multiplier relative to the corresponding month in 1984. The contribution of changes in the currency ratio varies considerably from month to month, and in several months is quite small. Changes in all the other ratios show little influence on the year-over-year changes in the multiplier.

Finally, we have been experimenting with forecasts from a log linear approximation to the multiplier model. This model uses the same component ratio ARIMA models as in Tables 1 and 2, but instead of using the exact non-linear formula to put the component forecasts together into a forecast of the multiplier, a linear Taylor series approximation is employed. In this case, the log of the M_1 - Adjusted Monetary Base Multiplier is expressed as the sum of the elasticities of the multiplier with respect to each of the component ratios multiplied by the appropriate components, plus an error term. The

52

elasticities are evaluated at the geometric means of the various ratios for the sample period. The sample period residuals of this expansion are modeled by an ARIMA process. The component models, plus the residual model form a log-linear system which can be solved for a forecast of the multiplier. The advantage of this linearization is that if we assume that the innovations of all of the ARIMA models are jointly normally distributed, we are able to construct standard errors for the multiplier forecast from the linear approximation model from the covariance matrix of the innovations of the ARIMA models. Since the M_2 and M_3 multipliers are functions of the same component ratios, this linearization technique can be applied to these multipliers at the same time, if desired, confidence ellipsoids for the several forecasts can be constructed. Forecasts from the linearized model together with estimates of a 95% confidence interval are given in Table 3. A comparison of the linearized forecasts in Table 3 with the exact non-linear forecasts in Table 2 reveals that the linearization is highly accurate.

53

APPENDIX TABLE 5

Comparison of Revised and Old M1 Growth Rates
(percent changes at annual rates)

	Revised (M1)	Old M1	Difference (1-2)	Difference due to Benchmark	Seasonals
	(1)	(2)	(3)	(4)	(5)
Monthly					
1983--Oct	8.1	6.2	1.9	0.2	1.7
Nov	5.0	3.2	1.8	0.2	1.6
Dec	4.1	5.3	-1.2	0.1	-1.3
1984--Jan	7.7	10.7	-3.0	0.1	-3.1
Feb	6.3	6.6	-0.3	0.4	-0.7
Mar	7.0	5.2	1.8	0.6	1.2
Apr	4.2	0.4	3.8	0.1	3.7
May	7.3	12.8	-5.5	0.0	-5.5
June	10.6	11.3	-0.7	-0.1	-0.6
July	-0.9	-1.1	0.2	0.2	0.0
Aug	4.4	1.8	2.6	-0.2	2.8
Sept	5.7	5.0	0.7	-0.1	0.8
Oct	-6.7	-7.4	0.7	0.2	0.5
Nov	12.0	8.6	3.4	0.6	2.8
Dec	10.4	11.1	-0.7	0.1	-0.8
1985--Jan[p]	9.2	9.7	-0.5	0.3	-0.8
Quarterly					
1983--QIV	6.3	4.8	1.5	0.3	1.2
1984--QI	6.2	7.2	-1.0	0.3	-1.3
QII	6.5	6.2	0.3	0.2	0.1
QIII	4.5	4.5	0.0	0.0	0.0
QIV	3.4	2.0	1.4	0.2	1.2
Semi-Annual					
1984--QIV '83 to					
QII '84	6.4	6.7	-0.3	0.2	-0.5
QII '84 to					
QIV '84	3.9	3.3	0.6	0.1	0.5
Annual (QIV to QIV)					
1983	10.4	10.0	0.4	0.3	0.1
1984	5.2	5.0	0.2	0.2	0.0

p--preliminary

TABLE 1

M$_1$ - Adjusted Monetary Base Multiplier Forecasts
1985
Seaonally Adjusted[1]

Month

January	2.5705
February	2.5955
March	2.5831
April	2.5916
May	2.5883
June	2.5725
July	2.5849
August	2.5937
September	2.5886
October	2.5874
November	2.5936
December	2.5891
January	2.5868
February	2.5920

[1]Seasonal factors for monetary aggregates published in February, 1985.
Seasonal factors for adjusted monetary base published in March, 1984.

TABLE 2

M_1 - Adjusted Monetary Base Multiplier Forecasts

February, 1985 Base, Not Seasonally Adjusted

Month	1985	1984	% change[1]	k ratio	t_1 ratio	% change due to changes in the:				
						t_2 ratio	g ratio	z ratio	rl ratio	tc ratio
Jan	2.5889	2.6175	-1.10	-.48	-.74	-.72	.02	.00	.82	-.01
Feb	2.5770	2.5835	- .25	-.20	-.59	-.57	.00	.00	1.03	-.01
Mar	2.5813	2.5871	- .22	-.11	-.59	-.46	.03	.00	.89	-.01
Apr	2.6269	2.6203	.25	-.02	-.56	-.35	.01	.00	1.15	.00
May	2.5694	2.5688	.02	-.24	-.64	-.31	-.01	.00	1.20	.00
June	2.5848	2.5838	.03	-.20	-.69	-.27	.00	.00	1.18	.00
July	2.5837	2.5688	.58	.04	-.58	-.19	-.02	.00	1.31	.00
Aug	2.5724	2.5539	.72	.26	-.50	-.21	-.01	.01	1.16	.01
Sept	2.5823	2.5588	.91	.27	-.48	-.22	.01	.02	1.29	.02
Oct	2.5920	2.5589	1.29	.53	-.30	-.12	-.04	.02	1.17	.02
Nov	2.5900	2.5589	1.21	.36	-.26	-.14	.00	.02	1.19	.02
Dec	2.6019	2.5796	.86	.05	-.28	-.17	.00	.01	1.24	.01

[1]Year over year percent change.

TABLE 3

M_1 - Adjusted Monetary Base Multiplier Forecasts
1985
February, 1985 Base
Not Seaonally Adjusted Linear Approximation Models

Month	Forecast	95 % confidence interval	
January	2.5889*		
February	2.5769*		
March	2.5807	2.5517	2.6100
April	2.6263	2.5820	2.6714
May	2.5693	2.5146	2.6251
June	2.5840	2.5191	2.6507
July	2.5830	2.5095	2.6587
August	2.5724	2.4916	2.6559
September	2.5822	2.4936	2.6738
October	2.5915	2.4960	2.6907
November	2.5905	2.4888	2.6964
December	2.6021	2.4936	2.7153

*Actual

INTERNATIONAL TRADE POLICY: THE TWO MAIN TASKS

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International trade policy exhibits a degree of instability unknown since the end of the 1940s. The repercussions are felt in many directions but in most of them they represent only a gradual deterioration, a growing burden on the world economy. The one area in which the general growth of protection could produce dramatic results soon is international financial relations. The international debt crisis is far from over and I would argue that a solution of it acceptable to both sides must include an international agreement stabilizing the conditions of trade.

Restoring credit worthiness is not primarily a question of increasing the export earnings the indebted countries can realize from existing production capacities. Such an increase goes, of course, in the right direction, but it is only a minor contribution given the magnitude of the problem. A number of indebted developing countries, including the two main ones, Brazil and Mexico, achieved large current account surpluses last year which led to a widespead perception that the debt crisis was easing and coming under control again. It is, however, unlikely that the 1984 current account achievements of most debtors can be repeated in 1985, certainly not those of Brazil, with inflation in three digits and rising, and the first civilian government in two decades taking power. Crisis headlines will reappear in the business, perhaps even on the front, pages of our newspapers.

A *solution* of the debt problem must involve a substantial improvement in the overall performance of the indebted economies and that is beyond the possibilities of financial policy alone. Rescheduling the principal, manipulating the interest, riding herd on the hundreds of nervous banks involved are all necessary measures but far from sufficient. The reason is simple. We know that all the debt cannot be repaid or even serviced but nobody is in a position to say today what proportion of it can be salvaged. That depends entirely on more general economic policies in both creditor and debtor countries.

The political constraints on macroeconomic policy, trying to squeeze a "sufficient" external surplus for debt service from the Latin American economies operating on their present level of efficiency, are obvious. Yet in the international discussion of the problem, microeconomic policy reforms needed to improve the overall performance of the indebted economies, have been given but minimal attention so far.

Not just more investment is needed to improve economic performance but a more efficient allocation of it. The average rate of return on investment cannot be raised in the debtor economies without a substantially improved *pattern of investment incentives*. Rising real rate of return on investment would ease the interim financing problems by increasing the voluntary inflow of capital, inducing even some repatriation of the private assets held abroad by nationals of the most indebted countries. But how is the level and pattern of investment incentives to be improved in economies where the public sector accounts for more than a half of aggregate gross investment and the allocative rôle of the market has been correspondingly weakened?

Trade policy appears to be the logical starting point, as it was instrumentally involved already in the emergence of the debt problem. It should be recalled that the large-scale borrowing by the now over-indebted countries coincided with rising protection everywhere. The increasing uncertainty of trading conditions could not fail to further distort investment incentives in the borrowing countries. It is thus a safe conclusion that a credible long-term stabilization of the conditions of international trade would allow attractive new investment opportunities to emerge in the debtor economies. The presence of such opportunities would be an additional, possibly quite effective, political argument for privatization of the industrial enterprises now inefficiently operating in the public sector.

Only the large creditor countries can stabilize international trade conditions sufficiently for these effects to occur. They should, of course, act unilaterally in this respect but it is important that the debtor countries also agree to accept a basic discipline in the conduct of their trade policy. At present, they have an almost unlimited freedom to restrict imports. They should be urged to eliminate or phase out existing quantitative restrictions, replacing them perhaps by higher, but bound, tariffs. The important point here is that tariffs do not insulate an economy from the international price system as quantitative restrictions do. Moreover, once tariffs are bound and the government's freedom of interfering with import transactions effectively constrained, most of the "purely" domestic policies distorting resource allocation (such as subsidies or enforcement of private cartel agreements) cease to be feasible, or at least lose much of their effectiveness. Liberalization of imports

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thus can be said to compel internal liberalization, strengthening the allocative rôle of the market.

The debt problem is, of course, only one argument for an international action to restore stability in the conditions of trade. The cost of protection to the protecting economies is another, in the long run even more important one; and there are many indirect, political costs of interfering with foreign transactions, especially for the United States with its global political responsibilities. Governments are becoming aware of these costs of allowing the present drift in trade policy to continue. Our diplomacy is now engaged in an effort to get a new round of trade negotiations underway.

It is at the moment impossible to say whether the effort will be successful. It may be useful, however, to point out the two dangers it entails. The Administration has proposed, and obtained statutory authorization, to negotiate free trade area arrangements with Israel, Canada, and the countries of the Caribbean Basin. This is widely interpreted as a stratagem to induce the European Community into a wide-ranging trade negotiation. A genuine free-trade area, with all trade between the partner countries relieved of all obstacles, is probably a good thing; as it eliminates the political uncertainty impinging on transactions between the partner countries, it promotes investment and growth by virtue of which the trade creating effects are likely to dominate the trade diverting ones. The danger is, however, that the free-trade area arrangements negotiable under the present trade policy conditions, conceptions and practices will fall considerably short of genuine free trade. There may be, for example, an agreement to eliminate tariffs accompanied by provisions for administrative "management" of trade in "sensitive" sectors. Should

that occur the system of internationally agreed rules to govern national trade policies would be weakened futher and the chances of a productive multilateral trade negotiation would grow even more remote.

The second danger inheres in the habitual approach of trade policy makers to international negotiating rounds. They are conceived of in terms of bargaining for concessions on the basis of reciprocity. This technique was developed specifically for tariff negotiations where it proved useful. It cannot, however, cope with the present difficulty which stems from advanced erosion of the very principles on which the system of rules was based. Approaching these problems in the adversary, bargaining mode would be not only pointless but in fact counterproductive.

The destabilization which occurred mainly in the 1970s can be traced to two specific breaches of the trade policy rules agreed upon after World War II. One is flagrant, concerns the main principle and conditions of the international trade system, and requires only a brief explanation. Protection levels could not have risen as much as they have if it had not been possible for governments to grant protection in a discriminatory way. While bilateral export restraints remain available as a form of protection which, though incomplete, is easily negotiated, little else can be done to stabilize the international trading system. The practice is clearly contrary to the GATT rules which prohibit quantitative restrictions on imports and exports in general, and discriminatory quantitative restrictions *a fortiori*. The restraint is a bilateral agreement, however, and where there is no plaintiff, rule breaking cannot be prosecuted.

There is a way of permanently remedying this defect. From the viewpoint of trade policy makers, it would amount to a virtual revolution. It would consist of a legal act by which the non-discrimination commitment (the unconditional MFN clause) would be transformed from a diplomatic convention to a requirement of national law, effectively binding the governments of at least the major trading countries.

The second major breach concerns issues of a highly technical nature, well beyond the attention and understanding of general public: administrative procedures for handling subsidy and dumping complaints. If sufficient political support is to be maintained nationally for an international trade system, there must be provisions against unfair competition. Subsidies and dumping are the two main forms here, the unfairness being real in the first case, widely suspected in the second. Firms required by law to compete against each other must have legal recourse when they find themselves competing with firms backed by public subsidies.

As economists we may find it difficult to understand why a country should refuse to accept subsidized imports. Indeed, if the foreign subsidy could be expected to stay in place for a sufficient length of time, it would be equivalent -- from the viewpoint of the importing country -- to a change in comparative advantage to which it would be efficient to adjust. When subsidization becomes widespread, however, as it has become in the last decade, it cannot but generate investment-inhibiting uncertainty in the importing countries. There is an additional, more practical argument. When we maintain that subsidized imports are a benefit, we assume that only some governments are foolish enough to subsidize, the importing country's government

64

being fully rational, impervious to the temptation. Is there such a government? International rules against subsidization were intended to protect all governments against domestic political demands for subsidies.

The traditional procedure in these cases was that firms exposed to such a competition would complain, an investigation would be instituted and if a significant margin of subsidy or dumping was ascertained, an offsetting duty would be imposed on the imported merchandise. A logically equivalent remedy might be to demand a "price undertaking" from the exporters, i.e., that they raise their price by the amount of the officially established margin between the original export price and the true cost of production. From the end of the 1970s, however, a third remedial practice has become legally established, in which an agreement by the exporting country to restrict exports of the challenged merchandise to a given amount -- a quantitative restaint -- is an acceptable alternative settlement of complaints against subsidized or dumped imports.

This practice has fundamentally changed trade policy. Exporting firms and industries fear perhaps nothing more than an investigation for subsidies or dumping. The investigation can drag on and while it lasts, the exporter is paralyzed as to reacting to market changes. The particular market, established through substantial investment of both finance and effort, may be lost to competiton while the official decision on a subsidy or dumping complaint is pending. Exporters are therefore strongly predisposed to settle for a quantitative limit on their sales when such an agreement *terminates* the official investigation. Export restraint settles the complaint quickly; but

then, too, a fundamental principle of legal procedure is sacrificed. Remedy is imposed (punishment meted out) without any proof of wrong-doing. Indeed, there is a glaring logical inconsistency: a restraint is agreed to offset the harmful effects of a putative subsidy or dumping the extent of which has not been established. Looked at from the viewpoint of the complaining domestic firms, protection is now available practically for the asking.

As long as this easy road to protection remains open -- that is, as long as the authorities administering the two largest important markets of the world, the US and the EC, have legal power to settle unfair competition complaints in this way -- the hope of a "standstill and rollback" agreement on new and recently imposed protectionist measures, even if all trading nations agree on its desirability, cannot lead to any practical results.

The correction of this defect of the trading system is theoretically simple, though it will be difficult to achieve in political practice. Where subsidization is involved there is no other solution than a legal requirement that all investigations must be completed. That ultimately means that governments will have to stop, or at least radically limit, subsidization of exportables. As regards dumping, it should be recognized that price differentiation across markets is a normal and efficient pricing practice rather than a predatory form of competition, and that it should not give rise to official intervention in the market.