

SHADOW OPEN MARKET COMMITTEE

Policy Statement and
Position Papers

March 8-9, 1987

PPS 87-01



**CENTER FOR
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SHADOW OPEN MARKET COMMITTEE MEMBERS

The Committee met from 2:00 p.m. to 7:30 p.m. on Sunday, March 8, 1987.

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

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

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

DR. MICKEY D. LEVY, Senior Vice President and 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.

POLICY STATEMENT

Shadow Open Market Committee
March 9, 1987

Sluggish growth and large trade deficits have dominated the economic news for the past 18 months. Many have regarded these economic conditions as unsatisfactory. But they are already changing. Unfortunately, present policies will not lead to a path of long-run stability.

Federal Reserve actions are inflationary. Treasury policies to depreciate the dollar and mitigate the international debt problem entail high costs. The United States is now a major debtor, and must achieve a trade surplus to service this debt. Faster money growth will not eliminate the trade deficit. Present fiscal policy will not boost U.S. productivity, exports and growth over the long run.

Economic growth will accelerate in 1987 in response to powerful stimulative actions by the Federal Reserve. These actions have been excessive. As a result, inflation -- and ultimately another recession -- now loom on the horizon. Central bank policies that rely on progressively larger swings in monetary expansion will not lead to sustainable economic growth and stable prices. We are pressing our allies to adopt the same mistaken monetary policy. This will only exacerbate the problems.

Monetary Policy

The Federal Reserve has returned to the go-stop-go monetary policy of the 1970s. It will produce the same result now as then. All measures of money growth increased markedly in the second half of 1986.

Federal Reserve actions are responsible for increased money growth, lower interest rates and devaluation of the dollar.

This policy has been prompted by the Treasury. Until recently, the Treasury seemed to know only one solution to the trade problem -- devaluation. Federal Reserve spokesmen try to give the impression that their actions are cautious. They profess concern about the risks of inflation and devaluation of the dollar. This is misleading. Federal Reserve actions have fully supported the Treasury's policy of devaluing the dollar. In recent months, rapid money growth has been a principal cause of devaluation.

To understand the impact of devaluation, it is important to distinguish between real and monetary devaluations. A real devaluation involves, one, raising domestic prices relative to costs of production including wages, and, two, raising foreign prices relative to domestic prices. A real devaluation can have a lasting effect on trade patterns.

By contrast, a monetary devaluation, achieved through inflation, raises both prices and costs of production, including wages. Monetary devaluations may have some short-term effect on the trade balance, but they have limited long-term effects.

On all sides, there are calls for faster money growth to stimulate the economy. This is a mistake. The United States is not suffering from weak growth of domestic demand. Domestic demand has been rising at a 4 percent annual rate for the past two years. Much of the rising demand has been satisfied by imports.

To avoid another costly inflation and disinflation, we again urge the Federal Reserve to abandon its inflationary policy and set the growth rate of the monetary base on the path toward sustained lower

inflation. We recommend that the rate of growth of the monetary base be reduced to 7 percent for the four quarters ending in December 1987 and further reduced each year until non-inflationary growth is achieved.

There is much speculation about the chairmanship of the Federal Reserve. This misses the basic issue. Monetary policy depends to a far greater degree on institutional arrangements than on the personality of the chairman. The go-stop-go policies that give us alternating periods of expansion and contraction, inflation and disinflation, have not changed with the choice of chairmen. They will not change until Congress requires the Fed to deliver stable, non-inflationary monetary growth.

Treasury Policy

Treasury policy is in disarray. If the recent Paris agreement to intervene in the exchange market to prevent further devaluation of the dollar is implemented, the Administration would lose its principal means of reducing the trade deficit and slowing the growth of debt to foreigners. The Treasury now has no policy to end the trade deficit and slow the growth of the U.S. liabilities to foreigners.

The Baker plan for international debt has achieved little and is now moribund. After more than four years, the Treasury does not have a policy to bring the international debt problem to an end. Additional lending to foreigners, or new loans from the World Bank, would add to the debt owed by foreigners, delay a solution and increase the cost to U.S. taxpayers.

U.S. Trade and Debt

The problems of trade and U.S. indebtedness arise because, as a nation, we spend too much relative to what we produce. Most of our spending is for consumption. The excess of spending over production shows up in the national accounts and impacts both the trade deficit and the budget deficit. The government spends mainly for consumption -- health, welfare, most of defense spending -- and very little on investment.

Privately, the share of spending for consumption remains near the highest rate we have experienced, while net investment remains at a very low rate. To maintain spending in excess of production, we sell assets and borrow abroad. The counterpart of this borrowing is the trade deficit -- net imports from abroad. For the last year, net imports have remained at about 4 percent of total output -- about \$150-billion in constant 1982 dollars.

In the past five years, we have borrowed so much that, instead of owning net foreign assets of nearly \$140-billion at the end of 1981, we had net foreign debts of more than \$200-billion at the end of 1986. Large borrowing will continue even on the most favorable assumptions about the decline in the trade balance. By the end of the decade we will owe foreigners between \$600- and \$900-billion.

Since our consumption is high and net investment is low, most of this borrowing finances consumption. If our borrowing financed a high rate of productive investment, as in 1983-1984, the returns on the investment would pay the interest and principal. Productive investments would raise living standards. Since the borrowing of the past two years has financed consumption mainly, we are living better now.

But the debt must be serviced and paid. At some point, we will be faced with two options:

Since our international borrowing is denominated in dollars, one option would be to reduce the real value of the debt by inflating faster than people now believe likely. Increased inflation would reduce the real cost of paying interest on the debt. Inflation would impose a large cost on the foreigners who bought the bonds. As recent experience with inflation and disinflation shows, there would be large costs at home also. The precise effect on international monetary arrangements of another period of U.S. inflation cannot be predicted.

The second option would be to service the debt without inflating. This would require producing more than we spend and selling the surplus abroad to pay the interest on the foreign debt. This option would require a trade surplus for the U.S. large enough to cover net interest payments abroad. Using an interest rate of 8 percent and a net foreign debt of \$600- to \$900-billion by the end of the decade, our trade surplus would have to remain at \$50- to \$70-billion per year indefinitely. A larger surplus in any year would reduce the debt and future interest payments; a smaller surplus would add to the debt and raise future interest payments.

The change from net imports of \$150-billion to net exports of \$50- to \$70-billion would require a major shift in world trade patterns and resource use. Because the debt will remain outstanding, the shift to a surplus must be permanent. A shift of this size, though large by current or past standards, would be manageable. A trade surplus of \$60-billion would be less than 2 percent of current real GNP and 1.5 percent of real GNP in 1990.

The problem cannot be solved in isolation, however. We are not the only debtor. Many other countries have debts that also must be serviced. These debtors, too, must have trade surpluses if they are to service their debts, currently close to \$1-trillion. This limits our options.

For example, we cannot expect to solve our problems by increasing net exports to Latin American debtors unless they increase their net exports to Europe and Asia. Nor, can we continue to be a net lender to Latin America to finance their trade and development. Every dollar we lend them has to be borrowed from the rest of the world or earned by exporting more than we import.

There is no way to avoid the conclusion that, if the debts accumulated in the seventies and eighties are to be serviced, there must be a major change in trading patterns and, therefore, in economic and trading relations. The U.S. must become a large net exporter to Western Europe and to Asia. Western Europe and Asia must become net importers. The postwar strategy of export-led growth to finance investment in many countries of Europe, Asia and parts of Latin America was highly successful. Standards of living rose. That strategy must change to reflect the debtor position of the United States.

The magnitude of the required change is impressive in relation to exports and world trade. Last year, the U.S. exported about \$370-billion and imported more than \$520-billion in constant dollars. Closing the gap between exports and imports and paying the interest on U.S. debt would be equivalent to increasing our current exports by 60 percent (in constant dollars) by 1990, or reducing imports by more than 50 percent, or some combination of the two. These amounts are more

than 10 percent of total current world exports and, perhaps more relevantly, more than three times the average trade surpluses (with all countries) of the two principal surplus countries -- Germany and Japan.

Much of Germany's surplus is earned within the European Economic Community, while much of Japan's surplus comes from trade with the U.S. It becomes clear that these countries must become, for the first time, large net importers from the U.S. and other debtor countries if the debts are to be serviced.

To illustrate, Japanese and German trade deficits equal to 2 percent of their 1990 output would provide only \$75-billion toward interest payments of the U.S. and other major debtors. This would be about one-half the amount of expected interest payments by these debtors in 1990.

Many observers who discuss the twin deficits appear to reach conclusions that are superficially similar. They urge monetary expansion by Germany and Japan to lower interest rates and stimulate demand for our exports. Others urge monetary expansion by the Federal Reserve to depreciate the dollar or monetary expansion in all three countries and perhaps elsewhere. These are stop gaps, not solutions. They work by putting the bandaid of additional demand on a problem that requires adjustment of costs and prices of exports and imports. They offer short-term, not long-term, solutions.

Options

The goal of policy should be to raise standards of living on a sustainable basis. Current policy does not do that. We have four options. None offers an easy solution, and only one would raise stan-

dards of living. Each deals in a different way with the problems of trade and debt:

First, we can continue inflating, as many now urge. Inflation would lower the value of the debt and devalue the dollar. The decline in the value of the debt would transfer wealth from the rest of the world but, sooner or later, inflation would raise all prices including interest rates and wages. The rise in wages and other costs of production would offset the effect of the devaluation on trade. To reduce the trade deficit permanently, we must reduce the cost of domestically-produced goods relative to foreign goods. Inflation not only does not solve the trade problem but, by encouraging consumption and possibly currency flight, it makes the problem worse.

Second, we can protect against imports using quotas, surcharges and perhaps tariffs. This would lower spending on imports but would invite retaliation and shrink the amount of world trade. A lower level of trade would make more difficult the task of squeezing out \$60-billion to pay interest on our foreign debt at the end of the decade. In addition to all the other, well-advertised disadvantages of trade restrictions, we must add that they are in a real sense counterproductive when we view the trade and debt problems simultaneously.

Third, we can devalue the dollar. We have done a lot of that in the past two years. A real devaluation, unlike inflation, would raise prices relative to costs of production and raise domestic prices relative to foreign prices. This method of adjustment, like protectionist policy, would reduce standards of living relative to foreigners and perhaps in absolute terms. We cannot avoid devaluation, but we should avoid policies aimed at manipulating exchange rates and "talking the dollar down." Exchange rates should be allowed to fluctuate freely.

Fourth, we can increase productivity. There are many ways to do this, none easy to accomplish. At the national level, the three most important policy changes would be:

- (1) Without increasing explicit tax revenues, shift taxation from capital to consumption so that the share of consumption spending falls and the share of capital spending rises to levels substantially above those achieved in the last twenty years;
- (2) Reduce government spending, particularly consumption spending and, if possible, shift government spending from consumption to productivity enhancing investments in infrastructure; and
- (3) Make a commitment to maintain these policies -- and a long-term pro-growth strategy -- to reduce uncertainty about future after tax returns to investment. Elements of this strategy include more deregulation, and less costly means of reducing pollution, enforcing product liability and ensuring safety and health.

Finally, we should shift from a policy of lending to foreign debtors to a policy of encouraging repatriation of foreign capital and debt reduction by foreign debtors. It makes little sense for a debtor country, the U.S., to borrow and sell assets to finance loans to Latin American debtors. Instead, we should encourage Latin Americans to sell equity in their large state sectors or to adopt policies that attract some of the capital held abroad by their citizens.

Conclusion

The problems of trade and debt require that we produce more relative to what we spend and that we transfer part of the difference abroad to service the debt. The four options take different approaches

to the problem. Inflation does little to solve the trade problem and, by encouraging consumption, would make the problem more severe. Devaluation (in real terms) and protection would solve the problem by lowering standards of living at home relative to living standards abroad. None of these options works to increase output and productivity.

A general tax increase to reduce the budget deficit would raise the tax on investment to maintain government spending on consumption. This is the opposite of a policy to close the gap between spending and production by increasing productivity. It is only by adopting measures that increase output per hour that we can hope to service our debt while shifting output from domestic use to exports without increasing inflation and without permanently reducing our standards of living relative to foreigners, and perhaps, absolutely. Reductions in government spending on consumption, higher taxes on private consumption and lower taxes on investment and capital would shift resources toward investment and raise productivity.

Economic policy is drifting. There is no coherent policy for dealing with the problems of trade and debt. The direction of drift is toward higher inflation and lower living standards. If we continue in our current, poorly thought out way, we risk a crisis which will force changes that are more costly and less orderly than those we urge.

ECONOMIC OUTLOOK AND MONETARY POLICY

Jerry L. JORDAN
First Interstate Bancorp

Outlook for 1987

While 1987 will be the fifth year of economic expansion of the U.S. economy, some sectors, regions, and industries will be experiencing only the first year of a mild turnaround. The uneven economic performance of different regions within the United States and different countries around the world has been one of the most striking characteristics of the current expansion. The forecast for 1987 is for somewhat faster average real economic growth and for significant lessening of the disparity that has been experienced.

Those regions within the U.S. that have experienced exceptionally strong growth in the past two years will expand less rapidly in the period ahead, while most of the depressed regions will stop contracting and begin a gradual recovery. Some sectors that were exceptionally strong in 1986, such as housing and motor vehicles, will contract this year. The hard-hit agriculture and energy sectors will finally bottom out and start to firm up as the year progresses, but they will not return to sustained prosperous conditions in the near future. Exporting industries and import-competing industries stand to show the greatest improvement within the manufacturing sectors.

In general, we expect:

- monetary policy to continue to be expansive;
- the Federal budget deficit to decline from \$221 billion last year to a still-quite-large \$175 billion or more this year;
- oil prices to average in the mid teens;
- the dollar to fall further;

- consumer prices to rise to about 4 1/2% this year;
- interest rates to rise about one-half to three-fourths of a percent point;
- real GNP growth to be about one percentage point higher than the past two years;
- employment to continue rising and the unemployment rate to drift towards the 6% level;
- domestic demand to strengthen in Japan and Europe, providing better markets for U.S. exports; and
- the U.S. trade deficit to begin falling, contributing to higher real output growth.

In summary, while U.S. final demand is not expected to strengthen this year, output growth is forecast to rise more rapidly. The weaker performance of the housing and motor-vehicles industries will be offset by stronger results in paper products, chemicals, computers, electronics, and service industries. The disappointingly slow real growth of the past two years is not likely to be repeated. It is more probable that surprisingly strong growth of final demand will cause our forecast to be on the low side.

Risks to the Outlook

Last year the "surprise" development that dominated the performance of the U.S. economy was the sudden and rapid decline of world oil prices. For 1987, there is a growing risk that the steep descent of the international value of the dollar could force a major policy shift and change the near-term outlook. Specifically, if Washington's policymaker were to become concerned about a "cumulative process" or "free fall" starting to occur in the foreign exchange markets, they would have to choose between risking an international financial crisis or administering a dose of old fashioned "tight money and credit." Our

judgment is that Federal Reserve policymakers would subordinate domestic economic and political considerations to international concerns and would accept a recession before they would risk a collapse of the dollar.

Monetary Policy Options

During the past two years monetary policy has been inappropriately conducted with a view to offsetting the adverse real shock effects of falling energy prices and depressed commodity prices. The fiscal impasse, represented by the high growth government spending relative to national income and the budget deficits, has given rise to substantial distortions in the performance of various sectors, regions and industries in the economy. The dislocations associated with the strong dollar followed by weak dollar regimes reflect the inconsistencies of U.S. economic policies. The monetary authorities have passively accepted the role of correcting the mistakes of the other parts of government, as well as attempting to mitigate the effects of external shocks. Such an activist, judgmental, and purely discretionary approach to the formulation and implementation of monetary policy increases uncertainty on the part of private decisionmakers and raises the likelihood that the central bank will become the scapegoat for whatever is wrong with the economy.

During the past two years the U.S. policymakers have been on a campaign to convince the world press and public opinion that external imbalances and disparity of economic performances has been caused by inappropriate policies being pursued by the strong currency/surplus countries. The U.S. position has been: when the dollar was strong in the early 1980s, it was a reflection on our good policies; now that the

dollar is falling it is a reflection of bad policies of others. The clear implication is that whatever is wrong requires policy changes on the part of other countries.

The classic prescription for a country experiencing huge fiscal deficits, huge trade deficits, explosive monetary growth and a rapidly depreciating currency is: cut government spending, raise taxes, and reduce monetary growth; none of that is likely to happen. Instead, the U.S. is urging other countries to increase spending, reduce taxes, increase budget deficits, ease monetary policies, and seek to "spend their way to prosperity" and lower trade surpluses. In a nutshell, since the U.S. has embarked on a policy of reinflating, other countries are being pressured into reinflating right along with us.

ECONOMIC AND MONETARY UPDATE

Shadow Open Market Committee

March, 1987

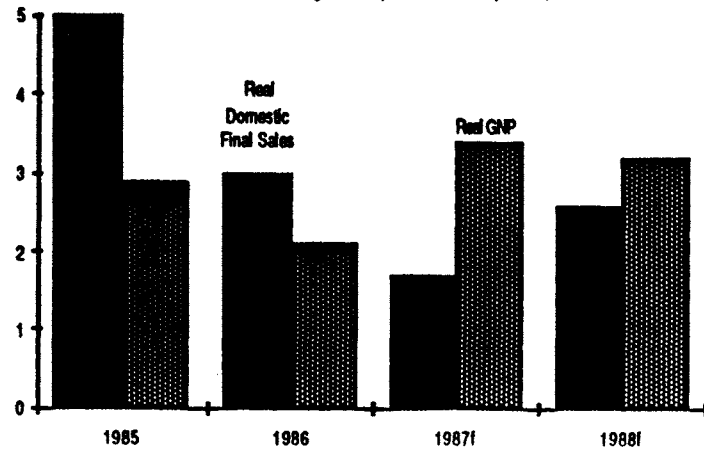
prepared by:

Jerry L. Jordan

First Interstate Economics

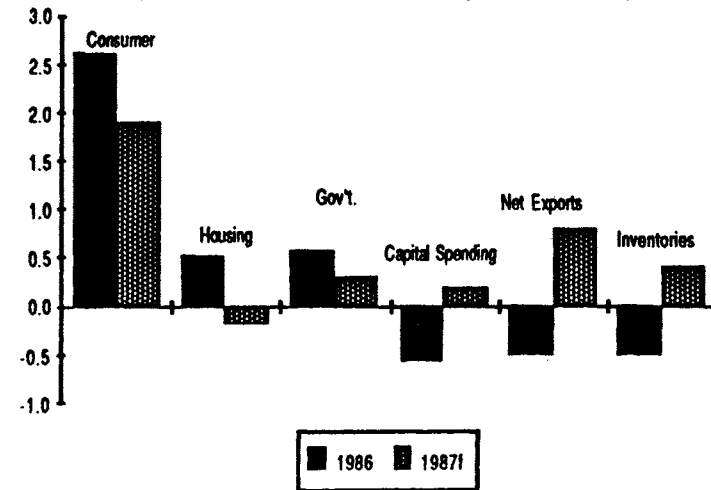
Demand vs. Production

(Percent change, 4th quarter to 4th quarter)



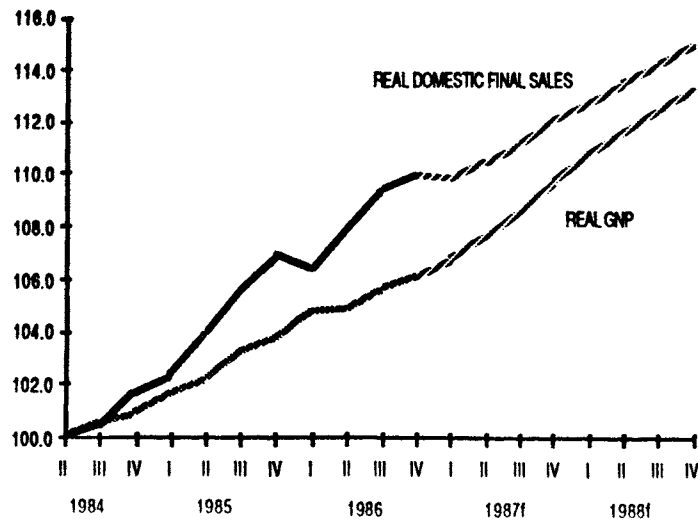
Contributions of Different Economic Sectors

(Addition or subtraction from Real GNP growth, 1986-1987)



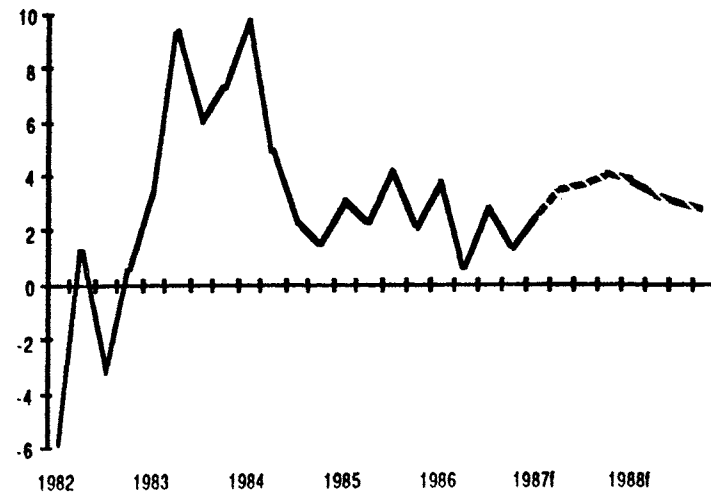
DEMAND vs. PRODUCTION

(Cumulative change from 2nd quarter 1984 = 100)



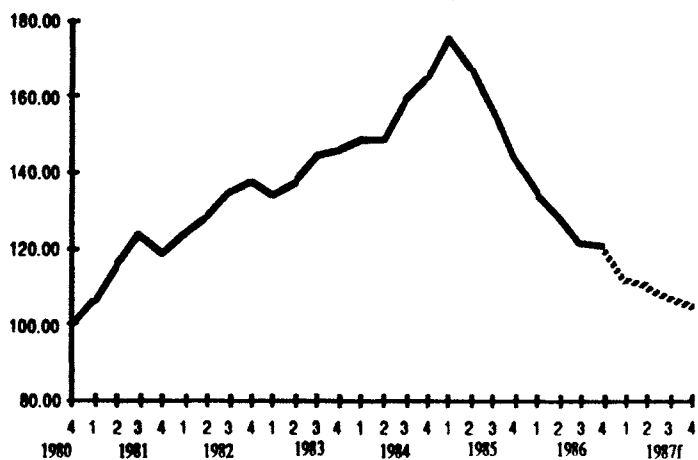
Real GNP

(Percent change from prior quarter, annual rate)



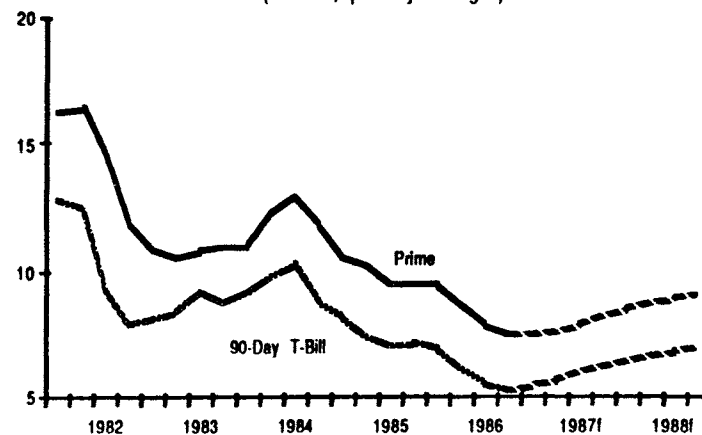
FEDERAL RESERVE TRADE-WEIGHTED DOLLAR

Index: 1980:4=100, Quarterly Averages



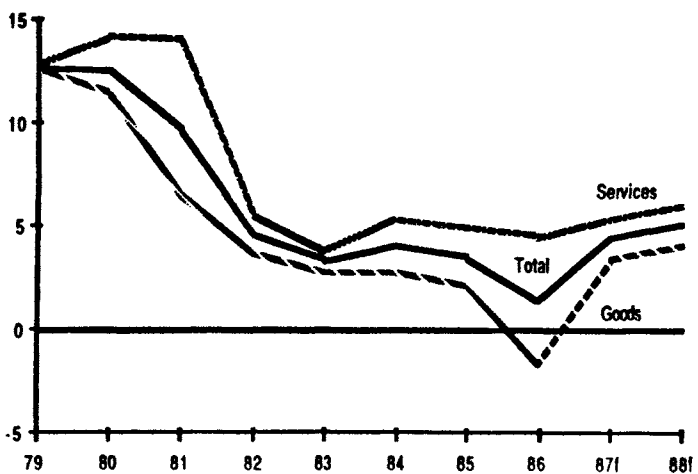
Short-Term Interest Rates

(Percent, quarterly averages)



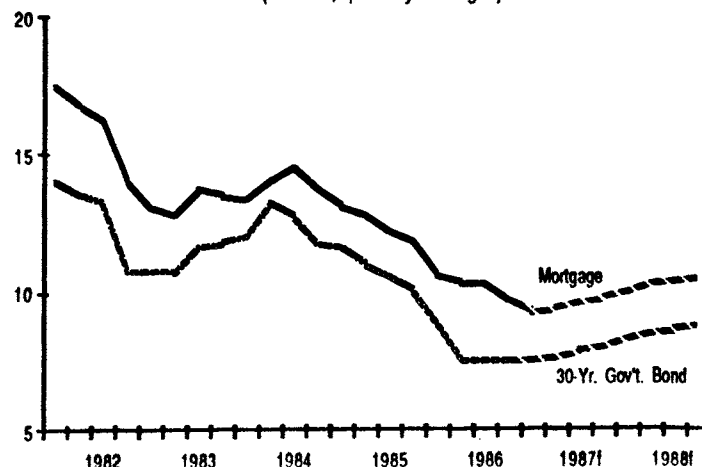
Consumer Prices

(Percent change, 4th quarter to 4th quarter)

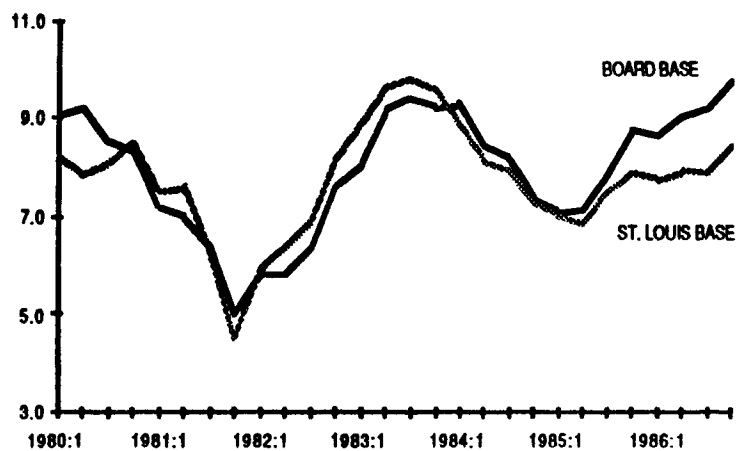


Long-Term Interest Rates

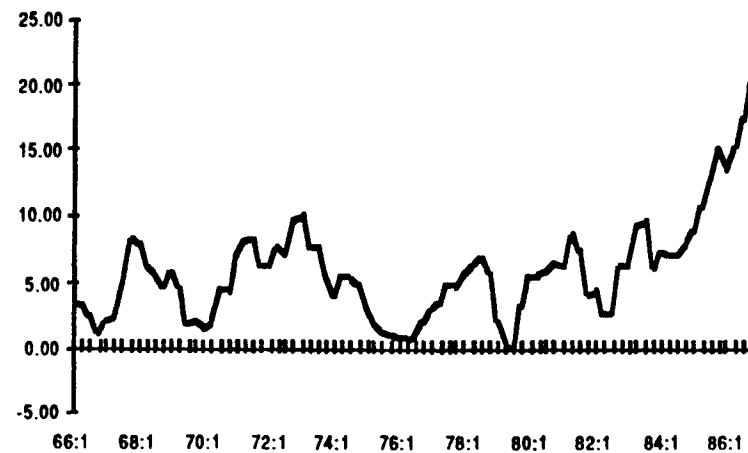
(Percent, quarterly averages)



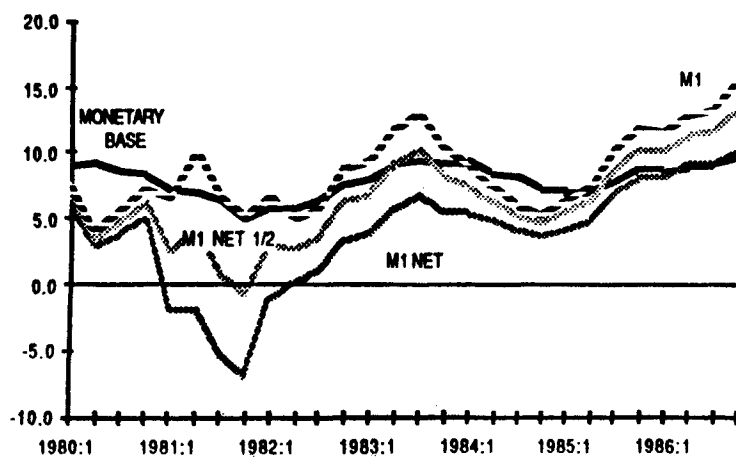
ST. LOUIS AND BOARD MONETARY BASE
QUARTERLY PERCENT CHANGE OVER YEAR AGO



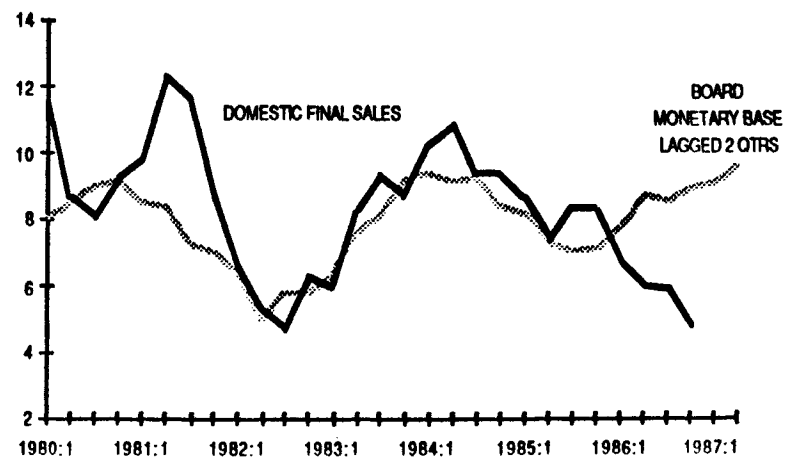
GROWTH OF TOTAL BANK RESERVES
QUARTERLY PERCENT CHANGE OVER YEAR AGO



BOARD MONETARY BASE AND M1
QUARTERLY PERCENT CHANGE OVER YEAR AGO

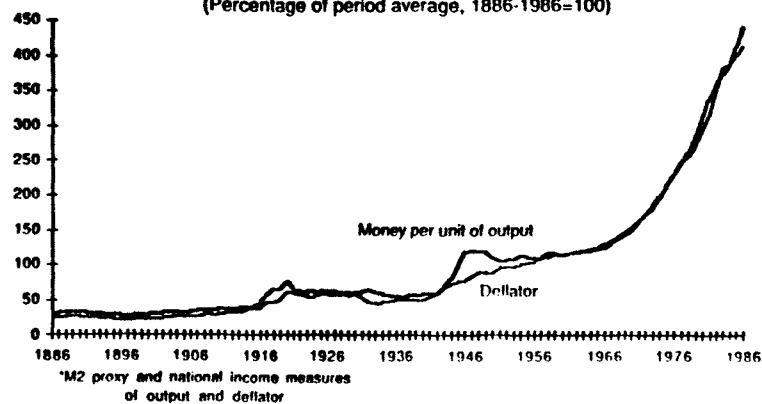


DOMESTIC FINAL SALES & LAGGED MONETARY BASE
QUARTERLY PERCENT CHANGE OVER YEAR AGO



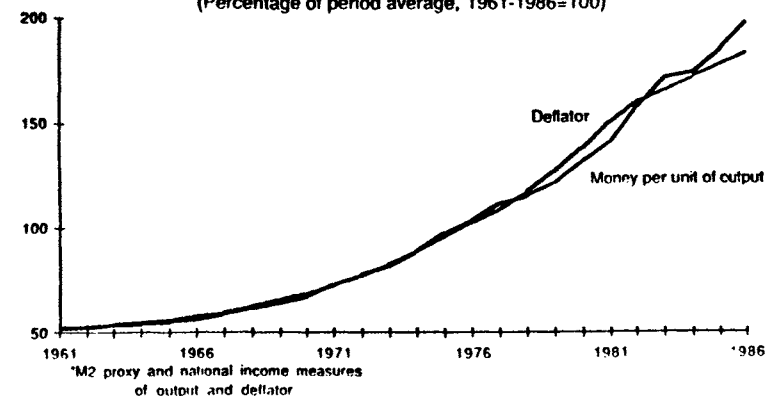
Money per Unit of Output and Deflator*

(Percentage of period average, 1886-1986=100)



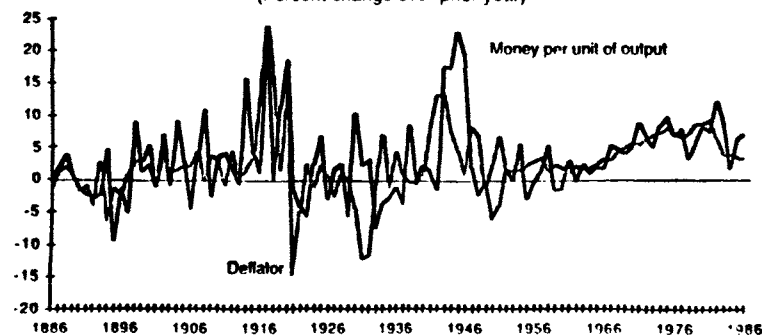
Money per Unit of Output and Deflator*

(Percentage of period average, 1961-1986=100)



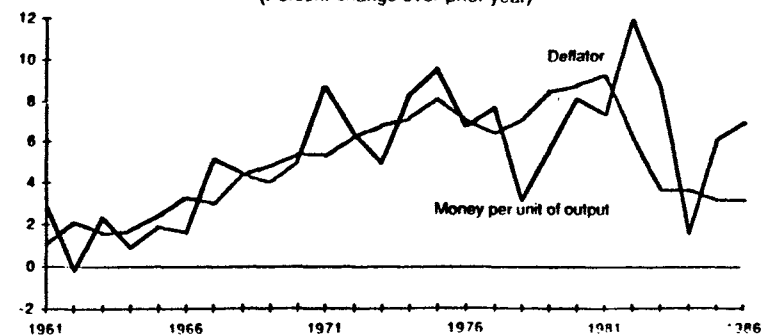
Changes in Money per Unit of Output and Deflator, 1886-1986

(Percent change over prior year)



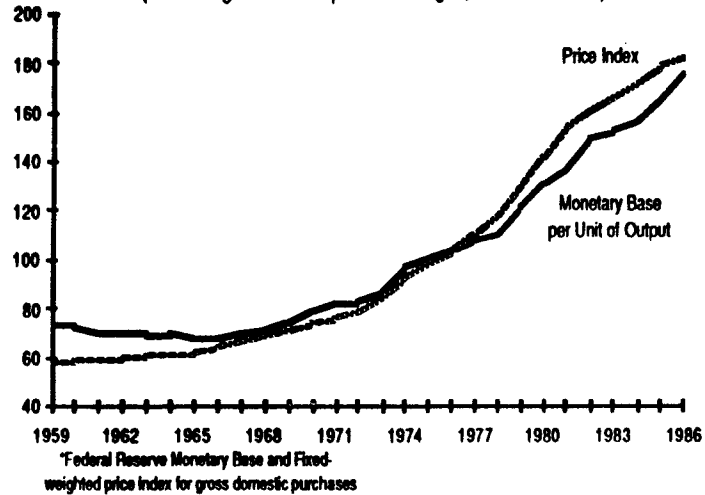
Changes in Money per Unit of Output and Deflator, 1961-1986

(Percent change over prior year)



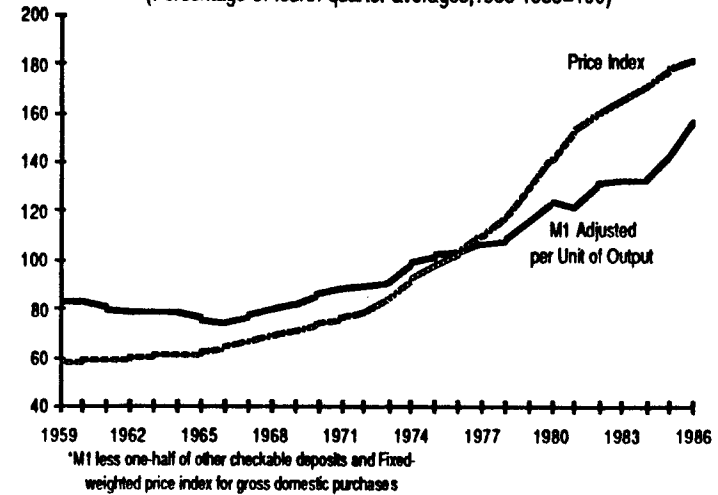
Monetary Base per Unit of Output and Prices^a

(Percentage of fourth quarter averages, 1959-1986=100)



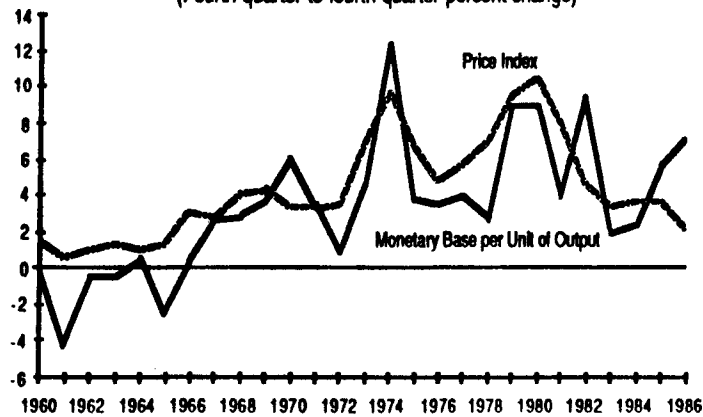
M1 Adjusted per Unit of Output and Prices^a

(Percentage of fourth quarter averages, 1959-1986=100)



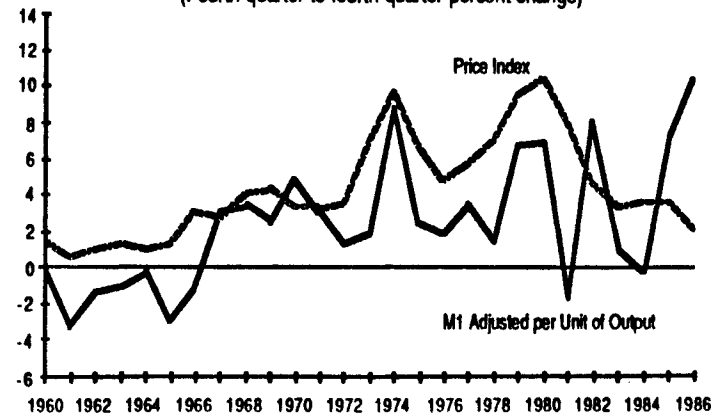
Changes in Monetary Base per Unit of Output and Price Index, 1960-1986

(Fourth-quarter to fourth-quarter percent change)

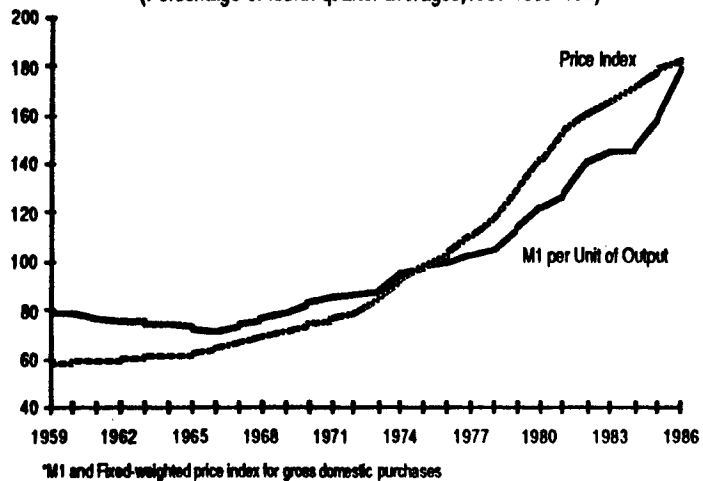


Changes in M1 Adjusted per Unit of Output and Price Index, 1960-1986

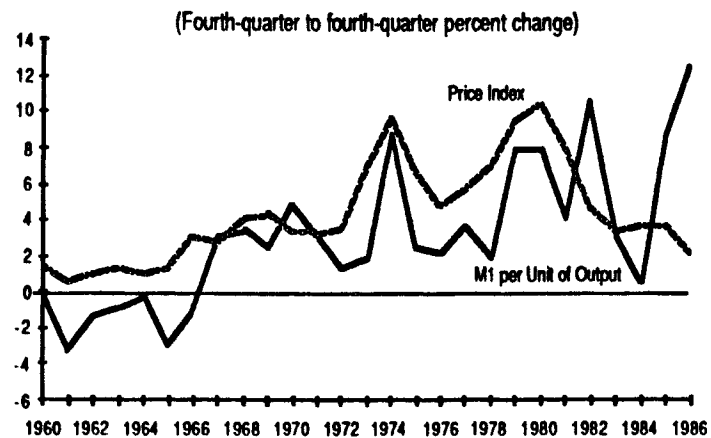
(Fourth-quarter to fourth-quarter percent change)



M1 per Unit of Output and Prices*
(Percentage of fourth quarter averages, 1959-1986=100)

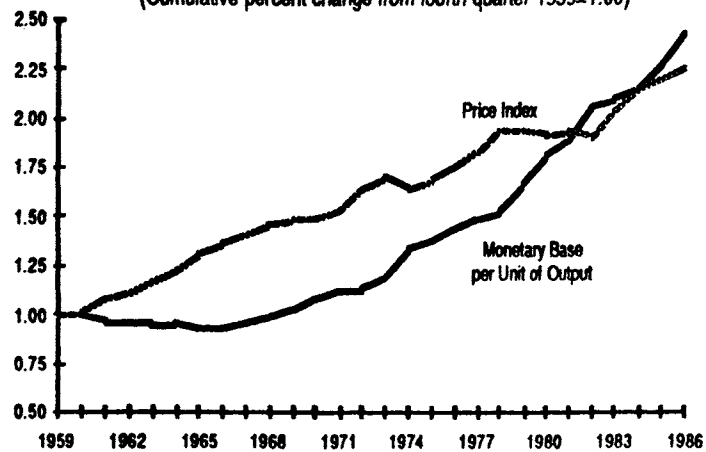


**Changes in M1 per Unit of Output
and Price Index, 1960-1986**



Monetary Base per Unit of Output and Prices*

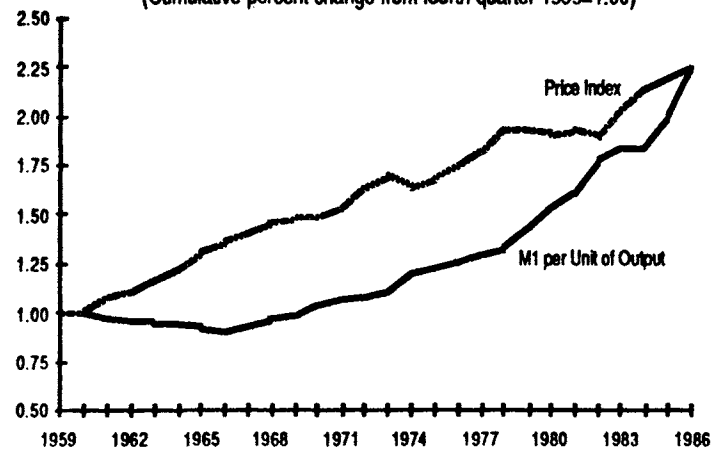
(Cumulative percent change from fourth quarter 1959=1.00)



*Federal Reserve Monetary Base and Fixed-weighted price index for gross domestic purchases

M1 per Unit of Output and Prices*

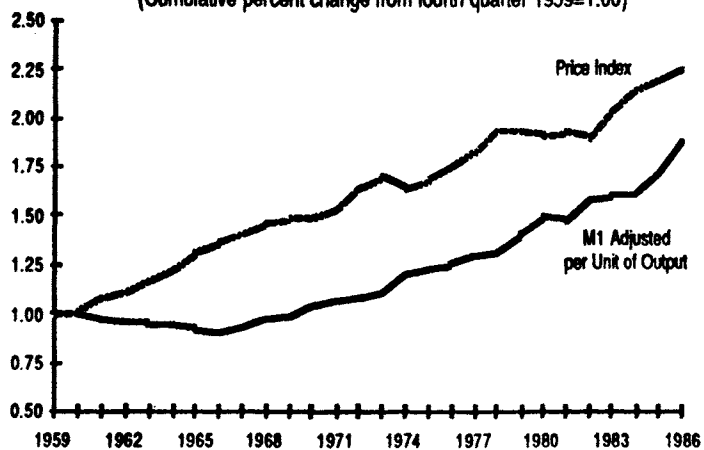
(Cumulative percent change from fourth quarter 1959=1.00)



*M1 and Fixed-weighted price index for gross domestic purchases

M1 Adjusted per Unit of Output and Prices*

(Cumulative percent change from fourth quarter 1959=1.00)



*M1 less one-half of other checkable deposits and Fixed-weighted price index for gross domestic purchases

MAJOR ECONOMIC INDICATORS QUARTERLY

4th QUARTER

	1986				1987				1988				% Change '86/'85		% Change '87/'86		% Change '88/'87	
	I	II	III Actual	IV	I	II	III	IV Forecast	I	II	III	IV	1986 Actual	1986 Actual	1987 Forecast	1988 Forecast	1988 Forecast	1988 Forecast
GROSS NATIONAL PRODUCT (billions of \$, annual rate)	4149.2	4175.6	4240.7	4260.6	4332.2	4407.3	4494.6	4589.1	4685.6	4780.6	4875.2	4972.8	4260.6	4.2	4589.1	7.7	4972.8	8.4
% Change, annual rate	6.2	2.6	6.4	1.9	6.9	7.1	8.2	8.7	8.7	8.4	8.2	8.2						
REAL GNP (billions of 1982 \$, a.r.)	3655.9	3661.4	3686.4	3696.3	3721.2	3752.4	3786.7	3824.0	3859.8	3891.3	3920.1	3947.3	3698.3	2.1	3824.0	3.4	3947.3	3.2
% Change, annual rate	3.8	0.6	2.8	1.3	2.5	3.4	3.7	4.0	3.8	3.3	3.0	2.8						
REAL FINAL DOMESTIC SALES (billions of 1982 \$, a.r.)	3742.0	3800.1	3850.0	3873.8	3865.7	3883.4	3907.7	3940.0	3963.8	3989.3	4012.1	4041.3	3873.8	3.0	3940.0	1.7	4041.3	2.6
% Change, annual rate	-1.8	6.4	5.4	2.5	-0.8	1.8	2.5	3.3	2.4	2.6	2.3	2.9						
REAL CHANGE IN INVENTORIES (billions of 1982 \$, a.r.)	39.9	15.1	-0.3	-24.4	3.0	12.0	16.0	11.0	19.0	22.0	26.0	21.0	-24.4	N/A	11.0	N/A	21.0	N/A
GNP DEFLATOR (1982=100)	113.5	114.0	115.0	115.2	116.4	117.5	118.7	120.0	121.4	122.9	124.4	126.0	115.2	2.1	120.0	4.2	126.0	5.0
% Change, annual rate	2.5	1.8	3.6	0.7	4.3	3.6	4.3	4.5	4.7	4.9	5.0	5.3						
CONSUMER PRICE INDEX (1987=100)	327.7	328.3	328.4	330.7	334.4	337.5	341.2	345.2	349.2	353.4	357.9	362.8	330.7	1.3	345.2	4.4	362.8	5.1
% Change, annual rate	1.5	-1.7	2.6	2.8	4.6	3.7	4.5	4.7	4.8	4.9	5.2	5.5						
AUTO SALES (millions, annual rate)	10.7	11.2	13.2	11.5	10.0	11.0	11.2	11.0	11.2	11.0	10.9	10.7	11.4 *	3.7	10.8 *	-5.3	11.0 *	1.4
HOUSING STARTS (millions, annual rate)	1.94	1.88	1.76	1.70	1.69	1.77	1.75	1.74	1.72	1.70	1.68	1.66	1.81 *	3.7	1.74 *	-4.0	1.69 *	-2.7
INDUSTRIAL PRODUCTION (1977=100)	125.0	124.4	125.0	125.9	126.6	127.9	129.5	131.2	133.0	134.5	135.6	136.7	125.9	1.0	131.2	4.2	136.7	4.1
% Change, annual rate	1.0	-1.9	1.9	3.0	2.4	4.1	5.0	5.5	5.4	4.6	3.5	3.0						
NONFARM EMPLOYMENT (millions)	99.4	99.8	100.3	101.1	101.8	102.5	103.2	103.9	104.6	105.3	106.1	106.7	101.1	2.4	103.9	2.8	106.7	2.7
UNEMPLOYMENT RATE (percent)	6.9	7.0	6.8	6.7	6.7	6.6	6.5	6.4	6.2	6.1	6.0	6.0	6.7	N/A	6.4	N/A	6.0	N/A
CORPORATE OPERATING PROFITS (billions of \$, annual rate)	296.4	293.1	302.0	305.0 e	309.0	313.0	318.0	327.0	332.0	338.0	344.0	350.0	305.0	6.8	327.0	7.2	350.0	7.0
% Change over year ago	11.3	6.9	1.9	6.8	4.3	6.8	5.3	7.2	7.4	8.0	8.2	7.0						
NET CASH FLOW (billions of \$, annual rate)	374.3	374.9	384.3	387.0 e	390.0	393.0	398.0	406.0	411.0	417.0	422.0	428.0	387.0	-0.6	406.0	4.9	428.0	5.4
% Change over year ago	3.7	1.1	0.4	-0.6	4.2	4.8	3.6	4.9	5.4	6.1	6.0	5.4						
MONETARY BASE (billions of \$, a.r.)	219.6	224.5	230.2	236.1	241.0	246.3	251.6	256.8	261.8	266.6	272.1	277.4	236.1	9.7	256.8	8.8	277.4	8.0
% Change, annual rate	8.4	9.2	10.5	10.7	8.5	9.2	8.9	8.5	8.0	7.5	8.5	8.0						

NOTE: All quarterly series are seasonally adjusted; % change, annual rate calculated from prior quarter; calculations based on unrounded data; a.r. = annual rate; e = estimate.

*Annual total; N/A = Not applicable.

Prepared by First Interstate Economics
February 23, 1987

AN UPDATE ON VELOCITY BEHAVIOR

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Last November I prepared a rather lengthy paper for the Carnegie-Rochester Public Policy Conference on the behavior of velocity and the stability of M1 money demand functions [Rasche (1987)]. This report updates that research in three ways. First, I will derive an alternative interpretation of the short-run money demand functions that appear in the November paper. This interpretation focuses on changes in velocity determined by the current expected change in the equilibrium demand for real cash balances and unanticipated contemporaneous shocks to the various determinants of the equilibrium demand for cash balances. This interpretation of the empirical specification is considerably different from the more conventional specification that emphasized long and very slow distributed lag responses of actual holdings of real cash balances. It should be emphasized that this is just a different way of looking at the regression results that have been previously presented, it is not a new set of results.

Second, I will present the new regression results from a covariance analysis of short-run money demand specifications for three distinct subsamples of the 1953-85 sample. The subsamples are 1953-74, 1975-81 and 1982-85. The covariance analysis suggests that in the significant "shift in the drift" of velocity that was previously identified as beginning in late 1981 is probably symptomatic of an increase in the interest elasticity of the long-run demand for real cash balances that has occurred since the introduction of interest bearing transactions accounts. The covariance analysis presented here

deals only with the monthly money demand specification of my November paper, but the consistent results are obtained for any of the quarterly specifications.

Third, I will present an analysis of the behavior of M1 velocity during the first 10 months of 1986. This is the question that is on everyone's mind, so I will risk addressing the question even though the data are so preliminary that any conjectures may be purely statistical artifacts. The reader who is interested only in the question of what has happened in 1986 should skip directly to section III.

I. An Alternative Interpretation of the Estimated Money Demand Functions

You should recall that the estimated results from annual data are consistent with an equilibrium log-linear money demand equation with a unitary real income elasticity of the form:

$$\begin{aligned}\Delta \ln(\overline{M/P})_t &= \alpha - \beta \Delta \ln \overline{RTB}_t + \Delta \ln(\overline{Y/P})_t + \epsilon_t \\ &= E[\Delta \ln(\overline{M/P})_t] + \epsilon_t\end{aligned}\tag{1}$$

where the bars over the variables represent annual averages of the corresponding data series. I do a bit of shuffling with the notation because the variables that were used in these regressions were changes in the logs of *arithmetic averages* of monthly data series, while for exposition purposes I will pretend that they are changes in *geometric averages* of the monthly data. Thus there is an element of inconsistency in the time aggregation of the data that I am fudging over.

The short-run money demand equations in section IV of the November paper are of the form:

$$\begin{aligned} \Delta \ln(M/P)_t = & a - b \sum_{i=0}^n \Delta \ln RTB_{t-1} + c \Delta \ln(Y/P)_t \\ & + (1-c)(1/n) \sum_{i=1}^n \Delta \ln(Y/P)_{t-1} + c \text{DIFU}_t + \mu_t \end{aligned} \quad (2)$$

where DIFU_t is the residual from a (0,1,1) ARIMA model of the inflation rate. I will assume that it is appropriate to interpret these residuals as:

$$\Delta p_t - \Delta p_t^e = p_t - p_{t-1} - {}_{t-1}p_t^e - p_{t-1} = (p_t - {}_{t-1}p_t^e) \quad (3)$$

where p_t is the observed inflation rate at t and ${}_{t-1}p_t^e$ is a measure of the expected inflation rate for t based on information available at $t-1$. A little algebraic manipulation gives an alternative expression for the short-run demand for money:

$$\begin{aligned} \Delta \ln(M/P)_t = & [a - (n+1)b\{(1/n) \sum_{i=1}^n \Delta \ln RTB_{t-1}\} + \{(1/n) \sum_{i=1}^n \Delta \ln(Y/P)_{t-1}\}] \\ & - b\{\Delta \ln RTB_t - (1/n) \sum_{i=1}^n \Delta \ln RTB_{t-1}\} \\ & + c\{\Delta \ln(Y/P)_t - (1/n) \sum_{i=1}^n \Delta \ln(Y/P)_{t-1}\} \\ & + d(p_t - p_t^e) + \mu_t \end{aligned} \quad (4)$$

Now if we ignore the fact that the n in the monthly regressions is less than a full year and that the annual regressions are not constructed using geometric averages, equation (4) can be interpreted as:

$$\begin{aligned}
\Delta \ln(M/P)_t = & E_{t-1} [\Delta \ln(\overline{M/P})_t] - b(\Delta \ln RTB_t - (1/n) \sum_{i=1}^n \Delta \ln RTB_{t-1}) \\
& + c(\Delta \ln(Y/P)_t - (1/n) \sum_{i=1}^n \Delta \ln(Y/P)_{t-1}) \\
& + d(p_t - p_t^e) + \mu_t
\end{aligned} \tag{5}$$

so that the observed change in real money balances is the sum of the expected change in equilibrium demand for real money balances plus the effects of current shocks to interest rates, real income, inflation, and an unallocated noise component. For this interpretation to be appropriate, the four "shock" terms should not be predictable based on information available at $t-1$. The inflation shock is constructed to be approximately independent of its own past history, since it is measured as the residuals from an ARIMA model. The other three shocks are not constrained in any way by the regression. The first twelve estimated autocorrelations of these series are:

	Interest Rate Shock	Real Income Shock	μ_t
1	.41	.01	.13
2	.00	.03	.07
3	-.03	-.08	.19
4	-.02	-.05	-.09
5	-.18	-.08	.06
6	-.38	-.14	.09
7	-.33	-.15	-.05
8	-.11	.04	.02
9	.02	.09	.10
10	.02	.05	-.10
11	.05	.10	-.03
12	.15	-.04	-.04

so, with the exception of the first, sixth and seventh autocorrelations in the interest rate series, there does not appear to be a tremendous

amount of serial correlation in these series. An interesting test of this hypothesis (which I have not yet had the opportunity to construct) would be to treat the "shocks" as a four equation VAR system and to test the hypothesis that the coefficient matrix in the VAR model is just an identity matrix. An alternative research strategy would be to estimate a multivariate ARIMA model that involved four equations to determine interest rate, real income, inflation and money demand shocks jointly. This would also permit Granger-Sims type "causality testing" of the interest rate, real income and inflation shocks against the money demand specification.

II. Some Additional Estimates of the Short-Run Demand for Money

Since I completed the research for the Carnegie-Rochester paper, I have done some additional investigation into the nature of the elusive "shift in the drift" parameter that occurred around the end of 1981. This research has focused on two questions: 1) attempts to include a more comprehensive measure of "transactions" and 2) covariance tests of the stability of the short-run money demand specification over various subsamples of the 1953-85 period.

The first line inquiry has not produced any great new insights. I thought that I had discovered a useful and apparently unexploited data series in the *Survey of Current Business* in the form of monthly data on the number of shares traded on registered stock exchanges and the monthly value of all such trades. I added either the trading volume measure, or the real value of trading (deflated by the GNP deflator) to the annual money demand specifications to try to model transactions that are not measured in GNP. Unfortunately, this variable is completely insignificant in sample periods that end prior to 1982. It has

the expected positive coefficient in samples extending through 1985, when interacted with a dummy variable that is zero before 1982 and one thereafter, but this result is equally as unsatisfying as just using the 1982 dummy variable by itself.

The covariance analysis proved to have a higher marginal product. All of the regression coefficients were allowed to assume different values in the subsamples mentioned above, and F tests were used to check for equality of coefficients across the three periods. The residuals of the *unrestricted* regressions were examined for homoskedasticity across the subsamples. This revealed that the residual variance in the 1953-74 subsample was considerably lower than that of the later two subsamples, but that the residual variance in the 1975-81 sample was virtually identical to that of the 1982-85 sample. Thus the observed drift in the standard error as the sample period was lengthened from 1974 to 1981 to 1985, is attributable to mixing heteroskedastic errors in changing proportions. The only change in the variance of the error process occurs in the mid 1970s and the previous conclusion that there is no increase in the residual variation of the short-run money demand function (or velocity) in the 1980s is fully supported. These results are consistent for the monthly regressions and the quarterly regressions (regardless of the income concept used).

The covariance analysis also supports the hypothesis that the long-run and short-run income elasticities and the short-run unexpected inflation elasticity of the demand for real cash balances are stable across the three subsamples. There is also no evidence of a change in the interest elasticity between the 1953-74 and 1975-81 subsamples. The only significant change in the specification, other than the shift

in the constant term that was found in the earlier work is an increase in the interest elasticity in the 1982-85 subsample. This is documented in Table 1, where column 1 repeats the estimates for the constrained monthly regressions from the November paper (reestimated on the latest available data revisions) and column 3 gives the results with a change in the interest elasticity permitted in 1982. It should be noted that unconstrained distributed lags were estimated for all three subsamples in the covariance analysis and the lag restrictions identified in the November paper were tested jointly with the covariance analysis restrictions. None of the restrictions imposed on the specifications in column 3 were rejected. This type of analysis has also been repeated on quarterly data using the three income concepts: GNP; Final Sales to Domestic Purchasers; and Personal Income and the conclusions are identical to those presented here.

An interpretation of the estimates in column 3 of Table 1 is presented in Figure 1. It appears that the significant shift in the drift parameter of velocity in 1982 is symptomatic of a rotation of the long-run velocity function of the type illustrated in Figure 1. Prior to late 1981, the long-run elasticity of the velocity function was relatively low, and that the drift in velocity (the change in velocity when interest rates were not changing) was positive. Subsequent to late 1981 it appears that the long-run interest elasticity of velocity has increased, but this has occurred with a rotation of the velocity function so that the current drift in velocity is approximately zero. My best explanation for this is that the change in the structure of the velocity function is a result of the relaxation of the zero interest rate constraint on transactions deposits.

It should be noted that at least one other piece of research has reached a conclusion that is similar, if not identical, to this. Mehra (1986), in Table 1 (p. 16) has estimated a monthly money demand equation (equation 2) very similar to the unrestricted distributed lag specification that underlies the results presented here, and has reached an identical conclusion about the change in the long-run interest elasticity of money demand in 1981. His research differs in that it considers only a 1961-85 sample period, and it does not address the issue of restrictions on the short-run money demand specification. In a perfect coincidence, that study chooses almost identical distributed lag lengths to those that I have used.

Mehra has also investigated the effect of adding a nonzero own interest rate elasticity of money to his specification of the short-run money demand equation, though in a highly constrained fashion (equation 3). He uses the variable $\Delta \ln(R_t - R_{m_t})$ where R_{m_t} is a weighted average of the rates on NOW accounts and SNOW accounts, with weights reflecting their shares in M1. A similar variable was used by Taylor (1985) in a quarterly study of money demand. This variable can be rewritten as $\Delta \ln R_t - \Delta \ln(1 - [R_{m_t}/R_t])$. When the variable is expressed in this form, it is clear that the specification does not introduce any independent estimate of the own interest rate elasticity. If β is the elasticity of the demand for real cash balances with respect to R , the elasticity of the demand for real cash balances with respect to the own rate, R_m , is constrained to $-\beta R_m/(R - R_m)$. This is a highly variable elasticity which has a value of 0 at $R_m = 0$, $-\beta$ at $R_m = .5R$, and approaches infinity as R_m approaches R from below. There does not appear to have been any testing of the appropriateness of this functional form. Further, the addition of the constrained own interest elasticity makes

no contribution to the "goodness-of-fit" of the Mehra's estimated equation. Based on this work, there does not seem to be any case supporting the argument that the change in velocity since 1981 is the result of own interest rate effects in the demand for real cash balances.

III. The Behavior of Velocity in 1986

A casual examination of the currently available data suggests that the behavior of M1 velocity in 1986 is a real anomaly judged against its history. I purposefully ignored the events of 1986 in undertaking the earlier research so that these data would be available for an independent test of whatever conclusions were reached. Preliminary data are now available through October, 1986 (data on the deflator for personal consumption expenditures have not yet been published for November or December). These data can be employed in two ways: 1) the estimated equations from Table 1 can be used to forecast the first ten months of 1986, and 2) the specifications can be reestimated using the ten additional observations to see if the structure proves unstable in 1986. I have not yet constructed the instrumental variable for the change in the Treasury bill rate for 1986, so the analysis here is confined to OLS estimates. I do not anticipate that the conclusions will vary with the estimation technique.

The results of the reestimation test are given in Table 1. The second column of this table reproduces column 1 with the sample extended through October, 1986. The fourth column of Table 1 is the corresponding extension of the results in column 3. There are no tremendous surprises here. The parameter estimates are quite stable and the estimated residual standard errors are not much different from

the equivalent estimates with the sample ending in 1985. However, the stability of these parameters should probably not be considered a particularly strong test of the model, since only ten observations have been added to the original sample of 391 observations. More interesting are the residuals for the 1986 months. These are given in Table 2, columns 2 and 4. At first glance, these residuals do not seem to be terribly out of line. The only residual that exceeds twice the estimated standard error of the equation is in May, 1986. A closer look reveals that there is a systematic behavior in the residuals in the run of overpredictions (negative residuals) of velocity starting in March through at least August. This is also evident in the mean of the residuals for the first ten months of 1986 which is substantially less than zero. This pattern in the residuals is reduced in the specification that allows for an increased interest elasticity after 1981 [column (4)], but is still substantial.

The results of the forecasting test are given in the first and third columns of Table 2. In this test, the estimated coefficients from the sample ending in December, 1985 were used with the actual 1986 data for real personal income and Treasury bill rates. The unexpected inflation variable was generated from one period ahead forecasts from the ARIMA model for inflation estimated through December, 1985. These predictions of inflation substantially overestimate the observed inflation rates in the early months of 1986. The prediction errors for velocity in 1986 are quite similar to the residuals of the velocity equations estimated through 1986. The same run of overpredictions of monthly velocity changes is observed, and the average forecast error is negative. The equation that is estimated with only the 1982 dummy

variable (column 1) outperforms on average the equation that allows the change in the interest elasticity of velocity in 1982, for reasons that are not apparent. Indeed, this equation (column 1) on average outperforms the same specification estimated through 1986!

My conclusion from these experiments is that in the substantial month to month residual variation in velocity changes, there is some systematic behavior that may, with a lot of data mining be identifiable. We should not overlook the fact that these results are derived from equations that have only four or five estimated parameters (on samples of over 400 observations). The velocity model is extremely parsimonious. That is its strength. But it suggests that the estimated equations are not likely to fit every wiggle in the data, particularly during a period when the economy experiences a substantial external shock. Nevertheless, the best conclusion that can be drawn from these results is that, absent drift in short-term interest rates, the future drift in M1 velocity will be close to zero. This is evident in columns five and six of Table 1, where the velocity equation has been reestimated for both sample periods with the post 1981 drift parameter constrained to zero.

TABLE 1

Revised Estimates of Monthly Personal Income Velocity Equations
First Differences

Constrained Distributed Lags
Ordinary Least Squares Estimates

	53,1-85,12	53,1-86,10	53,1-85,12	53,1-86,10	53,1-85,12	53,1-86,10
	(1)	(2)	(3)	(4)	(5)	(6)
Constant	.0307 (.0024)	.0305 (.0025)	.0310 (.0024)	.0309 (.0024)	.0310 (.0024)	.0308 (.0024)
D82	-.0406 (.0070)	-.0504 (.0066)	-.0305 (.0071)	-.0367 (.0068)	-.0310	-.0308
$\Delta \ln \text{RTB}$	.0058 (.0006)	.0059 (.0006)	.0053 (.0006)	.0052 (.0006)	.0053 (.0006)	.0053 (.0006)
$\Delta \ln Y/P$	.8374 (.0396)	.8514 (.0402)	.8351 (.0385)	.8465 (.0388)	.8351 (.0391)	.8474 (.0388)
D82* $\Delta \ln \text{RTB}$			.0122 (.0024)	.0134 (.0024)	.0122 (.0023)	.0143 (.0022)
\bar{R}^2	.60	.61	.62	.64	.62	.64
se	.0448	.0458	.0434	.0442	.0434	.0442
d-w	1.74	1.66	1.84	1.78	1.84	1.78

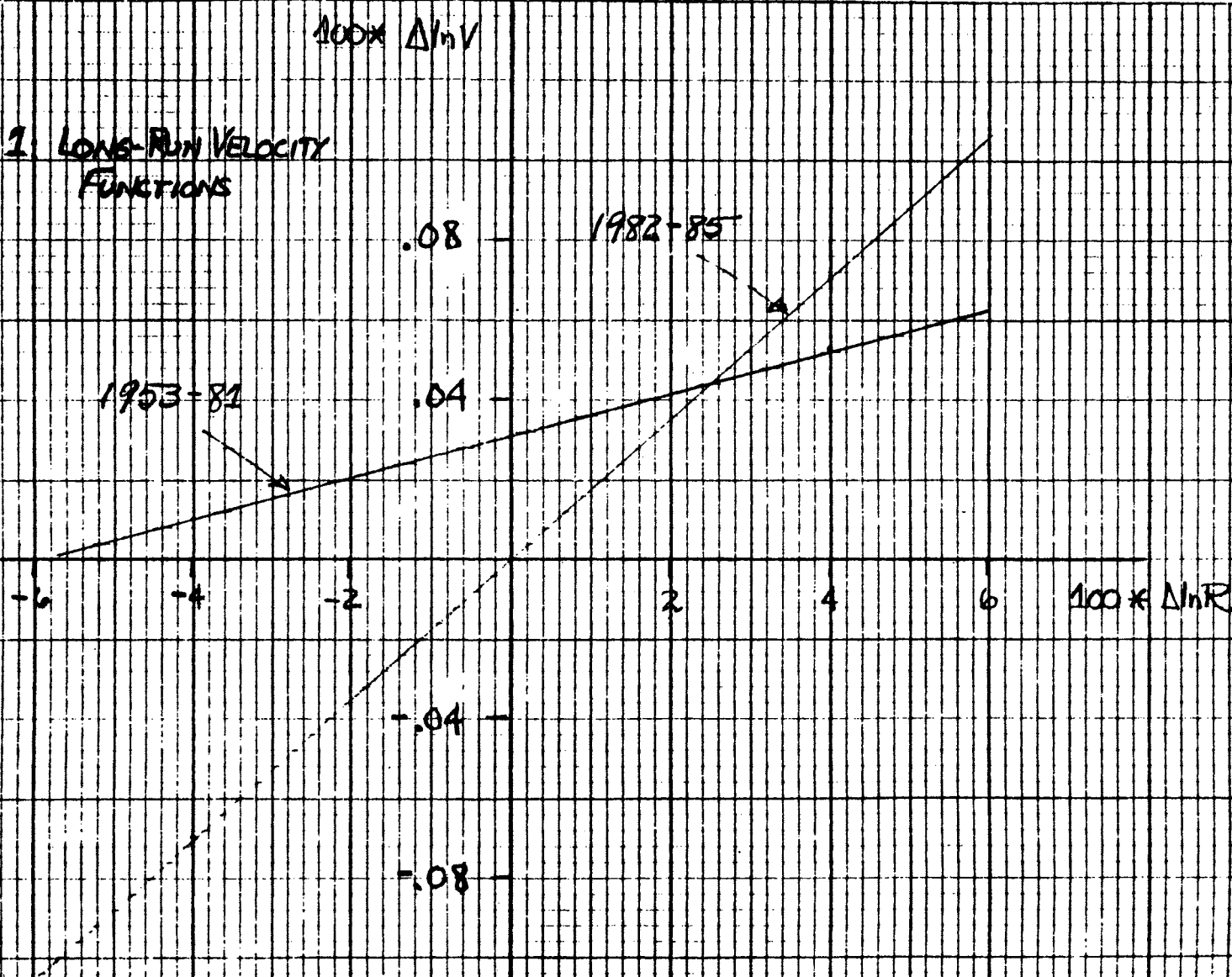
TABLE 2

1986 Velocity Errors
Monthly Velocity Equations
Annual Rates

	(1)	(2)	(3)	(4)
January	-.0643	.0689	-.0703	.0652
February	-.0119	.0046	-.0096	.0068
March	-.0318	-.0520	-.0295	-.0689
April	.0561	-.0470	.0444	-.0365
May	-.0933	-.1245	-.1037	-.1377
June	-.0716	-.0661	-.0799	-.0559
July	-.0494	-.0775	-.0677	-.0566
August	-.0609	-.1147	-.0883	-.0810
September	-.0429	-.0145	-.0760	.0236
October	-.0479	-.0537	-.0811	-.0085
Mean	-.0418	-.0476	-.0562	-.0350

Note: Columns correspond to the columns of Table 1. Columns 1 and 3 are post sample forecasts. Columns 2 and 4 are within sample residuals.

FIGURE 1. LONG-RUN VELOCITY
FUNCTIONS



PROJECTED PROGRESS ON DEFICIT REDUCTION:
WILL IT PROVE ILLUSORY (AGAIN)?

Mickey D. LEVY
Fidelity Bank

In the President's *FY1988 Budget* and the CBO's *Economic and Budget Outlook*, several important positive trends are projected:

- *federal spending growth is significantly slower than recent years
- *budget deficits shrink in real and nominal terms, and as a percent of GNP
- *the primary deficit -- deficits excluding net interest outlays -- is virtually eliminated within three years
- *the federal debt-to-GNP ratio stabilizes and begins to recede
- *the President's budget achieves the Gramm-Rudman-Hollings (GRH) deficit targets (see tables 1-2)

Clearly, some progress on the budget dilemma has occurred, but these projections over-estimate the improvement. As is typically the case, the Administration's budget is wildly optimistic. Unrealistic budget projections that on paper achieve the overly ambitious goals of GRH do not resolve the budget dilemma, nor do they necessarily represent sound fiscal policy. While deficits are scheduled to recede, actual budget outcomes again will be disappointing relative to these projections. Unacceptably high deficits will persist until some of the structural flaws that plague certain spending programs are corrected.

The sharp declines in projected deficits, even without enactment of the President's proposals, occur primarily due to the sharp slowdown in projected spending growth. Federal outlays, which were 24 percent of GNP in FY1985, are forecast in the President's current services budget to recede from approximately 23 percent of GNP in FY1987 to 21.4 percent in FY1990, while revenues remain unchanged at 19.1 percent.

This pattern of slower spending growth -- a significant shift from the FY1980-1985 period, when nominal outlays rose 9 percent annually -- reflects the sharp slowdown in defense spending, lower interest rates, the deficit-reducing provisions of the Budget Reconciliation Act of 1985 and the sequestration under GRH in 1986. The slowdown in defense spending has been dramatic: real defense authority in FY1987 will be approximately 2 percent below FY1985 levels, and the President's budget calls for 3 percent annual rise in real defense budget outlays in FY1988-1990. From FY1980-1985, real defense outlays rose at a 6.9 percent annual rate.

The President's *Budget* proposes even slower total spending growth. Its projected 0.9 percent rise is the primary factor that lowers the FY1988 deficit to \$107.8 billion, down from \$173.2 billion in FY1987. Most of the President's deficit cutting proposals involve cuts in spending programs or sales of government assets which are counted as negative spending. No new general tax increases are proposed.

A change in budget accounting gives the impression that progress on the deficit is larger than what will actually occur. The OMB and CBO budget projections (including those in tables 1 and 2) and the GRH targets include social security (OASDI), even though the program was placed off-budget by the Balanced Budget Act of 1985. The mounting surplus in the social security trust funds -- which occurs primarily due to rapidly rising payroll tax revenues -- will reduce the total deficit by approximately \$38 billion in FY1988 and \$67 billion in FY1991. The Administration estimates that the on-budget deficit in FY1988 to be \$189.2 billion without proposed legislation, and \$147.4 billion with full enactment of the President's proposals.

What Could Go Wrong?

Spending may grow more rapidly than the Administration projects for several reasons. Many of the Administration's proposed spending cuts and asset sales were included in its FY1987 Budget and have already been rejected by Congress. A reversal should not be expected. Second, there are always chances of legislative slippage in the fight to cut spending. In 1985, passage of the Food Security Act (farm bill) led to an unanticipated explosion of agricultural outlays. With the Administration's political clout waning, new spending legislation may offset recent budget savings initiatives. An obvious example is the Congressional override of President Reagan's veto of the Clean Water Act (HR1), a reauthorization bill which includes \$18 billion for municipal sewage treatment plant construction through 1994. A catastrophic health insurance bill is also being debated.

Third, the economic projections and assumptions underlying the budget projections may be too optimistic. In particular, the Administration projects sharply declining nominal and real interest rates (see table 3). Even if the Administration's inflation expectations prove correct, the dramatic declines in real rates are seemingly inconsistent with its forecast of accelerating real GNP growth through 1988 and above 3 1/2 percent growth through 1991. Achieving this rapid growth is possible, but it would be significantly above the average growth rate in recent decades.

The CBO forecasts less rapid economic growth and higher inflation than the Administration. Higher than anticipated interest rates would add significantly to net interest costs while slower real GNP growth rate would reduce revenues. The CBO estimates that a 1 percentage point higher rates beginning January 1987 would increase outlays by \$11

billion in FY1988 and \$23 billion in FY1991, and that 1 percent slower real GNP growth would add \$16 billion to deficits in FY1988 and \$76 billion in FY1991.

The CBO re-estimates of the the President's FY1988 budget proposals, based on its own economic projections and technical estimating assumptions, indicate that the deficit will be \$26.6 billion higher than the Administration forecasts in FY1988 and \$24.3 billion higher in FY1989. Similar to recent patterns, these CBO re-estimates may prove more accurate than the Administration's. With the exception of FY1984, every *Budget* issued by President Reagan has vastly underestimated the actual fiscal year deficit.¹⁾ These underestimates have stemmed from overly optimistic economic forecasts and the failure to enact deficit-cutting proposals. The same pattern will unfold in FY1988.

Back-Peddling on GRH

Systematically biased accounting procedures and deceptive tactics allowed Congress and the Administration to suspend GRH's across-the-board sequestration for FY1987. As a consequence, the actual deficit for FY1987 will be approximately \$175-185 billion, rather than the \$144 billion GRH target which was "satisfied" according to the GRH calculations in October 1986. Of course, the \$30 billion miss makes the achievement of GRH's FY1988 deficit target of \$108 billion

¹⁾The Administration's underestimates, measured as the difference between the projected deficit in the President's *Budget* issued in February and the actual budget deficit, are: 1982, \$83 billion; 1983, \$92 billion; 1985, \$17 billion; 1986, \$33 billion; and 1987, over \$30 billion. In FY1984, the Administration overestimated the deficit by \$38 billion.

virtually impossible. CBO estimates indicate that the President's FY1988 budget proposals will not be nearly enough to achieve the target, and Congress has already rejected a large portion of the President's proposals. Without deficit-cutting legislation, the FY1988 deficit will be approximately \$175 billion.

The widening gap between current deficits and GRH targets has only accentuated GRH's flaws: its dramatic cuts are overly rigid and arbitrary; its balanced budget goal is unsupported by theoretical considerations and therefore is an unreliable fiscal policy guideline; the numerous exemptions from the sequestration process grossly violate GRH's original intent that the burden of deficit cutting be distributed evenly; and so far, GRH has elicited many short-term, quick fixes to the deficit dilemma that have not contributed to, or have been inconsistent with, long-run program reform. In addition, GRH's viability is uncertain because of the absence of enforcement power of its automatic across-the-board spending cut procedures.

Despite these limitations, GRH has been a surprisingly successful political guideline for deficit-cutting efforts. It has been influential in forcing Congress to focus on the deficit and has provided a valuable incentive for deficit-cutting legislation. It has probably deterred enactment of some new spending legislation. Thus, simply abandoning GRH would be a mistake.

Faced with the virtually impossible arithmetic exercise of reaching the GRH deficit targets, some in Congress are considering ways to escape GRH's strangle-hold. House Budget Committee Chairman William Gray and Senate Budget Committee Chairman Lawton Chiles have indicated their intent to abandon or ease GRH's deficit targets. In contrast, the Administration asserts that the President's Budget achieves the

FY1988 target, and refuses to budge in its support of GRH. In Congress, Senators Gramm, Rudman, and Hollings have threatened to attempt to restore GRH's automatic spending cut mechanism by attaching a revised plan as an amendment to a new federal debt limit extension that must be considered this spring. If successful, they would hinder potential Congressional action to side-step GRH's across-the-board cutting mechanism.

Clearly, the Administration's game plan is to attempt to meet the GRH targets, albeit by quick-fix and temporary methods, including selective revenue increases. Recently, the Administration's strategy has been re-enforced by Treasury Secretary Baker's agreement with finance ministers of major economic allies that the U.S. will continue efforts to reduce U.S. budget deficits. The Administration's tactics have forced Congress into a defensive political posture.

There are two avenues Congress may pursue. It may enact a resolution that raises the GRH deficit targets. This may generate negative political fallout. Second, Congress may acknowledge that the FY1988 \$108 billion GRH deficit target should not be disregarded. Congress would agree to use various budgetary gimmicks to lower the projected FY1988 deficit. However, given the magnitude of the cuts required and the CBO's realistic budget projection, which must be averaged with OMB's projection in the GRH process, the FY1988 GRH deficit target will not be met. But even if the target is not reached, GRH's sequestration process is not automatic, and any across-the-board cuts would require passage of a joint Congressional resolution, which seems highly unlikely. Thus, whatever avenue Congress pursues, across-the-board cuts should not be expected for FY1988.

Table 1
Budget Projections

	Fiscal Years					
	1986	1987	1988	1989	1990	1991
Outlays						
President's Proposal	989.8	1015.6	1024.3	1069.0	1107.8	1144.4
President's Current Services	989.8	1016.8	1060.5	1115.1	1165.4	NA
CBO Baseline	989.8	1008.0	1069.0	1124.0	1184.0	1247.0
CBO Estimate of President	989.8	1010.4	1039.8	1086.2	1136.7	1182.6
Receipts						
President's Proposal	769.1	842.4	916.6	976.2	1048.3	1123.2
Current Services	769.1	842.3	910.4	968.2	1039.7	NA
CBO Baseline	769.1	834.0	900.0	962.0	1050.0	1138.0
CBO Estimate of President	769.1	834.2	905.4	969.1	1058.8	1146.9
Deficit (-)						
President's Proposal	-220.7	-173.2	-107.8	-92.8	-59.5	-21.3
Current Services	-220.7	-174.5	-150.1	-146.9	-125.7	NA
CBO Baseline	-220.7	-174.0	-169.0	-162.0	-134.0	-109.0
CBO Estimate of President	-220.7	-176.2	-134.4	-117.1	-77.9	-35.7
Memo:						
GRH Targets	-171.9	-144.0	-108.0	-72.0	-36.0	0.0
Difference From GRH						
President's Proposal	48.8	29.2	-0.2	20.8	23.5	21.3
Current Services	48.8	30.5	42.1	74.9	89.7	NA
CBO Baseline	48.8	30.0	61.0	90.0	98.0	109.0
CBO Estimate of President	48.8	32.2	26.4	45.1	41.9	35.7

Table 2
Selected Budget Projections

	Fiscal Years					
	1986	1987	1988	1989	1990	1991
Deficit-to-GNP Ratio						
President's Proposal	5.3	3.9	2.3	1.8	1.1	NA
CBO Baseline	5.3	4.0	3.6	3.2	2.5	1.9
Spending Growth (%)						
President's Proposal	4.6	2.6	0.9	4.4	3.6	3.3
CBO Baseline	4.6	1.8	6.1	5.1	5.3	5.3
Public Debt-to-GNP Ratio						
President's Proposal	41.9	43.2	42.6	41.5	39.9	NA
CBO Baseline	41.9	43.4	44.2	44.4	43.8	42.7
<u>Projections of Deficits and Surpluses Excluding Net Interest Outlays:</u>						
Deficit Projections						
President's Budget	-220.7	-173.2	-107.8	-92.8	-59.5	-21.3
CBO Baseline	-220.7	-174.0	-169.0	-162.0	-134.0	-109.9
Net Interest Outlays						
President's Budget	136.0	137.5	139.0	141.5	139.0	134.8
CBO Baseline	136.0	135.0	141.0	147.0	152.0	155.0
Primary Deficit (-) or Surplus (+)						
President's Budget	-84.7	-35.7	+31.2	+48.7	+79.5	+113.5
CBO Baseline	-84.7	-39.0	-28.0	-15.0	+18.0	+45.1

Table 3
Administration and CBO Economic Projections

	1986	1987	1988	1989	1990	1991
<u>Percent change, fourth quarter over fourth quarter:</u>						
Real GNP						
Administration	2.1	3.2	3.7			
CBO	2.1	3.0	2.9			
Nominal GNP						
Administration	4.2	6.9	7.3			
CBO	4.2	6.5	7.1			
CPI-W						
Administration	0.9	3.8	3.6			
CBO	0.9	4.4	4.4			
<u>Percent change, calendar years:</u>						
Nominal GNP						
Administration	5.2	6.9	7.3	7.2	6.8	6.3
CBO	5.2	6.0	6.9	7.2	7.4	7.0
Real GNP						
Administration	2.5	3.1	3.5	3.6	3.6	3.5
CBO	2.5	2.8	3.0	3.0	3.1	2.7
GNP Deflator						
Administration	2.6	3.3	3.5	3.5	3.2	2.8
CBO	2.6	3.2	3.8	4.1	4.2	4.2
CPI-W						
Administration	1.5	3.0	3.6	3.6	3.2	2.8
CBO	1.5	3.5	4.3	4.3	4.3	4.3
<u>Interest Rates, percent, Calendar Year Averages:</u>						
3-Month T-Bill						
Administration	6.0	5.4	5.6	5.3	4.7	4.2
CBO	6.0	5.6	5.7	5.6	5.5	5.3
10-Year Government Bond						
Administration	7.7	6.7	6.6	6.1	5.5	5.0
CBO	7.7	7.2	7.2	6.6	6.2	5.9

POLICY COORDINATION AND THE DOLLAR

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The reflexes of politicians to problems, in particular those created by their past policies, are well conditioned. This pattern holds in particular for international financial problems. Major swings in the dollar in foreign exchange markets seem reliably associated with rising demands for "policy coordination". European and U.S. officials rang the alarm bell in 1985 about the persistent rise in the foreign currency price of the dollar. "Policy coordination" was required in order to lower the "over valued" dollar. The growth rate of the German monetary base declined somewhat in 1985 and the first half of 1986 while it proceeded in the U.S.A. at double the German rate. The "policy coordination" observed in 1985 essentially offered the U.S. government an excuse to engage in a highly expansionary monetary course. The dollar's foreign exchange rate dropped by 40 percent and more against major currencies and threatens to fall ever further. Obviously another round of "policy coordination" is needed. The recent meetings of G-5 purported to establish a consensus designed to "stabilize" the dollar within a target zone preventing further major declines.

The volatility of the dollar has certainly been remarkable. And we may reasonably wonder how we could prevent a further fall and also lower the volatility of exchange markets. The first objective can be achieved by raising the level of monetary expansion in Germany and Japan and lowering it in the U.S.A. The most recent data from Germany and Japan suggest the possible occurrence of such an expansionary

shift, whereas the U.S.A. maintains the expansionary stance. We obtain from the Fed some conflicting signals, with Volcker expressing concern about the dollar and other governors emphasizing that the recent G-5 meeting imposes no relevant constraints on the Fed's policy.

The second objective is also achievable -- "in principle". A suitable combination of fiscal and monetary policy could assure comparatively stable exchange rates. Financial policies would have to become thoroughly geared to this requirement however. The U.S.A. would have to play a central role in any meaningful exchange rate stabilizing arrangements. It would in particular have to institute, as necessary conditions, stability and long-run predictability of budgetary and fiscal policies. Other countries interested in financial stability may choose an opportunity to peg their currencies to the dollar. A "club of financial stability" could thus be formed and maintained. Such "policy coordination" may be expected to achieve its purpose. With a stable, predictable, non-inflationary policy in the U.S.A., other nations would simply have to "coordinate" their policies in a similar fashion in order to maintain the pegged rates. But this state is highly improbable. The incentives governing Congressional policies prevent the first condition. The political conception and temptations guiding the Administration destroy on the other hand any opportunity for the second condition to emerge. The conditions responsible for volatile exchange rates will thus persist. "Coordinated" interventions by central banks in foreign exchange markets barely modify the pattern under the circumstances.

The inability of the U.S.A. to develop any sensible long-run strategies in financial policies does not suspend interest in "policy coordination". But this term simply covers as a request that other

countries please proceed with policies agreeable with the predetermined short-run interests of the U.S.A. This involved in 1985 a substantial monetary expansion in the U.S.A. matched with less expansion in Germany and Japan. And it means now that even larger monetary expansion in the U.S.A. should be supported by corresponding massive expansion in Germany and Japan. This kind of "policy coordination" may moderate some prevailing political pressures. But it will assure an indefinite series into the future of such "policy coordinations" with a built in longer-run inflationary bias combined with intermittent recessions.

**PERCENTAGE CHANGE IN THE GERMAN MONETARY
BASE BETWEEN CORRESPONDING MONTHS
OF ADJACENT YEARS**

	OBS	WG
1982	1	.
	2	.
	3	.
	4	.
	5	.
	6	.
	7	.
	8	.
	9	.
	10	.
	11	.
	12	.
1983	1	6.37297
	2	6.96560
	3	7.89377
	4	8.19072
	5	7.39754
	6	7.98090
	7	8.22758
	8	8.43457
	9	8.28732
	10	7.42240
	11	7.76546
	12	7.39542
1984	1	6.71472
	2	5.94640
	3	5.34717
	4	5.05113
	5	4.98390
	6	5.12925
	7	4.15999
	8	4.67023
	9	4.79725
	10	4.76638
	11	4.56830
	12	4.96834
1985	1	4.86605
	2	4.74658
	3	5.29846
	4	4.36771
	5	4.31033
	6	4.05687
	7	3.83437
	8	3.99750
	9	3.83626
	10	4.04550
	11	4.33127
	12	4.17994
1986	1	5.09966
	2	5.08373
	3	4.92488
	4	5.77754
	5	6.34773
	6	6.04709
	7	6.88683
	8	7.13137
	9	7.22544
	10	7.60325
	11	8.10669
	12	8.50920

The figure listed under December 1986 means percentage change from December 1985 to December 1986.