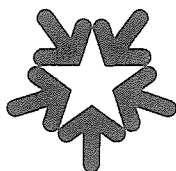


SHADOW OPEN MARKET COMMITTEE

**Policy Statement and
Position Papers**

September 22-23, 1985

PPS-85-2



CENTER FOR
RESEARCH IN
GOVERNMENT
POLICY
& BUSINESS

Graduate School of Management
University of Rochester

SHADOW OPEN MARKET COMMITTEE

Policy Statement and Position Papers

September 22-23, 1985

PPS-85-2

1. Shadow Open Market Committee Members - September 1985
2. SOMC Policy Statement, September 23, 1985
3. Position papers prepared for the September 1985 meeting:

Economic Outlook, Jerry L. Jordan, First Interstate Bancorp

The Money Markets, William Poole, Brown University

Recent Budget Policy and Economic Impact, Mickey D. Levy, Fidelity Bank

Where is the Mystery in the Behavior of the Monetary Aggregates?, Robert H. Rasche, Michigan State University

Update to the September, 1985 Shadow Open Market Committee Report: The Behavior of the Monetary Aggregates in August, 1985, or "The Grinch That Stole Christmas", Robert H. Rasche, Michigan State University

Commentary on Prospects For Money and the Economy, H. Erich Heinemann, Ladenburg, Thalmann & Co., Inc.

SHADOW OPEN MARKET COMMITTEE

The Committee met from 2:00 p.m. to 7:30 p.m. on Sunday, September 22, 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.

MR. ERICH HEINEMANN, Chief Economist, Ladenburg, Thalmann & Company, Inc., New York, New York.

DR. JERRY L. JORDAN, Senior Vice President and Economist, First Interstate Bancorp, Los Angeles, California.

DR. MICKEY D. LEVY, Chief Economist, Fidelity Bank, Philadelphia, Pennsylvania.

PROFESSOR WILLIAM POOLE, Department of Economics, Brown University, Providence, Rhode Island.

PROFESSOR ROBERT H. RASCHE, Department of Economics, Michigan State University, East Lansing, Michigan.

DR. ANNA J. SCHWARTZ, National Bureau of Economic Research, New York, New York.

DR. BERYL SPRINKEL, On leave from the SOMC; currently Chairman of the Council of Economic Advisers.

The Committee noted with sadness the death of its friend and colleague, Jan Tumlir. His important contributions to the preservation of a liberal trading system are sorely missed in the current protectionist climate.

POLICY STATEMENT

Shadow Open Market Committee
September 23, 1985

The economy appears poised for renewed expansion and faster growth. The short-term outlook is promising but long-term problems including inflation threaten economic stability. Four problems require attention.

Stop and Go Once Again

First, the Administration and the Federal Reserve have resumed the stop and go policies that produced stagnation and inflation. Recently both money growth and the growth of government spending have been excessive. Growth of money -- currency and checkable deposits -- is likely to set a postwar record in 1985. Since early 1984, real government spending -- government spending adjusted for inflation as measured in the national income accounts -- has increased at an average rate more than twice the rate of growth of real output.

The recent budget compromise reduces spending too little and does not face up to the necessary structural changes. Many of the reductions are overestimated. Others are postponements of spending rather than genuine program reductions. Most of the proposals by the Administration and/or the Senate to eliminate programs have disappeared. New spending for agriculture and bailouts for public and private financial institutions not included in the Budget Resolution threaten to cancel most of the reduction and increase spending now or later.

Recent trends in government purchases and private investment have reversed the trends at the start of this expansion. During the first five quarters of the current expansion, real government purchases, adjusted for inflation fell at a 3

percent annual rate, while real investment rose at a 46 percent annual rate. The share of resources used for investment rose, while the share used by government fell. During the next five quarters, ending in June 1985, real investment rose at only 0.6 percent annual rate and real government purchases rose by 6.6 percent. The latter rate is more than twice the rate of growth of real output during the same period. As a result, the share of current resources used for investment has fallen while the share spent by government has increased.

Money growth has shifted from high to low every three to five months since early 1984. This pattern increases uncertainty and discourages long-term planning. Further, the trend rate of money growth is rising, reopening the prospect of another round of inflation.

Three of the main justifications for current monetary policy repeat old errors. One is that financial deregulation has distorted the monetary aggregates. A second claim is that indicators other than money growth do not signal inflationary pressure. The third is that faster money growth is needed to bring down the exchange rate and aid manufacturing.

The driving force behind money growth is Federal Reserve policy, as shown by the growth of the monetary base. Our monthly forecasts of money growth, given base growth, remain highly accurate and show little evidence of distortion. Conjectures about effects on money growth of E.F. Hutton's management practices, the decline of the dollar or failures of thrift institutions have have no foundation.

The claim that money growth alone gives evidence of inflationary pressure is heard at the start of every new round of inflation. Each time, the high costs of previous inflation and disinflation are dismissed so that policymakers can pursue some short-term goal. Usually, the short-term goals are inconsistent with long-term stability. In the sixties and seventies, pursuit of employment goals or attempts to stimulate housing production produced high inflation accompanied by stagnation and left a residue of problems in agriculture, among thrift institu-

tions and in banking. These experiences should have convinced us that there is no permanent tradeoff between long-term price stability and growth.

Federal Reserve attempts to raise real growth or increase manufacturing output can at best succeed only temporarily. Monetary policy can lower the real value of the dollar only by reducing real after-tax rates of return on dollar-denominated assets. The strength of the dollar is a real, not a monetary, phenomenon arising from the higher anticipated real, risk adjusted returns on investment in the U.S. The Federal Reserve can reduce the real rate of interest and the real value of the dollar only temporarily. The longer-term effect of rapid monetary expansion will be a renewed flight from the dollar in anticipation of more rapid inflation. A decline in the dollar in response to inflation brings no benefit to U.S. producers and is costly for both consumers and producers.

The only way to avoid the high costs of inflation and disinflation is to avoid inflation. Inflation will not be avoided unless the Federal Reserve and the pro-inflationists in Congress and the Administration accept a long-term commitment to achieve stability. The Administration came into office with announced policies to achieve slow, steady and predictable money growth and to reduce the size of government. Neither has been achieved and these goals appear to have been abandoned.

We urge the Federal Reserve to end the erratic swings in money growth and turn to a stable non-inflationary growth path. The recent budget compromise does not reduce spending enough. We urge Congress and the Administration to adopt genuine and substantial reductions in spending sufficient to reduce permanently the growth of total government spending below the growth of total output.

The Heritage of Past Inflation

Second, policymakers have neglected or mismanaged several problems resulting from faulty policies and past inflation and disinflation. Inflation and mistaken government agricultural policies are the root of current problems of agriculture and agricultural lending. The precarious position of the thrift industry, as evidenced by a large number of forced mergers, failures and insolvent institutions that continue to operate, is the result of inflation, disinflation, mismanagement and mistaken regulatory policies. The belief that high inflation would continue encouraged large-scale borrowing by Latin American governments and other current, large debtors. The same belief encouraged the large-scale lending by U.S. banks that now weakens the financial structure. Policies of the lending and borrowing countries have done little to restore the conditions for economic progress in the debtor countries.

Rapid money growth in 1985 poses a dilemma. One choice would be to continue rapid money growth which would bring back the high rates of inflation experienced in the seventies. Market interest rates would rise, the dollar would fall and demands to stop inflation would grow. A new round of anti-inflation policy would then produce a new recession. The painful process of disinflation would start again. The costs of past inflation and disinflation are so large and visible that higher or even continued inflation should be unthinkable. Yet, the Administration, Congress and the Federal Reserve ignore current inflation of 4 percent or more and run large risks of increased inflation.

A second choice would be to reduce money growth gradually to a non-inflationary rate. We have recommended a gradual policy many times, but the Federal Reserve, while giving lip service, has never implemented such a policy. It has typically waited too long until inflation was well entrenched. Then, it has overreacted, pushing the economy into, at times, severe recessions.

A third choice would be to reduce money growth promptly. This choice would run the risk of a small recession now so as to avoid higher inflation and a bigger recession later. This course seems to us least costly at present. It avoids the costs of higher inflation and subsequent disinflation. The urgent task for the Federal Reserve is to return to a less inflationary path promptly and remain on a disinflation path.

We urge the Federal Reserve to achieve its targets, to stop rebasing and to return the money stock to a growth path of 5.5 percent from the second quarter of 1985 through the fourth quarter of 1986 as had been announced. The target for policy should be M-1, and other monetary and credit aggregates should be discarded.

International Debt and Protectionism

Third, world prosperity and the payment of interest on outstanding international debt are threatened by existing protectionist policies and demands for increased protection. Debtors can only service debt by exporting more than they import. Restrictions on imports by the United States and other developed countries increase financial instability and are contrary to the interests of consumers. Fear of default by debtors and the burden of outstanding debt reduce borrowing and lending and the ability of debtor countries to return to prosperity.

The U.S. and the IMF have no effective policies for reducing the burden of the debt for debtor countries. New non-inflationary approaches are needed to reduce the instability of the world financial system.

We urge the Administration and the Federal Reserve to promote a restructuring of international debt by encouraging banks (1) to sell within a reasonable time period a sufficient amount of their developing country loans to establish market values; (2) to encourage foreign governments to convert a

portion of their debt to equity in firms in the developing countries, including nationalized firms, at the current market value of the debt; and (3) to encourage banks to acknowledge their losses.

Tax Policy and Protectionism

Fourth, there are only two ways to change the competitive position of the U.S. world economy. Either productivity growth permits U.S. producers to compete effectively in world markets while maintaining or increasing the real incomes and employment opportunities of American workers or American incomes and costs of production must fall. There is no doubt about which choice is preferable.

The current capital inflow to the United States provides the opportunity to rebuild and renew our productive capital without reducing current consumption. Foreigners have been lending us billions of dollars that can be invested in new and old industries. This capital inflow from abroad is the driving force in the balance of payments. It permits us to raise our current standard of living while investing to improve our future.

The offset to the capital inflow is the current account deficit. Excessive concentration on the deficits in trade and current accounts ignores the beneficial effects of the capital inflow and ignores the main cause of these deficits -- the relatively attractive opportunities for investment that appeals to investors in the U.S. and the rest of the world.

Many, particularly in the Congress, share the mistaken belief that American industry cannot compete without higher tariffs, smaller quotas and other forms of protection against imports. Their proposals call for more protection.

Protectionist policies reduce the trade deficit by lowering living standards.

The more protection we give to our industry, the lower our standards of living.

There is a better way. The government can choose higher productivity and increased standards of living by reducing taxes on capital and lowering the cost

of capital to American firms. Although the Administration's tax reforms have many desirable features, they do not respond to the protectionist challenge and do not give sufficient weight to productivity, investment and the competitive position of the U.S. in the world economy.

We urge the Administration and the Congress, as a minimum program, to reduce the cost of capital to American corporations by reducing corporate tax rates, indexing depreciation and permitting dividend payments to be treated as an expense. The Administration's tax program fails in this respect. It is the wrong program for the United States at this time..

ECONOMIC OUTLOOK

Jerry L. JORDAN
First Interstate Bancorp

It now appears that monetary growth in 1985 will be the most rapid for any year yet recorded, exceeding even the extremely rapid 10.4 percent increase in 1983. Consensus forecasts that extrapolate recent sluggish pace of economic growth, in spite of extremely rapid monetary growth, suggests we will replay the experience of the spring of 1983. At that time both the Federal Reserve and the Administration were surprised by the sharp acceleration in the pace of economic activity even though the SOMC had signalled at the March '83 meeting that such a development was highly probable.

In another context, it now appears that economic policies overall are destined to create conditions similar to the late 1970s. The initial rebound in economic activity and the recovery of 1975 was very strong, only to be followed by the "pause" or "plateau" of 1976 (subsequent to the New York City financial crisis). Concerns about the economy slipping into recession at the time of, or shortly after, the 1976 elections caused economic policies to become extremely stimulative, producing substantial overheating of the economy by 1978.

In the current cycle, the vigorous recovery from the spring of 1983 to the summer of 1984 was followed by a four-quarter "pause" or "plateau" (subsequent to the Continental Bank financial crisis). Now, post-election year concerns about "growth recession" have once again produced highly stimulative economic policies which, if sustained, would produce significant overheating of final demand sometime in the next couple of years.

Rebasing Money Targets

At the March '85 meeting of the SOMC we raised the possibility that "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 signalled by Vice Chairman, Preston Martin when he acknowledged the possibility that M1 might be allowed to grow 8-10 percent in 1985, with the justification that velocity growth might be low".

Also at the March meeting, we noted the possibility that if the 11 percent growth of money recorded for the first quarter were to be continued through the second quarter then it would be necessary for the Fed to cut money growth to zero during the second half in order to return to the mid-point of the original target range. As it turned out, the Fed did rebase monetary targets in July essentially because they saw no good alternative. The Open Market Committee obviously realized that had they announced in July of this year that they were going to maintain the original target range it would have been very upsetting to financial market participants as well as members of the U.S. Congress to know that the intention of the central bank was to achieve essentially zero money growth for the balance of the year.

On the other hand, the Federal Reserve has never overtly raised the monetary growth targets during the previous ten-year experience with targetting. As of the middle of this year, had they simply announced that they were substantially increasing the target range for the whole year, it potentially could have had an adverse affect on long-term inflation psychology. By rebasing the target to the second half of the year, they were able to maintain the appearance of a long-run determination to produce a lower trend of money growth, ultimately achieving

stable prices, but forgive the substantial overshoot of actual money growth during the first half of the year.

Accompanying charts show the monetary growth so far in 1985 plotted against the original target cone and corridor and also illustrate the effects of the rebasing of targets as of midyear. In effect, the announcement by Chairman Volcker in July that the Committee would now seek growth of M1 in the second half of '85 in the range of 3-8 percent was identical to raising the target range for the entire year to a 6.8 percent to 9.4 percent band. Nevertheless, even with the substantial increase in the effective targets for this year, they continue to exceed the target range by a wide margin. Available data suggest that M1 growth for the third calendar quarter is going to be approximately 15 percent, resulting in growth for money for the first three-fourths of this year at 12.9 percent annual rate. Even if money growth now dropped to only 6 percent during the fourth quarter, growth of money for all of 1985 would be about 10.6 percent.

At the July midyear review, Chairman Volcker announced a tentative indication of a target range for 1986 of 4-7 percent, effectively setting a target of 5.5 percent plus or minus one-and-a-half percent. That tentative target range for 1986 implies a 50 percent reduction in money growth from this year to the next year which, at this point, looks highly unlikely and if it were to occur would be expected to have at least a short-run adverse effect on real output growth.

Once again the Fed's policy actions have created conditions under which there are no good alternatives available. If they sustain the extremely rapid money growth that we have seen so far this year, then inevitably inflation will accelerate. On the other hand, if they sharply curtail monetary growth in order to offset the overshoot of the recent past, their actions would probably produce at least a sharp slowing in economic growth, if not an actual contraction in output. Table 1 shows M1 and monetary base growth for intervals since 1976.

Monetary growth had contracted sharply in 1984 compared to the longer-term trend, but now the rapid monetary growth during the first three quarters of 1985 has been sufficient to restore the longer-term 7-8 percent trend rate.

Table 1

	<u>M1</u>	<u>MB</u>
Q4/76 - Q4/80:	7.8%	8.7%
Q4/80 - Q4/84:	7.4	7.3
Q4/76 - Q4/84:	7.6	8.0
Q4/84 - Q4/84:	5.2	7.3
Q4/84 - Q3/85:	12.9	8.4

Strong Final Demand

Spending by businesses and households in the U.S. economy so far in 1985, has been quite strong and should be expected to continue to be strong in view of the monetary stimulus. As measured by gross domestic purchases or final sales and illustrated in the accompanying charts, spending has gained strength with a relatively short lag following the acceleration in monetary growth that began late in 1984. The initial phase of the "pause" or "plateau" of economic growth in the second half of '84 and early '85 followed the significant deceleration in money growth that occurred in '84 compared to 1983. In the second quarter of '85 nominal final sales, retail sales, and gross domestic purchases rose at annual rates of 7.3 percent, 10.7 percent, and 6.7 percent, respectively, suggesting that the apparent weakness of the economy in the spring and summer was not due to a lack of demand. Another accompanying chart shows the growth of domestic purchases versus GNP, illustrating the point that the decline of net exports and the slower rate of inventory accumulation were the reasons that this strong final demand was not reflected in domestic production. For the balance of 1985 and

continuing into 1986, the extremely rapid monetary growth that is continuing at the present time suggests that demand will remain strong and most likely domestic production will strengthen as a faster pace of inventory accumulation resumes and net exports contract at a slower rate.

FOMC Projections

Table 2 shows the most recent FOMC projections for 1985 compared with the projections of last February. In addition, projections for 1986 are reproduced.

Table 2

FOMC Projections^a

<u>For 1985:</u>	<u>February '85</u>	<u>July '85</u>
GNP:	7-1/2 - 8%	6-1/2 - 7%
Output:	3-1/2 - 4%	2-3/4 - 3%
Prices:	3-1/2 - 4%	3-3/4 - 4%
Unemployment ^b :	6-3/4 - 7%	7 - 7-1/4%
 <u>For 1986:</u>		<u>July '85</u>
GNP:		7 - 7-1/2%
Output:		3-1/2 - 3-1/4%
Prices:		3-3/4 - 4-3/4%
Unemployment ^b :		6-3/4 - 7-1/4%

^aCentral tendencies;
^bYear-end

For next year, the Fed has a target for M1 centering on 5-1/2 percent and projections of nominal GNP centering on about 7 percent, suggesting an increase in M1 velocity of about 1-1/2 percentage points for the year. While that implicit forecast for velocity is faster than what has been recorded so far in

1985, it is only about one-half of the long-run trend of velocity growth. For the four quarters of 1984, M1 velocity increased 4.5 percent which is substantially above the long-run trend. In 1985, M1 velocity as conventionally measured has appeared to decline by a significant amount. However, measuring velocity as the ratio of GNP to M1 and ignoring lags creates a misinterpretation of the concept that could lead to erroneous conclusions about future prospects. A separate memorandum made available to the Committee by Alison Lynn Reaser of the First Interstate staff explains why there are problems in measuring velocity in the conventional way.

Following the three quarters of explosive money growth recorded for 1985, past experience would suggest that nominal GNP growth will accelerate significantly. If monetary growth should be curtailed simultaneously, then the ratio of GNP/M1 would jump up sharply, giving the appearance of a substantial reacceleration of velocity growth. The above trend velocity growth recorded for 1984 was produced by a similar set of circumstances. The highly stimulative monetary policy of 1983 produced rapid GNP growth for at least a part of 1984. However, since monetary growth was decelerating as 1984 progressed, the ratio of GNP/M1 rose sharply. Subsequently, the deceleration of monetary growth was followed by a deceleration of GNP growth, yet M1 growth reaccelerated thereby producing a dip of the ratio.

In view of this past experience, it would be very surprising if nominal GNP growth did not accelerate sharply in the near future making it appear that velocity was starting to accelerate again.

Outlook

For the second half of 1985, it now appears highly likely that both nominal and real GNP growth will be substantially faster than during the first half of the year. Specifically, real output growth of around 5 percent for the half with

nominal GNP increasing by more than 9 percent should be expected. In the early part of 1986, this momentum should be expected to continue. However, should a sharp deceleration of monetary growth get underway near the beginning of next year, then later in '86 another "pause" or "plateau" could emerge.

Table 3

	<u>GNP</u>	<u>Output</u>	<u>Prices</u>	<u>M1</u>	<u>V1</u>	<u>MB</u>	<u>YB</u>
Q4/84 - Q4/85:	7 - 8%	3 - 4%	4 - 4-1/2%	10-12%	-3 to -4%	9-11%	-2 to -3%
Q4/85 - Q4/86:	8-10%	3 - 4%	5 - 6%	6 - 8%	2 - 3%	6-8%	2 - 3%

It is tempting to view the 5.2 percent increase of M1 in 1984 as having been appropriate in order to offset the 10.4 percent increase of 1983. Similarly, for 1986 a growth of only about 5 percent could be averaged against the explosive double-digit money growth in '85 to sustain the long-run trend range of 7-8 percent.

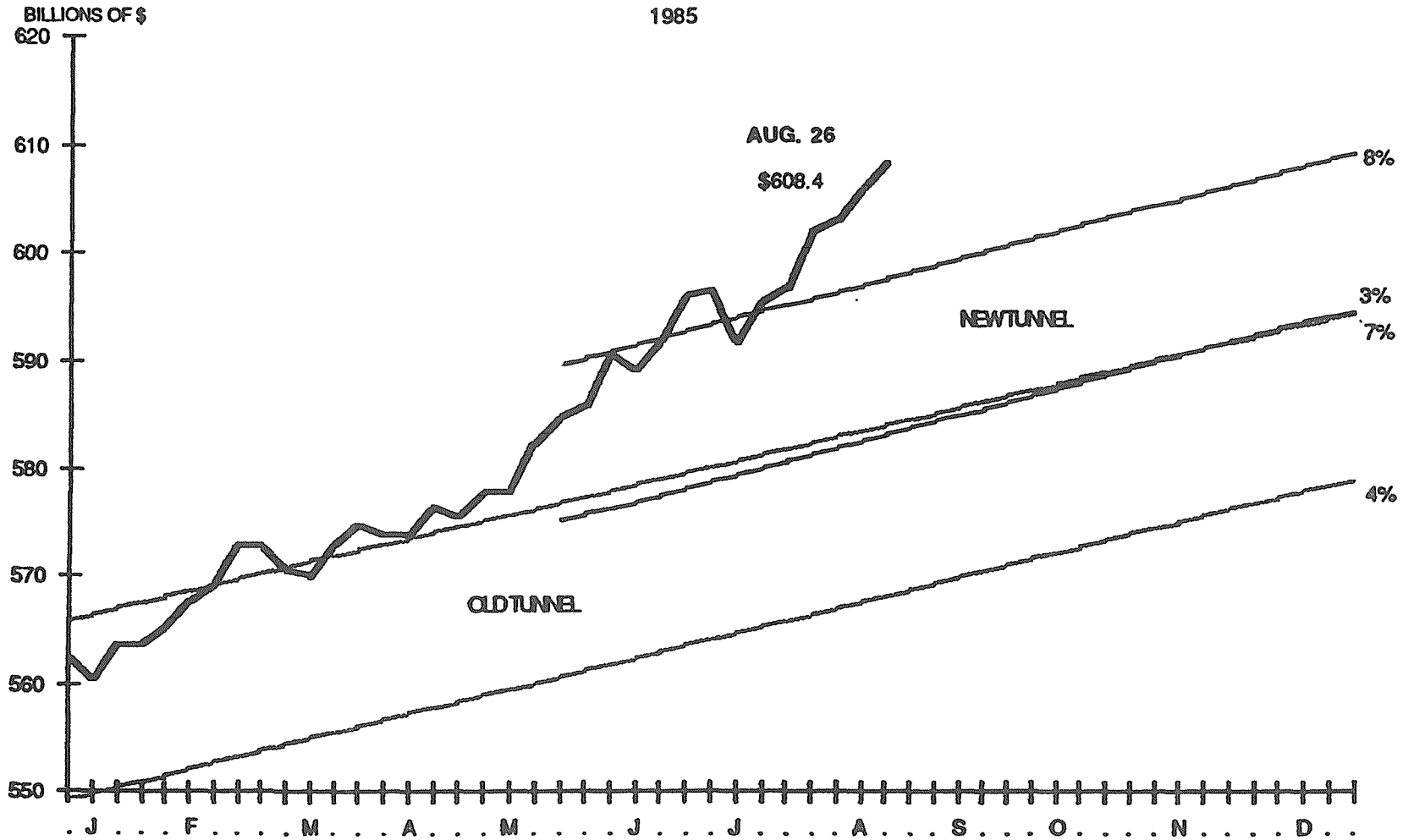
This is the eleventh year of monetary growth targeting by the Federal Reserve and for the entire period money growth has averaged 7.5 percent. Especially in view of the fiscal environment, there is little reason to expect that future average monetary growth will be any less than it has been in the past. However, it is also true that monetary growth has become increasingly volatile over two and three quarter intervals. Consequently, the three quarter monetary explosion such as we have recently experienced could be followed by a severe monetary contraction possibly lasting two or three quarters. In other words, the go-stop, go-stop policies of recent years are likely to be repeated in the future, making it virtually impossible to provide near-term economic forecasts in which anyone has any confidence. Over the longer-run, it seems safe to expect that a sustained trend rate of inflation in the 6-7 percent range is likely.

MONETARY BASE & M1 GROWTH

TWO QUARTER MOVING AVERAGE

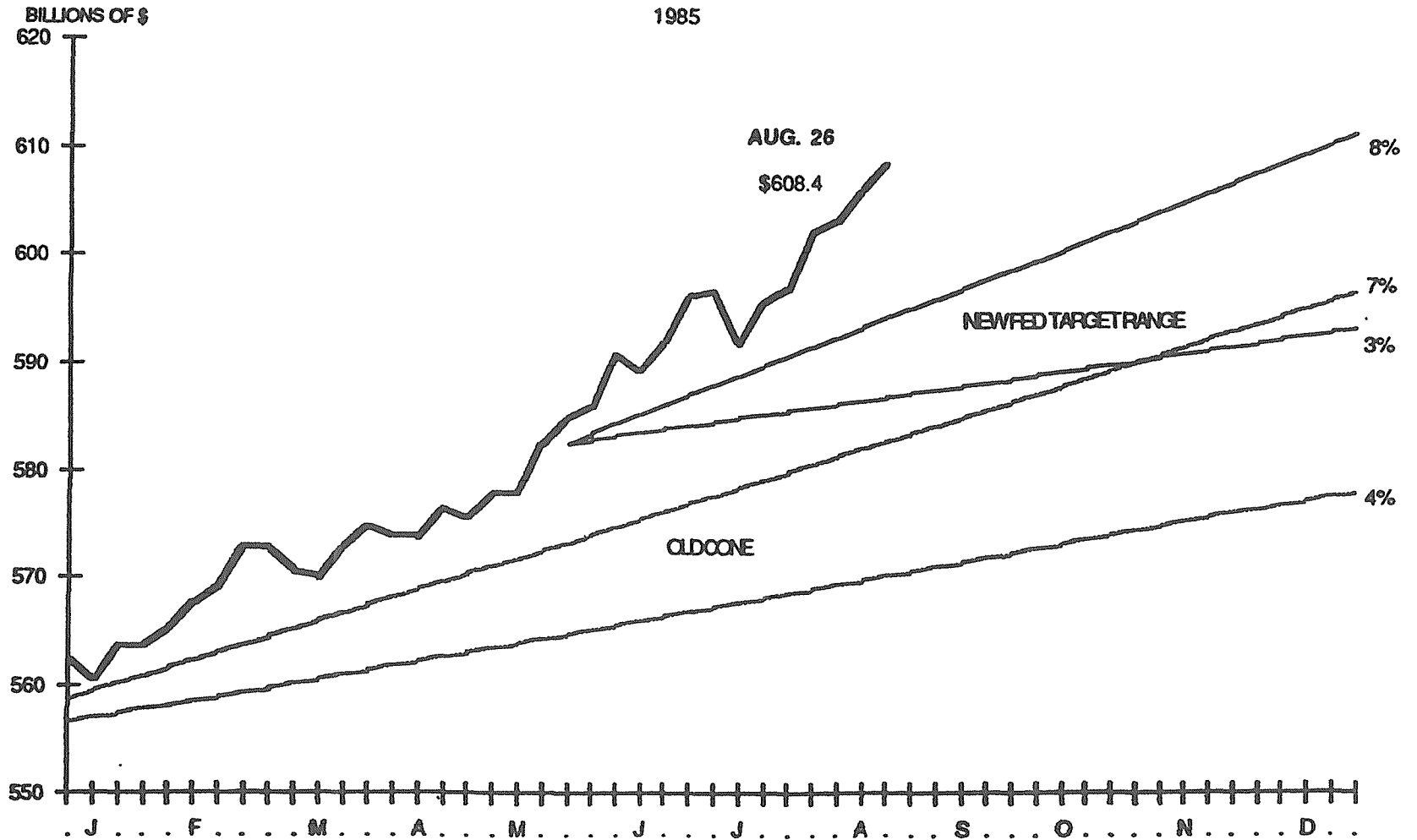


WEEKLY MONEY SUPPLY (M1) VS. FED TARGETS



17

WEEKLY MONEY SUPPLY (M1) VS. FED TARGETS



18

THE MONEY MARKETS

William POOLE
Brown University

Money market interest rates have fluctuated in a relatively narrow range since the last meeting of the SOMC on March 24-25, 1985. The weekly average federal funds rate has ranged between a high of 8.68 percent for the week ending April 3 and a low of 7.13 percent for the week ending June 19. Three-month Treasury bills have fluctuated between a high of 8.29 percent for the week ending March 29 and a low of 6.81 percent for the week ending June 21. In late August and early September federal funds traded generally in the 7.5-8 percent range and Treasury bills in the 7-7.5 percent range.

This sideways movement of money market interest rates reflects a standoff of opposing forces. On the one hand, the high rate of money growth has made the Federal Reserve reluctant to press interest rates down further; and the market, understanding both the Fed's reluctance and the danger that high money growth will lead to upward pressures on the inflation rate, has also been reluctant to push interest rates down.

On the other hand, a number of policy concerns have been pointing in the direction of holding interest rates down. Concern over slow growth of economic activity and the effects of higher interest rates on activity have suggested to the market that the Federal Reserve would be unlikely to permit rates to rise to any appreciable extent. Moreover, certain sectors of the economy -- notably agriculture and manufacturing industries suffering from intense import competition -- have appeared especially vulnerable to higher interest rates. Higher rates would have the direct effect of raising costs as seen by individual

firms and the indirect effect of strengthening the dollar, creating the prospect of a further loss of market position by U.S. farms and manufacturers to foreign producers in both foreign and domestic markets.

For these reasons, the Federal Reserve has been unwilling to permit interest rates to rise as necessary to choke off explosive money growth. (So far this year, M1 has been growing at a rate of about 12 percent, which may be compared with the approximately 8 percent rate that set off the late 1970s inflation.) The Fed's position has been reinforced by attitudes, sometimes expressed publicly, within the Reagan Administration and Congress. The policy environment is reminiscent of that in 1967, 1972 and 1977 just prior to the bursts of inflation in the late 1960s, the mid 1970s and the late 1970s.

Federal Reserve Money Market Targets

The Federal Reserve has described its short-run operating procedure as involving maintenance of a certain degree of "pressure" on bank reserve positions. This vague notion is given more concreteness by the Fed's target for the level of free reserves (when negative, sometimes called "net borrowed reserves"), and/or for the level of bank borrowing at the discount window.

As is well known, a free reserves target is essentially equivalent to a federal funds rate target. Free reserves are the difference between excess reserves and discount window borrowings. Other than when interest rates are extremely low, banks' holdings of excess reserves are insensitive to the rate of interest in the money markets. Borrowed reserves, however, depend on the spread between the federal funds rate and the discount rate; the higher is this spread the more willing are banks to borrow at the discount window.

If excess reserves were constant, and if the borrowing function were perfectly stable, then there would be a perfect one-to-one correspondence between a borrowed reserves or free reserves target and the federal funds rate. However,

because the excess reserves and borrowed reserves functions are not perfectly stable noise in these functions will transmit noise to the funds rate if the Fed maintains a free reserves target.

The Federal Reserve does, in fact, permit some of the noise in the excess reserves and borrowing functions to be transmitted in money market interest rates. However, the Fed also smooths out some of this noise in order to stabilize the federal funds rate. The Fed can also smooth rates by adjusting its free reserves target as necessary to keep the funds rate in a desired range.

To my knowledge, in recent years there has been no published justification going beyond pure description of a free reserves operating target by the Fed on an official basis or by a Fed Board or staff member on an individual basis. There can be little doubt that the Fed thinks of a free reserves target as a proxy for a federal funds rate target.

A free reserves target has the minor advantage to the Fed of making its views concerning the appropriate federal funds rate somewhat ambiguous to the market, thereby increasing operating flexibility to some extent. The underlying funds rate target can be adjusted somewhat more easily than under a pure funds rate targeting system such as that maintained in the 1970s because an adjustment, being less clear to financial analysts, is less likely to provoke an undesirable speculative response in the markets.

That the Fed's real target is the federal funds rate rather than free reserves is easily seen. Suppose that next week the banks' discount window borrowing function were to shift out and to the right by, say \$3 billion. To hit a free reserves target in these circumstances the Fed would have to push the federal funds rate up by several hundred basis points. Almost certainly, the Fed would accommodate the borrowing demand; it would keep the funds rate from rising by more than 50-75 basis points, and would instead either accept a missed free reserves target or revise the target.

Without question, the major advantage of a free reserves operating target to the Fed is purely political. In recent years a number of bills have been introduced in Congress that would require the Fed to target interest rates. The Fed regards these bills as unsound, which they are. But the Fed knows that it would be on weak ground in opposing such legislation if it were explicitly pegging the federal funds rate as it did during the 1970s. Thus, given the failure of its poorly-designed system of controlling non-borrowed reserves after October 1979, the Fed has found it convenient to revert to the free reserves and borrowed reserves targeting system used in the 1920s and 1950s.

The Federal Reserve is more or less active in cushioning pressures in the money market depending on its view as to the appropriate direction of interest rates in the light of the real economy, liquidity pressures in the financial markets, and a host of other considerations. Most unfortunately, controlling money growth has come far down the list of relevant considerations this year. Well above controlling money on this list has been the Fed's sensitivity to political pressures from the Administration and Congress.

The Asymmetry of Federal Reserve Policy

Because the Federal Reserve simultaneously leans against the economic winds and with the political winds in its stance toward interest rates, at certain times policy becomes asymmetric with respect to the direction of interest rate changes. There is at present practically no political concern whatever about inflation, but considerable concern about real economic activity and the level of the exchange rate. The arrival of economic statistics suggesting a stagnant economy tends to push the Fed toward prompt reduction in interest rates to stimulate activity. The main constraint is concern that falling interest rates today might have to be followed by a policy reversal in the near future, and concern that money growth has been excessively high this year.

A policy asymmetry exists, however, because the arrival of economic statistics suggesting a strong economy will not push the Fed toward a more restrictive stand involving higher interest rates. If interest rates come under upward pressure, the Fed is likely to give ground slowly; as we have seen this year, money will be permitted to grow at whatever rate is necessary to hold interest rates down. Under these conditions, it seems unlikely that the Fed will restrain money growth until it can make the case politically that action is required. Unfortunately, leaning with the political wind means that the case will not be made until inflation and the public's inflation fears revive.

Under present Federal Reserve policy another serious outbreak of inflation seems all but guaranteed. A policy of permitting money growth to proceed at a "normal" rate when interest rates are tending to fall and at an excessive level when interest rates are tending to rise is a recipe for disaster.

The Interest Rate Outlook

It is hard to see how the next major change of direction for interest rates can be anything but up; the upward-sloping yield curve indicates that the market shares this view. Since the last SOMC meeting, rates have declined only a little in the face of very rapid money growth. If the Fed acts to reduce money growth in the near future, rates are likely to rise temporarily. If the Fed does not act in the near future, continued high money growth will, sooner or later, boost economic activity and the inflation rate, both of which will raise credit demands and interest rates.

The only surprising feature of the present situation is the apparent complacency in the credit markets about the prospects for interest rate increases. Despite continuing high money growth bond yields are at about the same level as the beginning of the summer. If I were a bond investor, I'd be increasingly nervous.

RECENT BUDGET POLICY AND ECONOMIC IMPACT

Mickey D. LEVY
Fidelity Bank

The spending cut compromise incorporated into the First Concurrent Resolution on the FY1986 Budget substantially improves the budget outlook. Cyclically-adjusted deficits are forecast to recede in the next several years and, under a continuing economic growth scenario, the dramatic rise in the federal debt-to-GNP ratio should slow. The spending cuts will have only a minor near-term impact on the economy and are positive for long-run capital formation and economic growth. Certainly, federal outlays remain too high as a portion of GNP, and deficits would be much higher than official forecasts under a less optimistic economic path, but these spending cuts represent a step in the right direction.

In contrast to the positive impact of the spending compromise, the tax reform package proposed by the Reagan Administration would have a distinctly negative impact on capital spending and economic growth in both the short and long runs. Unfortunately, Congress and the Administration are concerned primarily that any tax package be "revenue neutral", a relatively unimportant issue. The potential economic impact of proposed tax reform deserves more attention.

The Budget Outlook

The savings generated from the budget compromise reached this summer are large, but significantly smaller than the advertised savings of the earlier House or Senate spending cut versions. According to the CBO, savings are approximately \$37 billion in FY1986, and \$203 billion in the three year period FY1986-FY1988,

compared to original House and Senate estimated savings of \$56 billion in FY1988 and either \$259 billion (House) or \$295 billion (Senate) for FY1986-FY1988. Half of the forecast savings occur in FY1988. Also, nearly two-fifths of the proposed cuts are in defense spending (see Table 1); the First Concurrent Resolution calls for zero real growth in FY1986 and approximately 2 percent real growth in later years, compared to inflation plus 5 1/2 percent growth under current services. (The defense budget compromise was achieved by taking the Senate's originally proposed Budget Authority for defense and the House's proposed budget outlays.) The conference resolution also includes large spending cuts in non-defence discretionary programs (particularly, a one-year civil service employment pay freeze and cuts in Farmers Home Administration, rural housing programs, the strategic petroleum reserve, and the Small Business Administration). Nearly half of these

Table 1

SPENDING REDUCTIONS IN FIRST CONCURRENT RESOLUTION ON FISCAL YEAR 1986 BUDGET FOR THE COMBINED THREE YEAR PERIOD FY1986 TO FY1988

	Total Outlays % Bil	Proposed Saving % Bil	Savings as a percent of: Proposed Savings	Current Service Outlays
Defense	856	77	37.9	9.0
Entitlements	1,405	38	18.7	2.7
Nondefense Discretionary	525	55	27.1	10.5
Interest	447	14	6.9	3.1
Offsetting Receipts	-166	4	2.0	2.4
Revenue Increases	--	16	7.9	--
Total Deficit Reduction		203	100.0	

Source: Congressional Budget Office, The Budget Outlook, August 1985.
 Note: Figures may not add due to rounding.

cuts involve reconciliation instructions for numerous authorizing committees. COLAs for social security and indexed transfer payments were not modified, and entitlement programs incur only modest cuts relative to their size. However, elimination of general revenue sharing in FY1988 and cuts in Medicare will provide approximately \$19 billion savings in FY1986-FY1988.

Under a scenario of 3 1/2 percent real GNP growth and relatively stable inflation and real interest rates, assuming all of the spending cuts in the Concurrent Resolution are realized, these savings would generate several positive budget outcomes: from FY1985 to FY1988, total federal outlays would rise 4.6 percent annually, less than half the 9.9 percent annual growth rate from FY1980-FY1985. Consequently, the ratio of outlays-to-GNP would decline from nearly 25 percent in FY1985 to 22 1/2 percent by FY1988. With little change in revenues as a percent of GNP, the ratio of budget deficit-to-GNP would shrink, from 5.5 percent in FY1985 to approximately 3 percent in FY1988. Associated with this spending slowdown, the cyclically, adjusted deficit also would be reduced significantly, in absolute terms and as a percent of GNP.

According to the CBO, deficits would be \$175 billion in FY1986, and would decline to \$143 billion by FY1988. (The FY1985 deficit will be approximately \$210 billion, reflecting the slowdown in economic growth and the one-time impact of the shift to on-budget accounting of HUD loans.) The Administration, in its *Mid-Session Review*, forecasts even lower deficits -- \$100 billion by FY1988 -- but it assumes enactment of all of the non-defense spending reductions the President proposed in February, which will not occur. (Also, it assumes sharp declines in real interest rates despite continued 4 percent economic growth, a seeming inconsistency.) Under either forecast, the federal debt-to-GNP ratio would end its current sharp climb, peaking below 42 percent in 1987, and begin a gradual descent. (That ratio has risen from 29 percent in 1981 to nearly 40 percent in 1985; under current services, it would approach 50 percent by 1990.)

The improvement in official budget forecasts must be tempered by the uncertainty of the underlying economic assumptions and uncertainty about whether all of the spending cut instructions included in the budget resolution will be implemented. Weaker economic growth or periods of higher interest rates would add substantially to the deficit forecasts. For example, the CBO assumes a 3-month Treasury bill rate of 7.4 percent in 1986 and 7.2 percent in later years; a one percentage point higher rate would add to spending and deficits \$4 billion in FY1986 and \$16 billion in FY1988. This would occur if inflation rises above the 4.2 to 4.4 percent range that the CBO assumes for 1986-1988. Also, tax revenues are very sensitive to slower economic growth, as evidenced in 1985; a one percentage point slower real GNP growth would reduce revenues by approximately \$3.4 billion in FY1986 and \$26 billion in FY1988; its net impact on deficits would depend on the interest rate movement associated with the slower growth.

Over the forecast period, a more conservative economic forecast would involve slightly slower real GNP growth (3 percent) and higher inflation (5-5 1/2 percent). This would raise the deficit projections to approximately \$182 billion in FY1988. These figures may be even higher if authorizing committees in Congress do not fully implement the reconciliation instructions of the First Concurrent Resolution in the FY1986 Budget, or if a portion of the proposed spending reductions lack permanence. It already looks as if outlays in certain programs -- for example, agriculture -- will be higher than proposed.

The budget outcome under these assumptions would be less optimistic than official forecasts: deficits would decline from FY1985 levels, but not significantly (see Table 2). The primary deficit (deficit less interest expenses adjusted for Federal Reserve payments to the Treasury) would decline toward zero, but would not become negative, as forecast by both the CBO and Administration. Consequently, under reasonable interest rate assumptions, the federal debt-to-GNP ratio would continue to rise, but at a much slower pace than its current path.

Table 2

ALTERNATIVE BUDGET PROJECTIONS
In \$ Billions

	Fiscal Years			
	1985	1986	1987	1988
Outlays				
CBO	946	965	1,021	1,082
Administration	947	958	989	1,037
Alternative*		970	1,030	1,102
Revenues				
CBO	737	790	858	939
Administration	736	780	850	937
Alternative		788	855	934
Deficit				
CBO	210	175	163	143
Administration	211	178	139	99
Alternative		182	175	168

Note:

Alternative projection assumes 3% real GNP growth (compared to CBO's 3.5% and the Administration's 4%), and assumes one percentage point higher inflation and interest rates than the CBO (The CBO assumes that the CPI rises to 4.2% and 3-month Treasury bill averages 7.2% in 1987-1988; the Administration's inflation assumption is similar to the CBO's, but it assumes that the yield on 3-month Treasury bills drops to 5.9% in 1988, which is seemingly inconsistent with respect to its 4% real GNP growth rate). Furthermore, the alternative projection assumes that not all of the spending cuts embodied in the Concurrent Resolution on the FY1986 Budget are realized.

Economic Effects

The spending reductions would have very little near-term impact on the economy and are positive for longer-run capital formation and economic growth. Government purchases of goods and services will be lower than they would be otherwise, modestly reducing GNP. The near-term impact will be minor, however, since the slowdown in defense purchases will lag legislated cuts in defense budget authority. The elimination of general revenue sharing (in 1987) will reduce incentives for state and local governments to spend, which will slow state and local purchases, also reducing GNP. Other spending reductions will have a negligible impact on the path of economic growth; the cuts are dwarfed by the \$1.7 trillion economy. Also, many public and private activities are

substitutable, so a cutback in some federal spending programs would be offset by increased private provision, leaving GNP unchanged. This is particularly true of goods and services whose demand is price inelastic.

The largest impact of the spending legislation will be to change the composition of economic activity rather than the growth path. In the longer run, slowing spending growth and limiting the rise in the federal debt-to-GNP ratio will increase investment, a positive factor for productivity and long-run economic growth.

Tax Reform

The Administration's tax reform proposal has many merits: it reduces marginal tax rates and eliminates certain deductions, credits and exemptions that have eroded the personal income tax base and distorted economic behavior. However, the entire tax package potentially would have a distinct adverse impact on economic activity, reducing investment and economic growth in the short and long run. President Reagan has advertised the Administration's plan as pro-savings and pro-growth, but neither assessment is correct. The proposals would substantially reduce personal income tax burdens, but historical experience suggests that rates of personal saving tend to be relatively insensitive to personal income tax cuts. Regarding investment and economic growth, I am particularly concerned about the potential adverse impact of the higher corporate tax burdens proposed in Treasury II. Elected officials jockey around the issue of "revenue neutrality", displaying their concern for the initial impact of the tax proposal on the budget deficit, but they overlook the important distinction between *revenue neutrality* and *economic neutrality*.

The provisions in the tax package that would adversely impact the economy are the elimination of the Investment Tax Credit (ITC) and the Accelerated Cost Recovery System (ACRS), and the recapture of some of the tax benefits from the

proposed reduction in marginal corporate tax rates to businesses that recently have invested in plant and equipment. The corporate income tax rate would be reduced from 46 percent to 33 percent, but these other proposals would lead to higher corporate taxes and a shift in the corporate tax burden, (see Table 3). Importantly, while the rate reduction provision would be provided to all corporate taxpayers, the higher tax burden from eliminating the ITC and ACRS and the recapture provision would fall on capital intensive firms -- it would raise the after-tax cost of investment in new plant and equipment and also reduce the expected after-tax cash flow of businesses that recently have invested in plant and equipment.

In response to the expected lower real after-tax rates of return on new capital investment, and the weakened cash flow of capital intensive firms, capital spending growth would slow, and possibly decline for several quarters. Non-residential construction would follow a similar pattern in a response to the elimination of the 10 percent ITC, the 25 percent ITC on rehabilitation of historical structures, and the tax exempt status of industrial revenue bonds. In

Table 3

REVENUE IMPACT OF SELECTED CORPORATE TAX POLICY CHANGES,
in Billions of Dollars, Fiscal Years 1986-1988

<u>Proposal</u>	<u>1986</u>	<u>1987</u>	<u>1988</u>
1) Eliminate ITC	15.7	30.4	35.0
2) Eliminate ACRS Recapture	8.0	19.3	24.3
3) Subtotal (1) + (2)	23.7	49.7	59.3
4) Lower Corp. Tax Rates	-10.0	-26.7	-35.9
5) Net Higher Corp. Taxes	13.7	23.0	23.4

Source: The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity, May 1985.

the short run, this could reduce real GNP growth by several percentage points within a year, and could generate several quarters of flat or slightly negative real GNP growth. Also, by lowering the capital intensity of production, the long-run path of potential GNP growth would be reduced.

Associated with this policy-induced economic weakness and lower real after-tax rates of return on capital investment, real interest rates and the exchange value of the U.S. dollar would recede. The weaker U.S. dollar would exert upward pressure on inflation and inflationary expectations. The subsequent composition of market interest rates, reflecting lower real rates and higher inflation and inflationary expectations, would be consistent with the weakened economic environment.

According to these results, the Administration unknowingly is advocating a policy that is the antithesis of "Reaganomics" -- a shift in incentives away from investment and toward consumption, and slower capital formation that could potentially impact future economic growth. This is particularly ironic, in that the capital spending response to the pro-investment provisions of the Economic Recovery Tax Act (ERTA) of 1981 stands out as one of the most visible and positive consequences of Reagan's original economic platform. Also, eliminating the ITC and modifying ACRS would place particular hardship on the traditional manufacturing sector that tends to be very capital intensive, and is currently feeling the largest pinch from foreign import competition.

The recent spending cut legislation represents a necessary first step toward fiscal responsibility. By slowing the ratio of spending-to-GNP and halting the dramatic rise in federal debt-to-GNP, it is long-term growth-oriented. Importantly, while some may argue that it was not enough -- entitlement programs were barely touched -- it has reduced political pressure for a tax increase. In stark contrast, enactment of the Treasury's tax package would not be conducive to long-run economic growth, and may accelerate the rise in federal debt-to-GNP by

generating a weak economic environment. Some of the politically sensitive issues of fairness and redistribution (i.e., eliminating the deductibility of state and local taxes) will delay its enactment, but passage of a watered-down version should not be ruled out for 1986.

WHERE IS THE MYSTERY IN THE BEHAVIOR OF THE MONETARY AGGREGATES?

Robert H. RASCHE
Michigan State University

About the only statistic that has been growing more rapidly than M1 in the past several months is the amount of speculation about why M1 is growing so rapidly. Once again, private analysts and Federal Reserve sources are quick with public statements that "special circumstances" are at work that make the growth of M1 over recent months atypical, if not unique, and therefore devoid of any predictive content. Among the "special circumstances" that have been cited in recent weeks are:

- 1) lower market rates of interest relative to rates paid on interest bearing checkable deposits,
- 2) widely publicized problems at savings and loan associations and savings banks,
- 3) fallout from charges that E.F. Hutton engaged in check kiting, and
- 4) the decline in the dollar in foreign exchange markets. (*)

All of these statements appear to be long on speculation and short on analysis. Most of the proposed explanations of the rapid M1 growth appear to be wide of the mark, and if not erroneous, are grossly misleading.

This position paper is divided into three parts. In the first part an analysis is present indicating the extent to which various forces have affected the growth of M1 since last November. (At the time of this writing August data are not yet available. I expect that the analysis can be updated to include August

(*) See for example, *Business Week*, Economic Diary, "What's Really Fueling the Money-Supply Spiral", September 9, 1985, p. 22 and *The Wall Street Journal*, "Money Supply's Rapid Growth Raises Odds of Interest Rate Surge, Many Say", September 3, 1985, p. 28.

data by the time the Committee meets.) In the second part the forecasts of the money multiplier that were presented at the meeting of the Committee last March, and forecasts which have been made on a regular basis since that meeting are reviewed to determine the extent that the growth of M1 that has been observed was predictable. The absence of large ex-ante forecast errors casts considerable doubt on the "special circumstances" hypothesis. Finally, the third section presents our current forecasts for the behavior of the M1-Adjusted Monetary Base Multiplier into early 1985.

The Sources of M1 Growth Since November, 1984

The data on the behavior of the Adjusted Monetary Base and M1 since November, 1984 are presented in Table 1. November was chosen as an appropriate starting point since it approximates the base from which the original FOMC M1 ranges were established. While we have chosen to present the St. Louis base numbers to be consistent with past practice, there would be no substantive difference if the Board of Governors base had been chosen, since the growth rates of the two measures are essentially identical during the past year.

The pattern in these data is the familiar one. M1 has grown at very rapid rates, the base has grown rapidly, but not as fast as M1, and accordingly there has been a steady upward trend in the base multiplier. The rampant speculation is about the cause of this upward trend in the multiplier.

Three significant features emerge from an examination of the behavior of the component ratios of the base multiplier. First, there has been a steady drift downward in the currency-deposit ratio (k) throughout the period. Second, the ratio of small time deposits to checkable deposits (t_1) remained relatively steady through March, drifted sharply lower in April through June, and then stabilized in July. Third, the ratio of large negotiable time deposits to checkable deposits (t_2) fell somewhat in February, stabilized through April, then

dropped steadily through July. In contrast, the reserve ratio ($r+1$) has bounced around considerably, but has not exhibited any distinct trend over the entire period. The behavior of the two time deposit ratios is consistent with some elements of the speculation cited above. The real question is what quantitative significance do all of these features have for the growth of the base multiplier and M1.

In Table 2 the growth rate of M1 has been decomposed into the growth rate of the adjusted monetary base and the base multiplier, with the latter further allocated to the component ratios. All growth rates have been expressed at percentage annual rates to allow comparisons across periods of different lengths (note that the growth rate is from November, 1984 to the indicated month in each line). The sum across each row of the growth rate of the base and the growth allocated to each component ratio equals the growth rate of M1. The component "resid" is the approximation error in the linearization of the formula for the growth rate of the base multiplier in terms of the growth of its component ratios. It is immediately apparent that this error is an insignificant element in the behavior of M1 since last fall.

The data in Table 2 do not support any of the speculative attacks on recent M1 growth. It is only since June that the behavior of the time deposit ratios collectively accounts for more than one percent (at annual rates) of the growth of M1 since last November. Even in these two months, the combined contribution of the two time deposit ratios to M1 growth has been only about 1.2 percent at annual rates. This contrasts with the contribution of the currency ratio, which consistently accounts for over two percent (annual rates) of the growth of M1 over the entire period December through July! Indeed, since February, the combined contribution of the monetary base and the currency ratio to M1 growth relative to the actual growth rate of M1 has been between .94 and 1.05. In January and February, the net contribution of the remaining component ratios was

larger, primarily because of a large contribution from the reserve ratio, but even then the combined contribution of base growth plus the currency ratio relative to observed M1 growth exceeded .75.

These data do not support the proposition that portfolio shifts out of time deposits, or other assets that are in M2 and M3, into checkable deposits by either consumers or firms has been a major influence on M1 growth at least through July. Furthermore, the major influence on the base multiplier coming from a *decline* in the currency ratio hardly seems consistent with a sharp deterioration in confidence in the financial system. Nor do the data seem consistent with an effect (perhaps lagged) from lower interest rates. Econometric studies of the interest elasticity of the currency-deposit ratio consistently suggest that it is quite small in absolute value. Furthermore, most such studies tend to find a larger (in absolute value) interest elasticity of the demand for currency than for checkable deposits, at least in the short run. This would suggest that a sharp decline in interest rates would be followed by an increase in the quantity demanded of both currency and checkable deposits, but that the former would increase proportionally more than the latter, so that the currency-deposit ratio would *rise* as a result. This is exactly the opposite of the result that has been observed.

There remains the possibility that the behavior of the base multiplier during this period has been unique, and hence unpredictable. To address this question, we turn to an examination of our past ex-ante forecasts of the base multiplier.

A Review of Recent Ex-Ante Base Multiplier Forecasts

The ex-ante M1-Adjusted Monetary Base Multiplier forecasts that we have constructed since the last meeting of this Committee are given in Table 3. The rows of this table indicate the data base on which the forecasts were based, and

the columns of the table indicate the months for which the forecasts were constructed. The actual data as of the August 22, 1985 H.6 Statistical Release are given in the final row of the table. The numbers in parentheses below each forecast are the percentage forecast errors relative to the actual values at the bottom of the table.

The first row of Table 3 gives the forecasts that were presented at the last meeting of this Committee. The forecasts proved highly accurate through May, and then failed to catch the upward drift of the multiplier that occurred throughout the summer. Nevertheless, the forecast errors are still well within a 95 percent confidence limit, which becomes quite wide for forecasts on such extended horizons (see Table 3 of the forecasts prepared for the last Committee meeting for estimates of the confidence interval of such forecasts).

The forecasts of the component ratios which are used to produce the forecasts in Table 3 are given in Table 4. These ratios can be used, along with the data in Table 1, for the actual values of the ratios to allocate the multiplier forecast error among the component ratios. This allocation is presented in Table 5. Once again, the major actor on the scene is the currency ratio. The second most important contributor to the forecast errors during this period is the reserve ratio, with the small time deposit ratio running a poor third. Indeed, the t_1 ratio is of little consequence until June and July. Finally, the contribution of the large time deposit ratio, t_2 , to the multiplier forecast error is of little consequence during the entire period.

Our conclusion, therefore, is that not only was the decline of the currency ratio the major influence on the observed behavior of the multiplier throughout 1985 to date, but it was the forecasting errors for the currency ratio on an extended time horizon that were primarily responsible for our failure last February to catch the upward drift of the multiplier that subsequently occurred in June through July.

While our forecasts for four to six months ahead last spring did not catch the movement of the multiplier correctly, it is inappropriate to conclude from this that the multiplier, or more precisely the currency ratio, has been influenced by some special factors. It can be seen from Table 3 that as we updated our ex-ante forecasts for new information, we tracked the behavior of the multiplier or short forecasting horizons with a great deal of accuracy. The root-mean-squared-percentage-errors for the five one-month ahead forecasts in Table 3 is .22 percent. The corresponding statistic for the four two-month ahead forecasts is .61 percent. These error statistics are quite small compared with the historical performance of these models, which suggests that none of the component models experienced large shocks during the period. This effectively rules out the "special circumstances" hypothesis.

While the actual data for the entire month of August are not available at the time of this writing, a comparison of the available weekly data with our June and July based forecast for August suggests that the one-month, or even two-month, ahead forecasts for August should be quite accurate.

The Outlook for the Multiplier Behavior for the Rest of 1985

The forecasts for the M1-Adjusted Monetary Base Multiplier based on data through July, for the period August through March, 1986 are given in Table 6. There a sharp increase from July to August is predicted, which seems likely to be realized; the multiplier drops in September and October, and then stabilizes around the present July value toward the end of the year and the beginning of next year. The percentage changes (at annual rates) from the July base are given in the second column of Table 6.

The allocation of the year-over-year percentage changes in these forecasts, on a not-seasonally adjusted basis, is given in Table 7. This again demonstrates that the major difference in the level of the multiplier during the forecast

period, compared with the level at the end of 1984 and the beginning of 1985 is in large part due to the decline in the currency ratio that has occurred in late 1984 and the first half of 1985. The stabilization of the multiplier toward the end of the year near its July level is the result of: 1) a sharp deceleration in the decline of the currency ratio, and 2) a stabilization of the t_2 ratio. The t_1 ratio is predicted to continue to decline through the end of the year on a not-seasonally adjusted basis.

TABLE 1

DATA FOR NOVEMBER, 1984 - JULY, 1985
(Seasonally adjusted)

Month	Base	M1	m1	k	t ₁	t ₂	g	z	r+1	tc
11/84	216.1	553.9	2.56317	.40415	4.58766	1.57051	.026363	.051196	.020584	.032299
12/84	217.6	558.5	2.56664	.40218	4.59503	1.57983	.031678	.051191	.020566	.032766
1/85	218.2	562.7	2.57883	.40040	4.61241	1.56167	.046722	.049234	.020317	.033250
2/85	219.2	569.4	2.59763	.39777	4.58865	1.53656	.039157	.047831	.020170	.033022
3/85	221.7	572.1	2.58051	.39778	4.58002	1.54427	.025401	.044390	.020705	.033478
4/85	222.6	574.9	2.58266	.39652	4.54242	1.54218	.037764	.044139	.020839	.034014
5/85	224.0	581.6	2.59643	.39482	4.50980	1.52796	.050593	.044299	.020669	.033722
6/85	227.6	591.2	2.59754	.39074	4.46888	1.49786	.035154	.042755	.021341	.034650
7/85	227.8	595.9	2.61589	.38978	4.46185	1.46915	.054404	.042393	.020879	.035650

(Not Seasonally Adjusted)

3/85			2.58062	.39960	4.66292	1.56939	.032008	.045011	.020219	.031915
4/85			2.61840	.38825	4.47399	1.51469	.037091	.043352	.020756	.032258
5/85			2.57797	.40039	4.57434	1.55299	.051276	.044897	.020483	.033088
6/85			2.60993	.39231	4.47400	1.49513	.035146	.042745	.020806	.036320
7/85			2.61425	.39197	4.45561	1.45608	.054251	.042273	.020880	.039545

Sources: Federal Reserve Bank of St. Louis, Monetary Trends, July, 1985
Board of Governors of the Federal Reserve System, Statistical Release H.6,
August 22, 1985

TABLE 2
 PERCENT CHANGES FROM NOVEMBER, 1984
 (Seasonally Adjusted at Annual Rates)

Month	M1	Base Multiplier									
		Base	i	k	t ₁	t ₂	g	z	r+1	tc	resid
12/84	9.96	8.28		2.52	-.36	-.48	-.24	.00	.24	.12	-.12
1/85	9.48	5.82		2.40	-.60	.18	-.36	.00	2.10	.12	-.18
2/85	11.04	5.68		2.76	-.04	.48	-.16	.04	2.16	.08	.04
3/85	9.69	7.68		2.07	.06	.03	.00	.06	-.48	.09	.18
4/85	8.93	7.10		1.99	.38	.24	-.10	.05	-.62	.10	.02
5/85	9.76	7.18		2.02	.58	.32	-.14	.04	-.24	.06	-.06
6/85	11.17	8.88		2.52	.75	.46	-.05	.05	-1.68	.10	.12
7/85	10.97	7.91		2.36	.71	.57	-.12	.05	-.59	.02	.08

Source: Computed from data in Table 1. Percent changes are measured as log differences.

TABLE 3

EX-ANTE MULTIPLIER FORECASTS
(Seasonally Adjusted)

	3/85	4/85	5/85	6/85	7/85	8/85
2/85	2.5831 (-.10)	2.5916 (-.34)	2.5883 (.31)	2.5725 (.97)	2.5849 (1.19)	2.5937
3/85		2.5891 (-.24)	2.5825 (.54)	2.5677 (1.15)	2.5752 (1.57)	2.5826
4/85			2.5931 (.13)	2.5783 (.74)	2.5867 (1.13)	2.5936
5/84				2.5877 (.38)	2.5969 (.73)	2.6045
6/84					2.6171 (-.05)	2.6255
7/84						2.6305
actual	2.5805	2.5827	2.5964	2.5975	2.6159	

TABLE 4

COMPONENT RATIOS FOR 3/85 SHADOW COMMITTEE MULTIPLIER FORECASTS
(Not Seasonally Adjusted)

Month	m1	k	t ₁	t ₂	g	z	r+1	tc
3/85	2.5813	.39985	4.67432	1.55494	.038961	.047407	.020149	.031946
4/85	2.6269	.38964	4.52867	1.49523	.038167	.045365	.020270	.031730
5/85	2.5694	.40505	4.68658	1.56309	.033551	.047546	.020040	.032446
6/85	2.5848	.40140	4.63072	1.53709	.031902	.047350	.020170	.034782
7/85	2.5837	.40262	4.62842	1.54065	.033965	.047186	.020135	.036749
8/85	2.5724	.40649	4.68860	1.59042	.029172	.046785	.019849	.036199

45

TABLE 5

ALLOCATION OF 3/85 MULTIPLIER FORECAST ERRORS TO COMPONENT RATIOS
(Not Seasonally Adjusted; percent)

Month	m1	k	t ₁	t ₂	g	z	r+1	tc	resid
3/85	-.03	.02	.04	-.06	.02	.00	-.10	-.01	.06
4/85	-.32	.15	.20	-.08	.00	.00	-.64	.01	.04
5/85	.33	.50	.41	.03	-.06	.00	-.59	.01	.03
6/85	.97	1.00	.58	.15	-.02	.01	-.83	.04	.04
7/85	1.18	1.17	.64	.31	-.06	.01	-.97	.07	.01

TABLE 6

M1 - ADJUSTED MONETARY BASE MULTIPLIER FORECASTS
1985-86
(Seasonally Adjusted)

Month		% change from July, 1985 (annual rates)
August	2.6317	7.23
September	2.6231	1.65
October	2.6050	-1.67
November	2.6277	1.35
December	2.6172	.12
January	2.6190	.23
February	2.6191	.21
March	2.5966	-1.11

TABLE 7
M1 - ADJUSTED MONETARY BASE MULTIPLIER FORECASTS
July, 1985 Base, Not Seasonally Adjusted

Month	85-86	84-85	% change ¹	% change due to changes in the:						
				k ratio	t ₁ ratio	t ₂ ratio	g ratio	z ratio	r+l ratio	tc ratio
Aug	2.6100	2.5539	2.17	1.45	.16	.21	-.04	.03	.28	-.05
Sept	2.6168	2.5589	2.24	1.48	.18	.26	-.03	.04	.22	.06
Oct	2.6237	2.5589	2.50	1.75	.38	.40	-.07	.04	-.07	.06
Nov	2.6241	2.5586	2.53	1.54	.42	.39	-.02	.04	.05	.06
Dec	2.6318	2.5798	2.00	1.24	.40	.39	-.03	.03	-.10	.04
Jan	2.6320	2.5915	1.55	1.14	.39	.35	-.04	.03	-.39	.04
Feb	2.6005	2.5801	.79	.72	.19	.23	-.05	.03	-.39	.04
Mar	2.5948	2.5802	.57	.60	.10	.24	-.05	.02	-.39	.04

¹ Year over year percent change

UPDATE TO THE SEPTEMBER, 1985 SHADOW OPEN MARKET COMMITTEE REPORT
THE BEHAVIOR OF THE MONETARY AGGREGATES IN AUGUST, 1985

or

"THE GRINCH THAT STOLE CHRISTMAS"

Robert H. Rasche
Michigan State University

In the report that I prepared for this meeting of the Committee two weeks ago, I reviewed in detail the behavior of M1, the Adjusted Monetary Base, the base multiplier and its components over the period November, 1984 through July, 1985. The data that became available this week show little if any revision in the numbers over this period of time, so I will not add to the confusion by redoing that analysis, since the major conclusions reached there still hold. Instead, I will concentrate on the August numbers.

I am sure that you are all well aware of the "explosion" in M1 that has been announced for August. Again, the explosion, while dramatic was predictable. In Table 3 of the report prepared two weeks ago, you will find that I predicted that the M1 -- Adjusted Monetary Base multiplier would rise to a value of 2.6305 in August, from a value of 2.6159 then reported for July (on a seasonally adjusted basis). The currently available numbers for July and August are 2.6132 and 2.6428, respectively. This gives a one month ahead forecast error in August of .47 percent, which is well within one standard forecast error for one month ahead forecasts. This leaves the question, if the jump was so predictable, just what is going on?

The August behavior seems to be considerably different from what was observed earlier this year. One way of looking at what happened is to express the percentage change in M1 (seasonally adjusted) as the sum of the percentage change in M1 (not seasonally adjusted) plus the percentage change in the implicit

M1 seasonal factor from July to August (measuring percentage changes as first differences in the logs). The percentage change in M1 (not seasonally adjusted) can be further decomposed into the percentage change in the adjusted monetary base (not seasonally adjusted) plus the percentage change in the base multiplier (not seasonally adjusted). The result is quite remarkable:

%change M1 (SA)	=	20.36% (annual rates)
%change Base (NSA)	=	1.35%
%change multiplier (NSA)	=	3.65%
%change implicit seasonal	=	15.36%

The effect of the seasonal adjustment is truly amazing. While M1 (NSA) increased by 2.5 billion from July to August, M1 (SA) increased by 10.2 billion. To try to trace this down, I went back to the seasonal factors published in the February 14, 1985 H.6 Statistical Release. There we find that the seasonal factor for transactions deposits *dropped* by .0159 from July to August. In comparison, the seasonal factor for transactions deposits will *increase* .0214 from November to December. In effect the current seasonal adjustments for transactions deposits are coming close to indicating an "anti-Christmas" effect between July and August. The same effect is present in the 1984 seasonal factors for transactions deposits, but I have not had the opportunity to trace back in the data to find out when it originated.

This effect seems to be unique to the seasonal for transaction deposits. It is interesting to perform the same decomposition as above on the M2 and M3 monetary aggregates for the change from July to August:

i =	1	2	3
%change Mi (SA)	20.36	11.18	8.60
%change Base (NSA)	1.35	1.35	1.35
%change multiplier (NSA)	3.65	3.69	4.41
%change implicit seasonal factor	15.36	6.14	2.84

The percent change in the base is the same for all three money stock concepts by construction. Note, however, that the percent change in the multiplier for each of the three money stock concepts was almost identical for the July-August period, and thus the differential growth rates in the past month can be accounted for *almost exclusively* by differential behavior of the implicit seasonal factors. Apparently, we are in some danger of being confused in the very short run by the ghost of some X-11 process. In spite of all this, I have gone ahead and updated Tables 6 and 7 of my previous report to reflect the data that are now available for August in the forecasts of the multiplier for the rest of the year. These updates are attached in Tables 6(r) and 7(r).

TABLE 6(r)
M1 - ADJUSTED MONETARY BASE MULTIPLIER FORECASTS
1985-86
(Seasonally Adjusted)

Month		% change from July, 1985 (annual rates)	% change from August, 1985 (annual rates)
August ¹	2.6428	13.51	
September	2.6403	6.19	-1.13
October	2.6216	1.28	-4.83
November	2.6431	3.41	.05
December	2.6334	1.84	-1.06
January	2.6345	1.62	-.75
February	2.6334	1.32	-.71
March	2.6114	-.10	-2.05

¹Actual

TABLE 7(r)
M1 - ADJUSTED MONETARY BASE MULTIPLIER FORECASTS
August, 1985 Base, Not Seasonally Adjusted

Month	85-86	84-85	% change ¹	% change due to changes in the:						
				k ratio	t ₁ ratio	t ₂ ratio	g ratio	z ratio	r+l ratio	tc ratio
Aug	2.6205	2.5539	2.58	1.79	.35	.27	-.02	.03	.03	.08
Sept	2.6338	2.5589	2.89	1.90	.44	.35	-.01	.04	.05	.07
Oct	2.6405	2.5589	3.14	2.17	.64	.51	-.06	.04	-.27	.08
Nov	2.6394	2.5586	3.11	1.96	.68	.52	-.01	.04	-.21	.07
Dec	2.6468	2.5798	2.56	1.61	.66	.53	-.02	.03	-.33	.05
Jan	2.6478	2.5915	2.15	1.56	.66	.49	-.02	.03	-.66	.05
Feb	2.6147	2.5801	1.33	1.14	.46	.37	-.04	.03	-.71	.05
Mar	2.6095	2.5802	1.13	1.01	.36	.38	-.04	.02	-.68	.05

¹ Year over year percent change

COMMENTARY ON PROSPECTS FOR MONEY AND THE ECONOMY

H. Erich HEINEMANN
Ladenburg, Thalmann & Co., Inc.

HIGHLIGHTS

Animal spirits in the bond market are misplaced. The Fed will have to tighten and interest rates will go up. The economy is stronger than appears on the surface.

The main industrial nations are islands of price stability in a world where inflation is still rising close to 15 percent.

A key report on the thrift industry shows that about 45 percent of insured S&Ls are "insolvent or nearly-insolvent."

FOOL'S PARADISE

The bond market was in a happy mood last week. A big surge in the money supply, a sharp drop in the dollar, clear evidence - if you chose to look beneath the surface of the "flash" estimate of third quarter GNP - that the business expansion is alive and well: none of these could calm the animal spirits.

Traders seemed relieved that the increase in money was "only" \$3.7-billion, and they interpreted the flash estimate of a 2.8 percent gain in GNP as an indication that the Fed will have ample excuse to continue to push for easy money.

But serious questions lurk behind the festivities.

How long can the Federal Reserve hold down interest rates by pumping money into the economy? Not long. Despite a 17 percent rate of growth in the money since last June, short-term interest rates are slightly higher today than they were then. This suggests that the demand for credit is building up rapidly. The economy is stronger, not weaker, than appears on the surface.

Eventually, when the Fed reverses course and tightens up (which, inevitably, it will), how will markets react? As we said two weeks ago, the longer the Fed lets the money supply run out of control, the higher the risk of resurgent inflation and recession (see Prospects for Money and the Economy, September 9, 1985). In our view, the coming rebound in the economy will not be sustainable, and both equity and debt markets may decline as business revives.

By trying to minimize changes in interest rates today, will the Fed maximize interest rate changes in the future? Clearly, our answer is "yes." Rapid money growth over the past year has already locked in a significant increase in the level of the yield curve (200 to 400 basis points) and a material flattening in its shape (short rates should go up more than long). The more the Fed procrastinates, the bigger the ultimate increase.

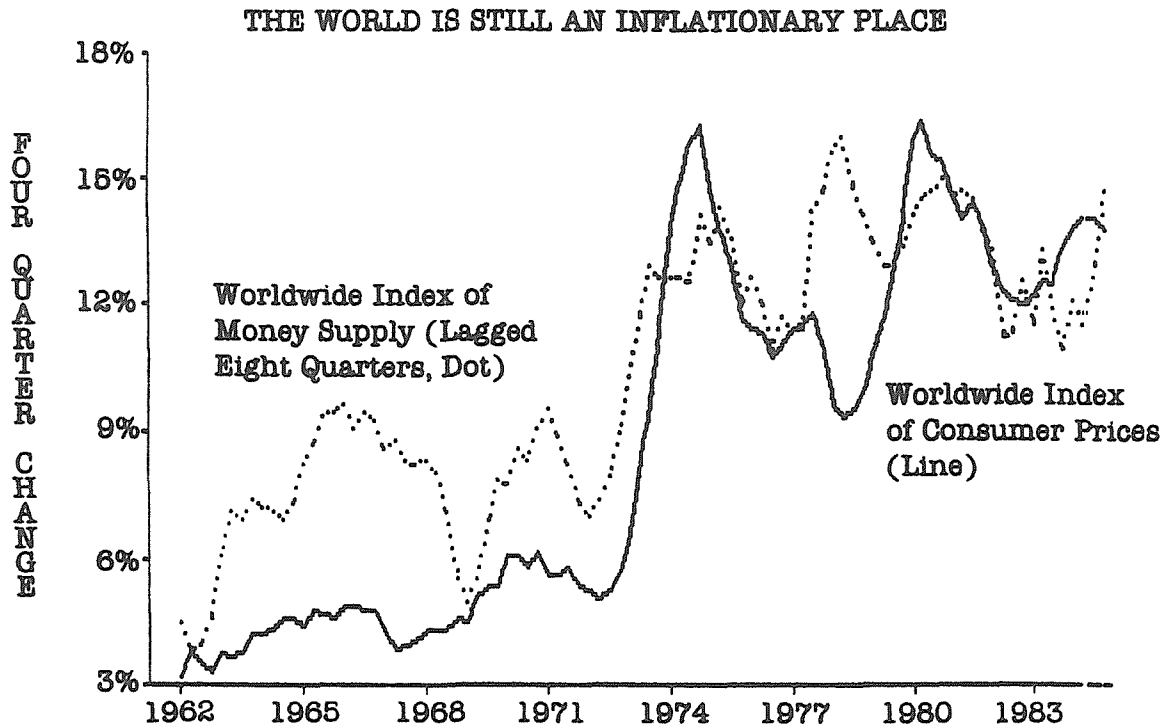
If interest rates do shoot skyward in 1986 or 1987, what will happen to the hundreds if not thousands of financial institutions (mostly savings and loans) that already are on the brink of failure? Whatever else, it won't be good. We'll have more to say on this topic later in this issue.

WAS KEYNES CORRECT?

There is always a possibility that the neo-Keynesians are correct: that monetary policy has suddenly become irrelevant; that there are no inflationary implications in record rates of expansion in the money stock, and that the money managers can continue to pump funds into the credit markets with impunity.

WEEKLY MONETARY DATA						
(Billions of dollars, except as noted)						
	Latest Week	Change from Previous Week	--Rates of Change Over--			Week Ended
			3 Months	6 Months	12 Months	
Money supply (M-1)	\$613.4	\$3.7	16.8%	13.7%	11.1%	9/ 9/85
Weekly components of M-2:						
Money market deposit accounts (NSA)	321.3	1.8	24.9	19.9	31.3	9/ 9/85
Small savings deposits	124.5	0.3	11.6	5.4	-1.5	9/ 9/85
Small time deposits	382.7	-0.6	-6.8	1.0	1.0	9/ 9/85
Money market funds (NSA)	176.0	-0.8	9.2	0.0	17.4	9/ 9/85
Other components (NSA)	65.9	1.0	2.6	-11.6	12.8	9/ 9/85
FED reserve aggregates (billions of dollars)						
Nonborrowed reserves	42600	-298	16.9	15.0	14.3	9/11/85
Borrowing, ex. extended credit (NSA)	723	245	NA	NA	NA	9/11/85
St. Louis reserve aggregates						
Adjusted monetary base	230.4	-1.9	7.0	8.3	7.8	9/18/85
Adjusted Fed credit	207.4	-2.2	8.9	9.3	8.6	9/18/85
Total reserves	64.7	-0.2	1.4	7.6	9.0	9/11/85
Total commercial paper outstanding	262.0	-1.0	24.7	15.2	17.9	9/11/85
C&I loans- all large banks	254.2	1.4	-3.4	-0.6	3.6	9/ 4/85
NA = Not applicable						
Notes: Data, except as noted, are seasonally adjusted. Rates of change are compound annual rates based on four-week moving averages.						

Figure 1



Sources: International Monetary Fund; Heinemann Economic Research

Plainly, however, this is not our view. Of course, the linkages between changes in the money supply, the level of economic activity and ultimately the rate of inflation are very loose over short time spans. But over longer periods - say, three to five years - the relationship has proven to be both stable and powerful.

WHAT THEY DESERVE

Sooner or later a sustained acceleration in growth in the money supply will breed, first, a sustained increase in total spending and, second, a faster rate of climb in the general price level. Despite fundamental changes in the financial system in recent years, this is one of the more durable rules in economics. Portfolio managers who ignore this fact will get the investment results they deserve.

The International Monetary Fund's indexes of world money supply and world inflation make plain that only a relative handful of major industrial nations have monetary growth and inflation truly under control at present. The rest of the world is still a very inflationary place. On a worldwide basis consumer prices rose 13.9 percent last year, just about the same as the average 13.5 percent rate of increase from 1981 through 1983 in the worldwide money supply (Figure 1). The weakness in dollar prices of basic raw materials is a function of the overvalued dollar - not of some mythical "deflation." If inflation is an excess of monetary demand, then deflation is a deficiency of monetary demand. That's hard for us to find in a world of double-digit increases in the money supply.

THE PRESIDENT'S DILEMMA

Meanwhile, the White House is face to face with a serious dilemma in economic policy. The dilemma is hardly recognized as such by the Potomac pundits who set the tone of the national political debate. Nonetheless, it is real and now, and its resolution - which is far from certain at present - should largely determine the course of the economy and whether the Republican Party will retain control of the Senate in 1986 and the White House in 1988.

There are five principal elements to the problem. Individually, each has been widely discussed, but only rarely are they linked together as representing a critical threat to continued expansion in the American, and hence also the global, economy.

First, as noted, Fed policy is far too expansionary and eventually will have to tighten. Mr. Volcker will either reverse his course or risk losing his credibility as the leader of the hard money bloc in Washington. Assuming he remains in office (that's far from certain), he wants to be remembered as an inflation fighter. On Mr. Volcker's go-stop-go record, a swing back to tight money is probable.

Second, is Mr. Reagan's ever-changing program of tax "reform," which seems to be based on the curious principle that close to \$150-billion of tax cuts (enormously popular) can be precisely balanced by \$150-billion of tax increases (not popular at all). The obvious danger is that the President could end up with much more in the way of tax cuts than increases. Were the plan to be passed as proposed, the burden of taxation would shift from individuals to the largely

WEEKLY ECONOMIC DATA						
	Latest Week	Change from Previous Week	--Rates of Change Over--			Week Ended
			3 Months	6 Months	12 Months	
WEEKLY PRODUCTION INDEX	163.4	-0.1	6.2%	3.0%	4.4%	9/ 7/85
OUTPUT, Production:						
Autos (units)	139981	-8169	12.9	-13.2	5.6	9/ 7/85
Trucks (units)	64548	-14300	88.1	49.2	10.3	9/ 7/85
Paper (thousands of tons)	646	-11	-2.6	-0.4	-0.1	9/ 7/85
Paperboard (thousands of tons)	653.4	-9.2	17.0	8.1	-3.1	9/ 7/85
Raw Steel (thds of short tons)	1651	-14	-12.2	3.8	7.3	9/14/85
Bitum. Coal (thds of short tons)	15728	-313	-22.8	-2.8	-9.3	9/ 7/85
Crude oil (thousands of bbls)	11460	283	-10.8	-3.2	-3.7	9/14/85
Electricity (millions of kwh)	49.37	-0.90	-7.4	8.4	3.4	9/14/85
TRANSPORTATION						
Class 1 railroad freight traffic (billions of ton-miles)	15.2	-1.4	-20.6	-9.0	-7.7	9/ 7/85
PRICES						
All commodities spot index(1967=100)	228.8	-1.6	-21.9	-16.3	-15.5	9/17/85
Foodstuffs spot index	217.1	-1.8	-35.2	-23.3	-18.3	9/17/85
Raw industrials spot index	237.1	-1.5	-11.1	-9.3	-13.4	9/17/85
Domestic spot mkt crude oil price	28.00	0.25	7.5	-2.0	-4.7	9/13/85
Trade-weighted value of the US dollar (March 1973=100)	142.12	-0.77	-20.5	-24.6	-2.1	9/18/85
Common stock prices S&P 500	183.39	-0.3	-6.7	7.1	11.6	9/19/85
EMPLOYMENT						
Initial unemployment claims (thds)	382	-6	-12.8	-9.7	2.7	9/ 7/85
Claimant level (thousands)	2469	-78	-7.8	-10.9	8.6	8/31/85
Notes: Data, except for prices, are seasonally adjusted. Rates of change are compound annual rates based on four-week moving averages.						

invisible corporate tax. Ironically, this should make the task of reducing the size of the Federal government still more difficult. Taxpayers are hardly likely to vote to restrict Federal services if they believe that government can be purchased at a discount through deficit spending or higher corporate taxes.

Third, is the international debt crisis, which is far closer to a flash point than popular accounts would suggest. In recent weeks, first Peru and then South Africa have apparently been successful in thumbing their noses at the international banking community. Obviously, the "solution" to the debt crisis (if there is one) will require many facets. The debtor nations must control inflation, stabilize their exchange rates, expand their economies, end the flight of capital and promote domestic investment. Where appropriate, they should consider exchanging a portion of their foreign debts for equity participations in their state-owned enterprises. In the North - in addition to maintaining stable, non-inflationary growth so that the LDC's have open markets in which to sell their products - Governments must also be willing to extend additional net credit.

THE PROTECTIONIST VIRUS

Fourth, is the spreading virus of protectionism. This has been spawned by distortions that have resulted from the absence of a coherent fiscal policy in Washington. The distress among American manufacturers is real enough, but there are huge risks if the United States closes its borders to foreign goods. That could easily start a trade war, which in turn would lead to a sharp contraction in the volume of world trade, not to mention a near-term resurgence of domestic inflation. Even with relatively open markets today, unit labor costs are already starting to move toward higher levels. There are no simple answers, but renewed growth in domestic manufacturing employment would be the best antidote, bar none, to the poison of protectionism.

Fifth, is the precarious condition of financial institutions in the U.S. According to a detailed report on the financial condition of the thrift industry by a team of economists at the Federal Home Loan Bank Board headed by James R. Barth, under generally accepted accounting principles, 1290 institutions representing 45 percent of the industry's assets were "insolvent" or "nearly insolvent" in 1984. Even under the more lenient "regulatory accounting principles," 877 thrifts were insolvent or nearly insolvent. These institutions have assets of more than \$300-billion, or 31 percent of all associations insured by the Federal Savings and Loan Insurance Corp. At the same time, record numbers of thrifts have failed.

Michael Patriarca, Deputy Comptroller of the Currency, told a House Banking subcommittee the other day that the "increasing number of problem banks and bank failures...does not reflect a widespread deterioration of the banking system. Rather, it reflects sharp declines in certain sectors of the economy that are, in turn, adversely affecting a small percentage of banks."

Whether or not Mr. Patriarca's conclusions, and the relatively rosy statistics that he presented to back them up, are correct is beside the

point. To quote E. Gerald Corrigan, president of the Federal Reserve Bank of New York, "Public confidence in banking and financial institutions is perhaps not as high as it should be as the cumulative effects of problems in financial institutions have taken a toll."

The Barth Report concluded that the large number of thrift failures in 1982 (252 all told) was caused primarily by maturity mismatch between assets and liabilities. Institutions were holding relatively large amounts of long-term mortgages yielding rates of return that were fixed at rates below the rates paid on deposits. "Beginning in 1983, however, thrift institutions became increasingly hampered by poor-quality assets. The FSLIC considers two-thirds of its current cases to be primarily asset-quality problems," the report said.

ONLY THE CONSPICUOUS OUTLIERS

The fact that the assets (and hence also the deposit liabilities) of insolvent or nearly-insolvent thrifts vastly exceed the FSLIC's reserves of \$5.9-billion, the authors concluded, means that "only a few of the more conspicuous outliers among insolvent institutions could be closed by the Bank Board due to the limited resources of the FSLIC."

The common denominator underlying each of these "five uneasy pieces" is the Administration's - and the country's - need to maintain stable, non-inflationary growth. Whatever else, renewed inflation and recession would make Mr. Reagan's present problems pale by comparison. It is true that inflation seems far away.

Wholesale prices declined slightly in August and the rate of increase in the GNP deflator this summer continued to be moderate. But keep in mind that if the Federal Reserve were to maintain a 20 percent growth rate in the money supply, it would only be a matter of time until the rate of increase in prices turned sharply higher.

At the same time, by pumping money into the banking system, the Federal Reserve is also helping to alleviate the thrift crisis for the immediate future. But easy money can, and will, backfire if it is pressed too long. No one knows when easy money will ignite rising inflationary expectations. But that point may not be far away. In a world of financial fragility, it is a risk that the Fed dare not take. A small rise in rates today may well avoid a big rise in rates - and severe problems - later on.

There are no easy answers to the President's policy dilemma. One thing is clear, however. An inflationary monetary policy at the Federal Reserve is not one of them.

Table 1
EXTERNAL DEBT OF DEVELOPING COUNTRIES

	1977	1978	1979	(\$ Billions)		1982	1983	1984	1985 F	1986 F
				1980	1981					
ALL DEVELOPING COUNTRIES										
Total Debt	332.5	398.4	470.0	665.0	820.6	747.0	790.0	827.6	825.3	826.4
Pct Change		19.82	18.17	20.01	16.82	13.02	6.06	4.64	4.67	3.59
Short-term	63.2	71.9	81.8	113.3	138.2	154.6	137.3	128.3	104.9	107.3
Pct Change		13.77	13.77	29.61	20.21	13.61	-11.19	-6.91	-16.64	3.29
Long-Term	269.3	326.5	388.0	451.7	624.4	622.4	652.6	701.2	720.4	719.1
Pct Change		21.24	19.14	16.12	16.69	12.97	10.31	7.39	6.44	3.77
Pct Long-term	81.0	82.0	82.6	79.0	76.4	79.3	82.6	84.7	87.9	88.0
DEVELOPING COUNTRIES WITH RECENT DEBT SERVICING PROBLEMS										
Total Debt	165.2	229.7	276.0	336.6	403.4	456.2	477.9	493.2	503.2	509.9
Pct Change		24.03	19.72	22.36	19.89	13.69	4.76	3.20	2.03	1.33
Short-term	29.3	38.9	46.6	67.9	84.1	95.2	76.8	65.6	43.0	44.2
Pct Change		32.76	17.22	48.90	23.89	13.20	-20.38	-13.69	-34.35	2.79
Long-Term	135.9	190.8	229.4	268.6	319.3	361.0	402.1	427.7	460.2	465.7
Pct Change		22.39	20.23	17.99	18.89	13.66	11.39	6.37	7.60	1.20
Pct Long-term	84.2	83.1	83.4	79.8	79.2	79.1	84.1	86.7	91.5	91.3
DEVELOPING COUNTRIES WITHOUT RECENT DEBT SERVICING PROBLEMS										
Total Debt	147.3	169.7	193.8	228.5	257.2	290.8	312.9	334.3	362.1	366.5
Pct Change		14.63	16.66	16.70	12.65	13.66	7.89	6.84	8.32	6.74
Short-term	33.9	33.0	36.2	45.4	62.1	69.4	61.6	60.8	61.9	63.1
Pct Change		-2.65	9.70	25.41	14.78	14.01	3.54	-1.14	1.01	1.94
Long-Term	113.4	135.7	159.6	183.1	205.1	231.4	251.4	273.5	300.2	323.4
Pct Change		19.66	17.61	14.72	12.02	12.62	8.64	8.79	9.76	7.73
Pct Long-term	77.0	80.4	81.5	80.1	79.7	79.6	80.3	81.8	82.9	83.7
MEMO										
Countries with recent problems, long-term debt owed to:										
Official Creditors	51.0	60.6	69.6	82.0	93.4	107.9	122.8	134.4	148.0	156.2
Pct Chg		18.82	14.85	17.82	13.90	16.82	13.81	9.46	10.12	6.54
Financial Institutions	46.7	64.8	85.2	101.3	122.5	140.4	174.0	189.5	214.0	214.8
Pct Chg		38.76	31.48	18.90	20.93	14.61	24.60	7.84	13.53	0.37
Other Private Creditors	58.2	65.4	74.6	85.3	103.4	112.7	104.6	104.8	98.2	94.7
Pct Chg		12.37	14.07	14.34	21.22	8.99	-7.28	0.29	-6.30	-3.56
Countries without recent problems, long-term debt owed to:										
Official Creditors	58.8	70.2	79.4	90.4	99.4	110.7	120.3	132.0	147.2	158.4
Pct Chg		19.39	13.11	13.85	9.98	11.37	8.87	9.73	11.52	7.61
Financial Institutions	26.2	34.8	45.0	52.7	59.6	68.1	78.0	82.6	90.2	98.6
Pct Chg		32.82	29.31	17.11	13.09	14.26	10.13	10.13	9.20	9.31
Other Private Creditors	28.4	30.7	35.2	40.0	48.1	62.6	66.1	68.9	62.8	66.4
Pct Chg		8.10	14.66	13.64	16.25	14.10	6.66	4.89	6.62	6.73

F= Forecast

Sources: International Monetary Fund; ~~McGraw-Hill~~ Economic Research

Table 2
DEBT SERVICE BURDEN OF DEVELOPING COUNTRIES

	1977	1978	1979	1980	1981	1982	1983	1984	1985 F	1986 F
TOTAL DEBT TO GDP:										
All developing countries	24.9	25.6	25.4	25.7	28.8	32.9	35.6	36.3	36.7	32.5
Countries with recent debt service problems	27.6	29.9	29.6	30.8	35.1	41.2	47.0	46.1	44.8	37.5
Countries without recent debt service problems	22.3	21.4	21.1	20.7	22.5	25.1	26.1	27.6	29.3	27.6
TOTAL DEBT TO EXPORTS:										
All developing countries	126.7	132.4	119.4	110.4	123.3	148.0	157.9	151.3	148.5	141.5
Countries with recent debt service problems	171.7	195.8	178.1	167.1	194.5	246.0	268.1	256.8	245.8	230.8
Countries without recent debt service problems	95.3	91.9	81.6	73.6	78.3	91.1	97.0	94.2	95.8	93.6
DEBT SERVICE:										
All developing countries										
Value (\$ Bill.)	39.5	56.4	74.7	88.5	111.9	124.0	111.1	123.1	134.5	139.5
Interest	15.3	21.6	32.2	46.7	63.8	72.3	67.4	71.0	74.0	72.5
Amortization*	24.2	34.8	42.5	42.8	48.1	51.7	43.7	52.1	60.5	67.0
Ratio to Exports	15.0	18.8	19.0	17.3	20.9	24.5	22.2	22.5	23.1	22.0
Interest	5.8	7.2	8.2	8.9	11.9	14.3	13.5	13.0	12.7	11.4
Amortization*	9.2	11.6	10.8	8.4	9.0	10.2	8.7	9.5	10.4	10.6
Countries with recent debt service problems										
Ratio to Exports	22.3	29.6	30.2	27.0	33.8	41.6	36.2	36.6	38.1	36.8
Interest	8.3	11.1	12.8	14.3	19.7	25.3	24.3	23.7	22.9	20.3
Amortization*	14.0	18.5	17.4	12.7	14.1	16.3	11.9	12.9	15.2	16.5
Countries without recent debt service problems										
Ratio to Exports	10.0	11.8	11.7	11.1	12.7	14.6	14.5	14.9	14.9	14.1
Interest	4.1	4.7	5.2	5.5	7.0	7.9	7.5	7.2	7.2	6.7
Amortization*	5.9	7.1	6.5	5.6	5.7	6.7	7.0	7.7	7.7	7.4

F= Forecast

*On long-term debt. Payments for 1985 and 1986 adjusted for expected reschedulings.

Sources: International Monetary Fund; Heinemann Economic Research